A call for action to ensure strong regulation of the financial sector to avoid environmental, social and governance risks

JUNE 2017
EXECUTIVE SUMMARY

Across Africa, Latin America and Asia families are being forced off their land and rainforests razed to the ground – for projects backed by European money.

Companies looking for land to grow crops for industries, such as oil, gas or mining or for housing or infrastructure, rely on finance and loans from the financial institutions we in the European Union (EU) invest in. However, with few rules in place to regulate those institutions, there is little to stop them funding projects that are socially or environmentally damaging.

Global Witness, Friends of the Earth Europe (FoEE) and others are campaigning for Europe’s financial regulations to be strengthened with robust Environmental, Social and Governance (ESG) safeguards, to stop investors from propping up companies that are grabbing land, abusing human rights and causing damage to the environment.

It is commonly believed that increased regulations will reduce European competitiveness and make financial sector institutions less profitable. This belief holds that companies can keep themselves in check when it comes to their social and environmental footprint. But the reality on the ground tells a very different story. EU-based investors are in fact putting themselves at significant financial and reputational risk by operating in regions where there are few guarantees, if any, that land has not been grabbed to make way for development.

The Capital Market Union (CMU) relaunch in September 2016 offers an ideal opportunity to ensure that the EU commits to fully integrating ESG factors into its financial regulation framework. Hailed as the final part of Europe’s response to the financial crisis, the CMU is the EU’s plan to develop different sources of finance to complement the banking system, to give savers more investment choices and offer businesses a greater choice of funding at lower costs.

It is our concern that without a strong regulatory framework this system risks making land-grabbing and environmental crime outside the EU even worse than it is currently by opening land and resources up to increased investment.

Other pieces of EU legislation currently regulating the financial sector at best contain only limited provisions relating to environmental and social concerns. This is the case for the Shareholders’ Rights Directive, Institutions for Occupational Retirement Provision Directive, Non-Financial Reporting Directive, Prospectus Directive, Prospectus Regulation and the Packaged Retail and Insurance-based Investment Products Regulation. These are all reviewed in this briefing.

RECOMMENDATIONS

TRANSPARENCY

Legally binding requirements should be imposed on the financial industry and other companies to increase transparency. This could include, but not necessarily be limited to:

- Develop an engagement policy with companies they invest in, which requires the latter to assess the ESG risks of financed projects and take steps to avoid those risks
- Publicly disclose, through the engagement policy as well as annual reporting systems, their exposure to ESG risks and how they are exercising due diligence to avoid such risks
- Ensure that information identifying investors in land is made known to the communities in the area and jurisdiction in
which they are located, so that they know who to seek redress from. This should include announcing land investment in the area and signage around the land itself.

Provide information on guarantees that they have secured from companies that they do business with that they are proactively avoiding ESG risks.

**ACCOUNTABILITY**

Member states should:

- Ensure that financial sector institutions that do not exercise adequate ESG due diligence in any investment they promote will be held to account and liable to civil lawsuit or criminal prosecution.

- Offer opportunities for individuals and communities, outside or within the EU, to seek redress in EU country courts in line with the United Nations (UN) Guiding Principles on Business and Human Rights that call on states to remove barriers to effective legal remedy.

**DUE DILIGENCE**

The financial industry and companies should:

- Undertake robust due diligence, which explicitly assesses the ESG risks of current and future land-tenure holdings and other investments.

- Oblige issuers and intermediaries promoting investments in land-based projects to include in prospectuses a proof of “good title”, to ensure that the land has not or will not be grabbed.

**THE EU SHOULD:**

- Support work within the UN Human Rights Council to adopt a binding treaty for businesses in relation to human rights, including considerations of the liabilities of both companies and financial investors for involvement in projects which violate such rights, as well as mechanisms for accountability and redress.

- Refrain from promoting investment models that result in the large-scale transfer of tenure rights to investors, in line with Article 12(6) of the Voluntary Guidelines on the Responsible Governance of Tenure of Land, Fisheries and Forests in the Context of National Food Security (VGGT). Free, Prior and Informed Consent (FPIC) should also be secured from all affected communities, for all land and natural resource-based investments it supports through lending.

**TOWARDS AN ESG DEFINITION**

The ESG acronym has been open to various interpretations. We believe that ESG safeguards should relate to established international human rights law, including the instruments which make up the International Bill of Human Rights, subsequent UN human rights conventions, and the eight core International Labour Organization (ILO) conventions. The definition should also draw from developing soft law standards, the Paris Agreement and other binding international environmental standards seeking to prevent environmental destruction.
LIST OF ACRONYMS

AIF  Alternative Investment Fund
AIFMD  Alternative Investment Fund Managers Directive
CMU  Capital Markets Union
ESG  Environmental, Social and Governance
EU  European Union
FoE  Friends of the Earth
FOEE  Friends of the Earth Europe
FPIC  Free, Prior and Informed Consent
HAGL  Hoang Anh Gia Lai
ILO  International Labour Organisation
IORP II  Institutions for Occupational Retirement Provision Directive
ICAR  International Corporate Accountability Roundtable
MEPs  Members of the European Parliament
NGOs  Non-governmental organisations
PEF  Private Equity Fund
PRI  Principles for Responsible Investment
PRIIPs  Packaged Retail and Insurance-based Investment Products Regulation
SDGs  Sustainable Development Goals
STS  Simple transparent and standardised securitisations
UCITS  Undertakings for collective investment in transferable securities
UN  United Nations
VGGT  Voluntary Guidelines on the Responsible Governance of Tenure of Land, Fisheries and Forests in the Context of National Food Security
VRG  Vietnam Rubber Group
2017 – TIME FOR ACTION

At the global level land-grabs and deforestation, and the human rights violations, abuses, and corruption that facilitate them, are a major threat to the lives of communities. Land-grabs and deforestation often accompany the development of large-scale economic agro-industrial, extractive, infrastructure and other projects. These projects are receiving monies from powerful financial institutions. Many of these are based in the European Union (EU). Land-grabs and deforestation are among numerous negative Environmental, Social and Governance (ESG) harms, which often accompany financial institution investments.

Failing to adequately integrate and mainstream ESG factors in the EU financial regulations is counter-productive not only for the delivery of EU environmental and social policy objectives (including the United Nations (UN) Sustainable Development Goals (SDGs) or the Paris Agreement), but can also be negative for financial returns. Climate change has a direct impact on investments, especially in light of extreme weather conditions. Investors who do not consider climate risks in their portfolios may suffer losses because of assets stranded by climate change.

Global Witness and Friends of the Earth Europe (FoEE) have issued numerous reports documenting land-grabs and deforestation related to projects receiving investments channelled through EU-based financial sector institutions. Globally, the UK, US, Germany, Netherlands and France consistently rank high among countries involved in large-scale overseas agribusiness investments. At the beginning of 2015 for example, the top EU-based financial sector institutions (including banks, institutional investors and alternative investment funds) had provided nearly US$18 billion in outstanding loans and recent underwriting services to foreign agriculture companies based in developing countries.

Global Witness and FoEE issued a report in November 2016 urging the development of a strong regulatory framework to ensure that the financial sector does not invest in land-grabs and deforestation and does not benefit from related human rights violations, abuses and corruption. Financial sector institutions and companies mainly rely on voluntary codes of conduct supposedly to ensure that they abide by corporate responsibility standards. But these codes have done little to prevent human rights abuses and violations, corruption and the land-grabs and deforestation that accompany them. What is required is a strong regulatory framework.

The implementation of the EU’s Capital Markets Union (CMU) Action Plan comprises new financial regulation initiatives and the review of financial regulation, which provide the EU with an opportunity to take decisive action. The European Commission’s plans to accelerate implementation of the CMU announced in September 2016, together with the mid-term CMU review in 2017 by the European Commission, offer an ideal opportunity to ensure that the EU commits to fully integrating ESG factors in formulating its financial regulation framework. Full integration of ESG factors could give substance to the term ‘sustainable finance’.

Communities suffer the human rights and environmental impacts of projects that ignore ESG factors. Action to oblige the financial sector to actively avoid negative ESG impacts would be in line with the EU’s international human rights obligations, the SDGs and the Paris Agreement. ESG impacts are not theoretical; they relate to real material environmental, human rights and social harms that can impact on companies – including those in the financial sector – in terms of legal, reputation and financial costs.
WEAK ESG PROVISIONS IN THE LEGAL FRAMEWORK

Current EU legislation does not oblige the financial sector to exercise due diligence to avoid negative ESG impacts. It contains few, if any, provisions to ensure that financial institutions can be held to account for failing to exercise such due diligence.

The EU should have in place a financial legal structure that prevents EU investment in projects which lead to negative ESG impacts, including land-grabs. It should be mandatory for financial institutions and companies to take action to avoid negative ESG impacts and for the avoidance of ESG risks to be factored into the development of all investment projects. Financial regulation adopted by the EU in the wake of the 2007-2008 financial crisis was supposedly designed to create greater financial stability and the CMU project was meant to ease the flow of capital throughout the EU. But this legal framework is seriously deficient when it comes to addressing ESG risk.

The next sections of this briefing highlight the deficiencies of the existing legal framework when it comes to obliging the financial industry to avoid negative ESG impacts.

They provide an overview of several key instruments (in elaboration or already approved) which include some or no ESG criteria: the Shareholders’ Rights Directive, the Institutions for Occupational Retirement Provision Directive (IORP II), the Alternative Investment Fund Managers Directive (AIFMD), the Non-Financial Reporting Directive, the Prospectus Regulation and the Packaged Retail and Insurance-based Investment Products (PRIIPs) Regulation. The briefing also makes reference to other pieces of current and draft legislation regulating the financial industry, which is also failing to specifically oblige those promoting investment packages to take account of and avoid ESG risk.

a) Shareholders’ Rights Directive

What it is: The Shareholders’ Rights Directive aims to strengthen the rights of shareholders in relation to companies registered in or trading in EU member states. Global Witness, FoEE and others have worked closely with Members of the European Parliament (MEPs) to put forward amendments to the regulation, which would require investors and asset managers to actively engage with their investee companies on social and environmental performance, and publicly disclose the results. Europe’s asset management industry controls €17 trillion of assets, so the Directive could result in far-reaching impacts if it encourages companies to adopt more responsible behaviour in ESG matters.

The Council of the EU explained that the new directive “will help institutional investors and asset managers to be more transparent as regards their approach to shareholder engagement. They will have to either develop and publicly disclose a policy on shareholder engagement or explain publicly why they have chosen not to do so.”

Woman walking through rubber plantation – Shan state, Myanmar, November 2014. © Global Witness
The positive language on ESG in the Directive:

(a) The Directive establishes that a remuneration policy “shall contribute to the company’s business strategy and long-term interests and sustainability and shall explain how it does so” and that “It shall indicate the financial and non-financial performance criteria, including, where appropriate, criteria relating to corporate social responsibility…”

It contains language calling on asset managers and institutional investors to:

(b) Publicly disclose their engagement policy which describes how they integrate shareholder engagement in their investment strategy: “The policy shall describe how they monitor investee companies on relevant matters, including strategy, financial and non-financial performance and risk, capital structure, social and environmental impact and corporate governance…”

(c) Publicly disclose annually how their engagement policy has been implemented, providing information on how they voted in the general meetings of companies in which shares are held, an explanation of the “most significant votes” and “the use of the services of proxy advisors”.

The loopholes:

The Directive makes clear that in disclosing their engagement policy, institutional investors and asset managers can omit information on ESG impacts if they do not consider these to be “relevant matters”, in other words the wording of the Directive provides them with one possible reason not to comply. In relation to the submission of remuneration policy information to a company’s annual meeting, a company is only obliged to provide information relating to corporate social responsibility “where appropriate”. In other words, there is no real compulsion on institutional investors or asset managers to report on how they monitor investee companies in relation to ESG risk. Neither does the Directive impose obligations on companies to engage with stakeholders to avoid or minimise negative ESG impacts. While the legislation may encourage companies to voluntarily take ESG risks into account, the legislation does little to guarantee that communities will be protected from negative ESG harms, and provided with a right to redress.

b) The Institutions for Occupational Retirement Provision (Pension Funds) Directive

What it is: Occupational pension funds otherwise known as “IORPs” (Institutions for Occupational Retirement Provision) are a form of employment-related retirement provision; alongside state social security pension schemes and voluntary supplementary retirement income, including those structured as life insurance, which are not at all covered by these rules. IORPs benefit from the principles of free movement of capital and free provision of services in the EU. This means, for example, that:

(i) pension funds can manage occupational pension schemes for companies established in another EU member state
(ii) pan-European companies can have a single pension fund for all their subsidiaries throughout the EU.

The rules governing the activities of IORPs in all EU countries are set out in Directive 2003/41/EC (the IORP Directive). IORP seeks to make it easier for these schemes to operate across EU member states.

The IORP Directive has recently undergone revisions to improve governance standards in the sector for the first time since 2003. The revised Directive, IORP II came into force on 12 January 2017 and member states must introduce legislation to comply with the Directive by 13 January 2019. IORPs hold assets worth €2.5 trillion on behalf of 75 million Europeans.

The positive language on ESG in the Directive:

(a) Recital 58 alludes to ESG factors as referred to in the United Nations-supported Principles for Responsible Investment. To this extent the amended IORP II helps define ESG factors in such a manner that they can be understood to incorporate a broad range of environmental, human rights and governance issues.

(b) The Directive requires member states to ensure that IORPs invest in accordance with the ‘prudent person’ rule and to ensure that they take account of the “the potential long-term impact of investment decisions on environmental, social, and governance factors.”

(c) IORPs are called upon to ensure that their system of governance takes into account ESG factors related to investment assets.

(d) The text stipulates that member states should require IORPs possess a risk management system which could cover “environmental, social and governance risks relating to the investment portfolio and the management thereof.”

The loopholes:

However, the IORP II amended text contains some serious weaknesses. A series of loopholes in the text mean that there is no clear obligation on IORPs, at least not on all IORPs, to assess ESG risks in their investment, risk management and governance policies. IORPs are provided with ample room to determine for themselves if they should take ESG factors into account:

(i) Language in the text stipulates that member states are not obliged to apply most of the provisions of the Directive to pension schemes with less than 100 members.

(ii) While language obliges an IORP to exercise the ‘prudent person’ rule, it is not an obligation to take ESG factors into account when applying this rule (member states must “allow” it).

(iii) Text stipulating that member states should require IORPs to possess a risk management system which incorporates ESG considerations is qualified, the consideration of these risks are only to be taken into account “where applicable.”

(iv) Similarly, the text makes clear that provisions urging the IORP to factor in ESG into their governance policies are again discretionary and consideration of these factors will be taken if they are deemed to “be proportionate to the size, nature, scale and complexity of the activities of the IORP.”

(v) The text only obliges IORPs to provide prospective members with information on “whether and how” it has considered ESG factors in their investment decisions.
In August and September 2015, fires in the forests and peatlands of Sumatra and Kalimantan caused 23 deaths (according to the national Human Rights Commission’s report) and impacted 45 million people in Indonesia and neighbouring countries. On 14 October 2015 an estimated 61 megatons of greenhouse gases were released into the atmosphere, accounting for almost 97 per cent of Indonesia’s total emissions that day. Indonesia’s daily average emissions in 2012 were approximately 2.1 megatons.33

Research conducted by FoE groups into five palm oil plantations in Central Kalimantan that belong to Wilmar International and Bumitama Agri Ltd. showed that, despite the fact that these companies have adopted voluntary policies prohibiting burning, deforestation and exploitation of peatlands, they appear to have flouted national laws and their own voluntary guidelines. Therefore, violating the human right to health and to a healthy environment and allowing the destruction of high carbon stock areas, as well as taking insufficient measures to prevent forest fires in their plantations.

According to Article 49 of the national forest law no. 41/199934, companies are legally responsible for fires within their concessions, recognising that accountability and legal liability rest ultimately with the concession owners, in this case Wilmar and Bumitama.

However, in their responses to FoE, both companies blame other parties, such as local communities, or climatic factors such as winds spreading fires into concession areas. However, neither company provided evidence to support these statements.

Financiers in the UK, Netherlands, France, the United States35 and other countries are providing direct financing to these companies – many of them doing so despite having publicly committed to ESG criteria that should prevent their financing such destructive activities. Of 11 financiers in the EU and 14 in the US to whom FoE has sent this report for comments, seven have responded by the time of publication. The answers FoE received ranged from: advice that FoE file a complaint with Wilmar itself or with the Roundtable on Sustainable Palm Oil (RSPO) – a multi-stakeholder body without a legal mandate and with a notorious time-lag in addressing complaints36 – to a lengthy response arguing that Wilmar is in fact operating sustainably.

Despite detailed, independent, satellite-based and ground-checked evidence on specific cases, even financiers that have committed to upholding environmental standards do not seem alarmed by the lack of implementation of their own and their investee companies’ policies during what many commentators are calling the largest environmental crisis of the 21st century.37 Such a lax attitude bodes extremely ill for the efficacy of voluntary corporate commitments to social and environmental responsibility.38

(continued opposite)
c) The Non-Financial Reporting Directive

What it is: The Non-Financial Reporting Directive seeks to complement legislation which regulates the financial information that companies must make public. It ensures that they also provide shareholders and stakeholders with non-financial information so as to ensure that they have access to “a meaningful, comprehensive view of the position and performance of companies”.

The Directive was drafted under European Parliament pressure through two resolutions adopted on 6 February 2013: ‘Corporate Social Responsibility: accountable, transparent and responsible business behaviour and sustainable growth’ and ‘Corporate Social Responsibility: promoting society’s interests and a route to sustainable and inclusive recovery’. The European Parliament had: “acknowledged the importance of businesses divulging information on sustainability such as social and environmental factors, with a view to identifying sustainability risks and increasing investor and consumer trust. Indeed, disclosure of non-financial information is vital for managing change towards a sustainable global economy by combining long-term profitability with social justice and environmental protection.”

The positive language on ESG in the Directive:

The Directive obliges large companies to include in their management report information “relating to, as a minimum, environmental, social and employee matters, respect for human rights, anti-corruption and bribery matters”.

The Directive is more useful than any of the other regulations mentioned in this report, as its main objective is indeed to oblige companies, including investors, to disclose more information on their ESG impacts.

The loopholes:

Nevertheless, there are some loopholes in the Directive. If the undertaking employs less than 500 people it is exempt from the Directive, although member states might impose their own rules. A company that “does not pursue policies in relation” to environmental, social and human rights matters, is not obliged to report on these issues although it should instead “provide a clear and reasoned explanation for not doing so.”
Companies are thereby given ample leeway not to report on ESG by arguing they have not developed a policy on the matter or alternatively simply by claiming that their business has no impact on these matters.

d) Alternative Investment Fund Managers Directive

**What it is:** Alternative investment funds (AIFs) are mainly hedge funds, private equity funds (PEFs) and venture capital funds. The Alternative Investment Fund Managers Directive (AIFMD) operates by regulating managers of hedge funds and private equity funds, usually based within the EU, whilst the funds they manage are usually located in tax havens. The AIFMD exists to regulate them via the companies who manage them. Private equity plays an important role in land grabs. According to a report by the Organisation for Economic Co-operation and Development, 44% of funds in farmland and agricultural infrastructure are derived from European private sector financiers.

**The positive language in the Directive:**

- **(a)** Language in the Directive relating to risk management obliges fund managers to exercise due diligence when investing: “according to the investment strategy, the objectives and risk profile” in the investment fund.
- **(b)** The Directive obliges fund managers to provide information on the “risk profiles” of the funds they are managing when applying for authorisation from competent authorities.
- **(c)** The Directive obliges fund managers to disclose to investors information on “the current risk profile of the AIF and the risk management systems employed by the AIFM to manage those risks.”

**The loopholes:**

The AIFMD was created in response to European Parliament calls for the development of specific regulation of hedge funds and PEFs in part to strengthen financial stability. In line with these concerns the AIFMD only intends to curb financial systemic risk and address investor protection issues: “Recent difficulties in financial markets have underlined that many AIFM strategies are vulnerable to some or several important risks in relation to investors, other market participants and markets”. It is therefore not a surprise that none of the provisions outlined in (a), (b) and (c) above make specific reference to ESG and so do not impose a specific obligation on alternative investment fund managers to take steps to:

- **(i)** Exercise due diligence to avoid ESG risks when investing.
- **(ii)** To provide information on ESG risks when seeking authorisation from competent authorities.
- **(iii)** To disclose to investors the ESG risks that an AIF may face, nor disclose how the fund manager’s risk management system avoids ESG risks.

The review of the AIFMD which will start by 22 July 2017 offers an important opportunity to ensure that wording in the legislation is clarified and ensure that investment fund
managers are both obliged to report on ESG risks and how they have exercised due diligence to avoid ESG risk. The problem, however, is that the points to be addressed in the review do not specifically refer to ESG risk, and it would be essential that the Commission’s mandate be amended so that it can consider amending the Directive in such a way that ESG risk considerations are fully incorporated. Given the timing of the review, it is unrealistic to expect major legislative changes before the 2019 European elections and new Commission.

In the past decade, both Cambodia and Laos have experienced a ‘land grab’ crisis. In Laos, due to the lack of transparency in the land sector, estimates for the amount of land leased out to private companies vary from 1.1 million to as much as 3.5 million hectares, with 18 per cent of villages in the country potentially affected. Cambodia has seen an equally rapid sell-off, with 2.1 million hectares of land leased out as land concessions and at least 830,000 people impacted.

In both countries, the land sector is dominated by secrecy and high levels of corruption. Business and political elites are seemingly able to get away with ignoring national laws designed to safeguard the rights of communities and the environment, and have been able to rely on state security forces to protect their private interests over those of ordinary citizens.

In its 2013 report “Rubber Barons”, Global Witness revealed how subsidiaries of two major Vietnamese rubber companies – HAGL and the VRG – acquired vast areas of land in violation of national laws in both Cambodia and Laos. In particular, the land lease purchases by both companies took place at the expense of local communities, which were barely compensated and whose free, prior and informed consent was not sought.

HAGL violated Cambodian law when it seized land without consulting villagers. For example, land grabs by HAGL in Ratanakiri Province in Cambodia severely damaged the livelihoods of 1,400 families from predominantly indigenous communities who lost both agricultural and forested land that they had relied upon for generations. These families received no or inadequate compensation for their losses.

Additionally, Global Witness uncovered evidence that in Cambodia, HAGL’s and VRG’s activities had significant negative environmental impacts, including clearing of valuable and legally protected forests within their concessions and the chemical pollution of local water sources. Only after Global Witness had released its report on these land grabs and international pressure, including from investors, increased did the companies enter into a dialogue with the communities concerned. Despite this engagement, very few of the affected individuals have received redress from the companies, although HAGL has at least begun a negotiation process with 14 Cambodian communities.

In April 2013, HAGL wrote to Global Witness, denying all the allegations described above, including any involvement in illegal logging and taking land from local residents. Furthermore, the company stated that it was the responsibility of the governments of Cambodia and Laos to ensure that community land and forests were not included in concession areas. VRG declined to comment on evidence of its members and affiliates being responsible for land-grabbing and illegal activities in Cambodia and Laos. Instead, the company pointed to a set of
“responsible investment principles” that it adheres to, which include observing national laws, respecting the welfare of local communities, and implementing social infrastructure projects.\footnote{responsible investment principles} 

In “Rubber Barons” Global Witness published evidence that the German banking giant Deutsche Bank was a source of finance for VRG and HAGL and on 13 November 2013 Global Witness called on backers to withdraw from investments in HAGL.\footnote{Six days later Global Witness learnt that Deutsche Bank no longer held significant stocks in the company. The Bank did not confirm whether this withdrawal was prompted by Global Witness’ call.} Six days later Global Witness learnt that Deutsche Bank no longer held significant stocks in the company. The Bank did not confirm whether this withdrawal was prompted by Global Witness’ call.\footnote{Six days later Global Witness learnt that Deutsche Bank no longer held significant stocks in the company. The Bank did not confirm whether this withdrawal was prompted by Global Witness’ call.}

However, Deutsche Bank has maintained a reduced interest in HAGL through Deutsche Asset Management Americas, part of the Deutsche Bank Group, holding 1.64% of HAGL’s shares. Whilst the holding may be small it is of concern that the Deutsche Bank Group has maintained its relationship with HAGL. In a letter to Deutsche Asset Management Americas of 27 March 2017, Global Witness expressed its concern that the company had either failed to conduct sufficient due diligence before investing in HAGL, or chose to ignore widespread reports that HAGL’s portfolio included failures to comply with national laws in countries of operation and business activities that have caused environmental damage and significant harms to the local population amounting to human rights violations. To date no response has been received.

Global Witness also wrote to HAGL on the same date. The company replied on 5 April suggesting that the size of rubber plantations held by three subsidiaries in Ratanakiri Province was smaller than that alleged previously by Global Witness. The company also stated that since 2015 it had been involved in a dispute resolution process with several communities, coordinated by the World Bank Group.

Had EU financial regulation been in place to prevent investors financing projects on land grabbed from local people, the chances of Deutsche Bank funds underwriting the HAGL project would have been greatly diminished.

e) Prospectus Directive\footnote{Prospectus Directive} and Prospectus Regulation\footnote{Prospectus Regulation}

What it is: The Prospectus Regulation, which will replace the Prospectus Directive by mid-2019, establishes the information companies must provide in prospectus documents to enable investors to make decisions on investments.

The Prospectus Directive came into force on 31 December 2003 through its publication in the EU Official Journal. As part of the CMU Action Plan the European Commission proposed a reform of the rules that allow companies to raise money on public markets or through a public offer with investors on 30 November 2015: “The prospectus rules proposed today will enable investors to make informed investment decisions, simplify the rules for companies that wish to issue shares or debt and foster cross-border investments in the single market. This is also an important measure in order to improve the regulatory environment for investments in the EU, as announced in the Investment Plan for Europe.”\footnote{The prospectus rules proposed today will enable investors to make informed investment decisions, simplify the rules for companies that wish to issue shares or debt and foster cross-border investments in the single market. This is also an important measure in order to improve the regulatory environment for investments in the EU, as announced in the Investment Plan for Europe.}

The positive language in the Directive, retained in the new Regulation:

(a) The legislation obliges the issuer of the securities to include in a prospectus information relating to risks associated with the securities offered.\footnote{The legislation obliges the issuer of the securities to include in a prospectus information relating to risks associated with the securities offered.}
(b) The legislation empowers competent authorities to “require the issuer to disclose all material information which may have an effect on the assessment of the securities admitted to trading on regulated markets in order to ensure investor protection or the smooth operation of the market;…”73

The new positive language in the Regulation:

The Regulation specifies that “environmental, social and governance circumstances can also constitute specific and material risks for the issuer and its securities and, in that case, should be disclosed”.74

The prospectus must include risk factors relevant for an investor75, potentially including ESG-related risk.

The loopholes:

The Directive does not specify obligations to companies to report on how they avoid ESG risks: neither of the provisions referred to in (a) and (b) above specify that the information required should include material relating to ESG risks identified by issuers and action taken to avoid ESG risk.

The Regulation widens the existing exemption excluding certain companies from the obligation of providing a prospectus if the total value of securities offered is “less than EUR 1,000,000, which shall be calculated over a period of 12 months.”76

In the new Regulation, the only direct reference to ESG risk (quoted above) is in a recital, which gives it less legal value. It remains to be seen whether national supervisors will pay attention to this provision in the process of authorizing prospectuses.

The generic requirement to disclose relevant risk factors is limited to “risks which are specific to the issuer and/or to the securities and are material for taking an informed investment decision”77 and as such might not include general risks arising from negative ESG impacts, if they do not disproportionately impact the issuer in question. On the other hand, the Commission is tasked to develop delegated regulation to further specify “criteria for the assessment by the issuer of the specificity and materiality of risk factors and for the presentation of risk factors across categories depending on their nature.”78, 79

f) Key information documents (KIDs) for packaged retail and insurance-based investment products (PRIIPs) Regulation (EU) No 1286/2014 of 26 November 2014 – Legislation applies from 1 January 201880

What it is: PRIIPs are types of financial products which can be sold to retail investors.81 The Regulation oblige distributors of such products to provide KIDs, which are drafted by banks and insurance companies issuing those products. The rules only cover packaged products, excluding “simple” insurance and investment products such as shares and life insurance.82

The positive language in the Regulation:

(a) The Regulation states that the KID should include any “specific environmental or social objectives targeted by the product”.83

(b) The Regulation contains a provision empowering the Commission to adopt delegated acts detailing the procedures to be used to establish whether a PRIIP targets specific environmental or social objectives.84

The loopholes:

(i) Language in the text, which empowers the Commission to develop procedures to determine whether a PRIIP targets specific environmental and social objectives, underlines the fact that there is no obligation whatsoever on PRIIPs to take ESG risks into account.85

(ii) The text states that the Commission should review this Regulation by 31
December 2018 (but we understand that the review is being delayed) taking account of the “costs and possible benefits of introducing a label for social and environmental investments”\textsuperscript{86}. This provision again suggests that while PRIIPs, which take into account ESG factors, will be “rewarded” with a label, it makes clear that avoidance of ESG risk in PRIIPs is not compulsory.

(iii) While the text specifies that the KIDs include information on “environmental or social objectives” this is not compulsory and the text makes it clear that this is only “where applicable”\textsuperscript{87}.

(iv) The Regulation calls on the Commission to specify “criteria and factors” to be used by the authorities “in determining when there is a significant investor protection concern or threat” and on that basis to take a decision to prohibit or restrict the marketing or sale of insurance-based investment products\textsuperscript{88}. But the language in the Regulation does not specify or make clear that ESG risk factors would be among those criteria used to order a prohibition or restriction of the sale or marketing of such financial products\textsuperscript{89}.

g) Other legislation relating to the finance industry

The EU has introduced a raft of other legislative measures to encourage the development of the EU financial industry, which it has presented as designed to increase the stability of the financial sector. A review of some of these pieces of legislation reveals that the EU has not imposed an obligation on the finance industry to factor in and avoid ESG risk:

**Capital Requirements Regulation and Directive\textsuperscript{90}** – this legislation implements the international “Basel III” package in the EU and seeks to ensure that credit institutions (banks) maintain sufficient reserves to avoid financial collapse as a result of exposure to risk. Neither the Directive nor Regulation contains language specifying that financial institutions take action to avoid ESG risks.

The Financial Stability Board’s Task Force on Climate-Related Financial Disclosures\textsuperscript{91} on 14 December 2016 published its recommendations for climate risk disclosure. This project is targeted at one form of environmental risk and focuses on disclosure only, hence its potential legislative impact on the Basel framework and bank capital rules in the EU will be limited.

**Simple Transparent and Standardised Securitisations Regulations\textsuperscript{92}** – In September 2015 the Commission adopted two legislative proposals governing the development of “simple transparent and standardised” (STS) securitisations, one a new regulation and the other a proposal to amend the Capital Requirements Regulation. The package seeks to encourage securitisations including, by lowering capital requirements for certain instruments that according to the Commission have a reduced financial stability risk. In its press release of 14 September 2016, the European Commission stated that the “swift implementation” of the STS regulation would be one of the first measures it would complete under its CMU Action Plan. In the STS legislative file\textsuperscript{93} entering in trilogue stage, the European Parliament has introduced an amendment\textsuperscript{94} for securitisations benefitting from favourable STS treatment. If accepted, it could at least encourage the originator and sponsors of STS securitisations to take some account of ESG risks when developing these instruments: “The originator and the sponsor shall publish information on the long-term, sustainable nature of the securitisation for the investors, using ESG criteria to describe how the securitisation contributed to real economy investments and in which way the original lender used the freed-up capital.”\textsuperscript{95}

**Undertakings for collective investment in transferable securities (UCITS)\textsuperscript{96}** – Directive
A call for action to ensure strong regulation of the financial sector to avoid environmental, social and governance risks

June 2017

2014/91 –regulates “undertakings for the collective investment in transferable securities” (UCITS), which are investment funds regulated at EU level. The Directive does not contain provisions specifically obliging managers of UCITS to avoid ESG risks, although some complex UCITS products will be covered by PRIIPs once the five-year transition period ends. There might, however, be an opportunity in the medium-term to align the remaining UCITS products to the PRIIPs rules, which would at least ensure some consideration of environmental and social matters are undertaken in line with the PRIIPs Regulation.

CONCLUSIONS AND GENERAL RECOMMENDATIONS FOR AN OVERARCHING PIECE OF LEGISLATION AS PART OF THE CMU REVIEW

Global Witness and FoEE are concerned that the legislative architecture regulating the financial industry contains hardly any binding obligation to factor in ESG criteria into the development of investments. Failure to exercise due diligence in ESG can translate into serious negative impacts on the environment, including deforestation, human rights abuses and violations of the right to life, and land grabs at the local and global level.

As financial sector institutions are given ample leeway to define what they consider to be risks, they are all too often free or relatively free to ignore ESG risks. In some cases ESG harms provide a means to bring down the costs of investments and so often it is convenient to not define them as risks. The challenge is to ensure that a strong regulatory framework is developed to oblige the financial industry to acknowledge these as risks. This should also ensure that financial institutions are liable to pay for harms caused, face legal civil or criminal proceedings arising from ESG harms and bear the full force of reputational damage costs of such negative impacts.

TOWARDS A DEFINITION OF ESG

The use of the ESG acronym has been open to various interpretations, but we consider that core ESG risks relate to established international human rights law including: the core rights and duties laid out in the International Bill of Human Rights, subsequent UN human rights conventions,97 and the eight core International Labour Organisation (ILO) conventions.98 The definition of ESG risks should also draw from developing soft-law standards that are heavily based on the binding treaties which make up the International Bill of Human Rights and additional human rights conventions including: the UN Guiding Principles of Business and Human Rights,99 the Voluntary Guidelines on the Responsible Governance of Tenure of Land, Fisheries and Forests in the Context of National Food Security (VGGT),100 the UN SDGs, the Principles on Responsible Agricultural Investment 101 and the UN-supported Principles of Responsible Investment, which itself includes a definition of ESG.102 Furthermore, the definition should also draw from the Paris Agreement and other binding international environmental standards seeking to prevent environmental destruction.103, 104

DEVELOPING A STRONG LEGAL UMBRELLA FRAMEWORK

It is essential that controls be enacted, and enforced, to ensure that funds allocated through investment instruments outside the EU do not support any investment that instigates or benefits from human rights violations and abuses, including those leading to land-grabbing and deforestation and other negative ESG impacts. These controls should apply to, but not be limited to, investments in jurisdictions where there is weak rule of law. In such jurisdictions there may be little if any guarantee that investments will not result in negative
environmental and social impacts spurred on by corruption, a lack of political will to end impunity in cases of human rights violations and abuses, or the promotion of legislation and policies by host states which weaken or undermine Free, Prior and Informed Consent (FPIC) rights or otherwise facilitate land-grabbing.

Such reform would oblige the manager or promoter of an investment instrument to exercise due diligence to actively avoid permitting investments in these contexts. Reform should also ensure that any investment instrument should not be authorized in economic projects that support illegal logging or armed conflicts and thereby undermine the EU’s Forest Law Enforcement Governance and Trade (FLEGT) Action Plan and EU Timber Regulation and the EU Conflict Minerals Regulation.

Regulation of the financial sector is covered by numerous pieces of legislation subject to review in a staggered timeframe; this means that to enact and enforce such controls would be a lengthy process. For this reason we consider that an overarching legislative measure should be implemented.

A strong regulatory framework should be built on the basis of the principles of Transparency; Accountability and Due Diligence:

**Transparency:** An obligation on a financial investment concern to publish clear and full information on any potential ESG risks involved in any investment strategy and what due diligence measures have been exercised by the issuers and offerors to avoid, identify, prevent, mitigate and account for negative ESG impacts in any investment they promote.

**Accountability:** Language which ensures that financial sector institutions that do not exercise adequate due diligence to avoid negative ESG impacts in any investment they promote should be held to account and as appropriate liable to civil lawsuit or criminal prosecution. Financial sector institutions should be held to account for failing to provide full and accurate information on potential ESG risks related to the investment packages they are marketing.

Member states should offer opportunities for individuals and communities, outside or within the EU, to seek redress in EU country courts in line with the UN Guiding Principles on Business and Human Rights that call on states to remove barriers to effective legal remedy. One way of achieving this may be through efforts to build on the Brussels I Regulation and the Rome II Regulation.

The Brussels I Regulation allows civil liability cases to be brought before EU member state courts even if the subject of the claim was committed outside the EU. The Rome II Regulation in most cases would oblige courts to apply the law of the state in which the harm was committed. This may be problematic if the local law does not provide sufficient redress for the harms caused. The Rome II Regulation allows for some exceptions to the rule that host state law should be applied. Accordingly victims of environmental destruction may request a court to apply the law “in which the event giving rise to the damage occurred” as opposed to the law of the country where the damage occurred. It would be important to expand this provision to ensure that the victims of human rights violations may likewise elect which law should be applied.

Since some of the ESG impacts may be criminal in nature the EU should also facilitate bringing criminal cases to courts in the EU where victims have not secured redress or are unlikely to secure redress. That the international financial and other economic sectors should be faced with the criminal consequences of failing to take action to avoid or draw benefit from negative ESG impacts is highlighted by recent decisions at the level of the International Criminal Court.

(See box below.)

**Due diligence:** An obligation should be imposed on issuers and intermediaries promoting investments in projects seeking
access to land to include in prospectuses a proof of “good title”, to ensure that the land is not subject to potential land grab or has already been subject to land grab. Proof of “good title” can be secured, at least to some extent, through consultation with affected communities, consultation of land registry documents (in areas where falsification of land registry documents is not a problem), UN agencies and other intergovernmental agencies and non-governmental organisations (NGOs) operating in the region. Financial sector institutions should be obliged to provide information on the guarantees they have secured from companies with which they maintain commercial relations that they will not get involved in land grabs.

Financial sector institutions must be obliged to exercise due diligence to avoid ESG harms – including by not contributing, exacerbating, causing or operating in a manner which benefits from ESG harms by design or through omission, as well as through action to identify, prevent, mitigate and account for them. They should also demonstrate how they exercise precaution and avoid investing in any company implicated or accused in possible land grab cases featured in UN, NGO reports, criminal prosecutions or civil lawsuits, whether or not in the same areas in which their planned investments are targeted.

The International Criminal Court decision to investigate international crimes associated with land-grabbing and destruction of the environment

On 15 September 2016 the Office of the Prosecutor of the International Criminal Court announced that it would give “particular consideration to prosecuting Rome Statute crimes that are committed by means of, or that result in, inter alia, the destruction of the environment, the illegal exploitation of natural resources or the illegal dispossession of land.” In effect executives in the financial and other industries could now be held criminally responsible under international law for crimes linked to land-grabbing and environmental destruction.
RECOMMENDATIONS

Bearing the above in mind and building on recommendations included in the FoEE and Global Witness joint report of November 2016 and other reports, a strengthened legal framework should include inter alia:

Transparency

Legally binding requirements should be imposed on the financial industry and other companies to increase transparency. This could include, but not necessarily be limited to:

- Develop an engagement policy with companies they invest in which requires the latter to assess the ESG risks of financed projects and take steps to avoid those risks
- Publicly disclose, through the engagement policy as well as annual reporting systems, their exposure to ESG risks and how they are exercising due diligence to avoid such risks
- Ensure that information identifying investors in the land is made known to the communities in the area and jurisdiction in which they are located so that they know who to seek redress from. This should include announcing land investment in the area and signage around the land itself
- Provide information on guarantees that they have secured from companies that they do business with that they are proactively avoiding ESG risks.

Accountability

Member states should:

- Ensure that financial sector institutions that do not exercise adequate ESG due diligence in any investment they promote will be held to account and liable to civil lawsuit or criminal prosecution
- Offer opportunities for individuals and communities, outside or within the EU, to seek redress in EU country courts in line with the UN Guiding Principles on Business and Human Rights that call on states to remove barriers to effective legal remedy.

Due diligence

The financial industry and companies should:

- Undertake robust due diligence, which explicitly assesses the ESG risks of current and future land-tenure holdings and other investments
- Oblige issuers and intermediaries promoting investments in land-based projects to include in prospectuses a proof of “good title”, to ensure that the land has not or will not be grabbed.

The EU should

- Support work within the UN Human Rights Council to adopt a binding treaty for businesses in relation to human rights, including considerations of the liabilities of both companies and financial investors for involvement in projects which violate such rights, as well as mechanisms for accountability and redress
- Refrain from promoting investment models that result in the large-scale transfer of tenure rights to investors, in line with Article 12(6) of the VGGT. FPIC should also be secured from all affected communities, for all land and natural resource-based investments it supports through lending.
A call for action to ensure strong regulation of the financial sector to avoid environmental, social and governance risks   JUNE 2017

ENDNOTES


14 Shareholder Rights Directive Article 9a(6).

15 ibid Article 3g(1)(a).

16 ibid Article 3g(1)(b).

17 ibid Article 3g(1).

18 ibid Article 3g(1)(a).

19 ibid Article 9a(6).


24 IORP Recital 58.

25 ibid Article 19(1)(b).

26 ibid Article 21(1).

27 ibid Article 25(2).
A call for action to ensure strong regulation of the financial sector to avoid environmental, social and governance risks

JUNE 2017

28 ibid Article 5.
29 ibid Article 19(1)(b).
30 ibid Article 25(2)(g) and 25(2).
31 ibid Article 21(2).
32 ibid Article 41(1)(c).

33 Such as Rabobank, ING, PGGM, HSBC, ABN AMRO, Blackrock, BNP Paribas, Crédit Agricole, JPMorgan Chase & Co.


35 ibid Article 19(1)(b).


37 ibid Article 41(1)(c).

38 ibid Article 15(3)(a).


44 Non-Financial Reporting Directive Article 1 introducing a new article 19a in Directive 2013/34/EU (Article 19a(1)).

45 ibid Article 1 introducing a new article 19a in Directive 2013/34/EU (Article 19a(1))

46 ibid Article 1 introducing a new article 19a in Directive 2013/34/EU. (Article 19a(1)).


49 HighQuest Partners, United States (2010), "Private Financial Sector Investment in Farmland and Agricultural Infrastructure", OECD Food, Agriculture and Fisheries Papers, No. 33, OECD Publishing, Paris. DOI: http://dx.doi.org/10.1787/5km7nzpjr1r-e

50 AIFMD Article 15(3)(a).

51 ibid Article 7(3)(a).

52 ibid Article 23(4)(c).


54 AIFMD Recital 3.

55 ibid Article 15(3)(a) The language in the Directive obliges a fund manager “to implement an appropriate, documented and regularly updated due diligence process when investing on behalf of the AIF, according to the investment strategy, the objectives and risk profile of the AIF” but this language does not make clear that due diligence incorporates action to avoid ESG risk.

56 ibid Article 7(3)(a). The reference to risk profiles in this article does not specify that this includes ESG risk.

57 ibid Article 23(4)(c). In referring to the risk profiles and the risk management system employed by a fund manager no specific reference is made to make clear this should include matters relating to ESG risk.

58 EU definition of what is meant by a “risk profile” leads to Commission Delegated Regulation (EU) No. 231/2013 of 19 December 2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision [2011] OJ L 83/1 which specifies that the risk profile must be in keeping with risk limits laid out in Article 44(2) of Article 44 provides a list of risks that primarily focus on those relating to threats to financial stability, with the exception of “operational risks”. Recital 65 of the Regulation makes clear that the interpretation of “the terminology is used consistently in both legal acts, therefore the definitions given in Directive 2006/43/EC are taken as
A call for action to ensure strong regulation of the financial sector to avoid environmental, social and governance risks

JUNE 2017

Council Directive 2003/71/EC of 4 November 2003 relating to the taking up and pursuit of the business of credit institutions (recast) (2006) OJ L 177/1, defines operational risk as the “loss resulting from inadequate or failed internal processes, people and systems or from external events, and includes legal risk”. ESG risks could fall into this category but Annex V (9) of this Directive states “credit institutions shall articulate what constitutes operational risk”. In other words ample leeway is provided to the undertaking to articulate what constitutes operational risk and so there is potentially ample room not to identify ESG risks as an operational risk.

59 AIFMD Article 69(4) states that the Commission should take into account “effects on investor protection, market disruption and competition, the monitoring of systemic risk and potential impacts on investors.”


62 Global Witness, Rubber Barons.

63 ibid

64 ibid

65 Global Witness personal communications (2016). In preparing this report, the International Corporate Accountability Roundtable (ICAR) attempted to contact both HAGL and VRG for responses to the allegations contained herein. No response was received from either company by the time of this report’s publication.

66 This text is largely copied from the Tainted Lands report published by ICAR and Global Witness in 2016. ICAR wrote to HAGL and VRG for a response on the allegations in this text, but no response was received.


72 Prospectus Directive Article 5(2) and Prospectus Regulation Article 16(1).

73 Prospectus Directive Article 21(4)(a) and similar language in Prospectus Regulation Article 32(1).

74 Prospectus Regulation Recital 54.

75 Prospectus Regulation Article 16(1).

76 ibid Article 1(3) (replaces Prospectus Directive Article 3(e)).

77 ibid Article 16(1).

78 ibid Article 16(5).

79 Consumer behaviour is an important mechanism for changing corporate behaviour on ESG factors, and as such retail investors can help accelerate corporate consideration of ESG risk if they change their investment behaviour accordingly. However, retail investors are likely to rely mainly on the prospectus summary, which only lists the 15 key risks attached to an investment (Prospectus Regulation Article 7(10)). If ESG risks are not among these key risks, they will not likely be part of a retail investor’s investment decision.


82 Funds covered by the rules for Undertakings for collective investment in transferable securities (UCITS) benefit from a five-year transitional period before the PRIIPs rules will apply.

83 PRIIPs Regulation Article 8(3)(c)(i).

84 ibid Article 8(4).

85 ibid Article 8(4).

86 ibid Article 33(1).

87 ibid Article 8(3)(c)(ii).

88 ibid Article 16(8) and Article 17(7).

89 Whilst the Parliament had suggested that the full set of ESG factors should be covered by the (rather limited) provisions
above, member states wanted to restrict the rules to the disclosure of environmental factors and certainly avoid disclosure of (corporate) governance-related factors. Hence, a compromise between “E” and “SG” was found covering “ES” factors, but not “G” factors, which are explicitly excluded throughout the Regulation.


95 Proposal for a Regulation Article 10(3a).


102 UN-supported Principles of Responsible Investment, “About the PRI” available at: https://www.unpri.org/about

103 United Nations Information Portal on Multilateral Environmental Agreements (InforMEA), “Treaties” (nd) provides a list of international environmental treaties see: https://www.informea.org/treaties

104 We consider that ESG risks should be understood in an integral fashion which is in line with international hard and soft human rights law: (i) Environmental risks – should be interpreted as including climate change risks as well as environmental destruction (ii) Social risks – should be understood in terms of incorporating issues related to human rights violations and abuses including: those that contribute to land-grabbing and deforestation (iii) Governance risks – should be understood not only in terms of incorporating risks accruing from the internal management failings of a company, but also those stemming from a failure to exercise due diligence to avoid environmental and social risks that could lead to financial costs and/or potential reputation costs, criminal or civil liabilities resulting from “stranded assets”, human rights violations and abuses linked to any investments made. Implicit here is the fact that the financial industry must avoid investments in jurisdictions where there is little if any guarantee that they will not result in negative environmental and social impacts, including land grabs and deforestation, because of weak rule of law, corruption, a lack of political will to end impunity in cases of human rights violations and abuses, or the promotion by a host state of legislation and policies which weaken or undermine Free, Prior and Informed Consent rights or otherwise facilitate land-grabbing. Careful exercise of due diligence would mean that the manager or promoter of an investment instrument would seek to actively avoid permitting investments in these jurisdictions and drawing financial benefit from these contexts. ESG interpreted in this holistic fashion may help give substance to what is meant by sustainable development and sustainable finance.
A call for action to ensure strong regulation of the financial sector to avoid environmental, social and governance risks

JUNE 2017

process to identify, prevent, mitigate and account for how they address their impacts on human rights”.

106 ibid Principle 26.


109 The EU’s Business.

With thanks to Joost Mulder, Financial Legislation Expert, for his advice and input in the production of this document.
Global Witness investigates and campaigns to change the system by exposing the economic networks behind conflict, corruption and environmental destruction.

Global Witness is a company limited by guarantee and incorporated in England (No.2871809)

Global Witness. Lloyds Chambers, 1 Portsoken St, London E1 8BT, United Kingdom

www.globalwitness.org

© Global Witness Limited, 2017

Friends of the Earth Europe unites more than 30 national groups with thousands of local groups is part of the world’s largest grassroots environmental network, Friends of the Earth International.

Friends of the Earth Europe, Mundo-B, Rue d’Edimbourg 26, 1050 Brussels, Belgium

www.foeeurope.org

Friends of the Earth Europe gratefully acknowledges financial assistance from the European Union and DGIS. The sole responsibility for the content of this publication lies with Friends of the Earth Europe. It does not necessarily reflect the opinion of the funders mentioned above. The funders cannot be held responsible for any use that may be made of the information contained therein.