

The Rule of Law and investor approaches to ESG: Discussion paper



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The war in Ukraine has provided a stark and tragic context for any discussion of the Rule of Law and corporate purpose. It has also produced significant shifts in strategic thinking about the deterrent role of co-ordinated sanctions. This, in turn, is likely to produce new thinking about the role of major corporations and their societal responsibilities, including the nature of the countries in which they choose to operate or rely on for their supply chains.

Most companies and financial institutions now devote considerable resource to ESG issues, whether through investigation, analysis or reporting. It is important that investors can see that this considerable resource is applied to good effect and produces outcomes and not simply activity.

This report argues persuasively that, in order to change the world rather than just measure its shortcomings, ESG must address the need for some fundamental building blocks which are either missing or are inadequate. The report identifies the Rule of Law as being a common thread across all ESG concerns. It argues that the Rule of Law provides a path to changed and improved outcomes.

The report is written by a professional investor and is aimed at investors and boardrooms. It is the first step in a process of engagement which the Bingham Centre hopes will lead to an understanding of the close connection between the Rule of Law and economic prosperity. This understanding can then lead to a collaborative, portfolio-based approach to building Rule of Law capacity.

The Bingham Centre believes that this will lead to positive outcomes for investors and we hope that the report will spark engagement and support from within the investment and business communities.

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Executive Summary

Environmental, Social, Governance (ESG) is an increasing focus for both companies and investors; this short paper argues that Rule of Law also needs to be, in order to support and reinforce the approach to ESG issues.

The focus on ESG – environmental, social and governance matters – encourages a longer-term mindset and greater consciousness of stakeholders. This approach is seen as having greater urgency in the context of our growing understanding of the risks of climate change, the social challenges arising from the Covid-19 pandemic, and the war in the Ukraine and its consequences for international businesses operating there and in Russia.

Regulation, for both companies and investors, increasingly encourages them towards this focus on ESG matters. This is inspired by the belief that it will lead to greater prosperity for society as a whole, and a fairer and more sustainable future for all. Preserved and enhanced Rule of Law will play a key role in helping deliver that fairness and sustainability. The Rule of Law provides a key foundation for each element of ESG.

Further, more investors are recognising that they are globally exposed to economies as a whole, and to global markets. This is driving a consciousness of the need to consider the underlying conditions that support security of long-term investment. Economic history over centuries demonstrates that one of those conditions is the Rule of Law. That's not surprising: the Rule of Law gives confidence that agreements will be kept to (or that there will be compensation), that people and businesses will be held accountable for their actions, and that stakeholders will be appropriately protected.

Rule of Law consists of the societal conditions that enable fairness and prosperity for all members of society. It is a fundamental framework of rules that applies to everyone and enables, among other things, trade and commerce to take place. It is axiomatic that business works best in an environment which is predictable and fair, where people and organisations are treated equitably, in good faith and with reliability, where access to efficient and timely justice is available at a reasonable cost, and where human rights and international rules are observed. These are basic elements for good business and for long-term prosperity, but they only exist where the Rule of Law is firmly in place.

Investment will not prosper unless there is broad-based societal prosperity, and Rule of Law is a crucial basis for that. It is no coincidence that long-lasting and successful societies have had strong Rule of Law foundations. ESG is underpinned by Rule of Law. Environmental rules cannot be put into place or enforced without Rule of Law. Healthy societal norms such as living without corruption are not possible without Rule of Law. Governance itself, corporate or public, fails unless underpinned by Rule of Law.

Some limit their focus on Rule of Law to emerging economies, but the issues can be relevant in any country. Rule of Law needs safeguarding across the world. The geographic spread of the case studies in this paper are a reminder that issues can arise in any market, even ones where Rule of Law has been long-established.

This paper attempts to draw out the interdependence between economic prosperity, long-term investment and ESG, and the Rule of Law. It offers investors insights into the ways in which their ESG activities already interact with Rule of Law concepts and delivery. It seeks to develop ways in which this background issue can be brought more into the foreground of investor and company ESG activities. Not least, it puts forward some key questions that can be built into the interactions between different players in the investment chain, and between company directors and management, to build further understanding and encourage greater underpinning of Rule of Law globally.

If we truly want to promote ESG then Rule of Law is essential – without this long-term investment, ESG and indeed properly functioning civil society cannot exist. Without Rule of Law life is 'nasty, brutish and short'¹. Investors, and companies, can play a greater role in promoting it.

¹ Thomas Hobbes, Leviathan, 1651

What is the Rule of Law?

Capitalism only works where the Rule of Law is in place. It means that the ownership of property is meaningful. It means that contracts are enforceable, and so can be relied on. It means governments cannot act capriciously and arbitrarily. It means that all receive fair treatment through the legal and regulatory system.

These are the key outcomes of the concept of the Rule of Law, which essentially means that the law and regulation matters and that legal rights will have the backing of the state. More than that, the state itself is constrained by law and cannot act unfairly or arbitrarily in relation to its own citizens and businesses. It constrains frictional costs on business, not least the heavy burdens of bribery and corruption.

Rule of Law has thus proven to be a core foundation for economic progress and financial prosperity. It should not be taken for granted. Those who seek to prosper for the long-run and value ongoing economic success need to continue to support and urge all to uphold the Rule of Law.

The Bingham Centre's vision is therefore of a world in which every society is governed by the Rule of Law "in the interests of good government and peace at home and in the world at large".

Lord Bingham's eight principles of the Rule of Law:

- i. *The law must be accessible and so far as possible intelligible, clear and predictable.*
- ii. *Questions of legal right and liability should ordinarily be resolved by application of the law and not the exercise of discretion.*
- iii. *The laws of the land should apply equally to all, save to the extent that objective differences justify differentiation.*
- iv. *Ministers and public officers at all levels must exercise the powers conferred on them in good faith, fairly, for the purpose for which the powers were conferred, without exceeding the limits of such powers and not unreasonably.*
- v. *The law must afford adequate protection of fundamental human rights.*
- vi. *Means must be provided for resolving, without prohibitive cost or inordinate delay, bona fide civil disputes which the parties themselves are unable to resolve.*
- vii. *The adjudicative procedures provided by the state should be fair.*
- viii. *The rule of law requires compliance by the state with its obligations in international law as in national law.*

Tom Bingham – the Rt Hon Lord Bingham of Cornhill KG, the pre-eminent UK judge of his generation – in his 2010 book *The Rule of Law*

What is ESG?

ESG stands for environmental, social and governance matters, an aggregation of the issues that have historically been neglected in business and investment thinking because their impacts are uncertain and often only seen over medium- and long-term time horizons. The issues do drive or destroy value over the long-term, but ignoring them in the short-term may provide near-term financial benefits. A capitalist system that aspires to being long-term and to consider the interests of all the stakeholders of business needs actively to embrace ESG matters.

There are two sides of the ESG coin, relevant to companies and investors respectively.

For companies: an ESG focus means building environmental, social and governance considerations into business decision-making. In many ways it is a reflection of the director's duty under English law in the form of s172 of the Companies Act 2006 to have regard to the interests of employees, customers, suppliers, local communities and the environment (and other stakeholders) in their efforts to promote the success of the company. ESG covers the issues that were once talked about as corporate social responsibility, but CSR was often seen as a narrow issue that was separate not integral to business decisions. Because it is material to long-term business success, ESG should be integral to decision-making.

For investors: an ESG focus means building environmental, social and governance considerations into investment decision-making, and also into their actions as a (part-)owner of the assets they invest in – usually now called stewardship. In many ways it is a reflection of the duty borne by any fiduciary (under English law at least, anyone who has been entrusted with the care of assets on behalf of another) to maintain and enhance the value of the investments they make for others over the investment time-horizon relevant to those beneficiaries' best interests. As most beneficiaries are investing for the long-term, this means incorporating factors that will matter for long-term value – even if they have historically been neglected by financially-focused investors. ESG covers the issues that were once talked about as socially responsible investment, but SRI was often seen as a narrow form of investment that was separate not mainstream. Because it is material to long-term business success, ESG should be integral to mainstream investment and ownership.

For many, best practice in ESG is set out by the Financial Reporting Council, the governance regulator, in its UK Stewardship Code 2020:

“Environmental, particularly climate change, and social factors, in addition to governance, have become material issues for investors to consider when making investment decisions and undertaking stewardship. The Code also recognises that asset owners and asset managers play an important role as guardians of market integrity and in working to minimise systemic risks as well as being stewards of the investments in their portfolios.”

UK Stewardship Code 2020, Financial Reporting Council

Rule of Law and E&S

The first two elements of ESG are environmental and social matters.

‘Environmental’ clearly covers how an organisation interacts with the natural world, either on a local scale or globally. Given the global sourcing of products, it also includes impacts within the company’s supply chain.

‘Social’ is a rather broader concept, encompassing among other elements:

- i. how a company treats its workforce (in the context of casual working, freelance relationships and the gig economy, itself a broader concept than just employees);
- ii. human rights concerns around labour issues (especially avoiding child or forced labour) in the supply chain;
- iii. health and safety, and occupational health issues, again both for workers and contractors;
- iv. union relations and the right to association; and
- v. relations with communities local to business operations.

In both cases, it will be apparent that local regulation plays a key role in the standards applied with regard to E and S issues. And it is not just the regulations themselves, but the extent to which they are enforced in practice, that actually matters.

The quality of regulation, and the effectiveness of its enforcement, are key Rule of Law issues.

In many cases, investors’ issues in relation to E and S issues are to seek to understand whether regulation (and enforcement of that regulation) ensures practices of an expected quality across all parts of a company’s business operations and supply chain. That may often mean companies filling the gaps in local regulation and enforcement through their own standards and assurance frameworks – ensuring that supply chain employment standards, for example, meet up with the investors’ view of what is acceptable for a company they are willing to invest in. The box discusses an example of this: an investor programme of engagement with companies taking supplies from the Brazilian iron and steel sector, which was perceived to face both slave labour and environmental exposures.

This mind-set is now reinforced in a number of jurisdictions through the application of human rights standards across the corporate world. Most prominent is perhaps France’s 2017 Loi de Vigilance (duty of vigilance act), which requires all large French companies (measured by having employees in the thousands) to mount due diligence of all contractors and suppliers as well as companies that they directly control. It requires active assessments of both human rights risks across the supply chain and controlled companies, and also significant environmental impacts. Companies must publish both a plan that has been

developed in consultation with stakeholders, and a report on the implementation of that plan.

A Dutch child labour due diligence act (Wet Zorgplicht Kinderarbeid) was passed in 2019 and comes into effect in mid-2022. It applies to all companies selling or supplying goods or services to Dutch consumers, irrespective of where the company is based and regardless of its size. All such companies are required to develop plans to bar child labour in their supply chains and to assess whether child labour is embedded in the production of their goods or services. Similarly, the UK and Australia both require modern slavery due diligence by their companies.

As well as these existing elements of legislation, the EU is actively considering moves towards mandatory human rights due diligence for its companies, as are a number of other countries.

Case Study: Slave labour and rainforest charcoal in Brazil's pig iron supply chain

In the late 2000s a coalition of dozens of investors coordinated through the UN-linked Principles for Responsible Investment (PRI) worked together to engage with companies potentially exposed through their supply chains to the use of slave labour and rainforest wood charcoal in the production of Brazilian pig iron. Brazil is an important source of raw materials for many steel producers, and manufacturers that use that steel, particularly for companies based in North America.

The collaboration was formed in 2006 following a Bloomberg Markets cover story highlighting renewed efforts by the Brazilian authorities to stamp out the horrors of modern slavery in the work camps which at the time produced the charcoal and the pig iron in remote rural parts of Brazil. The authorities' efforts brought attention to the scale and the appalling realities of the treatment of those trapped in these camps. That ensured those investors with a focus on human rights issues were keen to engage actively with companies potentially implicated. But the enforcement efforts also won the attention of more narrowly financial focused investors because it was clear that the pricing of these pig iron supplies was being artificially depressed by slave labour activities and that readjusting these prices to more appropriate levels would have implications for the profitability of some of those buying or using the steel produced using that pig iron. Investors were supportive of the assertion of Rule of Law in Brazil in this respect, to reset the marketplace and ensure that companies with good practice and clean supply chains could no longer be undercut by those that did not.

The collaboration focused on a number of companies whose supply chains were impacted. Over a period of years investors made positive progress in dialogue with the companies. Among the ways in which progress was made was through increased corporate support for NGO initiatives in the region, both directly and as a standard expectation set for suppliers. Both the National Pact for the Eradication of Slave Labor and the Citizens Charcoal Institute (ICC) in effect lent support to the enhancement to the Rule of Law in the relevant regions and promoted much better practice.

Investors seek confidence that environmental and social standards that they regard as vital are applied not just in their local markets but in countries in which they invest, or to which they are exposed through the companies in which they invest. They will therefore need to seek assurance that the Rule of Law applies in those countries. Sadly though, the Boohoo case study demonstrates that enforcement of regulation in domestic markets can also be poor and enable poor supply chain practices locally just as much in more distant supply chains.

By not taking Rule of Law for granted, companies and investors can help ensure that local regulatory standards are meaningful and likely to be enforced in practice – so that companies with positive approaches will not be outcompeted by companies with lower standards. It should also support companies in having confidence that the standards that they set for themselves and their supply chains will in fact be reflected on the ground.

Case Study: Boohoo supply weaknesses

Boohoo Group plc is an online retailer, and one of the UK's leading firms in the so-called fast fashion industry. It aims to have short supply chains so that it can be actively responsive to customer demand and produce goods promptly. It therefore relies on an extensive supplier network in the English city of Leicester.

In 2020 newspaper revelations, led largely by the *Sunday Times*, exposed significant failings within that supply chain, including unsafe working practices even during the pandemic and pay levels well below the national minimum wage. A report commissioned by the company following the ensuing furore concluded that the allegations were substantively true and that Boohoo's supply chain monitoring had been inadequate. It had also not moved quickly enough when it became aware of serious issues.

The media exposé of these issues came largely as a surprise to investors, even though some in the industry regarded poor practices in the Leicester garment industry as being largely an open secret. Boohoo's share price fell dramatically on the revelations. It became apparent that in spite of there being some broader perception in the industry of poor practices, enforcement of the UK regulations was limited and weak. The rules were in place but they held little meaning on the factory floors. The government has made renewed promises to enforce more actively, and the company has also enhanced its supply chain monitoring.

Climate change-related investments

The global context of the climate crisis and the increasing moves to address it will require significant action by investors – increasing numbers of which have committed to carbon trajectories that will make their investment approaches net-zero carbon by 2050 or earlier.

Geopolitics – and simple fairness – is likely to require support for emerging economies such that they can develop without increasing the carbon intensity of their economic lives. International investors may well play a part in this, finding attractive investment

opportunities in helping this process happen. One hindrance to this process however may be a lack of confidence that the returns from those investments will be available for repatriation to the foreign investment institutions. Greater certainty around the Rule of Law in many highly exposed emerging economies may encourage greater flows of international investment into climate aware opportunities.

Rule of Law will also play a significant part in investor confidence in the delivery of climate commitments, which will be crucial for investment institutions to feel the assurance necessary to make some climate-aware investments. As one investor commented to the author: "Can we rely on the climate change policy promises given by governments in countries where corruption is rife? If certain bribes are paid, isn't it likely that the promises will be soon forgotten?" Even in the absence of explicit bribery and corruption, the sway that extractives industry businesses may have because of short-term positive cashflows and tax payments may influence government policy in ways that hinder long-term climate policy-making. Some would argue that this influence has already been seen in many countries, in the economically developed world as much as the developing.

Rule of Law and G

Investor focus in governance is typically all about people and processes:

- i. having the right people in decision-making roles with the right skills and experience and diversity of view, and
- ii. having the right processes and structures in place to enable decision-making to be appropriately informed, questioned and assured.

Yet this focus is underpinned by more fundamental legal framework, embedded in the Rule of Law. Underpinning many investments are contracts, some highly visible and some slightly more implicit. For example, there is a contract between a company and its shareholders in the form of the articles of association or the company bylaws, which sets the terms of the relationship between the parties.

It's not just contractual rights; the legal system, and how reliably it is enforced, shape other investor rights and powers. One protection that many modern businesses rely on is the security of intellectual property ownership. It may be that jurisdictions respect the IP rights created elsewhere or they may require local registration and protection, but either way companies depend on being able to protect these key assets. If a local regime fails to offer proper protection it becomes very difficult to operate there. Underlying legal systems also shape other areas that are seen as part of the G in ESG, including issues such as anti-bribery and corruption measures, and tax responsibility.

Case study: Arm loses Chinese limb²

UK technology business Arm, a subsidiary of Japan's Softbank, attempted to fire the boss of its Chinese subsidiary in early 2020 in relation to alleged conflicts of interest. However, the individual refused to accept this decision and issued a formal denial when Arm made the firing public. Because this formal denial was stamped with the subsidiary's official chop – in effect the seal that makes documents official under Chinese law, it took precedence over Arm's statement.

While the individual retained control of the official company chop, he retained personal control over the subsidiary. Any process to address this would take several months; it might involve the police but typically Chinese police are unwilling to become involved in commercial disputes. Alternatively, the subsidiary might be re-registered at the State Administration for Market Regulation. At that point a new chop could be issued and the old one would no longer carry control. Neither route is straightforward nor quick.

"The system hurts the confidence of foreign investors," a lawyer told the FT in relation to the Arm situation.

² The 'chop' reigns in corporate China, Financial Times, July 1 2020

The very mechanisms of corporate and group structures rely on effective legal regimes. The basic lever for influence by shareholders is the investor vote (the right to vote against directors being an implicit lever in every discussion with board members, even when there is no actual vote immediately in prospect on the issue under discussion). Shareholder voting rights rest in the legal system of each company's incorporation (sometimes overlain by securities law requirements).

Similarly in other asset classes, basic routes for influence rest in the legal regime. Where bond covenants are put in place, their enforceability depends on the reliance that investors can place in the Rule of Law to deliver the result that they expect from the contractual agreement that they have reached. It is not by chance that the legal regime used for most of the documentation in the bond and derivative markets is either US or English law: these are seen as the legal systems where enforcement is most certain and reliable, as well as the legal systems that enable innovation in instruments and terms most effectively.

Furthermore, some of the basic parameters for investor rights are shaped by the legal system's understanding of property rights. The right of an owner not to have their property changed without having given permission drives a number of important rights, which may be in securities regulation or other standards but have their grounding in property law. These include the rights to vote on major transactions, and – a right that shareholders in some markets rate as particularly valuable – the votes on non-pre-emptive share issuances that mean investors must collectively give permission before their shareholdings are diluted by a share issuance.

Investors need to care not only about the legal system, and the Rule of Law that underlies it, of the parent company, but also the regime in place in relation to subsidiaries. This is amply demonstrated by the odd case of UK technology company Arm (by then itself a subsidiary of Japan's Softbank) apparently losing control of its Chinese subsidiary, discussed in the box.

Case study: Cyber vulnerability

The June 2017 NotPetya cyber-attack, which is generally seen as a malware attack rather than a ransom attempt, was according to western sources launched by Russian hackers. The principal target appeared to be Ukraine, both state and broader operators in the Ukrainian economy: ministries, banks, public transport and even the monitoring of the Chernobyl nuclear site were affected. However, the international impacts were if anything even greater; multinationals with operations in the Ukraine, including consumer goods company Reckitt Benckiser, transport giants FedEx and Maersk, food manufacturer Mondelez and pharma business Merck, among others, were severely affected. Each of those named faced damage to the tune of hundreds of millions of dollars. Total costs of the attack have been estimated at more than \$10 billion.

What is less known is the vector for the attack: an automated update of tax accounting software called MeDoc. This was used almost universally for calculating and submitting tax in Ukraine, because of a favourable deal from the government. It was installed at an

estimated 90% or more of businesses operating in Ukraine. Despite its robust financial position, the company had failed to update its servers for known vulnerabilities and so left the opportunity open for the hackers. Multinationals found themselves vulnerable simply by operating in a country whose Rule of Law protections did not prevent a favourable deal for an under-regulated company that failed to invest in appropriate cyber protections.

At the time of the NotPetya attack, Ukraine was ranked 130th out of 180 countries considered by Transparency International's Corruption Perception Index, with a very lowly rating of its anti-corruption measures, just 30 out of 100. Less than two years later, President Volodymyr Zelensky was elected after what was in part an anti-corruption campaign.

Rule of Law and real asset investments

Real assets – investments in property, infrastructure and agricultural land, among other things – are by their nature fixed in their location. That means that investors in them are tied to local rules and regulations, and many of these assets – particularly infrastructure, which is often the basis for fundamental public services – are often highly regulated. Further, foreign investment in some of these assets can be, or become, highly controversial and political. All these factors mean that the Rule of Law is of particular concern in relation to investment in real assets.

Yet real assets are coming to form increasingly large portions of many investor portfolios. Especially in our current low interest environment, they are seen as so-called bond proxies, providing secure contracted cashflows over long periods often at higher rates than bonds themselves, and with a solid asset backing. In addition, some real assets, notably renewable power generation infrastructure and, increasingly, agricultural land and forestry, are becoming more attractive to investors which are conscious of the climate challenge and are seeking to invest to mitigate carbon emissions.

Case study: Railtrack

Government expropriations of investor assets do not always occur in obscure markets. In 2001 the UK government decided to withdraw its financing of railway infrastructure business Railtrack – a plc listed on the London stock exchange – which promptly fell into administration. Most of Railtrack's assets were rapidly transferred to a new public body, Network Rail.

Private negotiations by institutional investors, and more public pressure through the court system from retail investors, ensured that the government felt obliged to pay some compensation for this expropriation. Payments helped mitigate the losses for all investors, but these were paid only because of the prospect that the government might lose legal challenges brought in response to their actions – they depended on the effectiveness of the Rule of Law.

However, these attractions, the solidity and certainty of the assets, and the reliability of those cashflows, depends wholly on the Rule of Law. The value of such assets arises from:

- i. The certainty of their cashflows; and
- ii. The security of property rights.

Without confidence in the Rule of Law, neither of these aspects will be worth much.

Investors will be seeking to understand the risk of expropriation, or the simple erosion of value through changes to the contractual certainty of the flows. This depends on the stability of nations and their political regimes, including that those certainties are not eroded by

simple changes of government – a basic expectation of the Rule of Law. And if the regulatory regime does change, it should do so not too suddenly and arbitrarily. Finally, should there be changes, investors may need confidence that they would receive appropriate compensation for any losses that they incurred.

Case study: Spanish solar generation

From 2007, Spain had been highly encouraging of investment into solar renewable power generation and had offered favourable terms. However, in 2010 it sought to overturn some of the generosity of those terms retrospectively as they appeared unaffordable following the financial crisis and in the light of the over-investment which had occurred.

Investors have pursued compensation for these changes through arbitration proceedings. For example, *Eiser Infrastructure and Energia Solar v Kingdom of Spain* (2017) found that the regulatory changes had been so dramatic that they had not been fair to investors and not given enough time for an appropriate response. This led to the conclusion that compensation was payable.

Governance in sovereign debt analysis

Any assessment of the G in ESG with regard to sovereign debt essentially comes down to an analysis of Rule of Law issues, at least on a broad understanding of the Rule of Law.

The application of detailed ESG analysis to sovereign debt investment is still relatively under-developed, even though it is often implicit in credit rating agency approaches and there are a number of publicly available tools from NGOs and international agencies, as well as provision from a few commercial rating firms. The commercial firms provide ratings across each of the elements of E, S and G. Some individual investment houses have also built their own internal rating systems.

Any of these sources of analysis should give some level of indication of the ESG characteristics of individual sovereign debt issuers and also of portfolios as a whole. Some asset owner clients may set minimum thresholds in the investment mandates that they give fund managers – perhaps excluding certain issuers because of their negative characteristics, or setting a floor for the ESG quality of the overall portfolio.

Depending on these mandates, fund managers may choose to invest in a way which favours more positive indicators across E, S or G. At its simplest, this might involve favouring issuance from sovereigns with better perceived ESG characteristics where the financials of the issues are otherwise the same, or closely comparable.

Case study: Mozambique tuna bond scandal

An example of where Rule of Law failures played a part in investor losses on sovereign bonds is the extraordinary tale of the so-called 'tuna bonds' issued by Mozambique in 2013. Credit Suisse and Russia's VTB arranged \$2 billion in bonds and loans for the impoverished African nation. In theory, this was to pay for the creation of a state tuna fishing fleet and to increase maritime security to protect newly-discovered offshore natural gas fields. US prosecutors allege that at least \$200 million of the funds raised funded bribes for Mozambican officials; other reports suggest that up to \$500 million is unaccounted for. The nation's legal and regulatory system was simply not robust enough to cope with this scale of money flow.

When it became apparent that there were problems with the bonds and the investments that they were supposed to be funding, some of the companies involved failed, debt was defaulted on and investor money evaporated. Worse, the country faced a financial crisis as donors cut off aid – perhaps plunging nearly 2 million additional Mozambicans into poverty. Nine years on, Credit Suisse has paid multi-million dollar fines to various regulators, and forgiven \$200 million in debt owed by the country. Three of its former bankers pleaded guilty to arranging bribes.

VTB has not been charged with any criminal conduct, though it has paid a small fine in relation to negligent disclosures in relation to a later restructuring of the tuna bonds.

Focusing on the G element of this ESG analysis reveals that governance, in regard to sovereign debt, involves an assessment of Rule of Law. How explicit this assessment is largely depends on how broadly the definition of Rule of Law is drawn; for example, the World Bank’s World Governance Indicators³ include Rule of Law explicitly as one of the six dimensions of their assessment. However, since the other five are Voice and Accountability, Political Stability and Absence of Violence/Terrorism, Government Effectiveness, Regulatory Quality and Control of Corruption, a broader definition of Rule of Law would encompass essentially the whole of the assessment.

Another example is the MSCI breakdown of the Governance ‘pillar’ of its ESG analysis for Sovereign Issuers is typical (see box). The Principles for Responsible Investment’s Practical Guide to ESG integration in Sovereign Debt⁴ explicitly references Rule of Law as a key factor in governance analysis – though it seems to apply a much narrower definition than usual, and Rule of Law issues appear embedded within many of the other categories considered under other stated governance factors.

MSCI breakdown of Governance pillar for Sovereign Issuers

Risk Factor	Sub-factors (Exposure)	Sub-factors (Management)
Financial Governance	Financial Capital	Financial Management
Political Governance	Institutions	Political rights and civil liberties
	Judicial and penal system	Corruption control
	Governance effectiveness	Stability and peace

³ <https://info.worldbank.org/governance/wgi/>, with data from 1996-2020

⁴ See <https://www.unpri.org/download?ac=9696>

Embedding Rule of Law in ESG programmes

Clarity of and confidence in the Rule of Law provides a more solid foundation for investors' work in relation to ESG. Having Rule of Law in place provides a firmer base for sovereign debt investment and for investments in real assets. It also enables fuller dialogues with companies on environmental, social and governance issues by providing a framework and backing that helps support companies in effectively delivering their ESG programmes and making improvements over time.

As well as discussing this opportunity for investor stewardship and actions by companies, this section also identifies some of the key potential sources of insight into the Rule of Law that might be useful tools for investors, in a series of three boxes. These three are in addition to the World Bank's World Governance Indicators, which have already been discussed.

Long-term investors have an interest in enhancing the regulatory frameworks of the countries and markets in which they invest, and in addressing the systemic risk that their investments face. This is perhaps made most explicit in Principle 4 of the UK Stewardship Code 2020, which calls on signatories to "identify and respond to market-wide and systemic risks to promote a well-functioning financial system".

Already 125 investors, responsible for £20 trillion in assets, are deemed by the FRC to meet the threshold as signatories of the Code (of the 189 which applied for signatory status) and a further 100 have since applied. In a recent reflection on the first year of reporting against the Code, and highlighting areas for improvement for next year, the FRC highlighted Principle 4 as an area for particular focus, saying: "Investors in the UK are entrusted to look after more than £6.1 trillion in private pensions, and with that comes the responsibility and opportunity to work with others to improve how markets function and anticipate significant risks to the markets and systems in which they operate."

The FRC went on to say: "By addressing market-wide and systemic risks and opportunities, investors can simultaneously improve the stability of portfolio investments and broader market systems." It is clear that efforts with regard to supporting and enhancing the Rule of Law would fall into this category.

Not only would efforts by investors to underpin and enhance the Rule of Law across the nations in which they invest funds support them in delivering Principle 4 of the Stewardship Code, but also work with investee companies to understand their concerns about gaps in the Rule of Law in markets in which they operate could significantly enrich ESG engagement dialogues. This could help provide further investment insights and opportunities for good stewardship.

There are four areas in which Rule of Law is likely to be relevant to ESG programmes:

- i. In the dialogue between asset owners and fund managers, holding them to account for delivery of high quality ESG;

- ii. In the integration of ESG factors into equity and debt investment processes, and in the stewardship dialogue between investors and companies in which they invest, either through equity or debt instruments;
- iii. In the integration of ESG factors into real asset investment processes, and in the stewardship dialogue between investors and those responsible for real assets in which they invest; and
- iv. In the integration of ESG factors into sovereign debt investment processes, and in the stewardship dialogue between investors and sovereign debt issuers.

Each of these is considered in turn below.

Case study: Collaborating to enhance the Rule of Law: the Voluntary Principles⁵

Dating from 2000, the Voluntary Principles on Security and Human Rights (usually referred to as the Voluntary Principles) arose from a collaboration between companies in the mining industry, host and other governments, and concerned NGOs. The Voluntary Principles provide a framework for companies to work with both public security authorities and private security providers. The aim is to promote the application of high human rights standards in each party's interactions with local communities. The Voluntary Principles include such fundamental expectations under the Rule of Law as: 'The type of forces deployed should be proportional to the threat', 'Force is used only when necessary' and 'Allegations of human rights abuses should be reported'. By creating a basic set of standards agreed across the major players in industry, companies have been able to heighten expectations, and signatories to the Voluntary Principles place themselves in a stronger position to insist on appropriate behaviour from public security forces.

Investors have also been almost universally supportive of the Voluntary Principles, recognising the way in which they provide a basis for companies to work with local public bodies to ensure that appropriate human rights standards are applied in practice. The risks of abuse of local communities is reduced, as are the risks to corporate reputations and their licence to operate.

Dialogue between asset owners and fund managers

Of the 125 successful signatories of the Stewardship Code so far, more than 20 are asset owners, which will invest indirectly through fund managers. Their stewardship activities are therefore typically focused on holding their fund managers to account for effective delivery on their behalf. While a few asset owners may address some Principle 4 regulatory and systemic issues themselves, in most cases they will seek to ensure that their fund managers are actively focusing on systemic matters and mounting efforts that both protect value and seek to drive change.

⁵ www.voluntaryprinciples.org

Asset owners could appropriately reflect on the Rule of Law as an area to explore with managers and to challenge them on as part of their ongoing assessments of how effective those managers are at addressing ESG factors in their investment and stewardship approaches, particularly as part of a focus on systemic risk issues. Building expectations with regard to integration of Rule of Law assessments into the investment process or into stewardship activities into the investment mandates that asset owners sign with their fund managers could be a powerful way of ensuring greater activity in these regards. Even without this, greater focus in the monitoring and expected reporting from managers could have salutary effects.

ESG integration for equity and debt, and stewardship dialogue between investors and investee companies

Given that Rule of Law underpins so much in the way of delivery by companies in terms of effective management of ESG issues, it is a fertile area for active assessment as part of the investment process, and for the ongoing dialogue between investors and their investee companies. Exploring which countries a company is exposed to, either in terms of direct operations or through its supply chain, may reveal risk exposures that investors had not previously considered.

Investors could use stewardship discussions to encourage companies to consider with care their different exposures to particular countries and whether the Rule of Law challenges in some of those markets make those exposures fundamentally unattractive, or more expensive. Perhaps investors could also explore the ways in which they could support companies to seek enhancements to Rule of Law protections for the business and its stakeholders, helping them to preserve and enhance value over time.

Sometimes companies will also decide it is prudent to protect themselves from local Rule of Law issues by pricing in the heightened risk, taking out political risk insurance, privately contracting under a different law and legal system (typically either English or US law applied in UK or US courts or international arbitration), or by relying on investment treaty protections. This may protect the interests of the company and its shareholders (at least as regards their position as shareholders in the company; their broader investments may face other risks and exposures) but does nothing to enhance local Rule of Law. Again, investors might choose to explore ways in which they could support companies to seek enhancements to Rule of Law protections under the local system, helping to enhance economic life in the country over time and potentially generating greater value opportunities.

ESG integration for real asset investment, and stewardship dialogue between investors and those responsible for real asset investments

Security of the cashflows from real assets, and the solidity of the property ownership that they represent, are key elements of the attraction of these investments. Rule of Law underpins this fully and so needs to be embedded within any investment decision-making processes, such that investors have comfort that they will get the returns that they believe

they are due – or will be compensated should the cashflows (or property ownership) be changed.

Very often real assets operate within tightly regulated businesses. Investors will seek confidence that the regulatory regime is robust, independent of government and business rival influence, and that any regulatory decision-making will not be arbitrary and unfair. Where appropriate, investors may mount stewardship efforts to help support the robustness of the regulatory framework and help ensure that it remains fair and reliable.

ESG integration for sovereign debt investment, and stewardship dialogue between investors and sovereign debt issuers

There are various commercial ratings available on the ESG characteristics of sovereign debt issuers, and many fund managers have also constructed their own models for such assessments, often using the publicly available assessments of countries by NGOs or international agencies. These enable a fuller integration of ESG factors into sovereign wealth investment processes. Most implicitly include significant elements of Rule of Law characteristics, particularly within the G assessment – and often where Rule of Law is explicit in the assessment, it is based on a narrow understanding of the term. Greater focus on Rule of Law might make the issue more clearly a matter for focus in the investment decision-making process, and so also a more explicit element of dialogue between investors and sovereign debt issuers.

The credit ratings agencies (the market is dominated by Standard & Poors, Moody's and Fitch) play a major role in facilitating investor understanding of the creditworthiness of issuers and of the risks of debt investments, including sovereign debt. These firms' sovereign debt ratings typically include assessments of key elements of Rule of Law. Investors might wish to explore whether they believe that these issues are given due weight in the firms' ratings, and made sufficiently explicit in how risks are articulated to the market, as well as reflected back to issuers (a process that can often be influential on government policies).

While most dialogue between investors and sovereign debt issuers is on the timing of issuance, and on inflation-linked characteristics (for example there has been much debate over the switch from RPI to CPI linkage in the UK), there is some increasing appetite among investors to consider engaging with sovereign issuers on ESG issues more specifically. Perhaps the most prominent such dialogue thus far has been the work of a group of 29 investors with assets of around US\$3.7tn (£2.6tn) to encourage the Brazilian government to do more to limit the destruction of the Amazon rainforest. Having also had contact through the Brazilian embassies in their home nations, the group wrote to the government in June 2020 noting among other things that "Brazilian sovereign bonds are also likely to be deemed high risk if deforestation continues".

Given the link between Rule of Law and broader economic prosperity, engagement to encourage enhancement of the Rule of Law in particular countries could form a powerful additional element of investors' engagement approach.

In the **Practical question-bank** section that follows we offer a series of key questions which might form part of each of these dialogues.

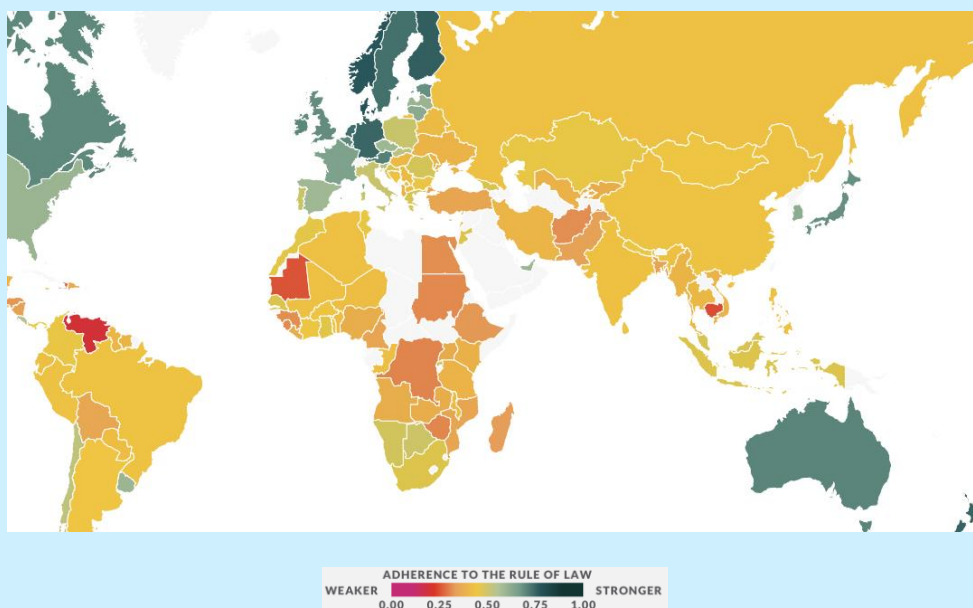
Sources of Insight

(1) World Justice Project Rule of Law Index⁶

Running for more than a dozen years, the WJP Rule of Law index is a global insight into the way in which most nations approach rule of law issues. It covers most countries active in international bond markets, and for almost all has series data providing insight into progress or decline in the rule of law in the country. Based on a survey of ordinary people in each country, supplemented by the views of local experts, it provides genuine insight into how citizens experience rule of law on the ground.

It is a very broad-based survey, covering rights to information on government activity, the timeliness of criminal justice and guarantees on freedom of belief and religion, as well as more business-facing issues such as the effectiveness of civil justice systems and regulatory enforcement. This breadth may mean that the signals from the overall rating may be less informative for investors than those from particular factors, such as Factor 6, Regulatory Enforcement – particularly given how regulation underpins countries' delivery against E and S factors, as discussed. We understand that WJP is working towards also releasing information on individual sub-factors (perhaps from 2022), and there may be helpful insights for investors in the disclosure of some of these, such as perhaps sub-factor 1.3 'Government powers are effectively limited by independent auditing and review' and 1.2 'Government powers are effectively limited by the judiciary'.

Image: Results for Factor 6 Regulatory Enforcement



⁶ <https://worldjusticeproject.org/rule-of-law-index/>

(2) Transparency International Corruption Perceptions Index⁷

Dating back to 1995, Transparency International's Corruption Perception Index sets out the extent to which business-people and experts believe countries to suffer from public sector corruption. The rating of some 180 countries on a scale of zero (highly corrupt) to 100 (very clean) reveals more than two-thirds of countries scoring below 50 – and the last index showed an average score of 43. "The data shows that despite some progress, most countries still fail to tackle corruption effectively," Transparency International says.

Ti also produces 'barometers', based on the experience of ordinary people – since 2003 on a global basis, and more recently in more detailed regional versions. Thousands of individuals are surveyed to uncover their views on corruption, and their experience of corruption on the ground. These reports highlight how frequently ordinary people feel obliged to pay bribes to get basic government services, and how often they have been offered a bribe in return for their vote. The surveys also reveal the degree of scepticism about the relationships between governments and the business sector.

(3) World Bank Ease of Doing Business Index⁸

The Doing Business survey was a flagship publication and data provision from 2003 to 2020. It represents a comprehensive view of the ease with which businesses can be started and operated in 190 countries of the world. Doing Business covers 12 areas of business regulation, 10 of which are included in the national Ease of Doing Business score and index. The two aspects that are not included in both are regulation on employing workers and contracting with the government.

Some aspects of the Doing Business analysis are of less interest to those considering Rule of Law, particularly from a large business perspective – such as starting a business, getting electricity and getting credit. But, in addition to the two elements included in Doing Business but not in the Ease of Doing Business Index, others are crucial to an understanding of Rule of Law in practice. These include enforcing contracts, protecting minority investors and resolving insolvency. Some aspects of registering property and dealing with construction permits will also be of importance. The data is released in various helpfully disaggregated forms, enabling investors to gain insights in the areas of particular importance to them.

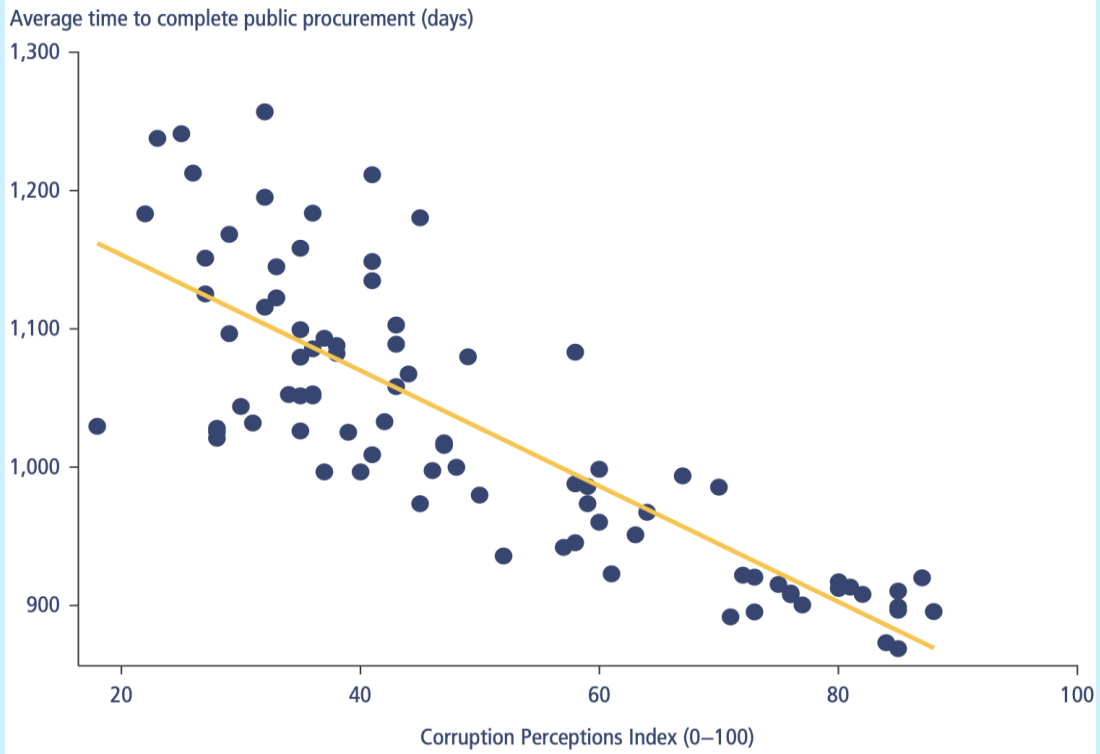
The World Bank announced in September 2021 that it would discontinue the Ease of Doing Business index because of certain data irregularities and ethical issues around the conduct of officials and staff. It says it is committed to developing a new approach to assessing the business and investment climate in countries around the world. Whatever this may look like could be a useful substitute for the Ease of Doing Business Index – but it is also possible that another (perhaps private sector) organisation will pick up the ease of doing business model and produces something equivalent going forwards. In the meantime, the data

⁷ transparency.org/en/cpi/

⁸ doingbusiness.org

irregularities in the 2020 report have apparently been corrected, and the Index and its time series data provide helpful insights.

FIGURE 5.4 Faster public procurement processes are associated with higher overall levels of transparency



Sources: *Doing Business* database; Transparency International data (<https://www.transparency.org/cpi2018>).

Practical question-bank

A selection of questions to help start positive conversations on the issues raised in this paper.

Questions from asset owners to their fund managers

Which countries, if any, would you avoid investing in because of Rule of Law concerns? If none, why not? Why do you believe that you have sufficient protection for your investments in the absence of confidence in the Rule of Law?

How do you integrate Rule of Law considerations into your investment decision-making? What characteristics of a company or of the markets in which it operates (or which form part of its supply chain) would give you greatest concern from a Rule of Law perspective?

We note your increased exposure over the period to investments in [country XXX]. What due diligence have you done to be confident that the Rule of Law is sufficiently in place in that country for you to be assured of the returns you hope for from those investments?

How do you integrate Rule of Law considerations into your stewardship activities, either in terms of activities to deliver against Principle 4 of the UK Stewardship Code 2020 or in your dialogues with investee companies?

What are you doing to help ensure a fair playing field for companies that are seeking to maintain high ESG standards across their activities and supply chains, so that they are not undercut by less scrupulous competitors? How do you avoid investing in those less scrupulous competitors?

Which countries in which you invest, either in sovereign debt or real assets – or indirectly through companies or other investments – give you greatest concerns about the risk of expropriation of assets or erosion of value through changes to rules and protections for investments? Where do you see the foundations for company ESG programmes being weakest in terms of regulation and its enforcement?

Questions from investors to investee companies

Which countries, if any, would you avoid investing in or working with suppliers from because of Rule of Law concerns? If none, why not? Why do you believe that you have sufficient protection for your investments and stakeholders in the absence of confidence in the Rule of Law?

Which countries do you operate in where you are most concerned about your ability to rely on the legal system to enforce your rights?

Are you confident about your ability to repatriate cash from your operations in [country YYY]?

Where do you see legal and regulatory frameworks eroding that you believe may be a cause for concern in future years?

Which countries do you operate in where you are most concerned about the extent to which the law allows others to outcompete on the basis of treating stakeholders less well than you believe is appropriate for your business?

What do you do to reinforce the legal and regulatory regimes in those markets? How could we support those efforts?

Which countries do you operate in where you seek to insulate yourself from local Rule of Law issues through increased pricing, insurance, use of extraterritorial law and jurisdiction clauses in contracts or investment treaty protections? Should we be concerned about the robustness and long-term health of those economies? What might we collectively do to build more confidence in local Rule of Law?

Questions from investors regarding real asset investments

How can we be confident that the contracted cashflows from the asset(s) will actually be paid on time? If they are not, to what extent can we rely on the legal system to enforce our rights?

Can we be sure that the asset(s) will not be expropriated, or that at least appropriate compensation will be paid if something happens to the asset(s)? To what extent can we rely on the legal system to enforce our rights?

Questions from investors for sovereign debt issuers

How can we be confident that the bond cashflows and principal will actually be paid on time? If they are not, to what extent can we rely on the legal system to enforce our rights?

To what extent is business life and economic activity in your country underpinned by a robust approach to the Rule of Law? If the Rule of Law is not as robust in your country as it might be, what is the economic drag as a result? If you enhanced Rule of Law, wouldn't economic activity increase and your ability to finance your debt improve – leading to a lower cost of funding?

By how much would your tax revenues increase were the informal sector moved more into the formal side of the economy? How much of a factor in economic activity occurring in the informal sector is issues with the Rule of Law in your country?

Questions from investors to credit rating agencies

To what extent do you factor in Rule of Law issues to your credit ratings? Is this enough to reflect the importance of Rule of Law both to confidence that the issuer will pay and/or our rights are enforceable, and to the robustness of wider economic life in the country?

Questions from board directors to executive management

Which countries do we operate in where it is most difficult to work according to the standards we aspire to? What can we do to address this and alleviate any risks that arise, reputational or otherwise?

What countries are we exposed to through our supply chains where the standards are lower than we might expect? What can we do to address this and alleviate any risks that arise, reputational or otherwise?

What frameworks can we choose to apply in those countries to ensure that we are living up to the standards that we believe are necessary? Who else should we work with to build such frameworks if they do not exist?

Are our pay and incentive structures right in markets where there is a high perception of corruption risk? How can we be confident that our staff will not be tempted to behave inappropriately?

Are there any particular cyber security issues that arise from our operations in individual countries? Could our protections be enhanced by better regulations or other standards, and heightened enforcement? What could we do to support such steps?

Which of our shareholders do we trust to support us in engaging with the relevant government in seeking to address [a particular] Rule of Law issue?

What is the Bingham Centre?

The Bingham Centre is an independent, non-partisan organisation that exists to advance the Rule of Law worldwide.

Established in 2010 as part of the British Institute of International and Comparative Law (BIICL), the Bingham Centre was brought into being to advance the Rule of Law globally. Its name honors the career of Lord Bingham of Cornhill KG, Senior Law Lord and the pre-eminent UK judge his generation. The Centre pursues Lord Bingham's inspiring vision: a world in which every society is governed by the Rule of Law "in the interests of good government and peace at home and in the world at large".

- i. We make strategic, impartial contributions to policy-making, lawmaking or decision-making in order to defend and advance the Rule of Law, making practical research-based recommendations and proposals.
- ii. We carry out independent, rigorous and high quality research and analysis of the most significant Rule of Law issues of the day.
- iii. We hold events such as lectures, conferences, roundtables, seminars and webinars, to stimulate, inform and shape debate about the Rule of Law as a practical concept amongst lawmakers, policymakers, decision-makers and the wider public.
- iv. We build Rule of Law capacity in a variety of ways, including by providing training, guidance, expert technical assistance, and cultivating Rule of Law leadership.
- v. We contribute to the building and sustaining of an international Rule of Law community

The Bingham Centre's Business Network is comprised of leading companies who understand the importance of the Rule of Law to business. Founded on the understanding that the collective voice is stronger than a single corporate voice, the Network allows members to work collaboratively to defend and promote the Rule of Law through participation in research, events and capacity building initiatives.

Launched in 2017, the Business Network aims to build understanding around the concrete Rule of Law challenges that confront business by providing a forum for members to identify and exchange learning on issues in their jurisdictions of operation. Issues identified by members inform the programme of research undertaken by the Bingham Centre and BIICL. This helps to ensure that research and related activities address issues that businesses themselves regard as the most pressing priorities.

Current members of the Business Network include Anglo American, BP, BT Group, Diageo, HSBC, Nestlé, Rolls-Royce, Shell International and Vodafone.

Further background reading

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