

## **JOHN RUGGIE AND SHIFT COMMENTS TO FINANCIAL REPORTING COUNCIL'S EXPOSURE DRAFT: GUIDANCE ON THE STRATEGIC REPORT**

**Shift<sup>1</sup> together with its Chair, Professor John Ruggie, welcomes the UK Government's plan to implement the UN Guiding Principles on Business and Human Rights and, in this context, its amendments to the UK Companies Act to clarify "that company directors will include human rights issues in their annual reports". We further welcome the FRC's draft guidance to companies on implementation of these regulations, and the opportunity to provide comments on that draft. This document sets out a number of proposed amendments to the guidance to enhance its alignment with the UN Guiding Principles on Business and Human Rights.**

### **Introduction**

The UN Human Rights Council unanimously endorsed the UN Guiding Principles on Business and Human Rights in June 2011. In September 2013, the UK Government was the first EU Government to issue a national action plan entitled *Good Business – Implementing the UN Guiding Principles on Business and Human Rights* (the "Implementation Plan"). This Implementation Plan states that "from 1 October a clarification of the Companies Act 2006, means that company directors will include human rights issues, in their annual reports."<sup>2</sup> This also builds on the Government's intention, set out in 2010, to "ensure that directors' social and environmental duties have to be covered in company reporting".<sup>3</sup>

The Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013 (the "Regulations") amend existing company law requirements and became effective on 1 October 2013.<sup>4</sup> The main change introduced by the Regulations is a requirement for certain companies to prepare a strategic report as part of their annual report. The new requirements apply for periods ending on or after 30 September 2013.

Section 414C(7)(b) of the Regulations provides that:

In the case of a quoted company the strategic report must, to the extent necessary for an understanding of the development, performance or position of the company's business, include—

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<sup>1</sup> Shift is an independent, non-profit centre for business and human rights practice, staffed by a team that was centrally involved in shaping and writing the UN Guiding Principles on Business and Human Rights, and chaired by their author, Professor John Ruggie. Shift works with businesses, governments and their stakeholders to help put the Guiding Principles into practice.

<sup>2</sup> HM Government, *Good Business - Implementing the UN Principles on Business and Human Rights* (September 2013), available at <http://www.official-documents.gov.uk/document/cm86/8695/8695.pdf>.

<sup>3</sup> 'The Coalition: our programme for government (May 2010)', available at <https://www.gov.uk/government/publications/the-coalition-ourprogramme-for-government>.

<sup>4</sup> The Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013, available at [http://www.legislation.gov.uk/uksi/2013/1970/pdfs/uksi\\_20131970\\_en.pdf](http://www.legislation.gov.uk/uksi/2013/1970/pdfs/uksi_20131970_en.pdf).

- (a) the main trends and factors likely to affect the future development, performance and position of the company's business, and
- (b) information about—
  - (i) environmental matters (including the impact of the company's business on the environment),
  - (ii) the company's employees, and
  - (iii) social, community and human rights issues, including information about any policies of the company in relation to those matters and the effectiveness of those policies.

In August 2013, the Financial Reporting Council ("FRC"), upon request by the Department for Business, Innovation and Skills ("BIS"), issued non-mandatory guidance supporting the strategic report requirements in the new Regulations ("Guidance").<sup>5</sup> The FRC invites comments on all aspects of the draft by 15 November 2013.

The Guiding Principles establish the authoritative global standard on the respective roles of business and governments in seeking to ensure business respect for human rights. They have been incorporated or reflected in other global standards, such as the OECD Guidelines for Multinational Enterprises, the ISO 26000 Guidance Standard on Social Responsibility, the revised Sustainability Framework and Performance Standards of the International Finance Corporation, and the European Commission's 2011 Communication on Corporate Social Responsibility. Increasingly, companies are applying the Guiding Principles in their operations, governments are reflecting them in policies and regulations, investors are referencing them in their engagements with companies, and civil society organisations are highlighting them in their activities.

The Guiding Principles make clear that companies are expected to respect human rights throughout their operations. This means that they should avoid infringing on the human rights of others and should address adverse human rights impacts with which they are involved, whether through their own activities or their business relationships.

In order to meet their responsibility to respect human rights, companies should have in place effective policies and processes, as further described in the Guiding Principles. While the Guiding Principles state that all companies should be prepared to communicate externally how they address their human rights impacts, they do not require that all companies necessarily report on this formally. However, they make clear that at least those companies whose operations or operating contexts pose risks of severe human rights impacts should do so.

Furthermore, a range of other companies – notably large, state-owned or listed companies – are increasingly being required or encouraged to report on human rights by government regulators and stock exchanges.<sup>6</sup> It can reasonably be expected that this trend will continue. For all these companies, the Guiding Principles provide a much needed reference point when considering what makes for meaningful human rights reporting.

### **Scope of these Comments to the FRC Guidance**

As Shift's area of expertise is business and human rights, Shift limits itself in the following comments to the proposed application of materiality in the Guidance and to paragraphs 6.65 to 6.67,

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<sup>5</sup> FRC, FRC consults on strategic report guidance, available at <http://www.frc.org.uk/News-and-Events/FRC-Press/Press/2013/August/FRC-consults-on-strategic-report-guidance.aspx>.

<sup>6</sup> Shift, Update to John Ruggie's Corporate Law Project: Human Rights Reporting Initiatives, available at <http://www.shiftproject.org/publication/update-john-ruggie's-corporate-law-project-human-rights-reporting-initiative>.

which relate to Section 414C(7)(b) of the Regulations and their inclusion of human rights.

The proposed amendments have been made in red in italics, with text boxes providing the rationale for each amendment. For further information relating to this submission, please contact Anna Triponel, Advisor at Shift, at [anna.triponel@shiftproject.org](mailto:anna.triponel@shiftproject.org).

### **Suggested Change to the Application of Materiality**

Section 414C(1) specifies that “[t]he purpose of the strategic report is to inform members of the company and help them assess how the directors have performed their duty under section 172 (duty to promote the success of the company).”<sup>7</sup> Section 172 of the UK Companies Act in turn provides that:

- (1) A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to—
- (a) the likely consequences of any decision in the long term,
  - (b) the interests of the company's employees,
  - (c) the need to foster the company's business relationships with suppliers, customers and others,
  - (d) the impact of the company's operations on the community and the environment,
  - (e) the desirability of the company maintaining a reputation for high standards of business conduct, and
  - (f) the need to act fairly as between members of the company.

The FRC Guidance proposes to apply a relatively narrow concept of materiality to the strategic report. We believe this misconstrues the UK Companies Act as well as the Regulations. The notion that the strategic report should only include information “if its omission from or misrepresentation in the strategic report might reasonably be expected to influence the economic decisions shareholders make on the basis of the annual report as a whole”<sup>8</sup> risks considerably restricting the type of information that would be included in the strategic report.

Even among recognised definitions of materiality, this definition is particularly narrow. For example, the US Supreme Court’s definition, followed by the Securities and Exchange Commission, refers to information “presenting a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the “total mix” of information made available.” This may well be the case with regard to severe or potentially severe impacts on human rights, where it may be very difficult (and even inappropriate) to place a financial value on the consequences of such impacts occurring.

As the Guiding Principles emphasise, the corporate responsibility to respect human rights focuses on risk to individuals. The materiality definition used in the draft guidance would imply that if a company’s operations severely impact the fundamental rights and dignity of communities or workers who in turn lack the voice or access to justice to impact the company’s bottom line, these impacts should be considered without relevance to investors. We are concerned that such a view marks a backward step from the intent of the Government’s stated policy and the Regulations.

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<sup>7</sup> The Companies Act 2006 (Strategic Report and Directors’ Report) Regulations 2013, available at [http://www.legislation.gov.uk/ukxi/2013/1970/pdfs/ukxi\\_20131970\\_en.pdf](http://www.legislation.gov.uk/ukxi/2013/1970/pdfs/ukxi_20131970_en.pdf).

<sup>8</sup> FRC, Exposure Draft: Guidance on the Strategic Report at Section 5, available at <http://www.frc.org.uk/Our-Work/Publications/Accounting-and-Reporting-Policy/Exposure-Draft-Guidance-on-the-Strategic-Report-File.pdf>.

We would therefore strongly urge that the FRC remove the notion of materiality as the method for determining what human rights information to include in the strategic report so as to be consistent with the underlying legislation, similar trends in other jurisdictions, as well as the UN Guiding Principles. Our further suggestions below indicate an alternative approach to ensuring that the information reported is concise and relevant.

### **Suggested Changes to Paragraphs 6.65 to 6.67 of the FRC Guidance**

**6.64 To the extent necessary for an understanding of the development, performance or position of the entity’s business, the strategic report should include information about:**

**(a) environmental matters (including the impact of the business of the entity on the environment);**

**(b) the entity’s employees; and**

**(c) social, community and human rights issues,**

***including information about any policies of the company in relation to those matters and the effectiveness of those policies.***

***If the report does not contain information of each kind mentioned in paragraphs (a), (b) and (c) above, it must state which of those kinds of information it does not contain.***

The Regulations’ requirement for quoted companies’ reporting on human rights to include information about their human rights policies, including the effectiveness of those policies, is an important one. This is lost when it is placed in paragraph 6.67 rather than upfront in this paragraph 6.64. Similarly, for completeness, the Guidance should include here reference to paragraph 414C(7) of the Regulations, which requires companies to describe which information they have chosen not to include.

6.65 There may be a strong relationship between the development, performance, position or future prospects and the matters described in paragraph 6.64, particularly over the longer term. The strategic report should include information on these matters when their influence, or potential influence, on the development, performance, position or future prospects of the entity’s business is of such a nature or magnitude that they are relevant to shareholders. The strategic report should not, however, be seen as a replacement for other forms of reporting addressed to other stakeholders.

***6.66 Various environmental, social, employee and community impacts may rise to the level that they involve an adverse impact on human rights. Some of those impacts may in turn be particularly severe and therefore potentially influence the development, performance or future prospects of the entity’s business and be relevant to shareholders.***

Human rights impacts already imply impacts on people of a particularly significant nature, whether they stem from environmental, social, employee or community issues. Where actual or potential human rights impacts are themselves severe – meaning particularly grave, widespread or difficult to remediate – they cross an even higher threshold and necessarily stand out as being relevant to shareholders.

***6.67 As set out in the UN Guiding Principles on Business and Human Rights, and the OECD Guidelines for Multinational Enterprises, a company needs to assess the risk of being involved with human rights impacts in order to know the existence and nature of such risks and to be able to address them. Evidence that a company effectively assesses these risks will, by its nature, be relevant to shareholders, since significant human rights risks may otherwise remain unidentified and unaddressed.***

*6.68 Where an entity is involved, or potentially involved, with gross violations of human rights, or other severe human rights impacts, this will be of a magnitude that it is relevant to shareholders to know whether and how those impacts are managed. Under the UN Guiding Principles, the severity of human rights impacts is judged by their gravity, the number of people potentially affected, and whether those impacted can be restored to their situation before the impact.*

Paragraph 6.65 states that: “the strategic report should include information on these matters [including human rights] when their influence, or potential influence, on the development, performance, position or future prospects of the entity’s business is *of such a nature or magnitude* that they are relevant to shareholders.

The most basic information a reporting company should provide with regard to human rights is how it has established whether or not it is at risk of involvement with negative impacts on human rights. The absence of an adequate knowledge or understanding of these risks is, *by its nature*, relevant to shareholders.

Where a company has identified that it is or may be involved with severe impacts on human rights, this is, *by its magnitude*, relevant to shareholders. Reporting should therefore include information on how those impacts are managed.

*6.69 Where a company identifies actual or potential human rights impacts on which it needs to report, the UN Guiding Principles provide key guidance on the kinds of supporting information a company could usefully include. In particular, they describe the policies and processes that a company should have in place to address human rights impacts. These are:*

- 1) A high-level policy commitment to respect human rights, supported by measures to embed the company’s commitment throughout the organization*
- 2) A process of human rights due diligence through which the company:
  - (a) assesses the actual and potential impacts on human rights arising from its own activities and through its business relationships,*
  - (b) integrates the findings from these assessments and takes action to prevent or mitigate adverse impacts,*
  - (c) tracks the effectiveness of its efforts to address human rights impacts, and*
  - (d) communicates these efforts externally, in particular to affected stakeholders.**
- 3) Participation in legitimate processes to remediate human rights harms that the company has caused or to which it has contributed, including, where appropriate, through effective operational-level grievance mechanisms.*

The UN Guiding Principles provide clarity on the policies and processes that companies should have in place to know and show that they respect human rights in practice. The same provisions are mirrored in the OECD Guidelines for Multinational Enterprises, which all adhering Governments, including the UK, have an obligation to promote.

Inclusion of proposed paragraphs 6.67, 6.68 and 6.69 in the FRC’s Guidance would provide valuable clarity to the user regarding when and what it is appropriate for them to report on with regard to human rights. A link in the FRC’s guidance to the UN Guiding Principles might also be helpful as a reference point for further information. This proposed approach can provide a viable and appropriate means of meeting the FRC’s objective of ensuring that company reporting is both concise and relevant, without requiring recourse to a narrow definition of materiality that would exclude many human rights issues of relevance to investors.

*[We suggest moving the linkage examples to the end of this guidance, and moving the first sentence of current paragraph 6.67 here, with the following changes, and the second sentence of current*

*paragraph 6.67 to paragraph 6.64 above.]*

6.70 Where a discussion of an issue related to any of the matters described in paragraph 6.64 is *not* considered necessary for an understanding of the development, performance, position or future prospects of the entity’s business, the strategic report should make clear why it is *not* considered necessary.

The Regulations specifically note that “[i]f the report does not contain information of each kind mentioned in paragraphs ([a), (b) and (c) above], it must state which of those kinds of information it does not contain.” We therefore do not believe it is appropriate to reverse the burden of proof in this situation.

6.66—Where this information is material it should be placed in the strategic report. If the directors consider that this type of information is important but not material to shareholders, the information could be located elsewhere, for example, in a sustainability report.

Placing this discussion in the context of materiality, as defined, undercuts the original legislation which placed no such parameters on it. Please see the discussion above in the Section titled: “Suggested Change to the Application of Materiality” for our further views on this point. Introducing the materiality definition also cuts across the language of paragraph 6.65 which is somewhat broader.

### *Example*

An entity that sources its products from overseas could face risks relating to stakeholder (eg customer) concerns relating to local labour practices **of involvement with labour rights abuses by its suppliers**. In this situation, the entity might have put in place a **code of conduct requiring suppliers to respect internationally-recognized labour rights, along with a** system to validate and monitor supply chain performance. **Some entities may also work with suppliers to improve their performance or collaborate with others in the relevant industry or country to address systemic problems, specifically related to adherence to stated policies.** The directors might also monitor the effectiveness of those policies **and processes** with KPIs. ~~Where the nature or magnitude of the potential effect of the risk on the business is such that it would be of interest to shareholders, it should be described and discussed in the strategic report.~~ **Where the actual or potential labour rights abuses are severe, such that they would be relevant to shareholders, the strategic report could highlight this, together with the entity’s actions to address the situation.**

The proposed amendments to the example are designed to align it with the UN Guiding Principles and with the suggested provisions that precede it in this amended version.

### *Linkage example*

The way an entity conducts its business in relation to the issues in paragraph 6.64 may affect its licence to operate/trade in a particular location or market, or result in a major event that will directly or indirectly affect the entity (eg a material litigation, loss of revenue or reparation cost). The risk of such an event may constitute a principal risk or uncertainty to the entity.

### *Linkage example*

~~The identification of the key inputs and outputs of the business, together with the key stakeholder relationships could be linked to the business model and strategies to help explain the reasons why~~

~~each particular matter or issue is important to the business.~~

In light of the suggested change to paragraph 6.70 above, we would suggest deleting or amending this linkage example.