# Response to the Call for Input on Investors, ESG and Human Rights

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Swedwatch is an independent, non-profit research and advocacy organisation based in Stockholm, Sweden. It examines state and business actors' obligations to protect and respect the environment and human rights in accordance with international standards including the United Nations Guiding Principles (UNGPs). Swedwatch strongly believes that as business actors, investors cannot disregard their obligations to respect and safeguard sustainable environment and human rights through its business relations. Swedwatch submission for the call focuses on three core questions, including responsibilities of environmental, social and governance (ESG) index and data providers and investors as well as the importance of integrating conflict sensitivity in investment decision making.

**General**

1. **What responsibilities and capacity do ESG index and data providers have regarding the assessment of adverse human rights and environmental impacts, and how can ESG indexes and research products be improved to align with the UNGPs approach?**

Growing demand for responsible investment that seeks to mitigate environmental and human rights risks and impacts has increased the importance of the role of ESG index and data providers (hereafter, ESG service providers). Often, service providers generate ESG ratings of companies, and this is increasingly influencing the ways in which investors make decisions. While financial actors are progressively integrating human rights and environmental risks in their financial asset management practices[1], accountability of ESG service providers remains a question. Swedwatch regrets that ESG service providers have for too long been allowed to operate in an unregulated market, and welcomes regulatory initiatives, most recently at EU level, aimed at enhancing transparency and accountability within the industry.[2]

Several Swedwatch research projects (see "Key Swedwatch References" at the end of this document) and years of dialogue with investors inform Swedwatch perspective on ESG service providers' capacity to adequality assess adverse human rights and environmental risks and impacts.

[1] See König, J. and Wåhlin, M. (2011) *Rena guldgruvan? AP-fondernas investeringar har en smutsig baksida*. Stockholm, Swedwatch; Arounsavath, F. (2015) *Blir Guldet till Sand? En Rapport om Fondförvaltning utan Klimatmål*. Stockholm, Swedwatch; and Arounsavath, F. (2017) *Turning the Tide: The Urgent Need to Shift Capital Flows to Climate Solutions, A Case Study of Ten Fund Management Companies*. Stockholm, Swedwatch.

[2] In June 2023, European Commission has proposed a package under the EU's sustainable finance framework to regulate ESG rating service providers under the European Securities and Market Authority. See, https://ec.europa.eu/commission/presscorner/detail/en/ip_23_3192

Key concerns regarding shortcomings of ESG service providers, in their practices, products and advisory services include:

- Excessive reliance on corporate disclosure to assess companies' due diligence practices as well as on specific allegations of adverse impacts. Corporate disclosures often tend to be biased towards environmental and climate risks, at the expense of meaningful analysis of known and salient human rights risks in business operations.
- Excessive reliance on dialogue with companies when assessing controversies and impacts, especially in relation to mitigation and remediation of adverse impacts without meaningful engagement with affected right-holders.
- Excessive reliance on secondary information (e.g., mainstream media articles, third-party reports, and other published materials) that is biased towards English language sources. There is also a disproportionate focus on processing high volumes of secondary information at the expense of collecting and assessing primary information through engagement with business affected right-holders, local media, and civil society organisations.
- Poor understanding of business actors' responsibility to respect human rights, especially in relation to the well-established notions of "contributing to" and "being linked to" adverse human rights impacts, as defined in international standards such as the UNGPs.
- Narrow focus on companies' operations and their direct involvement in controversies, both originating and resulting in:
  - Poor understanding of local contexts including historical inequalities and injustices; preceding grievances towards corporate projects; as well as roles of state actors in areas where companies operate. Without contextual understanding of companies' operations, violence and/or intimidation perpetrated by state actors against defenders opposing corporate projects could be sometimes assessed as extraneous to companies' responsibilities and obligations. Similarly, anti-union measures imposed by state actors may deter workers from raising grievances or reporting ESG-related incidents, which in turn may have a perverse effect on companies' ESG ratings.
  - Limited value-chain mapping to proactively ascertain linkages to reported controversies.
  - Lack of assessment and/or poor and perfunctory assessment of business operations with regards to climate impacts, labour conditions, extraction of natural resources and how they contribute to systemic issues like inequality, poverty, and environmental degradation.
- Narrow scope and interpretation of indigenous rights, including definition of groups that are considered indigenous, and how Free, Prior and Informed Consent is applied in practice.

- Methodologies developed, utilised, and commercialised by ESG service providers are sometimes subject to external and commercial pressure at the expense of human rights[3].
- Aggregation of environmental, social and governance indicators into ESG rating frequently masks the severity of environmental harm and human rights violations and can mislead institutional investors, causing unintentional greenwashing.

Given these concerns Swedwatch calls on regulators to critically evaluate the role of ESG service providers and their use by investors. For investors to fulfil their obligations and prevent, mitigate and remediate adverse impacts, regulatory bodies must urgently adopt measures which oblige ESG service providers to:

- Improve transparency on data collection and how ratings are derived, including disclosure of methodologies and limitations.
- Improve the quality of data collected through reducing high dependency on secondary information, as well as improving ways to collect and assess primary information. This requires ESG services providers to seek ways to engage directly and meaningfully with right-holders that are directly affected by business operations.
- Harmonise sets of criteria based on international standards, and disaggregate environmental, social and governance ratings to prevent greenwashing.
- Consistently assess how businesses are effectively engaging with affected communities and individuals to prevent and mitigate risks, and to remediate human rights and environmental impacts in accordance with international standards such as the UNGPs and OECD Guidelines.

**Corporate responsibility to respect human rights**

2. **To what extent do investors assess human rights risks and adverse impacts using a risk to right-holders lens as being separate from ESG materiality considerations or as part of double materiality assessment? Are these integrated into an ESG approach and if so, how? Please provide examples of practices.**

While the analytic solutions provided by ESG service providers may offer investors a starting point to improve business strategies, corporate disclosures, and analysis of ESG information should be seen as a first step towards implementing duty of care obligations by investors. Investors are increasingly relying on and demanding ready-made ESG data from ESG service providers to inform their investment decisions, including raw and more granular ESG data covering various datapoints. Investors need to recognise that while ESG service providers typically align these datapoints with a wide range of international standards, including the

[3] For example, in 2022 Morning Star-owned ESG service provider Sustainalytics removed the UN Human Rights Council as a source to collect ESG data and ceased to use the terms "Occupied Palestinian Territory" or "occupied territory" following accusations of anti-Israel bias. See https://www.responsible-investor.com/morningstar-ditches-un-human-rights-council-data-to-address-anti-israel-bias-concerns/

UNGPs and OECD Guidelines, concerns remain about potential conflicts of interest which may affect the reliability of ESG data and methodologies involved in ESG ratings.

Such conflicts of interest include but are not limited to the following:

- ESG service providers sometimes are a part of larger proxy advisory firms[4] which recommend clients on how to vote at annual shareholder meetings. Such voting recommendations at times fail to adequately integrate ESG analysis produced by other parts of the firm or insufficiently reflect pertinent human rights and environmental risks, which has drawn criticism from more progressive asset managers[5].
- ESG service providers may offer engagement services to facilitate dialogue between investor clients and the companies they rate. While, in theory, these services have the potential to provide investors with a platform to exercise leverage over their portfolio companies in accordance with UNGPs, it is important to recognise that engagement services, just like any other service offered by ESG service providers, are commercial products and marketed as such. Even if ESG service providers typically do not advise clients on which investment decision to make, by promoting for-profit engagement services they might create a bias against responsible exits and/or divestment.
- ESG service providers may provide data and other consulting services to clients that may be involved in ESG-related controversies. For example, a commercial bank may be both a client and is simultaneously financing a project which allegedly causes, contributes, or is linked to adverse human rights and environmental impacts. Another example might be a case where a client is allegedly involved in facilitating money laundering, bribery, corruption or tax avoidance and evasion. This heightens the risk that ESG analyses are compromised to protect clients and their market share.

It should be noted that the concept of ESG has always been grounded on market-driven solutions to create shareholder value while respecting people and the planet. Although integration of ESG considerations by institutional investors are heightening awareness on corporate sustainability, Swedwatch observes that investors still fall short of adopting a right-holders lens when assessing human rights risks and adverse impacts.

ESG ratings typically do not measure company performance on human rights or environmental due diligence or consider right-holders' perspectives and grievances. In the same vein, ESG ratings are not meant to inform investors on how they are or might be causing, contributing, or linked to identified adverse impacts through business relations. Rather, ESG ratings predominantly function as reputational risk assessment tools based on secondary data. Although ESG service providers collect data on business activities that adversely impact right-holders and the environment, these data are typically analysed and

[4] For example, ISS-ESG is the responsible investment arm of Institutional Shareholder Services Inc. which offers proxy voting services.
[5] https://www.reuters.com/sustainability/investors-call-iss-overhaul-its-net-zero-proxy-advice-2023-08-31/

repackaged into rating scores. Primary objective of such scores is to service clients to evaluate their reputational risk exposure and associated actual and/or potential financial implications[6].

In other words, while ESG ratings may give investors an indication of how a company manages environmental, social, and governance-related risks, in the absence of on-site visits and meaningful stakeholder engagement, they cannot be seen as a substitute for environmental and human rights due diligence or an appropriate tool to advise to investors on their responsibilities to prevent, mitigate or remediate adverse impacts. Most importantly, investors need to recognise limitations of ESG ratings, and take active measures to avoid falsely claiming investment decisions as being environmentally and socially sustainable.

Considering recent development in regulatory frameworks, some ESG service providers are looking beyond financial materiality and integrating climate and environmental impacts of business operations or double materiality aspects in their ESG assessments. However, without disclosures of how double materiality is measured and assessed by ESG service providers, risk of greenwashing remains. Swedwatch, therefore, calls for stronger regulatory framework obliging ESG service providers to be fully transparent about application and interpretation of various materiality considerations, especially in those cases where ratings merely measure companies' ability to manage ESG risks relative to peers in the industry rather than their degree of compliance with UNGPs and other international standards.

**Corporate responsibility to respect human rights**

12. **How should investors take gender-responsive, disability-responsive, and intersectional-responsive approaches? How should investors take a heightened human rights due diligence approach in conflict affected areas?**

Drawing on Swedwatch's work in high-conflict regions, it is critical for investors and companies to recognise that investments in fragile and conflict-affected areas (FCAs) require heightened due diligence regardless to political and economic positions of investors and companies involved. Investors should continuously implement human rights due diligence (HRDD) and conflict-sensitivity assessments to ensure that investment activities do not contribute to or become linked to human rights violations and further exacerbate existing social tensions and conflicts.[7]

As enablers, investors have an important role to pressure companies to comply with heightened HRDD in their operations and implement conflict-sensitivity assessments

[6] https://www.finance-watch.org/esg-ratings-must-disaggregate-esg-parameters-to-repair-sustainable-investors-trust/

[7] See examples of conflict-sensitivity and heightened HRDD for investors involved in the energy sector, from an event co-organised by Swedwatch on 5 October during the Building Bridges 2023 in Geneva, https://www.youtube.com/watch?v=cGUwyCb4jn4&t=5s

throughout different stages of project cycle. It is important to remember that large scale investments that incur adverse impacts on communities' access to land, water, and food sources which communities depend upon can particularly intensify conflicts. These include investments in agriculture, mining, as well as largescale infrastructure development in the renewable energy sector. Therefore, investors in these sectors must particularly heighten their awareness of their responsibilities in accordance with international standards and improve their understanding of national contexts to apply heightened due diligence in high-conflict environments.

## Key Swedwatch References


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