Investing in conflict and post-conflict areas: risk analysis and mitigation

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Introduction
Publicly listed companies are active in numerous conflict-affected areas around the world. Their activities there vary, but even if their involvement is limited to procurement, their investors risk being directly linked to extremely severe adverse human rights and environmental impacts. Based on the OECD Guidelines and UN Guiding Principles on Business and Human Rights (UNGPs), investors are expected to use their influence to prevent or mitigate such adverse impacts and to ensure that victims have access to remedy.

What does this mean in practice? What are "conflict-affected areas"? When is a company linked to adverse impacts, and when is it not? What can be reasonably expected of companies, and what steps can institutional investors take? This document offers guidance in answering these questions.

What are conflict-affected areas?
Conflict-affected areas are often marked by political instability, repression, institutional weakness, inequality, a dysfunctional legal system, a polarised society, restrictions on freedom, and a weak civil infrastructure. They are characterized by widespread human rights malpractices and violations of national or international law. In circumstances such as these, a company's activity is never neutral and always affects the situation, Therefore, companies must be aware of the positive and adverse impacts of their presence on conflict and make targeted efforts to avoid becoming involved in adverse impacts.

There are various ways to define a conflict-affected area. We give two important definitions below, which provide a firm basis for addressing the issue.

1. *<u>OECD definition of conflict-affected and high-risk areas</u>:*

Conflict-affected and high-risk areas are identified by the presence of armed conflict, widespread violence, or other risks of harm to people. Armed conflict may take a variety of forms: international or non-international, chronic or transitory, and local or affecting vast areas.

2. *<u>EU definition of conflict-affected and high-risk areas</u>:*

"Areas in a state of armed conflict, fragile post-conflict areas, as well as areas witnessing weak or non-existing governance and security, such as failed states, and widespread and systematic violations of international law, including human rights abuses."

The next step is to identify areas that match such a definition. As already described, there is no universally accepted definition of conflict-affected areas. Not all countries that experience violent conflict will fully fit the above definitions and vice versa, while countries with low levels of violence can still share multiple characteristics of the definition. This makes a strict application of these definitions be problematic. It is therefore important to acquire data from multiple sources and cross-check them.

1. Worldbank: The World Bank Group publishes an annual list of countries in conflict or vulnerable to conflict. Important indicators are institutional resilience and social fragility. This list is not meant to be comprehensive, but an excellent starting point for any classification. The list of fragile and conflict-affected situations (FCS) https://www.worldbank.org/en/topic/fragilityconflictviolence/brief/harmonized-list-of-fragile-situations

2. For a more in-depth analysis of countries, the OECD provides the *States of Fragility* framework. In this framework, there is particular attention to the fragility of states from both an economic, as well as a political and social approach. http://www3.compareyourcountry.org/states-of-fragility/overview/0/

3. The Heidelberg Institute has come up with a conflict Barometer in which they pay special attention to the political climate. This index is therefore highly suitable for risk-analysis of not only (post)conflict countries, but also troubling regions of high political instability. Heidelberg Institute for International Conflict Research: – Barometer: https://hiik.de/conflict-barometer/current-version/?lang=en

4. The Fragile State Index made by Fund for Peace focuses on the institutional and societal fragility of states. This index is one of the oldest existing and thanks to their longitudinal research that the index is based on, excellent for tracking regional trendshttps://fragilestatesindex.org/

5. Freedom House uses a narrower approach and measures the accessibility to *political rights* and *civil liberties* in countries. This makes Freedom House an excellent source to analyze countries that have not been in conflict for a while but still carry substantial risk because of the widespread infractions on civil rights and fundamental freedoms. https://freedomhouse.org/countries/freedom-world/scores

Where do institutional investors' responsibilities lie?
According to the OECD Guidelines and the UNGPs, it is the responsibility of institutional investors to know the human and environmental risks of their investment portfolios and to use their influence to prevent and mitigate those risks as much as possible and where necessary.

Companies operating in conflict areas do not necessarily contribute to malpractices. A company may, for example, supply medicines or food, and ceasing its activities will quickly have a detrimental impact. However, companies may also be involved in supplying arms, in public surveillance, or by financing warring parties through their operations. Even if companies provide services or products that appear to have no direct link with the conflict, their presence alone may influence it.

By investing in companies operating in conflict-affected areas, investors run the risk of being directly linked to adverse human rights and environmental impacts. Based on the OECD Guidelines and UNGPs, investors are therefore expected to take the steps explained below.

What steps are institutional investors expected to take?
To prevent and mitigate their involvement with adverse impacts, investors are supposed to conduct RBC Due Diligence[1]

This process includes 6 steps as explained by the OECD Due Diligence Guidance for Responsible Business Conduct. The following steps can be taken by investors within this Due Diligence process to address the specific risks associated with conflict affected areas.

[1] Responsible Business Conduct Due Diligence, also known as ESG Due Diligence or human rights and environmental risk due diligence

The six steps of *due diligence* according to the OECD Guidelines:

1. Embed responsible business conduct into policies and management systems.
2. Identify and assess actual and potential adverse impacts associated with the enterprise's operations, products, or services.
3. Cease, prevent, and mitigate adverse impacts.
4. Track implementation and results.
5. Communicate how impacts are addressed.
6. Provide for or cooperate in remediation when appropriate.

Step 1: Policy

It is important for investors to explicitly define what they consider to be conflict-affected areas and what they expect from companies that operate in these areas. The definitions provided in the previous section may be useful in that respect.

Additionally, there are various tools and guidelines for companies operating in conflict-affected areas that may also be relevant to an investor's policy.[2] These can help investors to state what they expect from investee companies in this regard and what goals to set for engagement processes.

For example, a recent report published by the UN Working Group on Business and Human Rights[3] makes clear that when discharging their responsibility under the UNGPs in such situations, investee companies should complement their due diligence with a conflict-sensitive approach[4] to avoid potential adverse impacts. The first step in the due diligence process is to analyze the investee company's impact on the conflict and vice versa. As investee companies are per se expected to know their impacts and investors are unable to do this for them, this implies that institutional investors cannot but expect investee companies to carry out such due diligence.

The following, additional, steps[5] are crucial for the due diligence processes of investee companies operating in conflict-affected areas. They can interest investors thato have undertaken certain types of investment, such as project finance or majority shareholdings:

1. Identify the root causes of the conflict, including a comprehensive context analysis.
2. Pinpoint the main actors in the conflict and their motives, capacity, and ability to influence the conflict.
3. Analyze the impact of the company's business activity on the conflict and the various actors.
4. Draft and implement an action plan to prevent and/or mitigate the identified risks of adverse impact.

All these steps taken together are referred to as 'enhanced' or 'heightened' due diligence.

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[2] https://www.unpri.org/sustainability-issues/environmental-social-and-governance-issues/social-issues/conflict-zones
https://www.angloamerican.com/~/media/Files/A/Anglo-American-PLC-V2/documents/communities/seat-v3-jan-15-2.pdf
https://www.cdacollaborative.org/wp-content/uploads/2016/01/Preventing-Conflict-in-Exploration-Tool.pdf
https://www.international-alert.org/sites/default/files/Economy_HumanRightsDueDiligenceGuidance_EN_2018.pdf
https://www.securityhumanrightshub.org/sites/default/files/2019-10/ASHRC_Toolkit_V3.pdf
http://www.voluntaryprinciples.org/wp-content/uploads/2019/12/ImplementationoftheVoluntaryPrinciples%E2%80%93InformationforCompanies.pdf

[3] Report of the Working Group on the issue of human rights and transnational corporations and other business enterprises, *Business, human rights and conflict-affected regions: towards heightened action*, Geneva, September 2020, https://undocs.org/en/A/75/212.

[4] https://www.international-alert.org/sites/default/files/Economy_ConflictSensitivityBusinessHumanRights_EN_2016.pdf

[5] See Appendix 1 for guidance on analysis and enhanced due diligence.

Step 2: Identify and prioritize
Institutional investors are expected to implement a due diligence process that covers their entire investment portfolio. If necessary, investors can prioritize their efforts to address the most salient issues that they have identified. Both the OECD and the UN acknowledge that some of the most salient adverse impacts to people and planet occur amongst (armed) conflict.
Therefore, investors need to identify which investee companies are active in or linked to conflict-affected areas. Secondly, they should be aware of aggravating factors that indicate high-risk profiles.

- Conflict areas in which investee companies operate and where violations are known or have the potential to occur.
- Sectors that are known to pose specific risks in conflict areas, e.g., arms production, raw materials extraction, or the supply of surveillance equipment.
- Investee companies that are lagging in the field of human rights and/or due diligence processes.

If an investee company is found to pose a heightened risk, investors are advised to conduct heightened due diligence as described by the UN Working Group on Business and Human Rights. this serves to:

1. assess whether the investee company has carried out adequate (enhanced/heightened) due diligence on its own operations and services or services provided in the conflict area and/or has complied with the investor's stated policy in that regard.
2. Assess whether the investee company has complemented its due diligence with a conflict-sensitive approach.
3. Investigate which (potential) adverse impacts the company has identified.
4. Monitor the company's progress in performing heightened due diligence and addressing (potential) adverse impacts.
5. report on the (potential) adverse impacts identified and the actions taken by the investee company to prevent or mitigate them and to contribute to access to effective remedy for victims.

Lundin Energy has been severely criticized for contributing to and benefitting from Sudan's civil war, 20 years ago. Its operations allegedly motivated a cruel local war that killed 12.000 people. In 2010, the Swedish Prosecution Authority opened a criminal investigation and in 2018 it stated that there was sufficient evidence to indict the company's Chairman and CEO are for aiding and abetting international atrocity crimes. The company has opted for a confrontational legal strategy. It denies any wrongdoing and does not communicate with victims. Court hearings are likely to open in the 2nd half of 2021.

Lundin Energy is receiving high ESG-ratings. This suggests that prevailing due diligence mechanisms fail to duly identify specific high risks and following ESG-ratings does not necessarily substitute for a proper due diligence process. Adequate inclusion of conflict risks in due diligence will raise important red flags and prevent that high-risk companies fly under the radar.

Step 3: Engagement
Based on the outcome of the risk assessment and prioritization, investors should engage in discussions with companies that are associated with (potential) malpractices to prevent and mitigate those adverse impacts. What can reasonably be expected of companies that run a heightened risk of being or are already implicated in violations?

As discussed above, an investee company operating in conflict-affected areas must carry out a proper context and conflict analysis and translate the outcomes into action, i.e.:

1. perform a comprehensive context analysis in which it also identifies the root causes of the conflict.
2. pinpoint the main actors in the conflict and their motives, capacity, and ability to influence the conflict.
3. analyze the impact of its own business activity on the conflict and the various actors.

4. develop and implement an action plan to prevent and/or mitigate the identified risks of adverse impact.

It is vital that the investee company's management and/or supervisory board are sufficiently knowledgeable and that the company has a complaint mechanism in accordance with UNGP 29-31 to identify possible malpractices at an early stage and provide potential victims access to effective remedy.

Finally, investee companies and investors need to be transparent about the steps they take. [6]UN PRI)[7] and the UN Guiding Principles Reporting Framework offer investors suitable guidelines for their due diligence disclosure and to assess the quality of an investee company's due diligence.

In line with this, it is important for institutional investors to engage on:

- how the investee company can reduce adverse impacts on the conflict and, if possible, help to prevent and/or mitigate conflict. how future malpractices can be prevented, e.g., by integrating a conflict and risk analysis and drawing up company policy on activities in conflict areas.
- how potential victims can have access remedy.

Step 4: Increasing leverage if individual engagement is not effective
If individual engagement is not effective, the investor should consider steps to increase its leverage. For example:

- Use of the engagement outcomes to make informed voting decisions. In addition to specific ESG resolutions, other issues might include board appointments and remuneration. Is the management board knowledgeable enough about human rights and areas of conflict? Does the governance structure adequately address human rights? In several markets (co-) filing resolutions can be an additional step to take.
- Increase leverage. For example, by contacting other investors in taking a pro-active approach to get an issue on the agenda, issuing a public statement or addressing the meeting of shareholders.
- Consider exclusion of a specific investee if engagement does not produce results and malpractices continue.
- Also, consider excluding specific risk sectors and/or companies operating in high-risk areas if engagement is not expected to be effective across a specific sector.

Step 5: (access to) Remedy
Most of the time, investors would only be directly linked to an adverse impact and are expected to use their leverage to encourage investee companies to provide access to remedy for victims of adverse impacts. In exceptional cases, a situation may also arise in which Investors 'contribute' to an adverse impact through their investments, in which case investors are also responsible to contribute to remediation.

However, remedy is a relevant consideration in all cases in which an investor is connected to a negative impact, as in many cases where severe negative impacts occur, (access to) remedy is still not available. Therefore, investors should, also in a scenario where the investor is directly linked to an impact, address this in their engagement with investee companies and have special attention to the existence and functioning of operational-level grievance mechanisms.

[6] https://documents-dds-ny.un.org/doc/UNDOC/GEN/N18/224/87/PDF/N1822487.pdf?OpenElement, p. 88.
[7] https://www.ungpreporting.org/wp-content/uploads/UNGPReportingFramework_2017.pdf.

Appendix 1 Context & conflict analyses

To minimise the risk of being directly linked to human rights and environmental malpractices, investors should complete the six due diligence steps.

They can use the criteria below to assess the adequacy of the investee company's due diligence process, not only prior to investing but also to evaluate their existing portfolio or as guidance in discussions with companies operating in conflict/post-conflict areas.

A company operating in a conflict or post-conflict area should have at least the following information available as part of an effective enhanced due diligence process:

1. **A context analysis addressing**
    a. The geographical and physical attributes (regional and national) of the activity, including
        i. Existing natural resources
        ii. Water reserves
        iii. Climate impacts
    b. History of the region and earlier conflicts, including
        i. Human rights abuses
        ii. Legacy issues
        iii. Geopolitical relevance
    c. Socio-economic and demographic data, including
        i. Population size and distribution
        ii. Ethnic and religious groupings
        iii. Gender relations and the position of women
        iv. Income inequality and poverty
        v. Social norms
    d. Legal and institutional system, including
        i. Legislation and the judicial system
        ii. Political system
        iii. Formal and informal standards
        iv. Public security agencies
        v. Corruption

2. **A conflict analysis addressing**
    a. The status of the conflict, including
        i. Origins and history of the conflict
        ii. Most important groups involved in the conflict
        iii. Underlying drivers of the conflict (crucial)
    b. Stakeholder analysis, including
        i. Political groups
        ii. Local communities
        iii. Ethnic and/or religious leaders
        iv. Individuals/groups whose rights may have been violated
        v. Human rights defenders
    c. Direct impact of business activity, including
        i. Potential adverse impact (social and environmental) and analysis of prevention and/or mitigation options
        ii. Potential positive impact (social and environmental) and analysis of expansion options
        iii. Relationship with local communities
        iv. Presence of grievance mechanisms

d. Indirect impact of business activity
    i. Relationship with conflict actors, including interdependency/mutual benefits, influence of the relationship on conflict drivers, and how other actors perceive it
    ii. Influence of financial and economic relationships on relative strength of conflict actors, their legitimacy and their behaviour
    iii. Potential and discernible influence of company's presence and activities on underlying conflict drivers.

3. Measures

a. For each potential or discernible adverse impact or influence identified, propose one or more preventive and/or mitigating measures.
b. For each potential positive impact or influence identified, explain why it has or has not been expanded.