A LEGAL FRAMEWORK FOR IMPACT

Sustainability impact in investor decision-making

Freshfields Bruckhaus Deringer

generation foundation

CONTENTS

1. What is investing for sustainability impact?
2. Investing for sustainability impact: goal certainty, assessment of impact and understanding an investor's contribution
3. What portion of global assets under management is currently subject to investment approaches involving investing for sustainability impact?
4. In what ways do people want their assets invested to bring about sustainability impacts?

1. Methodology
2. Investing for sustainability impact: different legal regimes but common themes
3. Investing for sustainability impact in eleven jurisdictions – summary of findings
4. Do existing market features create a risk that sustainability factors are given insufficient weight by investors in complying with legal duties?

1. Potential impediments to investing for sustainability impact investment approaches
2. Reform options

- Australia
- Brazil
- Canada
- China
- European Union
- France
- Japan
- Netherlands
- South Africa
- United Kingdom
- United States

FOREWORDS

The Generation Foundation

Al Gore and David Blood

When we founded Generation Investment Management in 2004, the concept of sustainable investing was widely considered an admirable but fringe approach. Now, 17 years later, sustainable investing has not only become mainstream, but is recognised as a mark of prudent investment practice. Pioneering analyses like the 'Freshfields report' in 2005, and Fiduciary Duty in the 21st Century helped drive this transition by challenging accepted wisdom about investors' duties and helping them re-envision their roles. And in the intervening years, environmental, social and governance issues have introduced both new risks and new opportunities across investors' portfolios, awakening many to the material costs of failing to incorporate these values, as well as the prospects for using ESG analysis to better identify new, fast-growing business trends.

Yet, too many investors still approach ESG investing from a defensive posture. We consider that risk management alone is not enough. Investors should make decisions on the basis of risk, return and impact in order to take full advantage of the opportunities provided by what we call the Sustainability Revolution.

This first-of-its-kind report, commissioned by The Generation Foundation, PRI and UNEP FI, considers the role of the investor as an active agent in shaping the world around us, rather than as a spectator betting on the side lines. This detailed, global legal analysis demonstrates that investors should feel empowered to set impact goals and measure progress against them. It also highlights what must change to ensure that the rules that govern our financial system foster a truly sustainable economy.

We hope that investors, intermediaries, policymakers and regulators will read this report as a call to action to build a better financial system. We do not have another 17 years to wait.

FOREWORDS

United Nations Environment Programme (UNEP)

Inger Andersen

The Sustainable Development Goals and the Paris Climate Agreement are our best chance for not only a livable but also a brighter future. Reaching these goals requires an updated financial system that is fit for purpose – one in which assessing and accounting for the sustainability impact of investment decision-making is a core part of investment activity. This groundbreaking report provides a much-needed roadmap.

To date, despite significant advances, capital markets continue to operate beyond sustainability boundaries. It is clear that we need to change. The science cannot be disputed. Business-as-usual is having a devastating impact by propelling climate change, destroying nature, and raising pollution levels. The triple planetary crisis is not only being exacerbated by inequality, but it is also likely to further deepen inequality. At the same time, we are seeing a rapid awakening in some segments of society, and in particular among young people, demanding better from business and government. Capital markets must treat all these risks as the serious, systemic risks that they are.

Investing and collaborating for sustainability impact is no longer optional. It is essential for financial stability, for managing systemic risks, and for protecting the world for our children. It is now clear that investors can and must consider how these issues affect their goals and their impact on the real world.

This report offers a blueprint for how to better align the provision of finance with sustainability objectives, looking at existing opportunities and obstacles.

Taking account of the vast regulatory landscape, this report identifies areas of reform to foster a more supportive environment for investors to integrate impact into investment decision-making. For capital markets to significantly help solve the big societal issues we face requires regulatory frameworks that move beyond merely integrating ESG issues where they are financially material, towards more effective integration of sustainability impact. This requires determined and collective action from investors, policymakers and regulators, unified in the journey to achieving the goals of the Paris Agreement and the SDGs.

As stewards of the common good, it is vital that all actors steer our world onto a more sustainable path. A Legal Framework for Impact highlights paths forward to strengthen the financial system so that impact is systematically managed by all investors – a pre-requisite for meeting our sustainability goals. The health of people and planet, as well as of investments across the world, depend on investors and policymakers engaging with the issues addressed in this report.

FOREWORDS

Principles for Responsible Investment (PRI)

Fiona Reynolds

Responsible investment has come a long way over the past few decades as investors have started to recognise the importance of ESG issues to their investment decisions. This has been driven in large part by the Freshfields report of 2005 which concluded that investors are permitted and arguably required to integrate ESG factors into their analysis, and the subsequent UNEP FI, PRI and Generation Foundation programme: *Fiduciary Duty in the 21st Century*, which determined that ESG factors must be considered for investors to meet their fiduciary duties.

Today investors are starting to look beyond the impacts of ESG risks on their portfolios to understand the impacts their portfolios have on the real world around them—the world their beneficiaries live in and will ultimately retire into. They are beginning to assess, measure and manage the real-world sustainability outcomes of their investment activities.

As it currently stands, many investors still do not systematically consider their role in shaping sustainability outcomes. But this mode of operating, without considering the positive and negative impacts of investments on people and the planet, will not be sufficient for a sustainable economy. A gap has emerged in the ways of working we need in responsible investment to minimise harms and deliver on increasingly urgent environmental and social needs.

The Legal Framework for Impact project was launched by PRI, UNEP FI and The Generation Foundation to address this gap. This groundbreaking report shows how investing for sustainability impact is relevant for all investors, and that they will likely have an obligation to consider doing so where it can help in pursuing their financial objectives. It lays the foundation for the financial policy reforms we need to reorient investors and, through them, markets and economies towards net zero and inclusive, sustainable economic growth.

The clock is ticking on our opportunity to achieve the Sustainable Development Goals and align with the Paris Agreement and it is clear that we need to move faster and go further. PRI, UNEP FI and The Generation Foundation are launching a 3-year work programme to translate the findings of the report into jurisdiction-specific engagement with policymakers, lawyers and investors on investing for sustainability impact, so we can work together to accelerate change.

A paradigm shift towards investing for sustainability impact is upon us. This is a new frontier that we must navigate together.

FOREWORDS

Freshfields Bruckhaus Deringer LLP

Georgia Dawson and Edward Braham

We are proud to have been asked to produce this report, in collaboration with firms in our Stronger*Together* network. The report addresses the pressing issue of how far institutional investors are legally required or permitted to invest for sustainability impact, covering the world's major investment hubs.

The report sets out the law as it stands and indicates the direction of travel around the world. It also lays out policy options that facilitate investing for sustainability impact. It should therefore help investors, business leaders and policymakers.

The firm's 2005 report on institutional investor duties for the UNEP FI has been highly influential in sustainable finance practice and regulation around the world. It also affected the firm's own thinking and contributed to our decision in 2007 to be carbon neutral, a key milestone towards the larger goal of net zero and delivering on broader sustainability goals.

More than fifteen years on, with global society increasingly appreciating the importance of sustainability issues and their interdependence with finance and economic activity, the questions addressed in this report have never been more urgent. We hope that this report contributes to a brighter future for the world.

INTRODUCTION

This report is about achieving the goals we value. It is about how institutional investment management can help with that, and it is about how the law supports the process.

The goal most associated with institutional investment management is earning a financial return. People and organisations depend on institutional investors to generate the finance they need to sustain themselves. Earning a financial return is a valued goal.

But earning money is obviously not the only goal we have for our lives or for our world. It exists alongside broader goals concerning the quality of the social and natural environment we inhabit, or at least its sustainability. These too are valued goals.

There may have been a time when it was possible to approach the goal of earning a financial return largely in isolation from the others. In reality, however, financial and economic systems are part of wider social and natural ecosystems, the health of which is vital to broader goals. Financial and economic systems can help these ecosystems flourish, particularly in their social dimension. However, they also depend upon and can adversely affect them. They can both strengthen and undermine the systems on which they rely.

The impact of laws on how people behave depends, among other things, on what those laws say, but also how they are understood and followed in practice. Both are affected by prevailing beliefs about the way things are. If it has been assumed that investment could be approached as no more than an exercise in generating financial return, detached from its social and natural environment, then it is not surprising if laws and the way they have been understood have reflected that.[1]

But if it was once possible to approach the goal of earning a financial return in isolation from other valued goals, that time is not now. The interdependence between financial and economic activity and the systems on which it relies – and on which achieving broader goals depend – is ever clearer.

Because of that, there has been an increasing focus on the financial community as a source of solutions and on the question of whether finance law needs to change to achieve sustainability-related goals. At least in part, that question needs to be answered through political processes. The challenges are systemic, and finance is part of the system, so clearly finance has a role. However, solutions also involve looking more widely at consumption and production activities and facing questions of inter-generational and inter-group justice.

It is therefore not the purpose of this report to answer the question of what *ought* to happen. Rather, the report looks at 11 jurisdictions that represent a cross-section of investment hubs, cultures and legal traditions, including the world's largest centres of investment management. It asks whether the law as it stands in those jurisdictions requires or permits institutional investors, specifically pension and mutual funds and insurers and their investment managers, to tackle sustainability challenges in discharging their legal duties and exercising their discretions: does the law do so in order to enable them to realise a financial return, and does it do so in a way that allows them to treat resolving some sustainability challenges as an end in itself? This is, essentially, what is meant in this report by 'investing for sustainability impact'. To the extent the law does not require or permit that, and to the extent the political processes mentioned above determine that it should, the report also looks at what options might be available to policymakers.

The report is, then, in three parts following the executive summary.

- Part A looks at what investing for sustainability impact is, how extensive it is and growing evidence that people want their money managed so as to have positive sustainability impacts.
- Part B addresses the question of whether the law in the jurisdictions covered requires or permits investing for sustainability impact, considering both the 'black letter' of the law and circumstances that are relevant to the way in which it is applied.
- Part C discusses options available to policymakers to facilitate investing for sustainability impact.

As well as focusing on the goals investors are required or permitted to pursue, a key theme in this report is cooperation. Many sustainability challenges are essentially the result of problems caused by multiple actors and require collective action to resolve them. The outcome of a collective action is the product of a multitude of individual acts. However, those acts are not atomised. They are trained on a common goal. In investment markets, one way of achieving this sort of coordination is through investor coalitions. Policy intervention is another.

1 Mark Carney, *Value(s): Building a Better World for All* (William Collins 2021); David Rouch, *The Social Licence For Financial Markets: Reaching For The End And Why It Counts* (Palgrave Macmillan 2020).

INTRODUCTION

In a sense much has changed and yet little has changed since we started writing this report. The sustainable finance landscape has developed at dizzying speed, with a host of sustainability-related initiatives and commitments from major financial institutions, and an acceleration of work among governments and NGOs. Much of it is relevant to this report and is mentioned in it. We had to hit a moving target. And yet, the underlying sustainability challenges remain, and in some cases are growing. The questions addressed by this report are therefore as pressing as ever.

We are enormously grateful to the considerable number of people who have contributed to providing answers, both the jurisdictional legal teams in our offices and the members of our Stronger*Together* network who have prepared the legal memoranda in the annexes and all of those who have commented on and helped in drafting it, whose names are included in the acknowledgements that follow. We would especially like to thank Philip Richards, Annabel Sykes and Mark Kalderon for invaluable assistance and challenge and the core team who have supported the work: Emma Rachmaninov, Shona Hughes-Daly, Olivia Carrington, Gabriela Rocha Gomes Strieder and Angela Evans. We are grateful to our clients, the UNEP FI, the PRI and the Generation Foundation for asking us to prepare the report and to the partners of Freshfields Bruckhaus Deringer LLP for having made such a generous commitment to it and given us the opportunity to undertake this important work on their behalf.

The concern of this report is a collective global challenge and, appropriately enough, meeting the challenge of preparing it, particularly during the Covid-19 pandemic, has been very much a collective global exercise.

David Rouch and Juliane Hilf

July 2021

ACKNOWLEDGEMENTS

We are grateful for the support and assistance of experienced industry leaders in a variety of jurisdictions, senior representatives of leading financial institutions and NGOs with expertise on a broad range of relevant subject areas and relevant jurisdictions. Their insights have been invaluable. We would like to thank:

Jesica Andrews, Julie Ansidei, David Atkin, Elise Attal, Clara Barby, Stephen Beer, David Blood, Nicole Bradford, Vanessa Casano, Jeremy Cooke, Xander den Uyl, Grace Eddy, Maria Elena Anker, Rebecca Elliott, Joanne Etherton, Nathan Fabian, David Farrar, Gerard Fehrenbach, Elodie Feller, Jess Foulds, Rob Gardner, Michael Garland, Sean Gilbert, Esther Gilmore, Jeffery Gordon, Al Gore, Iris H Chiu, Gregory Hershman, Oliver Hunt, Daniel Jackson, Carlos Joly, Martin Jonasson, Ryan Klausing, Libby Klein, Kelly Krauter, Claudia Kruse, Laxmi Kumar, Richard Lacaille, Ben Leblique, Steve Lydenberg, Susan Mac Cormac, Mark Manning, Alexander Marshall, Will Martindale, Edward Mason, Mike McCreless, Hiro Mizuno, Renosi Mokate, Olivia Mooney, Robert Nash, Alina Neculae, Chris Newton, Geoff Nicholas, Stuart O'Brien, Colleen Orr, Alison Paton, Margarita Pirovska, David Pollard QC, Rema Rajeswaran, Fiona Reynolds, Jake Reynolds, Philip Richards, Simon Rowse, Lesley Russell, Elsa Savourey, Keith Scott, Omar Selim, Marcelo Seraphim, Kazuyuki Shigemoto, Annabel Sykes, Di Tang, Tom Tayler, Montgomery Taylor, Tara Tilbury, Michael Torrance, Roger Unwin, Eric Usher, Margaret Wachenfeld, Steve Waygood, Kong Wei, Shelagh Whitley, Clare Wilkinson and Daniel Wiseman.

At Freshfields, we would like to thank Olivia Carrington, Jonas Dereje, Oliver Dudok van Heel, Angela Evans, Gabriela Rocha Gomes Strieder, Shona Hughes-Daly, Mark Kalderon, Daniel Klingenbrunn, Geoff Nicholas and Christopher Simpson.

We are also very grateful to the specialist authors of the jurisdictional reports.

Jurisdiction	Firm	Authors
Australia	Corrs Chambers Westgarth	Anton Bobenko, Michael Chaaya, William Chaffey, Kon Mellos, James Whittaker and Phoebe Wynn-Pope
Brazil	Mattos Filho	Flávio Barbosa Lugão, Fernanda Basaglia Teodoro, Tábata Boccanera Guerra de Oliveira, Vitória de Assis Pacheco Morais, Gabriel de Freitas Queiroz, Eduardo Cezar Delgado de Andrade, Anália Cristina Ferreira Brum, Júlio Figueiró Melo, Renata Fonseca Zuccolo Giannella, Juliana Furini de Vasconcellos Puntel, Juliana Gomes Ramalho Monteiro, Luis Eduardo Kussarev Al-Contar, Ary Oswaldo Mattos Filho, Maria Luiza Miranda Geraldi, Vinícius Paula Castro, Lina Pimentel Garcia, Isabela Sartori, Bárbara Gabriel de Vasconcelos Silveira, Marcela Venturini Diorio and Gabriel Zampieri Ferreira Batista
Canada	Stikeman Elliott LLP	Nicholas Badeen, Stuart S. Carruthers, Christopher D. Lofft, Stewart Sutcliffe and Natasha vandenHoven, with thanks to Sagar Darar and Alexandra Ghelerter
China	Freshfields Bruckhaus Deringer LLP	Amber Liu, Yuxin Shen and Wang Zhe
EU	Freshfields Bruckhaus Deringer LLP	Markus Benzing, Wessel Heukamp, David Jansen, Daniel Klingenbrunn, Jadwiga Loiko, Bastian Schuster and David Schwintowski
France	Freshfields Bruckhaus Deringer LLP	Marc Perrone
Japan	Kanagawa International Law Office	Shinsuke Kobayashi
Netherlands	Freshfields Bruckhaus Deringer LLP	Marit Balkema, Michael Broeders, Igor Dovgaliouk, Hakan Gargili, Charlotte Kriekaard, Maxine Lemstra, Sharon Sloof, Barbara Slooter and Marco Vogels
South Africa	Bowmans	Carmen Bradfield, David Geral, Richard Griffin, Ryan Kitcat, Wandisile Mandlana, Deirdre Phillips, Christine Rodrigues, Kirsten Serrurier and Bright Tibane
United Kingdom	Freshfields Bruckhaus Deringer LLP	Edmund Barber, Olivia Carrington, Gareth Davies, Rachel Duffy, Lisa Eger, Morag Elwis, Angela Evans, Laura Feldman, Abdullah Geelah, Tom Howard, Shona Hughes-Daly, Gregory King, Priti Lancaster, Charles Magoffin, Martin McElwee, Emma Rachmaninov, Tom Rhodes, Christopher Simpson and Annabel Sykes
United States	Freshfields Bruckhaus Deringer (US) LLP	Elizabeth Bieber, Melina E De Bona, Lori Goodman, Timothy Harkness, Lauren Kaplin, Hannah Khalifeh, Brian Lewis, Sam Lowenstein, Laurie Morgan, Travis Panneck, Jerome Ranawake, Brian Rance, Jordan Salzman, Elvira Sihvola, Altin Sila, Aaron Voloj Dessauer and Timothy Wilkins

EXECUTIVE SUMMARY

KEY MESSAGES

What is the issue?

Human wellbeing relies on the sustainability of key environmental and social systems. In some cases, that sustainability is under threat. This is partly the result of economic activity and, if not addressed, will create risks to economic systems and all who rely on them. Solutions require action from individuals and institutions, but also a system-wide response: collective action, coordination and cooperation.

Investment is part of and depends on these systems to generate financial returns. So, there is a question whether the investment sector needs to be more focused on addressing sustainability challenges, even if its only motive in doing so is to achieve its own financial purpose.

What is the solution?

Investment activity within the scope of 'investing for sustainability impact', or 'IFSI', has been identified as a way for the investment sector to do just that. Investors are increasingly focusing on their impact. Clarity on the legal framework for doing so is therefore of key importance.

IFSI describes any investment approach where investors *intentionally* seek (through the activities they finance or otherwise) to influence what investee enterprises and third parties do in *assessable* ways that address sustainability challenges. It therefore differs from many existing forms of sustainable investing which focus on integrating sustainability factors into investment decisions but do not necessarily involve intentional influence of this sort. It addresses a similar issue to current work on corporate purpose, but from the point of view of investors. Growing evidence suggests that this more purposeful investing is what many individual investors want from those managing their investments.

The aim of our project has been to establish whether the law currently requires or permits IFSI (looking at the main categories of asset owner and their investment managers in 11 jurisdictions), and to identify options for policymakers wishing to facilitate IFSI.

Does the law require or permit IFSI?

To a significant extent it does although, given the diversity of jurisdictions and investor types covered, there are all sorts of variations. Financial return is commonly the primary goal of institutional investors, so the situation is most clear where a sustainability risk bears on investors' duties to pursue financial goals. Here, where sustainability impact approaches can be effective in achieving an investor's goals, the investor will likely be required to consider using them and act accordingly. However, there are differences of understanding and uncertainties. Cases where investors can pursue sustainability goals for their own sake *in parallel* with financial goals are more limited, but there are instances in most jurisdictions, usually subject to prioritising financial goals.

Whether institutional investors conclude in practice that IFSI is legally required or permitted will also depend on the circumstances in which they act; for example, an IFSI approach might, in principle, be attractive in a given case, but there could be too much uncertainty as to outcome or cost to adopt it. In addition, prevailing market features, such as commonly used performance benchmarks, may reduce attention to sustainability factors in investment practice.

Facilitating IFSI: what can be done?

Since the behaviour produced by legal rules depends on what those rules say and the circumstances in which they are applied, we identify options for policymakers wishing to facilitate IFSI that tackle both. They are possibilities for consideration, not recommendations. They do not cover wider interventions in primary economic activity or fiscal policy (which can also fundamentally affect investment decisions), although policymakers will undoubtedly want to consider these.

Options include:

- changing investors' legal duties and discretions and how they are understood in ways that facilitate IFSI (such as allowing the pursuit of sustainability goals as long as financial return goals are prioritised, and a presumption in favour of investor collaboration in tackling sustainability challenges);
- changing the circumstances in which rules are applied in three broad ways: (i) building the enabling environment for IFSI (eg by ensuring the availability of decision-useful corporate sustainability data); (ii) promoting in-depth research to establish whether market features (such as prevailing investment theory, the terms on which investment managers are appointed and stock lending to short sellers) may lead investors to underweight sustainability factors and steps to address this if so; and (iii) strengthening market discipline (eg through product labelling and governance rules for sustainability-branded products and ensuring that investors' sustainability preferences are properly reflected in the investment process).

EXECUTIVE SUMMARY

EXECUTIVE SUMMARY

This report is about achieving the goals we value. It is about how institutional investment management can help with that, and it is about how the law supports the process. It concerns an approach to investing which is orientated towards addressing sustainability challenges either to achieve financial investment goals, or in addition to those goals.

In this report, that approach to investing is called 'investing for sustainability impact', or 'IFSI'. IFSI is not a legally defined expression and is not used in this report as a term of legal art. Nor is it intended to add to the alphabet soup of the sustainability world. Instead, it serves here as no more than a 'conceptual net' to catch, broadly, any activities that involve an investor *intentionally* attempting (through the activities it finances or otherwise) to influence the behaviour of investee enterprises and other third parties in *assessable* ways that can help to achieve **overarching sustainability outcomes** – outcomes consistent with the social, environmental, economic and human rights goals suggested by various international instruments such as the Paris Agreement and the Sustainable Development Goals.

1. What is the issue?

Human wellbeing relies on the sustainability of key environmental and social systems. In some cases, that sustainability is under threat. This is partly the result of economic activity and, if not addressed, will create risks to economic systems and all who rely on them. Solutions require action from individuals and institutions, but also a system-wide response: collective action, coordination and cooperation.

The investment sector is part of and depends on these systems to generate financial returns. So, there is a question whether it needs to be more focused on addressing these challenges, even if its only motive in doing so is to achieve its own financial purpose.

Sustainable finance and investment activity has grown significantly, driven among other things by opportunities created by sustainability transitions and a desire to protect financial asset value. The need for investor attention to sustainability factors is ever-more pressing. However, it is unclear how far activities to date have helped in achieving overarching sustainability outcomes.[1]

Some of the main forms of sustainable, responsible or ESG investing tend to focus on investing in enterprises considered as having a positive sustainability profile and avoiding those that are not. These investment approaches may have an influence that is aligned with overarching sustainability outcomes and could be used as part of an IFSI strategy. However, in isolation, they do not involve the investor intentionally seeking to bring about assessable changes in the behaviour of investee enterprises and others.

2. What is the solution?

Investor activities within the scope of IFSI would involve seeking to bring about change in just that way. Investors are increasingly focusing on their impact. Clarity on the legal framework for doing so is therefore of key importance.

The purpose of our project has not been to test whether IFSI investment approaches can bring about change, although it seems credible. Rather, the principal aim has been to reach a view on the basic question of how far the law in key jurisdictions[2] currently requires or permits investment approaches that fall within IFSI, as part of or in addition to the usual financial goals of investment. That said, the two issues are not entirely separable. Consequently, we have needed to assume for this project that IFSI investment approaches can indeed contribute to achieving overarching sustainability outcomes and help realise institutional investors' investment goals, financial or otherwise.

IFSI essentially addresses the same issue as current attention to corporate purpose, but from the point of view of investors: what is the purpose of economic activity and how does it relate to the wellbeing of people and planet? Questions of investment purpose and corporate purpose both concern what is valuable, not just financially but also in terms of outcomes for the social and natural environments on which people depend. IFSI approaches these questions from the perspective of investors, corporate purpose from that of the companies in which they invest. In answering them it is helpful to recognise that they converge on similar ground. Growing evidence suggests that this more purposeful investing is what many individual investors want from those who manage their assets (see Part A.4).

1 See for example, *World Economic Outlook: A Long and Difficult Assent*, International Monetary Fund, October 2020, Chapter 3.
2 The 11 jurisdictions covered represent a cross-section of investment hubs, cultures and legal traditions, but include the world's largest centres for investment management.

EXECUTIVE SUMMARY

3. What are the key characteristics of IFSI?

The key feature of IFSI is the sort of goals an investor is pursuing (see Part A.1). IFSI will always involve an investor intentionally using its powers to try to bring about assessable behaviour changes among business enterprises or policymakers aligned with achieving overarching sustainability outcomes. This includes, but is not limited to, investment funding for sustainability-focused projects. Influence could be direct, or indirect through engagement with others, such as scientific or industry bodies. In this report, changes of this sort targeted by investors are called '**sustainability impact goals**'. Targeted changes can involve a reduction in negative or an increase in positive impact, or both.

Sustainability impact goals could take many forms ranging, for example, from a change in a business process to reduce its negative sustainability impact (such as polluted water emission levels), or the launch of a new enterprise that involves a positive sustainability impact (such as developing battery technology), through to higher-quality enterprise sustainability disclosures to inform investment decisions and impact-oriented stewardship and policy engagement. Goals could also involve steps to achieve better policy alignment with international sustainability commitments.

Two levels of impact. Investors engaging in IFSI are therefore concerned with two sorts of related sustainability impact.

First, the impact on social and environmental sustainability of business enterprises, and the impact of policymakers and other third parties on the operating environment for enterprises and investors.

Second, the influence, or impact, that the investors themselves can have on the sustainability impact of enterprises, policymakers and other third parties.

Some forms of sustainable, responsible, or ESG investing essentially focus on the first sort of impact, as noted previously, by investing in enterprises that have a positive sustainability profile and avoiding those that do not. By contrast, IFSI concerns both sorts of impact. It involves an investor recognising that to achieve its objectives it needs to pursue sustainability impact goals by influencing the sustainability impact of others (see Diagram below). What is often called 'impact investing' would be an example of this, but IFSI covers a much broader range of practices than has typically been the case with impact investing to date.

Ways to pursue impact. Investors can pursue sustainability impact goals in various ways. However, the project has looked at the legal position on investors' use of investment powers, stewardship activities and public policy engagement. Which of these it is appropriate for an investor to deploy in pursuing a given sustainability impact goal, and in what combination, will depend upon the precise circumstances, including the sustainability goal concerned and asset class. Legal attention has hitherto tended to focus on the use of investment powers. However, in public markets, there is likely to be a particular role for stewardship and policy engagement, especially when undertaken collectively. Indeed, for the growing portion of global assets under management (AuM) committed to passive investment strategies these may effectively be the only means of influence available.

Investors and investment relationships covered. The concept of IFSI is not confined to any section of the investment market or any asset class (so would cover holdings of debt instruments, funds and private equity interests as well as publicly traded shares).

4. The purpose of IFSI: instrumental IFSI and ultimate ends IFSI

The key defining feature of IFSI is the investor's purpose. IFSI will always involve trying to influence the behaviour of third parties in ways aligned with overarching sustainability outcomes, but for what reason?

One reason will be protecting or enhancing the *financial performance* of the investor's portfolio. In particular, targeting sustainability impact goals might be intended to help support the sustainability of economic, environmental and social systems on which financial value depends, the declining sustainability of which could (as with climate change) create systemic risks to investors' ability to achieve their financial goals. Another case might involve seeking an increase in value through working with one or more investee companies to address a given sustainability challenge. However, an investor might also pursue sustainability impact goals for reasons not directly connected with its financial return objectives, including treating impact goals as worthwhile ends in themselves.

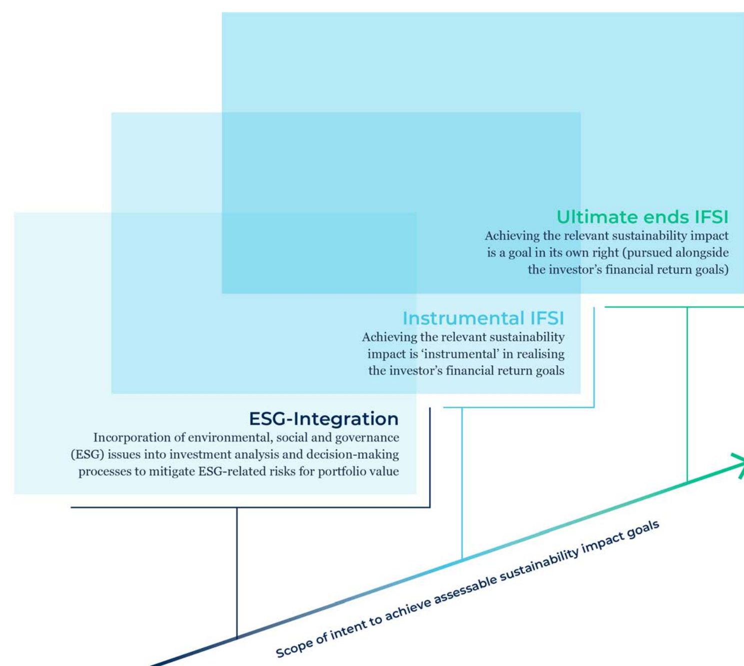
EXECUTIVE SUMMARY

This report makes a key distinction between two kinds of IFSI based on this difference (See Diagram).

- **Instrumental IFSI** is where achieving the relevant sustainability impact goal is 'instrumental' in realising the investor's financial return goals.
- **Ultimate ends IFSI** is where achieving the relevant sustainability impact goal, and the associated overarching sustainability outcome, is a distinct goal, pursued alongside the investor's financial return goals, but not wholly as a means to achieving them.

The goals of ultimate ends IFSI can be broader than instrumental IFSI. However, that does not mean that they would necessarily be inconsistent with investors' financial goals, nor that they should take priority over them. It simply means that an investor's decisions are partly motivated by seeking to achieve a sustainability impact goal for reasons other than achieving the investor's financial goals.

Clarity on this question of purpose is important because of how the purpose of an activity influences the way it is undertaken and its outcomes, including which legal rules are relevant and how they are applied.



5. How feasible is it in practice for investors to set and pursue sustainability impact goals?

It is not the purpose of this report to answer this question. However, it is relevant to the legal analysis.

Investors' capacity to define sustainability impact goals, assess progress towards them and understand their own contribution is developing but is more advanced in some areas and for some aspects of sustainability than others (see Part A.2). This presents challenges for investors, not least in terms of expense. These challenges affect what investors can and should do. That is because what legal duties and discretions require or permit does not just depend on what the relevant rules 'say' (their 'black letter') but also the circumstances in which they are applied. Current challenges should reduce as market understanding, methodologies and practice develop and relevant, consistent data become more available. However, for now they may lead investors to focus on areas where the ground is more certain, extending their activities as this 'market infrastructure' evolves.

6. What level of global AuM is currently subject to IFSI?

The concept of IFSI has not so far been used to define AuM research, so there is no easy answer to this (see Part A.3). An investor could engage in IFSI in various ways. A proper answer would therefore require a qualitative assessment; just because assets appear to be subject to an IFSI approach does not necessarily reveal much about its rigour or outcomes.

Management of the bulk of global institutional investor AuM (approximately $ 110tn) does not

> EXECUTIVE SUMMARY

EXECUTIVE SUMMARY

currently appear to involve IFSI. Nonetheless, with important caveats including those just mentioned, a significant and growing proportion may be subject to IFSI at some level. This is based especially on the activities of investor coalitions whose activities appear to involve to some extent pursuing sustainability impact goals. Members of the NetZero Asset Managers Initiative and Net-Zero Asset Owners Alliance control AuM of $ 43tn and $ 6.6tn of AuM respectively.

The increasing concentration of AuM with a number of large investment management firms potentially gives them a particularly important role in the development of IFSI investment approaches.

7. Does the law require or permit IFSI?

Investment markets involve a multitude of different operators all of which may influence how far investors engage in IFSI. However, at its core, the answer to the question posed for our project depends on legal rules applicable to two categories of investors: asset owners and their investment managers. Our project has therefore focused on these and, in the case of asset owners, on the three largest subcategories by global AuM: pension funds, mutual funds and insurance companies (Asset Owners).

The legal duties and discretions that apply to Asset Owners in managing their assets are key to the analysis. But what these require or permit is not just relevant to them; it also shapes the obligations and discretions of investment managers and others who assist Asset Owners in managing their assets. For example, to discharge their own legal duties, investment consultants need to understand the Asset Owner's duties and discretions to decide how best to advise. In other words, there is a legal 'cascade effect' from Asset Owners to all those who directly or indirectly provide services to them.

7.1 High level conclusions

There is no single or simple answer to the question of how far IFSI is legally required or permitted across the jurisdictions covered, or in any single jurisdiction. The legal rules that apply to different investor types vary considerably between jurisdictions. Their content, application and interpretation reflect the culture of the jurisdiction concerned. Even within a jurisdiction, there are different rules for different categories of investor. In addition, the circumstances of each investor are unique. Because of these differences, precisely what an investor is legally required or permitted to do will also be specific to that investor: investors need to consider their position on a case-by-case basis (see Part B.2). Nonetheless it is still possible to reach a set of broad conclusions about what the law generally requires or permits. The following is not intended to be an exhaustive statement of all the circumstances in which IFSI could be required or permitted (see Part B.3).

- **Financial return as the primary goal of investors**

The primary purpose of Asset Owners' investment activity is generally regarded (by legislators, regulators, courts and the Asset Owners themselves) as generating a financial return for beneficiaries within acceptable risk parameters. Thus, applicable legal duties have generally been interpreted to require financial investment objectives to be prioritised, and in some cases a financial return is the only goal that an Asset Owner should pursue. This is then reflected in the terms upon which Asset Owners appoint investment managers.

- **Instrumental IFSI**

If an Asset Owner or investment manager concludes, or on the available evidence ought to conclude, that one or more sustainability factors poses a material risk to its ability to achieve its financial investment objectives, it will generally have a *legal obligation* to consider what, if anything, it can do to mitigate that risk (using some or all of investment powers, stewardship, policy engagement or otherwise) and to act accordingly. Possible options include seeking to bring about specific sustainability impact goals that can reasonably be expected:

- to help influence the relevant sustainability factor(s) or the exposure of investee enterprises to it/them; and
- to do so in ways that reduce the investment risk.

Investors also talk of addressing sustainability factors that present risks of this sort as being necessary for long-term value enhancement.

It is also possible to envisage cases where an investor seeks a return consistent with its financial objectives by investing in and working with a number of enterprises to tackle specific sustainability challenges in order to achieve an increase in their value.

Relevant factors for an investor in determining whether it should engage in instrumental IFSI include the direct and indirect costs and risks of pursuing this course of action (including as between different generations of beneficiaries, where relevant), and the relative likelihood that doing so will help address the relevant sustainability factor so as to reduce the financial risk posed (or realise financial opportunities). An investor may decide to act individually. However, both of these factors are likely to weigh in favour of a decision to foster or join collective investor action aligned with the same goal.

In current conditions, it seems unlikely that an investor, acting alone in public markets and considered in isolation, would have sufficient influence over an investee enterprise's sustainability impact to justify use of its investment powers alone as a basis for instrumental IFSI. However, it is more foreseeable that a group of investors, acting collectively and

EXECUTIVE SUMMARY

holding in aggregate a substantial portion of the securities of relevant investee enterprises, or proposing to invest at scale, could achieve an impact of this sort, especially if their proposed action aligns with similar market movements more widely.

Especially in relation to publicly traded investee enterprises, we anticipate that stewardship and public policy engagement are likely to be a particular focus for investors considering instrumental IFSI. However, where an investor has concluded that it should engage in stewardship to pursue sustainability impact, it may also conclude that it should use or threaten to use its investment powers from time to time to over or underweight investee enterprises in the portfolio or exit altogether, to strengthen its voice in support of that. Doing so to achieve a positive sustainability impact would fall within the concept of instrumental IFSI.

- **Ultimate ends IFSI**

There will be a legal duty to IFSI where an investor is managing the assets of an investment arrangement that has specific sustainability impact objectives, for example, a mutual fund established with the aim of bringing about a particular type of sustainability impact. This would involve ultimate ends IFSI. These sorts of investment arrangement are permissible in most relevant jurisdictions in some shape or form, subject to compliance with consumer protection safeguards.

In most jurisdictions, certain other investors are also likely to have legal discretion to engage in ultimate ends IFSI, but usually only as a parallel objective alongside financial return objectives. Examples include: where some Asset Owners have discretion to pursue sustainability objectives provided adequate financial returns are achieved; where beneficiaries have indicated that they want this; and in some cases where the Asset Owner is a corporate insurer. In the case of the last, while some of a life insurer's investment activity may be restricted by insurance policy terms, directors of insurance companies will otherwise be guided in their investment approach by the broader interests of the company, which may permit the pursuit of positive sustainability outcomes.

Most jurisdictions prohibit investors from engaging in certain activities, such as money laundering, and compliance with these restrictions can be said to have a positive sustainability outcome. An example more specifically targeted at investors, but less common, is legislation prohibiting investment in businesses manufacturing cluster munitions, with the goal of causing manufacturing to cease. Clearly, it would not be usual to think of compliance with rules of this sort as IFSI. That said, the prohibition of support for activities not aligned with the SDGs has the equivalent impact to a collective ultimate ends IFSI decision by investors to achieve reduction in these activities. In a few jurisdictions there are also positive sustainability related legal obligations in relation to the use of investment powers.

- **IFSI and collective action**

Collaboration with other investors is likely both to reduce the costs and enhance the prospects of a successful sustainability outcome and therefore of achieving the goals of IFSI investors. This may well weigh in favour of a decision to act, whether the investor is discharging a duty to achieve financial returns or pursuing a discretion in the context of ultimate ends IFSI. Investor cooperation at some level is clearly permitted in all jurisdictions (although there are legal rules that need to be complied with) and a significant number of collaborative ventures are already underway at both national and international levels, such as Climate Action 100+ and those mentioned in paragraph 6. Whether or not there is the possibility of formalised collective action, the activities of other investors or third parties which are aligned with the investor's goal could also be relevant in deciding whether to act if, for example, they increase the prospect of the goal being achieved.

What investors' duties may require with regard to collective action will depend on their circumstances. Some large investors may be in a position to catalyse collective action. Where collective action is already underway, smaller investors may conclude that adding their weight is a cost-effective way to pursue their investment goals. However, in understanding how any action has helped an investor to discharge its duties, the focus of a court would likely be on the logical and evidential credibility of the investor's explanation for the difference it has made in the context of the collective action as a whole more than the precise quantification of the individual impact or benefit of its involvement: the essence of collective action is that the sum is intended to be greater than its parts and for any one investor to benefit from a sustainable system the system as a whole must be sustainable.

- **IFSI and delegation to investment managers**

Asset Owners commonly delegate day-to-day investment management of all or part of their assets to investment managers. These tend to conduct the bulk of stewardship activities and also undertake policy engagement. In doing so, they need to balance or otherwise manage the various objectives of their clients. Given the high levels of AuM now concentrated in the hands of the world's largest investment managers, they are an increasingly significant feature in the stewardship and policy landscape. This concentration has the potential to lower the unit cost of their stewardship activities and increase their impact, considerations which, as noted, would tend to favour a decision to act.

Asset Owners delegating to investment managers need to satisfy themselves that the activities of the manager are aligned (or at least not inconsistent) with their own goals and duties to beneficiaries.

EXECUTIVE SUMMARY

However, subject to that, where an Asset Owner concludes that it is otherwise appropriate to appoint a particular manager because that manager can most fully support its needs, it seems unlikely that the Asset Owner would be prevented from doing so simply because the manager's stewardship approach is not identical to what the Asset Owner would do if it had its own in-house stewardship team.

- **The significance of investor disclosure regimes for IFSI**

The legal and policy landscape relevant to IFSI is changing rapidly. This includes rules requiring institutional investors to disclose how far they have taken sustainability factors into account in their investment process. The fact that there is a disclosure regime of this sort will not usually on its own be sufficient to change an investor's underlying legal duties; it does not of itself tackle the question of whether and in what circumstances IFSI or any other sort of sustainable investment is required or permitted. However, where the law is unclear on the extent to which an investor is permitted to take sustainability factors into account, this kind of disclosure regime could potentially be an affirmative factor, for example, if it appears to be based on the assumption that they are permitted.

7.2 What rules say and the circumstances in which they are applied

As noted at paragraph 5 above, whether legal rules require or permit IFSI in practice depends both upon what the rules say and the circumstances in which they are applied, and current circumstances may limit what is possible as a technical matter or in terms of cost.

However, circumstances can also influence investors' decisions by affecting what is thought relevant to them. In this context, many market professionals suggested to us in the course of our project that certain market features (such as commonly used investment theories and benchmarks or the effect of intermediation and the relatively short-term nature of investment management agreements) may result in sustainability factors receiving insufficient attention in the investment process (see Part B.4). If this is correct, then it could undermine investors' attempts to comply with their duties, including decisions on activities within the scope of IFSI. Taking this a step further, in considering whether an investor has complied with its legal duties, a court or regulator may, among other things, assess the investor's actions by reference to established professional practice. Where an investor has done what would be considered appropriate by a respected body of professional practice, then a claim is generally less likely to succeed. Consequently, if sustainability factors are being underweighted in the course of existing market practice, then *legal duties* could unintentionally strengthen that tendency because of how those duties interact, or are believed to interact, with market features.

Investors need to understand these potential issues and ensure that they nonetheless comply with their duties. Among other things, as circumstances change, so should investors' decisions on what they are required or permitted to do. For example, as awareness grows of the financial risks and opportunities created by sustainability factors and how investors can respond to them, existing legal rules (notably, those imposing standards of care and skill) will likely lead investors to act in future in ways they would not necessarily contemplate today.

8. Facilitating IFSI through policy: what can be done?

While there are circumstances in which the law requires or permits IFSI, there are also impediments (see Part C.1). Policymakers may be able to help address them.

Where policymakers decide to intervene, they need to make their purpose clear since this will drive a host of subsequent decisions, not just on which policy tools to use but also in the way investors will apply any new rules. Subsequent judicial or regulatory interpretation may also take the purpose of a given legal measure into account. The purpose of intervention will often be to secure financial or economic goals, but it may also concern achieving overarching sustainability outcomes consistent with international commitments.

Facilitating ultimate ends IFSI raises a particular question about how best to achieve outcomes aligned with core social values and the role of institutional investors in that. The answer has potential implications, financial and otherwise, for beneficiaries, wider society and future generations. It may be possible to place a monetary value on some sustainability outcomes in trying to balance these needs. Certainly, many have financial implications. However, the value of positive sustainability outcomes ultimately rests in the life that depends on them and is not solely financial. These issues need to be addressed by the relevant societies through a political process. It is not realistic to expect institutional investors to resolve them on their own.

Since the behaviour legal rules produce depends on what those rules say and the circumstances in which they are applied, we identify options for policymakers wishing to facilitate IFSI that tackle both (see Part C.2 and the Appendix to this Executive Summary). They are possibilities for consideration, not recommendations. They are not exhaustive. They do not cover wider interventions in primary economic activity or fiscal policy (which can also fundamentally affect investment decisions), although policymakers will undoubtedly want to consider these.

Sustainability challenges are often systemic and international. International policy coordination is therefore likely to heighten the impact of policy change. Coordination may also be needed at a national level between regulators responsible for different categories of institutional investor, to ensure a consistent approach.

EXECUTIVE SUMMARY

APPENDIX – SUMMARY OF POLICY OPTIONS FOR FACILITATING IFSI

1. Change investors' legal duties and discretions and how they are understood

1.1 Investor duties and instrumental IFSI

Introduce guidance making clear that in discharging existing duties to seek to achieve a financial return, pursuing sustainability impact goals is an option that investors should consider (for example, in responding to systemic financial risks created by sustainability factors).

1.2 Investor duties and discretions and ultimate ends IFSI

Introduce or extend existing discretions to allow investors to pursue sustainability goals that reflect actual beneficiary preferences, assumed beneficiary preferences (based on third-party, potentially government, research), or objectives set by government. The scope for this would probably be greatest where any discretion is subject to prioritising financial investment goals.

For especially pressing sustainability goals, consider requiring investors to pursue them or refrain from activities inconsistent with them. This is a blunt tool, so may only be feasible, if at all, for very precise and urgent goals.

Particularly for insurers, guidance on or, if necessary, legal reform to directors' duties to secure the success of their company, making clear that success is not limited to narrow, short-term, financial measures but should be understood by reference to broader factors relevant to the company achieving its purpose over the long-term.

1.3 Collective action to secure sustainability goals

Investor cooperation to address sustainability challenges is widespread. However, guidance could make clear that investors should consider collective action in seeking to achieve their objectives and that this can assist in discharging their duties even if the investor's contribution and the portfolio benefit cannot be precisely measured (since, like political security, the benefits of sustainable systems as a whole are enjoyed by each person that relies on them). As an alternative, this could be in the form of a *prima facie* legal presumption in favour of cooperation unless there are solid reasons against.

1.4 Rules that could inhibit stewardship activity

Review competition law and rules on handling price sensitive information, shareholder concertedness and collective action in relation to a legal entity, and rules on requisitioning shareholder votes, to ensure that they do not unnecessarily restrict stewardship activity on sustainability factors. Where necessary, adjust to provide greater freedom or provide guidance to reassure investors that freedom already exists. In the case of competition law, consider an explicit safe harbour for sustainability related investor initiatives.

1.5 'Financial factors' and 'non-financial factors'

Review use of these expressions. Guidance should turn not on whether a given factor is 'financial', but on its implications for the *objective* of the investor; where an investor is discharging a duty to pursue a financial return, and a sustainability factor (or any other factor) is materially relevant to that, then the investor needs to decide what to do about it. Use of these expressions should also avoid giving the impression that sustainability factors that only have indirect financial implications (for example, because of reputational risk), or sustainability risks that are hard to predict, are not relevant.

2. Change the circumstances in which investors discharge duties and exercise discretions

- **Strengthen IFSI 'infrastructure'**

2.1 Support for development of market-based IFSI infrastructure

Steps to support the development of knowledge, practice and market-wide consensus in areas necessary for investors to engage in IFSI, making it easier for them to do so; for example, the ability to define sustainability impact goals and assess progress towards them, and to understand the relationship with financial outcomes. This could include facilitating specialist work and centres of excellence in which solutions can be worked through, and helping to establish the outcomes as authoritative.

2.2 Frameworks for IFSI capacity-building by investors

Establish frameworks for capacity-building by investors (in terms of their processes, systems and controls for addressing sustainability impact) using 'process regulation' or industry good practice statements that set out practical steps that investors could or should take in considering whether to pursue sustainability impact goals and *how*. The most stringent standards could be applied to investment products and strategies held out in ways that suggest they achieve sustainability impact goals.

2.3 Corporate disclosure and reporting

Internationally consistent disclosure regimes for businesses, generating 'decision-useful' information, are key for all forms of IFSI. Policymakers need to consider, as they already are, how best to facilitate these and various associated matters such as any need for external validation. Logically, investors seeking to address the effect of sustainability factors on their portfolio in the round could be expected to need two sorts of

EXECUTIVE SUMMARY

information: how an enterprise is impacted by and is responding to sustainability factors, and how the activities of an enterprise have an impact on sustainability factors (since the second of these could be relevant to the sustainability position of other portfolio companies). Disclosure regimes could involve financial quantification of costs and opportunities, and publication of transition plans, in relation to key sustainability factors.

2.4 Ascertaining investors' sustainability attitudes generally

High-quality government-sponsored work to establish greater clarity about the sustainability attitudes of individual investors generally (so centralising cost and reducing uncertainty) for use by institutional investors in exercising discretion in relation to ultimate ends IFSI (where permitted based on investor wishes) and policy formation.

2.5 Strengthen stewardship code coverage of matters relevant to IFSI

Ensure that there is a stewardship code applicable to all key business enterprises, investor-types and investment relationships (so not just restricted to publicly traded equity) covering, among other things, enterprise risks (systemic or otherwise) from sustainability factors, possible use of sustainability impact goals in seeking to enhance long-term value growth and collective engagement towards that end.

Consider how adherence is strengthened (using, for example, industry working groups, publication of stewardship policies and outcomes and external review of stewardship standards).

Review the relationship between asset owners and investment managers (and advice given on this by consultants) to ensure that the interests of asset owners as they concern sustainability factors are being adequately reflected in stewardship activity conducted by investment managers on their behalf.

■ **Address investment market influences that may diminish attention to sustainability factors in the investment process**

2.6 Portfolio theory, use of benchmarks and short-term trading activity

Intensive high-quality cross-disciplinary work coordinated by a group of investors and international-profile academic institutions on:

- the use of key elements of portfolio theory and benchmarks to establish whether they result in insufficient attention to sustainability factors, especially systemic risk, and whether this could prejudice the realisation of financial goals; and
- short-term trading activity to establish whether it helps achieve, is inconsistent with or is neutral with regard to achieving positive sustainability outcomes.

Further policy options would depend on the results but, in the case of the first, could include continuing education requirements and a review of business school training to ensure appropriate coverage.

2.7 Selection and appointment of investment managers

Market studies on how far longer-term investment approaches (factoring in sustainability risks and opportunities for clients beyond the term of a manager's appointment) are being properly reflected and incentivised, including in relation to stewardship, and what can be done if they are not.

Encourage the development of good practice standards on diligence, appointment, monitoring and relationship management, potentially supported by disclosure requirements for asset owners on how they approach these, including in relation to sustainability factors that are relevant to their objectives.

2.8 Investment consultants and fiduciary managers

Market studies on how far investment consultants and fiduciary managers adequately establish asset owners' sustainability needs and goals and reflect these in their services, and whether the use of portfolio theory and benchmarks in service provision is appropriate. Any concerns could be addressed by rules and guidance for asset owners or directly through consultancy industry work on good practice or regulation.

■ **Transparency and market discipline as to IFSI investment approaches through helping individual investors realise sustainability aspirations**

2.9 Disclosure of sustainability approach, including on pursuing sustainability impact goals

Institutional investor disclosure on how achieving their objectives could be affected by sustainability factors and their response, including whether that involves pursuing sustainability goals, how and with what success. Since a range of approaches could fall within IFSI, consider ways of enabling individual investors to understand the intensity and quality of the IFSI approach of the relevant institutional investor.

2.10 Sustainability impact-focused investment products

Distinguish between labels such as 'sustainable', 'responsible' and 'impact' and make their use dependent on satisfying minimum operating and disclosure standards including, in the case of impact, the credible intentional pursuit of sustainability impact goals and assessment of progress.

EXECUTIVE SUMMARY

2.11 Encourage independent rating of sustainability impact products

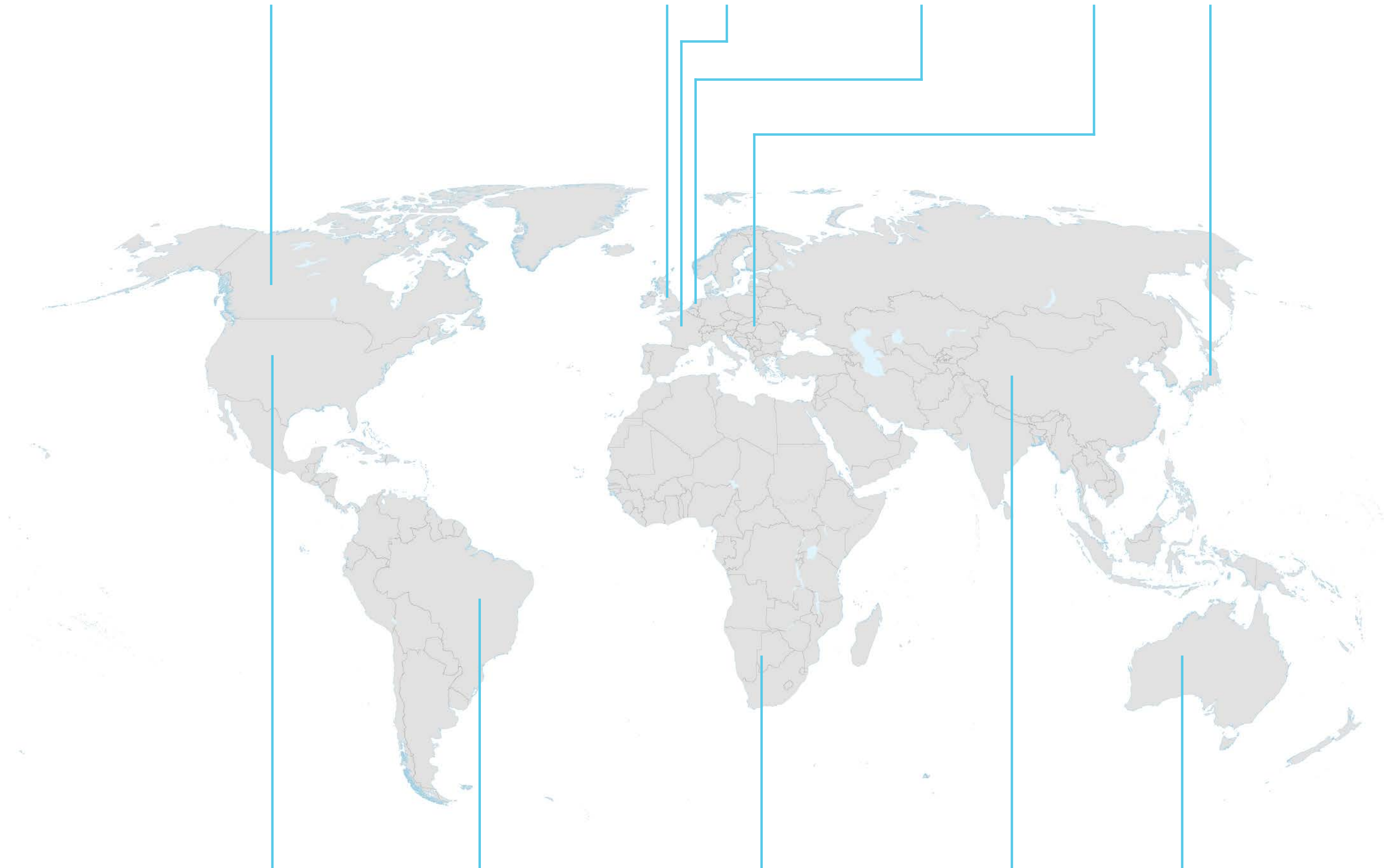
Steps to take greater account of investors' sustainability aspirations in investment services and distribution.

Require investment managers, consultants and advisers to establish a client's sustainability objectives at the outset of their relationship, including in relation to pursuing sustainability impact goals, and reflect these in their service provision. Alternatively, there could be a regulatory presumption that each investor has a long-term horizon and/or that they wish their money to be managed in ways that achieve certain sustainability goals.

2.12 Beneficiary education

Undertake investor education campaigns to help them understand that their money can make a difference in sustainability terms, how (especially the role of pursuing sustainability impact goals), and the possible trade-offs involved.

JURISDICTIONS



INVESTING FOR SUSTAINABILITY IMPACT

INTRODUCTION

Part A of this report looks at what is meant by 'investing for sustainability impact' (IFSI) and where it fits in the current investment landscape. It provides the context for the rest of the report.

- Section 1 describes the concept of IFSI. It also outlines the relationship between IFSI and what is often called 'impact investment', and with 'sustainable investment' more widely.
- Section 2 looks at the need for three elements when considering IFSI from the perspective of legal rules: clarity about the impact goal being pursued; the ability to assess how far a goal has been achieved; and an understanding of the causal link between an investor's activity and a given outcome. It touches briefly on emerging frameworks for goal setting and assessment, and the challenges of doing so.
- Section 3 gives a sense for what proportion of global AuM could currently be described as invested for sustainability impact.
- Finally, Section 4 surveys growing evidence that investors are often motivated not just by a desire to earn a financial return, but also want to support sustainability outcomes consistent with the idea of IFSI.

INVESTING FOR SUSTAINABILITY IMPACT

1. WHAT IS INVESTING FOR SUSTAINABILITY IMPACT?

1.1 Introduction

1 The key feature of IFSI is the sort of goals an investor is pursuing: the investor's *investment purpose*. An investor engaging in IFSI will always be using its powers to try to bring about *assessable* changes in behaviour or circumstances that support *positive sustainability outcomes*, including the reduction of negative outcomes. In this report, targeted changes of this sort are called '**sustainability impact goals**'. An investor might pursue sustainability impact goals by, among other things, seeking to influence the activities of business enterprises or sectors or public policy relevant to those enterprises.[1]

2 One purpose of pursuing sustainability impact goals is likely to be protecting or enhancing the financial performance of the investor's portfolio (including supporting the sustainability of systems on which financial value depends). However, an investor may regard the sustainability outcomes it is pursuing as ends in themselves. Clarity on this question of purpose is important because of how the purpose of an activity influences the way it is undertaken and its outcomes, including decisions about what legal rules are introduced and how to apply them. It is also fundamental in terms of which legal framework applies to the activity.

3 The idea of IFSI reflects the fact that, as a functional matter, institutional investment serves essentially two purposes:

- generating a financial return for the investor or its beneficiaries; and
- allocating capital to business enterprises and others in need of funding.[2]

4 Until relatively recently, the first has received the most attention among institutional investors and their advisers. However, there is growing awareness of the potential for investee enterprises positively and negatively to affect the social and natural environment on which, among other things, they and the investment returns they generate depend. The concept of IFSI addresses this.

5 So, the idea of IFSI poses a question for investors similar to that raised for business enterprises by the growing attention to 'corporate purpose': what is the purpose of economic activity and how does it relate to the wellbeing of people and planet? Questions of investment purpose and corporate purpose both concern what is valuable: valuable not just financially, however important that is, but also in terms of outcomes for the social and natural environments on which people depend to survive and flourish. IFSI approaches these questions from the perspective of investors; corporate purpose from the perspective of the companies in which they invest. In answering them it is helpful to recognise that they are converging on similar ground.

6 The following looks at three things:

- what IFSI is (Section 1.2);
- the relationship between IFSI and what is often called 'impact investing' (Section 1.3); and
- the relationship between IFSI and sustainable investing more broadly (Section 1.4).

1.2 Investing for sustainability impact defined

7 'Investing for sustainability impact' or 'IFSI', is not a legally defined expression and it is not used in this report as a term of legal art. Nor is it intended to add to the alphabet soup of the sustainability world. Instead, it serves here as no more than a 'conceptual net' to catch, in broad terms, any activities of an investor of a sort described in the Introduction (paragraphs 1 and 2).

8 A key aim of our project has been to reach a view on the basic question of how far the law requires or allows for investment approaches that fall within that net, as part of or in addition to the usual financial goals of the investment process. We do not need an exhaustive definition of IFSI to do that. A grasp of the basic concept and its constituent elements is enough.

9 As noted, IFSI involves seeking to achieve *assessable* impact goals. This aspect of IFSI is discussed further in Part A. 2. However, putting it to one side for the present, the core concept of IFSI involves three elements: *sustainability*, *sustainability impact*, and *investing for sustainability impact*. The following discusses each briefly (see Sections 1.2.1-3 below), but it is important

INVESTING FOR SUSTAINABILITY IMPACT

to be clear from the start that an investor engaging in IFSI is concerned with two sorts of related impact:

- first, the impact on social and environmental sustainability of business enterprises, and the impact of policymakers and other third parties on the operating environment for enterprises and investors; and
- second, the influence, or impact, that investors themselves can have on the sustainability impact of enterprises, policymakers and other third parties.

10 Some forms of sustainable investing focus on the first, by investing in enterprises that are considered as having a positive sustainability profile and avoiding those that are not (see Section 1.4 below).[3] However, they do not necessarily involve the investor intentionally seeking to influence the sustainability impact of those enterprises. By contrast, IFSI is concerned with both sorts of impact. It involves an investor recognising that to achieve its objectives it needs to set and pursue sustainability impact goals.

11 Sustainability impact goals could potentially take many forms, ranging, for example, from a change in a business process to reduce the negative sustainability outcomes produced by an enterprise (such as polluted water emission levels), or the launch of a new enterprise that generates positive sustainability outcomes (such as developing battery technology), through to higher-quality enterprise sustainability disclosures to inform investment decisions and impact-orientated stewardship and policy engagement. Goals of this sort might be pursued on an enterprise-specific basis or sector-wide. They could also involve attempts to secure policy change that is relevant to the operating environment for (a) businesses (ranging, for example, from reporting regimes on what they are doing to respond to sustainability risks to their operations, through to carbon pricing), or (b) investors (for example, to ensure that their investment approaches on sustainability factors are transparent and comparable for market users).

12 In this report, the words ‘impact’ and ‘outcome’ are used in accordance with their ordinary English meaning, not in any specialist sense (see Box 1: Outcomes and impacts).

Box 1: Outcomes and impacts

This report uses the words ‘outcomes’ and ‘impacts’ extensively. There are various disciplines, especially economics and sociology, where, broadly, the term ‘impact’ when applied to the activities of a particular actor implies that they have changed something (ie been causative) while the term ‘outcome’ is used to describe a result in which the causative role of the relevant actor has been less direct or does not exist at all, or in a way that is neutral as to what has caused it. However, in this report they are being used in accordance with their ordinary English meaning except where used in an expression that has been specifically defined. In other words, broadly:

impact is (i) the effective action of one thing or person upon another, (ii) the effect of such action, or (iii) used as a verb, the act of having a pronounced effect on someone or something; and

- an outcome is a state of affairs resulting from some process.[4]
- The meaning of the two expressions therefore overlaps. Because the word ‘impact’ has more than one meaning we have, wherever used, sought to be clear about which sense applies. In particular, when the report talks about an ‘impact goal’, it means the desired effect of an action or a desired outcome.

INVESTING FOR SUSTAINABILITY IMPACT

1.2.1 Sustainability

13 The challenges of defining 'sustainability' are well known.[5] However, at its core, the concept concerns the interconnected fate of people, planet, and prosperity.[6] For the purposes of this report, 'sustainability' is treated as referring, as a minimum, to an outcome that is consistent with the social, environmental, economic and human rights goals suggested by a number of international instruments, discussed briefly below. In this report, we refer to these goals as **overarching sustainability outcomes** and the aspects of the natural or social environment to which they relate as **sustainability factors** (see Box 2: Sustainability factors). None of these international instruments individually or collectively defines every aspect of sustainability comprehensively, and they are generally only legally binding on investors and enterprises where equivalent standards apply under national (or, where applicable, EU) law.[7] They can, however, be relevant to the discharge of investors' duties, among other things, for the reasons discussed in this report.

Box 2: Sustainability factors

The expression 'factor' in the context of 'sustainability factors' is used in the general sense to denote a fact or circumstance that can contribute to a particular outcome. It is not being used in the technical investment sense of 'factor investing' (ie broadly, an investment approach that selects investments based on features (or 'factors') that are believed to be associated with higher returns, whether those features relate to individual investee enterprises or are macroeconomic).

14 The seminal 1987 Brundtland Report defined 'sustainable development' as, 'development that meets the needs of the present without compromising the ability of future generations to meet their own needs.'[8] When people talk of 'sustainable development' they do not necessarily mean quite the same as 'sustainability', and the Brundtland definition gives rise to some much debated questions, such as what sort of 'needs', how many 'generations', and so on. However, in practice, the formulation has continued to underpin international development and sustainability efforts in the decades following.[9] The 17 Sustainable Development Goals (SDGs) and their accompanying framework of targets and indicators are now the most widely recognised international blueprint for pursuing a more sustainable world by 2030 and cover all three elements of environmental, social and economic sustainability.[10] The Paris Agreement under the UN Framework Convention on Climate Change reinforces the SDGs' climate change goals, establishing commitments to seek to limit global warming within two degrees Celsius of preindustrial levels.[11]

15 Sustainability is also often taken to encompass a wider set of international norms concerning businesses' management of environmental and social impacts, their adherence to human rights and labour standards, and their approach to 'business ethics'. These are articulated in instruments such as the OECD Guidelines on Multinational Enterprises,[12] the Ten Principles of the UN Global Compact,[13] and the UN Guiding Principles on Business and Human Rights.[14]

1.2.2 Sustainability impact

16 Sustainability impact concerns the effect that human activity has on how far overarching sustainability outcomes of the sort described above are being realised. As used in the expression 'investing for sustainability impact', it is particularly concerned with the sustainability impact of *business enterprise*. In this report, business enterprise includes any sort of business enterprise ranging from major listed international corporations through to private businesses and investment in public sector projects designed for private investment. It also includes business sectors. However, IFSI also concerns the activities of policymakers as relevant to the operating environment for businesses and investors, including their sustainability impact and the sustainability risks to which they are exposed and, in the case of investors, their ability to exercise an influence.

17 All business enterprises have sustainability impacts, positive or negative. An enterprise has a positive sustainability impact where it does something that advances an overarching sustainability outcome. This can include steps to eliminate activities that make those overarching outcomes less likely. The aim of IFSI is to influence the activities of businesses so that they change in a way that supports identified overarching sustainability outcomes while not causing a material deterioration in the impact of the businesses on other sustainability outcomes, recognising that there may be situations where a balance needs to be struck.

INVESTING FOR SUSTAINABILITY IMPACT

18 Investee enterprises are also potentially exposed to the negative sustainability impact and reliant upon the positive sustainability impact of third parties, including other investee enterprises, businesses more broadly, and the activities of policymakers. Their financial return, and hence the investment return they produce, and their ability to achieve their short and long-term goals depends, in part, on others. IFSI may also therefore involve pursuing sustainability impact goals in relation to these third parties.

1.2.3 Investing for sustainability impact

19 IFSI is not simply about investing in enterprises that are already well aligned with achieving overarching sustainability outcomes and divesting from those that are not, although that could be part of an IFSI strategy. Rather, the key defining feature of IFSI is an investor's recognition that to achieve its objectives it needs to set and pursue assessable sustainability impact goals. As noted previously, sustainability impact goals can involve targeting reduction in the negative sustainability impact of a third party or an increase in its positive sustainability impact. The following looks at what sort of goals are involved ((a)) and how investors might seek to pursue them ((b)).

(a) The different sorts of goals involved in IFSI

20 Achieving the sort of overarching sustainability outcomes described in Section 1.2.1 in full is obviously beyond the power of any single actor. The goals targeted by investment activities within the scope of IFSI would nonetheless either be intended to contribute to achieving those outcomes or at least have that effect. Essentially, therefore, it is possible to think of the goals involved in IFSI at three levels, although investors may not always approach them in quite this way:

- first, the investor would establish which overarching sustainability outcomes are relevant to the investor in managing its portfolio;
- second, the investor would articulate a goal (or goals) for its activities in relation to its portfolio which, it is reasonable to think, would be consistent with helping to bring about that outcome at some level that is relevant to the investor in discharging its duties or exercising its discretions (operating in a similar way to a financial investment objective, but in relation to sustainability); and
- third, the investor would identify a series of more specific steps it can take to secure action on the part of business enterprises or other third parties which it is reasonable to think will help to realise that goal.

21 Examples of the first would be achieving the climate change targets set by the Paris Agreement or ensuring availability and sustainable management of water and sanitation for all (SDG 6). An example of the second might be to ensure that all companies in an investor's portfolio have credible, regularly updated, transition plans that are aligned with that outcome. An example of the third would be enterprise-by-enterprise targets for steps they need to take to achieve alignment and the steps the investor will take to encourage them to do so.

22 This report treats both goals described at the second bullet point above and the specific steps described at the third bullet point as sustainability impact goals. However, it will be clear that there is a distinction between the two (which becomes relevant, for example, in the context of assessing an investor's impact). This difference is highlighted below where particularly pertinent.

23 We have identified two sorts of sustainability impact goals, the pursuit of which would be consistent with IFSI. The distinction between them is key in the analysis that follows, so much so that we distinguish between two sorts of IFSI depending upon which goals are being pursued: instrumental IFSI and ultimate ends IFSI. See Box 3: Two sorts of IFSI: instrumental IFSI and ultimate ends IFSI.

INVESTING FOR SUSTAINABILITY IMPACT

Box 3: Two sorts of IFSI: instrumental IFSI and ultimate ends IFSI

Two sorts of sustainability impact goals would be consistent with IFSI:

- where achieving the relevant sustainability impact is 'instrumental' in realising the investor's financial return goals, for example, where an investor concludes that its financial return goals may not be realised unless a particular overarching sustainability outcome can be achieved and the targeted sustainability impact goal can help with that; and
- where achieving the relevant sustainability impact goal, and the associated overarching sustainability outcome, is a distinct goal, pursued alongside the investor's financial return goals, but not wholly as a means to achieving them.

This is a key distinction. We refer to pursuing goals of the first sort as **instrumental IFSI** and pursuing goals of the second sort as **ultimate ends IFSI**.[15]

- Instrumental IFSI could include, among other things, seeking to protect or enhance portfolio value by pursuing sustainability impact goals (a) that are intended to help in addressing systemic risks (see Box 4); or (b) that address risks or opportunities created by a given sustainability factor for a series of investee enterprises or a sector which could have financial implications (and hence affect portfolio value), thereby improving sustainability in the area concerned.
- The goals of ultimate ends IFSI can be broader. While ultimate ends IFSI would involve seeking to achieve a sustainability impact goal as an end in itself (ie because of its positive contribution to sustainability), that does not necessarily mean that the goal, if achieved, would not be aligned with investors' financial goals. Nor does it mean that the sustainability impact goal concerned must take priority over an investor's duties to secure a financial return, although that would be possible. It simply means that a decision is partly motivated by the desire to achieve the sustainability impact goal as an end in itself.

In practice, different elements of human motivation cannot be neatly separated in this way so, in reality, there may be a good deal of motivational overlap between ultimate ends IFSI and instrumental IFSI. In any event, factors that are often described as 'non-financial' could conceivably turn out to have longer-term financial implications (making the shorthand use of expressions like 'financial' and 'non-financial' to distinguish between things that can be more or less easily measured in monetary terms potentially misleading).

Connected with this distinction is the ongoing debate in various jurisdictions over when ESG factors are considered 'financially material' - and, as a result should be taken into account in the investment process (see Part B.2, Box 1) - and the extent to which 'non-financially material' or 'non-financial' factors can ever be taken into account. The underlying assumption involved in focusing on financial materiality is that the only goal of investing is to achieve a financial return and that ESG factors should be taken into account when material to realising this goal. However, as noted by a number of those we have spoken to in preparing this report, sometimes another set of concerns is implicitly being debated between the lines of this discussion. The language is that of financial return, reflecting the desire of those involved to comply with their legal duties on generating financial returns. Yet an underlying question concerns how far portfolios should or can be managed in a way that supports both longer-term financial goals and positive sustainability outcomes.[16] Sometimes, these aspirations are more explicit.

The distinction between financial motives and wider motives for investing is nonetheless important in following and enforcing legal rules. That is mainly because not all sustainability factors will necessarily be financially material to a portfolio, even in the long-term. In general, as will become clear later in this report, current legal rules are more likely to require or permit IFSI where this supports the realisation of an investor's financial goals (ie instrumental IFSI) than they are to require or permit ultimate ends IFSI.

INVESTING FOR SUSTAINABILITY IMPACT

Box 4: Systemic risk

In recent years investors have increasingly focused on what must be done to protect the value of their portfolios from *system-wide risks* created by the declining sustainability of various aspects of the natural or social environment. System-wide risks are the sort of risks that cannot be mitigated simply by diversifying the investments in a portfolio. They threaten the functioning of the economic, financial and wider systems on which investment performance relies. If risks of this sort materialised, they would therefore damage the performance of a portfolio as a whole and all portfolios exposed to those systems. In this report, we call these **systemic risks**, although in other contexts they are sometimes described as 'systematic', 'non-diversifiable' or 'market' risks.[17]

Identifying all the sustainability factors that currently present systemic risks for investors lies outside the scope of this report. It is possible to imagine that, particularly in the longer-term, there could be quite a number. However, the most obvious example at present is the risk of a climate change disaster, and pursuing sustainability impact goals that address it so as to protect portfolio value would be within the scope of IFSI. In the words of the Bank of England, 'The financial risks from climate change have a number of distinctive elements which present unique challenges and require a strategic approach to financial risk management.'[18]

(b) How investors can pursue their goals

24 The important topic of how investors' sustainability impact goals are defined and set, and how progress towards them can be assessed, is discussed in Part 2. However, there is a separate question of what practical steps investors can take to seek to achieve sustainability impact goals. What is appropriate would depend, among other things, on the sort of sustainability goal involved and asset class but three broad means of influence are available:

- decisions on which enterprises to invest in and, potentially, on what terms;
- stewardship activity with investee enterprises; and
- seeking to shape public policy as it concerns business enterprises and their operating environment and the ability of investors to influence them.[19]

25 The first two concern how investors seek to influence enterprises,[20] the third relates to investors' relationship with policymakers. The following looks briefly at each. In practice, however, the use of these approaches is inter-connected: legal duties that are most relevant to the question of whether an investor should or can seek to achieve sustainability impact goals concern an investor's activities as a whole, not one sort of activity in isolation. Most obviously, stewardship may be more effective if combined with the prospect of further capital allocation where progress is made or divestment if it is not. Until now, attention has tended to focus on the use of investment powers. Because of that, our project has considered these three activities separately to assess what investment duties require or permit in each case.

(i) Powers of investment and divestment

The example of Zurich Insurance Group

'As a global insurance company with a growing presence in emerging markets, Zurich is exposed to many of the risks associated with climate change, competition for scarce natural resources and extreme poverty. We believe that impact investments, which can have a targeted, positive and measurable effect on society and the environment, while generating a financial return commensurate with the risks they entail, are one way to help mitigate and address the exposure to such risks: this is also why Zurich has direct interest in sustainable economic growth and in developing resilient communities.'

Manuel Lewin, Head of Responsible Investment, Zurich Global Investment Management[21]

26 Providing capital to, or withdrawing it from, an enterprise has the potential to influence the sustainability impact of the enterprise by supporting or incentivising some activities over others. However, the effectiveness of using investment powers in this way will depend upon the asset type and precise circumstances. For example, it may be more effective in specific situations, such as where a company is seeking to raise new funds or to 'roll' its bonds (replacing maturing with newly issued bonds) or early-stage investment (such as that provided by impact investors, see Section 1.3 below) in private enterprises

INVESTING FOR SUSTAINABILITY IMPACT

that may not be able to access mainstream sources of capital. Further, especially in the context of a collective action with other investors, decisions to overweight or underweight a company's stock may well influence its behaviour even where no new capital is being raised (see discussion of collective action in Part B.2, Box 2). Investment decisions (or the threat of them) can also be used to enhance the effectiveness of stewardship activities, especially where they are likely to provide a respected signal to the wider market.[22]

27 However, reliance on investment powers to achieve sustainability impacts also has its limits.[23]

28 First, an important question concerns how much influence investment decisions have on a company's activities where the company is large and its securities are listed and liquid.[24] Once securities have been issued and finance raised, investors no longer hold the purse strings; companies are not principally dependent upon trading in the secondary market for their funding (although executives whose remuneration is partly dependent on stock prices may have a different interest).

> '…in a world in which many investors trade only based on securities' financial performance, it is difficult to argue that merely trading the securities of public companies, based on social or environmental criteria, will affect the quantity of the social value they produce.'[25]

29 That said, assessments of the importance of 'exit' over 'voice', divestment over stewardship, can sometimes be overly focused on its limited effect on share price and underestimate the practical impact on (i) the behaviour of company management of having the company's stock put on investor stop lists and (ii) investor and consumer attitudes more widely because of what it signals.[26] That is partly why exit or the threat of it can be a way of strengthening voice in stewardship discussions.

30 Second, there is limited scope for passive investors to use investment powers strategically, unless the design of the index they track results in the allocation of capital to enterprises in a way that achieves positive sustainability impacts.[27] However, passive investors may still have some flexibility where they are not seeking to replicate the index perfectly (see Part B.2, Box 4 and Part B.4, Box 6).

31 Third, investors may feel constrained in allowing sustainability considerations to influence investment decisions where investment practice is focused on short-term financial performance. While sustainability risks can crystallise in unpredictable ways, the prospect is often perceived to be longer-term, so that sustainability risks may not be fully reflected in shorter term investment prices. Among other things, investors may be concerned at the possibility of legal liability if they invest by reference to what are thought to be longer-term criteria and funds underperform by reference to shorter-term measures (see Part B.4).

32 Finally, it may be difficult to verify that investee enterprises have used capital in a way that really changes their sustainability impact. For example, there have been suggestions that discretely financed 'sustainability projects' using 'green bonds' may sometimes effectively be used to shelter the non-sustainable activities of an enterprise by focusing external funding decisions on 'green' activities.[28] Where that is the case, it may be relevant to the question of whether investment is likely to secure a sustainability impact.

(ii) Stewardship

33 Depending on the jurisdiction, type of enterprise and investment relationship, there is a range of other ways for investors to influence investee enterprise behaviour, such as introducing shareholder resolutions, voting at general meetings (including supporting resolutions strategically introduced by other more active investors, thereby minimising their own expenses[29]), monitoring and reporting on aspects of business activities, providing management training and technical assistance, and engaging in dialogue with management. This report refers to these activities collectively as '**stewardship**' although people also sometimes describe them as 'engagement' or 'active ownership'.

34 It is sometimes assumed that stewardship principally concerns the use of formal shareholder powers, such as voting rights. However, dialogue with management may be one of the most effective stewardship tools, with the possibility of investor resolutions and use of investment

INVESTING FOR SUSTAINABILITY IMPACT

powers in the background.[30] There are understandable concerns in some quarters over the legitimacy of discussions of this sort which are inevitably not as public as shareholder meetings, especially where investment is concentrated in a small number of institutions.[31] These concerns are not the subject of the current exercise. However, as a minimum, ensuring that there is a wider social consensus on the goals of stewardship activities should help to allay them.

Stewardship compared with use of investment powers

35 Stewardship is likely to be a particularly important IFSI tool, especially for those investing through public markets.[32] In contrast with the use of investment powers, stewardship may provide greater scope to influence the way in which capital is allocated *within* an enterprise or other areas of its behaviour.[33] Investors may also have greater freedom in practice to engage in stewardship as compared with using investment powers.[34]

36 First, some existing market features may tend to focus investors on portfolio composition (ie use of investment powers) to secure shorter-term financial performance. However, stewardship does not directly affect portfolio composition. Further, any impact from stewardship on investment performance, short-term or otherwise, in relation to a given enterprise is shared across all investors and reflected in the benchmarks against which investment performance is measured (see Part B.4). So, for example, in jurisdictions where there is strong legal support for what can loosely be described as modern portfolio theory, which might inhibit the use of investment powers for sustainability impact, an investor may still be able to engage in stewardship (subject to considerations discussed more fully in Part B).

37 Second, investors that have adopted passive investment strategies, with little or no flexibility over investment selection, are still, in principle, able to engage in stewardship.[35] Large passive managers increasingly recognise their responsibility to do so.

> 'In managing our index funds … BlackRock cannot express its disapproval by selling the company's securities as long as that company remains in the relevant index. As a result, our responsibility to engage and vote is more important than ever. In this sense, index investors are the ultimate long-term investors – providing patient capital for companies to grow and prosper.'[36]

38 Finally, the legal terms governing the investment of portfolios (such as mutual fund investment policies and regulatory rules on portfolio liquidity and diversification) may constrain the use of investment powers in pursuing IFSI in a way that does not always affect stewardship activities to the same degree.

39 As a practical matter, particularly in public markets, it may also be easier to identify specific sustainability targets for an investor's stewardship activity (ie steps designed to help it to meet its portfolio-level sustainability impact goals) and to assess whether those targets have been achieved than it is with decisions on whether to invest in an enterprise or not. Concentrating on stewardship may also prevent instruments issued by enterprises with poor sustainability performance being passed on to investors who are less concerned about, and therefore less likely to engage those enterprises on, sustainability impact, (although in some areas of sustainability, especially the move towards net-zero, the number of investors in that category appears to be reducing).[37]

Stewardship and investment managers

40 In practice, much stewardship activity is undertaken by investment managers on behalf of their asset owner clients with varying degrees of asset owner involvement. However, managers' incentives to engage in stewardship have been mixed, with investment selection activities tending to overshadow stewardship.[38]

41 For active managers, trading a given stock may often be a more efficient way of realising or protecting value than engaging with an enterprise. For passive managers or those with highly diversified portfolios, diversification reduces the impact of enterprise-specific performance factors on portfolio performance, potentially reducing incentives to engage, and results in holdings in a large number of enterprises, potentially limiting the prospects for meaningful engagement across the portfolio.[39] However, there are ways of addressing this.[40] Because managers have shorter-term mandates

INVESTING FOR SUSTAINABILITY IMPACT

and will be assessed on their investment performance, they could also have less of an incentive to consider the sort of longer-term implications of sustainability-related risks which may lead asset owners to want to engage in stewardship activity. There are also expense considerations. Consequently, while stewardship capacity may be an emerging source of competitive advantage between firms, there may also be reluctance to incur more cost than is necessary. Asset owners who recognise a need for stewardship in pursuing sustainability impact goals should address issues such as these in the terms upon which they appoint their investment managers.

Stewardship and collective action

42 It can be challenging for a single investor in a large enterprise, acting alone, to influence the sustainability impact of that enterprise, or to do so cost-efficiently. However, fostering change through joint stewardship activity is a different matter (see Part B.2, Box 2).[41] The concentration of asset ownership at large institutional investors (sometimes called 'universal investors') potentially gives them particular influence in this context, including by catalysing collective initiatives involving investors with lower levels of AuM.[42] The increasing consolidation of investment management in the hands of a small group of global investment managers (see Part A.3.2.2) may also strengthen shareholder voice where those managers engage on behalf of their clients: in a sense consolidation of management can also bring consolidation of voice although even large firms recognise a role for collective action.[43]

(iii) Public policy engagement

43 Investors can also engage with policymakers, regulators and others in seeking to influence the direction of policymaking on matters relevant to achieving sustainability impact goals.[44] In practice, however, the extent to which some categories of investor will feel able to do so may be influenced by cultural expectations or even more formal regulatory guidance in the jurisdiction concerned (see further in Part B.3).

44 Policy engagement can include, among other things, addressing issues that inhibit investors from investing for sustainability impact (eg uncertainties over investor duties), addressing legal or practical barriers faced by business sectors in moving to more sustainable business models, and encouraging interventions in primary economic activity or fiscal policy (for example, policies designed to achieve a transition to a 'green economy') which can help to reduce systemic risks but also fundamentally affect investment decisions. In other words, policy engagement could be focused on the behaviour of investee and potential investee enterprises, factors relevant to an investor's ability to influence that behaviour (such as the need for effective, consistent and internationally standardised disclosure on sustainability factors), or other areas of activity that create risks or set the operating environment for those enterprises or investors. The goals of engagement can be inter-related. For example, some investors have suggested that they are currently hampered in using their investment powers to invest in enterprises that are aligned with averting climate change due to a shortage of suitable potential investees, adopting a 'best in class' approach instead. Changes in industrial policy designed to tackle climate change might be expected to stimulate new businesses or changes in existing businesses that would generate opportunities.

45 Engagement may be especially significant for long-term investors who may be more reliant on policies that ensure market integrity, resolve market failures and address damaging government action.[45] However, sustainability-related risks to a portfolio could also crystallise in the short-term. Investors unable to manage these risks effectively at enterprise or portfolio level can seek solutions through policy engagement. As with stewardship, it is in principle possible to undertake engagement regardless of what has driven portfolio composition.

1.3 Investing for sustainability impact and 'impact investing'

46 An obvious question concerns the relationship between what is commonly referred to as 'impact investing' and the kind of activities that fall within the scope of IFSI. Essentially, the concept of IFSI is broad enough to cover impact investing. Indeed, there appears to be a strong correlation between the two at a broad conceptual level. However, they are distinguishable, in particular, because of the sort of investors and investments involved.

47 Interest in various forms of 'impact investing' has grown in the last decade. Various international initiatives have emerged that seek to define what it is and develop effective approaches for managing

INVESTING FOR SUSTAINABILITY IMPACT

and measuring impact outcomes. They have led the way in generating valuable know-how and investment tools. They include the Global Impact Investing Network,[46] the Impact Management Project,[47] the Operating Principles for Impact Management[48] (promulgated by the International Finance Corporation), the 'Future of Investing' platform of the World Economic Forum,[49] the OECD Social Impact Investment Initiative,[50] the Global Social Impact Investment Steering Group[51] and the (wider in scope) United Nations Environment Programme Finance Initiative Positive Impact Initiative.[52] There is joint working between many of these groups.

48 As noted, there is a basic consistency between the features of IFSI and the key elements of impact investing, as described by the groups and initiatives mentioned above.[53] With differences of emphasis, the way they define impact investing involves three recurring themes:

- the key distinguishing feature is its *purpose*, which is to secure identified positive outcomes of some sort;[54]
- there is generally an expectation that the investor's purpose also includes earning a financial return; and[55]
- the importance of being able to assess progress in achieving the relevant impact goal.

49 The main area of difference concerns the way impact investing functions in practice, especially (i) the types of investors involved and (ii) the sort of enterprises in which they invest and the associated methodologies applied. This may result, in part, from its origins at the interface between investment and philanthropy (see Part A, Appendix 1). Some of the initiatives mentioned above seek to draw on and apply more widely experience and techniques developed in this context.

Investor types

50 In terms of investor types, impact investing has tended to be the preserve of development finance institutions, private investors and specialist investment funds more than major institutional investors and investment firms. That has begun to change in recent years with attempts to 'mainstream' impact but, at least in the context of capital allocation, it remains largely the case. Even where more 'mainstream' investors use their investment powers to engage in impact investing, they can tend to do so through specialist impact investing units more than their core investment activity.[56]

Investment targets

51 As to what these investors invest in, while it is not easy to generalise, the targets have often been discrete, early-stage, private enterprises that tend to be concerned with addressing a specific social or environmental issue; enterprises that have sometimes been described as 'impact-driven organisations'.[57] They fall along a spectrum from those intended to generate market levels of investment return through to others which prioritise a social or environmental goal. Some impact investors think of 'impact' in terms of the positive impact their capital provision can have for these early-stage enterprises that may not be able to access other capital sources. Impact investing has historically been less concerned with securing sustainability impacts in larger, more mature and diversified businesses, including major multinationals whose securities are traded on the world's investment exchanges. However, as noted, that has begun to change. The concept of IFSI is intended to catch impact-driven investment activities whatever sort of business enterprise is involved.[58]

1.4 The relationship between investing for sustainability impact and 'sustainable investment' more widely

52 IFSI falls within a group of investment approaches in which social, environmental and economic sustainability factors are deliberately taken into account in some way. These include 'ESG investing', 'impact investing', 'ethical investment', 'socially responsible investment', 'sustainable investment', 'stewardship' and 'responsible investment'.

53 The main difference between investment approaches that are within the conceptual net of IFSI, and sustainable investment approaches that are not, concerns investment goals. All approaches to sustainable investing involve investors pursuing investment goals. However, the defining characteristic of those within the scope of IFSI is that an investor recognises that, in order to achieve its goals, there is a separate need to set and pursue specific sustainability impact goals and assess progress towards them – it involves the investor intentionally seeking to

INVESTING FOR SUSTAINABILITY IMPACT

influence the sustainability impact of those enterprises in assessable ways.

54 Broadly, the main approaches to sustainable investing tend to involve some combination of the following:

- making investments or excluding them from a portfolio based on an explicit and systematic inclusion of environmental, social and governance factors in investment analysis to better manage risks and improve returns (generally in the short-to-medium term);
- applying filters to lists of potential investments to rule companies in or out of contention for investment based on an investor's preferences, values or ethics;
- various forms of stewardship activity;
- various forms of sustainability-themed investing, where there is an intention to contribute to specific environmental or social outcomes, including impact investing.[59]

55 Both the first and second of these could certainly be used as part of an IFSI strategy.[60] However, considered as distinct activities, neither *necessarily* involves pursuing sustainability impact goals, unlike IFSI which does.

- The first might look like instrumental IFSI in that it is concerned with achieving a financial goal. However, it tends to involve allocating capital based on the quality of an enterprise's sustainability standards on the assumption that this will yield better investment returns (for example, in the belief that more sustainable enterprises carry less investment risk). By contrast, instrumental IFSI involves deliberately setting and pursuing specific sustainability impact goals for one or more business enterprises; realising these goals is regarded as necessary to achieve a desired outcome beyond the sustainability impact goal itself, namely financial return or reduction of investment risk.
- Likewise, the second might seem similar to ultimate ends IFSI. However, again there is a difference. That is not because the motivating values are necessarily different, but because it tends to involve pursuing those values by avoiding investment in companies that are not value-aligned and, possibly, the hope that diverting capital away from them will stimulate change (as to which, see Section 1.2.3(b) above). By contrast, ultimate ends IFSI involves setting and pursuing specific sustainability impact goals for one or more business enterprises in order to align market practice with those values.

56 So, for example, merely reshaping a portfolio so that it is less exposed to financial risks posed by sustainability factors (eg by screening to remove entities with a poor understanding of how to decarbonise their activities) would not of itself fall within IFSI since it does not involve setting and seeking to achieve specific sustainability impact goals (although, as noted, that does not mean it could not be used as part of an IFSI strategy). However, a deliberate and well-signalled move by large numbers of investors towards, for example, steel companies with a good understanding of how to decarbonise their business, intended to persuade other companies in the sector to develop effective transition plans would potentially do so.

57 We are not intending to suggest that the reshaping of investment portfolios with the intention of reducing financial exposure to a risk posed by sustainability factors should only happen where the investor is also pursuing a particular sustainability impact goal. We stress the distinction merely because this report is primarily concerned with activities designed to achieve sustainability impact goals, whether to improve to the quality of financial return or as an end in itself.

58 Similarly, if an asset owner were to invest in an enterprise that had a purpose that involved making a positive sustainability impact, but chose that investment *only* because it anticipated an attractive financial return, this would not be IFSI, even though the enterprise might generate a positive sustainability impact. That is because the asset owner's only goal is financial return, not achieving a sustainability impact. Once again, we are not suggesting that such a decision would be any more or less legally permissible than one intended to achieve a positive sustainability impact. We are just delineating the activities with which this report is primarily concerned.

59 Both of the forms of sustainable investing described in the first two bullets of paragraph 54, above, could nonetheless

INVESTING FOR SUSTAINABILITY IMPACT

have sustainability impacts that may be aligned with IFSI (see Part B.2 Box 3).[61] For example, as noted above, inclusion of a company on investors' stop lists because of the company's poor sustainability record would likely attract directors' attention.

60 As to the third form of sustainable/responsible investing, stewardship activity, it follows that when stewardship is designed to result in improvements in the sustainability footprint of a given enterprise or sector, it may often be a form of IFSI. That is because it necessarily involves assessing the current activity of business enterprises and seeking to change it by reference to some sort of goal.

61 The fourth form of sustainable/responsible investing includes impact investing (see 1.2 above). In some cases, investment approaches in this category may therefore fall within the concept of IFSI.

62 The terminology that is used to describe different sorts of sustainable investing has evolved over many years. For a brief summary of the historical background, see Part A, Appendix 1. Common expressions, such as 'sustainable investing', are generally not legally defined, although legislators and regulators do sometimes use them, especially in guidance, and they are beginning to appear in legislation.[62] They also get used interchangeably or in ways that can make it hard to know what they involve in practice and how they differ. That suggests that there is only a loose consensus about what they mean, which can be a source of confusion and criticism.[63] As an indication of this, Part A, Appendix 2 provides a selection of definitions advanced by well-known institutions and industry bodies of some of the most commonly used expressions.

INVESTING FOR SUSTAINABILITY IMPACT

2. IFSI: GOAL CERTAINTY, ASSESSMENT OF IMPACT AND UNDERSTANDING AN INVESTOR'S CONTRIBUTION

2.1 Introduction

63 Section 1 looked at the basic concept of IFSI. However, it deferred three key issues to this Section 2:

- the need for an investor to be able to identify sufficiently clear impact goals (ie *goal certainty*);
- how progress towards the goals is to be *assessed*; and
- how to understand what difference an investor's action can make or has made in progressing the goals (ie the question of *causation* or the investor's *contribution*).

64 Each is needed for an investment approach to be a form of IFSI. They also have a bearing on what the legal rules considered in Part B of this report require or permit and on the policy options in Part C.

65 In what follows:

- Section 2.2 looks at the legal significance of each issue; and
- in light of that, Section 2.3 makes some high-level observations on the current means available for addressing them.

66 Investors' capacity to define impact goals, assess progress towards them and understand their own contribution is developing but is more advanced in some areas and in relation to some aspects of sustainability than others. This presents challenges for investors, not least in terms of expense.[64] These challenges have a bearing on what investors can and should do. That is because what legal powers, duties and discretions require or permit does not just depend on their 'black letter' (ie what they 'say') but also the circumstances in which they are applied (see Part B.2.2 and B.4).

67 The challenges should reduce as market frameworks and practice develop. However, for now they may lead investors to focus on areas where the ground is more certain, extending their activities as the 'market infrastructure' evolves. Collaboration between investors is one way to facilitate solutions. Work can be undertaken strategically, know-how shared, and costs spread (see Part B.2, Box 2). Policymakers may also have a role (see Part C.2).

2.2 Requirements for legal rules relevant to IFSI

68 Reasonable certainty about the goals being pursued, an ability to assess progress towards achieving them and an investor's role in that progress are all important in formulating and applying legal rules that are relevant to IFSI.

69 By '**legal rules**', we mean any legal provision (whether established in legislation or arising under judge-made law) that is intended to guide behaviour by imposing duties or discretions or conferring powers.[65] Most of the legal rules considered in the legal assessments in the annexes to this report are in that category.

70 Legal rules are intended to influence behaviour. Their effectiveness in doing that depends, among other things, on:

- clarity about the behavioural outcome at which the rule is directed (ie goal certainty);
- a reliable way of working out whether it has happened ('assessment'); and
- an expectation that the person at whom the rule is directed has some influence on the outcome, making it necessary to be able to understand the relevant person's role or 'contribution' in bringing about a particular outcome.

71 None of these must be perfectly satisfied to create new laws or apply existing ones. However, some level of certainty is needed on each.

2.2.1 Goal certainty

72 Part A (Section 1.2.3(a)) identified three types of goals that are relevant to the concept of IFSI:

- overarching sustainability outcomes reflected in international instruments such as the SDGs and the Paris Agreement that are relevant to the investor in discharging its duties;
- portfolio-level sustainability impact goals an investor sets for its activities which are consistent with helping to bring about overarching sustainability outcomes that are relevant to the investor (similar to a financial

INVESTING FOR SUSTAINABILITY IMPACT

investment objective, but relating to sustainability); and

- the more specific steps an investor can take to secure action on the part of business enterprises or other third parties which it is reasonable to think will help to realise the portfolio-level sustainability impact goals (which could be seen as a sustainability equivalent of an investment policy).

73 An investor needs to be reasonably clear about the portfolio-level sustainability impact goal it is seeking, and the specific sustainability impact targets in its action plan for pursuing that goal. It should also have a reasonable basis for thinking that achieving the portfolio-level sustainability impact goal is aligned with moving towards an overarching sustainability outcome that is relevant to the investor.

74 In practice, investors' portfolio-level sustainability impact goals may not involve specific outcomes that are either achieved or not but may instead be about securing steady change of some sort that is aligned with a particular overarching sustainability outcome, such as ensuring that all participants in a given business sector have credible transition plans to net zero emissions. They could also include steps to discourage activities of a sort that are not so aligned. Whatever the goal, clarity is still needed on what amounts to progress in achieving it. That might, in turn, be defined, for example, by reference to whether the more specific impact targets in an investor's action plan are being met.

2.2.2 Assessment

75 Investors carrying on activities within the scope of IFSI may need to make or access various assessments in seeking to discharge their duties, including as to:

(a) the extent to which human behaviour is aligned with overarching sustainability outcomes and how that is changing;

(b) the impact of business sectors on (a) and how it is changing;

(c) the impact of individual business enterprises on (a) and (b) and how it is changing; and

(d) the impact of government policy on (a) to (c).

76 Assessment is needed *before* any steps are taken, to define what action is needed, and *during* and *afterwards* to establish whether it has been effective in achieving the relevant goal. Assessments need to be sufficiently standardised for those with an interest, including courts and regulators, to know that they are talking about the same thing and to facilitate comparison between outcomes achieved in similar circumstances.

77 For an investor to define its sustainability impact goals in the first place, it needs a credible basis for assessing how far circumstances it is able to influence are aligned with overarching sustainability outcomes that are relevant to it. However, once set, sustainability impact goals remain largely meaningless without a reliable way of establishing whether they have been achieved. Sustainability impact goals are therefore likely to involve some sort of qualitative or numerical target, the achievement of which is capable of assessment by the investor and others. Assessments would cover both progress towards portfolio-level sustainability impact goals and the more specific targets set by the investor in pursuing those goals. The outcome could also be considered by reference to assessments of how far overarching sustainability outcomes are being achieved.

78 However, these are not the only kinds of assessment that investors seeking to achieve sustainability impact goals may need to undertake. Importantly, they will also usually need to assess the effect, if any, of pursuing sustainability impact goals on the financial performance of their portfolio (see Box 5).

INVESTING FOR SUSTAINABILITY IMPACT

Box 5

Assessing the impact of IFSI on financial performance

Investors seeking to achieve sustainability impact goals will generally need to assess how, if at all, doing so affects the financial performance of their portfolio (see Part B.2 and 3). Potential challenges include (a) a lack of clarity as to the nature and extent of exposures to sustainability factors at individual enterprise, sectoral and system-wide levels and, consequently, their longer-term financial and therefore portfolio implications and (b) the available measurement tools (see Section 2.3.2 and Part B.4). Particularly when a sustainability impact goal is intended to help in addressing systemic risks, which are difficult to quantify, simple cost-benefit analysis is unlikely to be feasible or appropriate. However, that does not mean that the risks are not real or that investor activity cannot help in mitigating them. Decisions may therefore need to rely, at least in part, on an assessment of the potential adverse impact for portfolio value and performance if these risks are not addressed.

The sort of judgements that may be needed on possible trade-offs between financial return and sustainability impact could vary depending upon whether the investor's approach involves instrumental IFSI or ultimate ends IFSI. In the case of the former, the judgement is more likely to focus principally on the timing and extent of any financial impacts. However, since the value of sustainability impact goals may not reduce to financial measures alone, further challenging judgements may be needed, particularly in the case of ultimate ends IFSI. Since financial and sustainability assessment methodologies are often not interoperable, there is also potential for a 'siloed' approach between staff focused on pursuing narrower financial objectives and those concerned with sustainability impact.[66] Developing the necessary methodologies is a matter of investment and wider practice. It is therefore not considered further here. However, it is likely to be important in applying at least some legal rules, especially rules that require investors to prioritise financial return but nonetheless allow them to pursue what we have described as ultimate ends IFSI.

The wider question of whether there is generally an impact on portfolio performance where investors deliberately take account of sustainability factors and, if so, of what sort, has generated considerable debate and provides some context for these assessments but has not generally looked at IFSI investment approaches.

Work to date has tended to focus on historical performance where investment selection in pursuit of financial investment objectives is influenced by the ESG profile of investee enterprises.[67] It is less concerned with, among other things, the potential future performance impact of systemic risk resulting from sustainability factors (except, perhaps, to the extent these risks have already been reflected in that historical investment performance). In view of the definitional questions concerning sustainable/responsible investing discussed in Part A.1.4, it is possible that some of this work included portfolios being managed in ways that involved IFSI. Even so, it seems unlikely that these portfolios would have comprised a material portion of the relevant assets under management. Because of that and the definitional ambiguities involved in concepts such as ESG, that work may therefore be of limited relevance in making the sort of assessments mentioned above. However, one of the most comprehensive assessments of studies on this topic to date found that roughly 90 per cent of those studies indicate at least a non-negative impact of taking account of ESG factors and the majority suggest a positive impact.[68] Meanwhile, the IMF has concluded that the available literature on this point is inconclusive, but that the performance of sustainable and conventional funds may at least be comparable.[69]

79 Given the definitional questions surrounding sustainable/responsible investing, some of the work mentioned above may also have covered the performance impact of sustainability-related stewardship activity. However, while the understanding behind stewardship codes is that stewardship is relevant to corporate value and hence portfolio value, analysis of the financial value implications of stewardship specifically concerning sustainability factors remains a developing area.[70] There is, nonetheless, some evidence that it can make a positive difference, both in terms of investee financial performance,[71] and in helping to protect shareholders from the risk of loss as a result of sustainability factors.[72] Less attention has been given to the impact on financial performance of policy engagement.

2.2.3 Understanding the investor's contribution

80 Investors need to use their legal powers to achieve the purpose for which the powers were given. In deciding what steps to take, whether to pursue sustainability impact goals or otherwise, they therefore need to be satisfied that their intended actions will help in realising that purpose, and in a way that merits any proposed use of resources. Similar considerations apply when they (and others, such as courts and regulators) review the effectiveness of what they have done.

INVESTING FOR SUSTAINABILITY IMPACT

81 For each sort of sustainability impact goal an investor sets, the investor and those with an interest therefore need to be able to understand the investor's role in bringing about a given change – ie there needs to be a credible basis for understanding the *causal connection* between the investor's actions and the relevant outcome.

82 Precisely what this might mean in practice will differ depending on the investor's circumstances and strategy and the goal concerned. The level of expense for the investor and its portfolio may also be relevant; if a given step effectively involves no expense or risk to the portfolio, then the need to assess the investor's contribution may be limited. However, in practice, establishing an understanding of the investor's contribution may focus especially on the investor's influence, individually or collectively, on individual business enterprises, sectors and policymakers.

83 Perhaps most notably, as discussed in Part A.1.2.3 there are differences between the influence an investor might have as a significant source of capital for a private enterprise as compared with investment in public markets. In private (and in some cases in illiquid public) markets, investors may have more control over the amount and cost of capital available to investee enterprises and the terms on which it is provided, allowing them to have more of an influence on investees in addressing their sustainability impact. This is less feasible as a secondary market investor in a company with a large shareholder base. In that context, understanding the investor's contribution to a given sustainability impact is likely to involve a greater focus on outcomes achieved collectively with other investors (see Box 6 and Part B.2, Box 2).

Box 6: Investor contribution and collective action

It is obvious to business people that achieving just about any major commercial goal requires collective effort. Large commercial projects are invariably collective endeavours and even the contribution of those directly involved depends on the activities of third parties far beyond them. Much as with an orchestra performing a piece of music, a sports team in a competition, or even voting in an election, this collective activity is designed to bring about a desired outcome. It produces a result for which each member is partly responsible and to which each has contributed, even if their role can only be fully understood in terms of the collective whole and cannot be perfectly separated out and defined. The collective result is different from the product of individualised behaviours and can be significant both to those directly involved and those affected by their collective activities.

Similarly, an investor engaging in collective action in pursuit of a sustainability impact goal which is designed to help in achieving an overarching sustainability outcome may be able to point to the result of that action. However, it may not be able to demonstrate that, viewed in isolation, the result led to a particular sustainability outcome being achieved or even advanced, that the sustainability outcome concerned has enabled the investor to achieve its legal objectives, or that the collective action would not have been successful but for its own participation.

That does not mean that the investor has not made a contribution and been discharging its duties. However, in understanding what and how, the focus would be on the logical and evidential credibility of the investor's explanation for the difference it has made in the context of the collective action as a whole, and other related activity, more than the precise quantification of the individual impact of its involvement: the essence of collective action is that the sum is intended to be greater than its parts.

In the event of a dispute, courts may tend to look more closely at whether a *proper process* was followed than the *outcome achieved* in determining whether duties have been discharged.

INVESTING FOR SUSTAINABILITY IMPACT

2.3 Observations on the current state of market practice

84 Investment frameworks, methodologies and metrics are developing in each of the three areas discussed above. Particularly for sustainability goals such as tackling climate change, it is credible to think that investors can make an effective contribution, for example, by pursuing sustainability impact goals, and there are many examples of this in practice (see Box 7).[73] In any event, we have assumed that in preparing this report.

Box 7: The example of Climate Action 100+

Having seen a substantial increase in company decarbonisation commitments, the Climate Action 100+ initiative is increasing its focus on actions and outcomes. It has recently released a net zero company 'benchmark' for evaluating company performance in relation to reducing greenhouse gas emissions, improving governance, and strengthening climate-related disclosures and assessing the extent to which companies are delivering on their commitments.

'... tangible outcomes at companies ... must happen for the initiative to succeed. ... So far, Climate Action 100+ engagement teams have secured numerous net zero and SBT commitments across a range of hard-to-decarbonise companies and sectors where this was unimaginable a short time ago. ... in less than three years, the initiative [has] become the leading driver of corporate decarbonisation efforts.'

Andrew Gray, director, ESG and stewardship at AustralianSuper and Climate Action 100+ steering committee member and chair, interviewed by Climate Action 100+.[74]

'We cannot manage what we cannot measure. The benchmark gives us the tool needed for engagement and to inform our proxy voting. The first assessments show the scale of ambition, where we are and where we need to get to, with measures along the way. We're in the foothills of a long climb. This is tough, but necessary.'

Anne Simpson, managing investment director, board governance and sustainability, CalPERS and Climate Action 100+ steering committee member[75]

85 Nonetheless, the available tools and information are far from complete. There has clearly been considerable progress in the area of climate change, and the experience of the TCFD shows just how swiftly this can happen.[76] However, looking at sustainability goals more broadly, there is currently no commonly agreed basis, among other things, for investors to set sustainability impact goals, for defining what it is to have a positive sustainability impact, for determining the sustainability impact of an enterprise in the round, or for measuring progress towards many potential impact goals. There is also a lack of consensus as to which sustainability factors present financial risks for investors, or over what timescale, and uncertainties that are challenging to resolve, for example in terms of the second- and third-order effects of not achieving overarching sustainability outcomes.[77] Up to a point, therefore, these questions need to be considered by investors on a case-by-case basis, although investor coalitions can help to beat a path for all.

86 We should emphasise that we are not suggesting these issues mean that investors cannot or should not seek to achieve sustainability impacts. Part B considers what legal rules require of investors or permit them to do in terms of seeking to achieve sustainability impacts. Here, we are simply highlighting the likely need for further work for it to become more feasible for investors to pursue some sorts of sustainability impact. This may influence where investors are currently best able to concentrate their efforts, and how.

87 Developing solutions is a work of many hands. Our project has not been intended to assess what is required. However, since this market environment is relevant to how legal rules apply, some of the more significant initiatives are mentioned briefly below to indicate the kind of challenges that investors may face. This provides a context for the discussion of legal rules in Part B. Legal frameworks can also help in addressing some of the challenges. This context is also therefore relevant to the policy options in Part C.

88 The three themes of goal certainty, assessment and understanding the investor's contribution have been separated out in what follows, but initiatives mentioned under one heading are sometimes relevant to others. For example, it may be challenging to define an impact goal without reference to an assessable numerical or qualitative outcome. In some cases, therefore, an initiative is mentioned in one context rather than another simply for descriptive convenience.

INVESTING FOR SUSTAINABILITY IMPACT

2.3.1 Goal certainty

89 As discussed in Part A.1.2.1, international sustainability-related instruments such as the SDGs and the Paris Agreement can provide a high-level framework for impact goal definition.[78] However, these were principally intended for use by policymakers in setting country-level goals. A certain amount of legwork is needed to convert them into impact goals for investees and investors.

90 Ongoing initiatives should help to define which business activities are aligned with some of these overarching goals. A prime example is the EU sustainable finance taxonomy.[79] This seeks to provide a single basis for investors, issuers and policy makers to assess the environmental sustainability of economic activities referenced to six objectives: climate change adaptation; climate change mitigation; sustainable use and protection of water and marine resources; transition to a circular economy; pollution prevention and control; and protection and restoration of biodiversity and ecosystems. While it does not itself stipulate stainability goals, it is based on national and international goals and can be used in defining portfolio-level sustainability impact goals. The UK government intends to create a UK taxonomy and a number of other jurisdictions are working on similar frameworks including China, Malaysia, New Zealand, Russia and South Africa.[80]

91 Yet investors still need to make judgements in setting their sustainability impact goals. These include the basic decision about which overarching sustainability outcomes are relevant to their investment-related activities and, in the light of that, which portfolio-level sustainability impact goals to adopt. This second step may involve challenging decisions, for example, as to whether nuclear energy has a positive sustainability impact by reducing fossil fuel reliance, what is needed to ensure that reducing fossil fuel reliance does not adversely affect social sustainability by falling disproportionately on the most economically vulnerable, and how to approach the environmental impacts of technologies replacing the internal combustion engine.

92 Various frameworks have been developed that can help with setting portfolio-level goals. Very broadly, they approach the issue from one of two overlapping perspectives:

- determining which areas of sustainability impact to target and the type of impact the investor intends to have; and
- defining the quality of impact the investor is seeking.

93 The following looks briefly at examples of available frameworks in relation to each.

(a) Target-setting frameworks

94 Two of the most fully developed examples of target-setting frameworks are the Net Zero Asset Owner Alliance 2025 Target Setting Protocol and the Institutional Investors Group on Climate Change Net Zero Investment Framework, concerning target setting in relation emissions reduction.[81] The basic aim of both is for signatories to have transitioned their portfolios to net zero emissions by 2050 in line with the Paris Agreement. Each provides a framework of steps for investors, including setting impact goals which they pursue in the way they manage their portfolios and undertake policy engagement. For example, signatories to the Target Setting Protocol commit to set sub-portfolio-level targets for emissions levels for investees represented by asset classes within portfolios (starting with those where there are already credible methodologies and data and extending as these develop for other asset classes). These are combined, among other things, with targets for investors' stewardship and policy engagement and positive financing targets to support net zero transition-compatible business. The Climate Action 100+ aviation strategy provides an example of how this could work at a sectoral level.[82]

95 A further example of a target-setting framework, this time by reference to the SDGs, is the PRI's Impact Investing Market Map. The stated aim is to 'bring more clarity to the process of identifying mainstream impact investing companies and thematic investments so that asset owners and fund managers can better assess opportunities in this market.' The Market Map identifies 10 sustainable investment 'themes': energy efficiency; green buildings; renewable energy; sustainable agriculture; sustainable forestry; water; housing; education; health; and inclusive finance. These themes are linked to specific SDGs and their associated targets and indicators. The map also includes a list of key performance

indicators that can be used by those seeking to achieve sustainability impact goals to assess performance against a specific theme, highlighting the close connection between goal definition and assessment.[83]

(b) What quality of impact?

96 One of the most notable examples of a framework concerned with defining the quality of impact sought in a given area of sustainability is the Impact Management Project's ('IMP') 'five dimensions of impact'. These are part of the IMP's 'impact norms'.[84] The five dimensions of impact identified by the IMP essentially help in defining what it is to have an impact and have been represented in tabular form, as set out below (see fig. 1). However, they are also relevant in assessing the extent to which an impact has taken place and what steps are needed to secure it, again highlighting the connection between goal-setting and other parts of the process of pursuing sustainability impact goals.

Figure 1: The Impact Management Project five dimensions of impact[85]

WHAT	HOW MUCH	WHO	CONTRIBUTION	RISK
What outcomes does the effect relate to, and how important are they to the people (or planet) experiencing it?	How much of the effect occurs in the time period?	Who experiences the effect and how underserved are they in relation to the outcome?	How does the effect compare and contribute to what is likely to occur anyway?	Which risk factors are significant and how likely is it that the outcome is different from the expectation?
Important negative outcome(s) ↔ Neutral outcome(s) ↔ Important positive outcome(s)	Marginal effect ↔ Deep effect For few ↔ For many Short-term ↔ Long-term Slowly ↔ Quickly	Well-served ↔ Under-served	Much worse than what is likely to occur ↔ Much better than what is likely to occur	Low risk ↔ High risk

2.3.2 Assessing impact

97 To facilitate investment approaches within the scope of IFSI, there is a need for reliable, consistent data on, and consensus about, how to assess the sustainability impacts of business sectors, enterprises and other third parties such as policymakers.[86]

98 As an example of the sort of assessment challenges potentially facing investors, the following focuses specifically on assessing investee enterprise impact. There may be similar issues with some of the other assessments that an investor may need to undertake. That said, assessment may be simpler in other contexts, for example, where a specific policy change can reasonably be expected to result in market-wide behaviour aligning with an investor's sustainability goals.

INVESTING FOR SUSTAINABILITY IMPACT

99 In looking at enterprise impact, an investor may find it needs to assess, among other things:

- the impact of an enterprise on overarching sustainability outcomes; and
- whether that impact has changed over a given period in a way that can help to realise an investor's portfolio-level sustainability impact goals.

100 In assessing enterprise impact, a key distinction concerns:

- frameworks for assessing enterprise impacts;
- disclosure and reporting frameworks through which information relevant to those assessments is made available by the enterprise; and
- metrics and other criteria that can be used in assessing enterprise impact.

101 The following looks briefly at each, but it is important to note that assessment involves a number of interconnected challenges, only some of which can be addressed by disclosure and more effective metrics. Focusing on disclosure might suggest that the necessary information is available but not being adequately disclosed or, even if it is not currently available, can be generated. However, some sustainability-related risks do not lend themselves to easy quantification and the long-term consequences of some of them are not easily foreseeable.

(a) Frameworks for assessing enterprise impact

102 Three basic frameworks have been identified which can be used to assess enterprise and portfolio-level impact. There are no industry-wide standards for how they should be applied, creating challenges of reliability and comparability in terms of the resulting assessments.[87]

- **Impact targets**: the investor selects an indicator or indicators that are relevant to the impact goal of the portfolio or for specific portfolio investments and uses that to set targets for investee enterprises at the outset of the investment relationship. The progress of the enterprise towards the target is periodically reviewed thereafter. An example of this would be setting a net zero target for an investee enterprise.[88]
- **Impact rating**: this is a more holistic approach, so can be more complex and costly. Essentially, it uses an overarching impact rating system to capture multiple sustainability impacts of an enterprise (or multiple impacts in a given area of sustainability) and generate a single overall numeric or qualitative enterprise rating.[89] The investor therefore needs to decide which areas of impact to assess and performance indicators to use for assessing positive or negative impact (eg by reference to the dimensions of impact, mentioned above). Weights are then assigned to each factor in developing an overall rating.
- **Impact monetisation**: this attempts to reduce desired environmental and social impacts to monetary values, putting a financial figure on progress towards a given impact. Of the three approaches, it is possibly the most demanding to apply effectively.[90]

103 Using these frameworks can involve considerable judgement. Each has advantages and disadvantages and can be applied with varying degrees of depth and rigour. There may be benefits in using two or more concurrently, or in relation to different parts of the investment process. This is particularly so where an investor wants to address an identified impact theme (such as health) without causing a deterioration in the wider sustainability impact of a given enterprise, ie there can be a specific impact target assessment in relation to the theme and a broader impact assessment framework can be used to assess the wider sustainability impact of the enterprise as a whole.

104 For all these frameworks there is no single system for categorising and rating different sorts of impact or determining appropriate benchmarks. However, the UNEP FI's Corporate Impact Analysis Tool, launched in 2020, seeks to help financial institutions and investors to analyse the impacts of clients and investee companies across different sectors and countries. Its three-step approach involves identifying impacts based on company typology, geography and sector and assessing and monitoring a company's impact performance and management capabilities.[91] Meanwhile, the SDG Action Manager seeks to provide a way for companies to set impact targets and measure progress against them, sharing data with relevant stakeholders as they choose, including investors.[92]

A. INVESTING FOR SUSTAINABILITY IMPACT

2. IFSI: Goal certainty, assessment of impact and understanding an investor's contribution

INVESTING FOR SUSTAINABILITY IMPACT

(b) Disclosure and reporting frameworks for sustainability impact information

International standard setters

105 There is a multiplicity of disclosure and reporting frameworks for enterprise-specific sustainability performance information. The current arrangements are fragmented and complex and, even where enterprises use them to disclose and report, may not provide investors with decision-useful information, for example where disclosure requirements focus on the activities of an enterprise in relation to particular areas of sustainability, more than changes in its sustainability impact. The fact that each framework has been developed for a different purpose adds to the complexity. Notably, for example, two of the most prominent sustainability reporting bodies have different objectives: SASB intends its reporting standards to enable businesses to communicate 'financially material' sustainability information,[93] whereas the GRI describes its approach as an accountability mechanism to ensure companies adhere to responsible sustainability principles.[94]

106 However, there is now a clear recognition that this complexity needs tackling.[95] The situation has been developing rapidly and investors are pressing for further progress.[96]

107 Since 2018 the IMP has facilitated the IMP Structured Network, a group of international organisations that are coordinating efforts to provide comprehensive standards and guidance for impact measurement, management and reporting. A sub-set of these IMP members has been progressing efforts towards a comprehensive corporate reporting system.[97] More recently, September 2020 saw notable policy communications from three initiatives to bring greater standardisation to corporate sustainability disclosure and reporting: the world's leading sustainability disclosure standard setters, CDP, CDSB, GRI, IIRC and SASB announced a shared vision for comprehensive corporate sustainability reporting and the intent to work together to achieve it;[98] the Trustees of the International Financial Reporting Standards Foundation launched a consultation to assess whether it should establish a Sustainability Standards Board as a standard-setter, complementing the work of these other bodies with the aim of greater standardisation (and have since confirmed that work is underway to establish a new International Sustainability Standards Board);[99] and there has been work by the World Economic Forum with the 'big four' accountancy firms designed to identify a set of 'universal, material ESG metrics and recommended disclosures that could be reflected in the mainstream annual reports of companies on a consistent basis across industry sectors and countries' on sustainable value creation.[100]

108 For the present, however, the complexity and fragmentation remain and it is yet to be seen how far these initiatives will result in the sort of information that investors need, or how soon.

TCFD and other international frameworks

109 On climate change, specifically, there has been a rapidly growing alignment around the disclosure standards published by the TCFD (see Box 8). Work is currently underway on additional guidance on the use and disclosure of forward-looking metrics.[101] Meanwhile, within the investor community itself, the Sustainable Development Investments Asset Owner Platform is intended to facilitate investor assessment of companies based on their contribution to the SDGs.[102]

INVESTING FOR SUSTAINABILITY IMPACT

Box 8

The Task Force on Climate-related Financial Disclosures

The TCFD[103] was established by the Financial Stability Board in 2015. Following consultation, it issued a set of recommendations on climate-related financial disclosure. These are designed to provide greater transparency to markets on the climate risks companies are facing and to help companies understand what financial markets want from disclosure in order to measure and respond to climate change risks, encouraging firms to align their practices and disclosures with investors' needs. The TCFD has developed guidance aimed at organisations in all sectors as well as supplemental guidance for financial institutions and companies operating in the energy, transportation, materials and buildings and agriculture, food and forest products sectors.

The TCFD recommendations are highly influential and are being taken on board by companies and in government policy in a number of jurisdictions where they are integrated into governance and disclosure requirements.[104] The initial focus of the Better Alignment Project between the CDP, GRI, SASB, the CDSB and the IIRC has been on ensuring that their standards are aligned with the recommendations published by the TCFD.[105]

Statutory regimes

110 Statutory corporate disclosure regimes on so-called 'non-financial' reporting have also been evolving, perhaps most notably in the EU and UK. For example, the EU Non-financial Reporting Directive requires companies to disclose information on, among other things, environmental and social matters to the extent the information is needed to understand the company's performance and impact.[106] Essentially, this reflects a 'double materiality' approach where in-scope companies need to assess the materiality of these environmental and social factors to their own financial performance, but also their own impact on, essentially, environmental and social outcomes (involving a distinction similar to that made in Part 1.A, Box 3 between instrumental IFSI and ultimate ends IFSI).[107] Important questions remain over how far disclosure and reporting requirements should be set by regulation, and the extent of reliance on private initiatives of the sort mentioned above. Jurisdictional cultures vary, with some favouring a more rules-based approach than others.

Third-party data and ratings providers

111 Many large investors use third-party data providers to support measurement of investment impact. Those organisations provide ESG data and scores and are increasingly providing impact data that can be used, for example, in setting goals and assessing progress. There is a separate question about how information is used by analysts and ratings firms in providing resources for investors, for example, as to the quality of extensively used sustainability ratings produced by some agencies.[108]

(c) Metrics and other available criteria for assessing enterprise impact

112 Similar issues surround the underlying assessment metrics and standards on which disclosure is based.[109] Very broadly, it is possible to distinguish between:

- separate standards that have been developed to provide an indication of an enterprise's sustainability performance in particular areas; and
- reporting frameworks that may incorporate some of those standards (with or without adjustment) and add some of their own and which, in some cases, purport to provide an overview of an enterprise's sustainability footprint.

113 An example of the former is the 200 sets of industry-focused metrics and standards which the SASB references in producing its own 77 sustainability accounting standards (which are themselves an example of the latter).[110] Other examples include more than 200 sets of assessment tools covered by the EU's GLOBAL VALUE tool navigator, designed to assist users to select

INVESTING FOR SUSTAINABILITY IMPACT

the most appropriate for their needs.[111] Similarly, the PRI's Impact Investing Market Map organises commonly used key performance indicators by sustainability theme (water, housing, education etc.),[112] the GIIN maintains the Impact Reporting and Investment Standards ('IRIS') Catalog of Metrics[113] covering over 600 impact measurement tools and created specifically with the impact investing community in mind, and the World Economic Forum Measuring Stakeholder Capitalism White Paper groups sets of metrics by reference to four pillars (governance, people, planet and prosperity).[114]

114 Looking specifically at impact assessment practice among impact investors, according to the GIIN 2020 survey of impact investors, of those surveyed, 89 per cent use external resources to assess impact, the most common being the SDGs (37 per cent), the IRIS Catalog of Metrics (36 per cent), IRIS+ Core Metrics Sets[115] (29 per cent) and the IMP's five dimensions of impact (21 per cent).[116]

2.3.3 Understanding an investor's contribution - credibility and causation

115 Investors have developed various approaches to understanding or assessing the difference their activities make in changing the impact of business enterprises and other third parties such as policymakers. This section looks briefly at some of them.

116 Investors talk of these assessments in terms of, among other things, having 'an impact thesis' or 'a theory of change', 'contribution', and 'additionality' or 'social value added'.[117] These concepts are not identical but overlap. However, whatever the context, the focus is on establishing a reasonable level of confidence that steps the investor is planning, or has taken, are likely to lead in some way to a change of third-party behaviour that is material in moving towards the investor's sustainability impact goal.

117 As noted in Section 2.1, demonstrating the precise extent to which an investor's intervention has resulted in a change of outcome is not always straightforward. Much may turn on the sort of activities the investor is engaging in and with whom, and what sustainability impacts it is targeting. In some cases, the means of influence necessarily involve reasonably clear measures of an investor's influence, either individually or as part of a group, for example, where a company agrees to change its practices following engagement with the investor community or where resolutions are passed or legislation is changed.

118 In relative terms, understanding the difference an investor has made is, perhaps, most straightforward where an influential investor has a substantial funding role in a privately held enterprise pursuing a goal which is aligned with realising positive sustainability impacts. Here, it should be possible to apply a form of 'but for' test, which is essentially what the concept of 'additionality' does (see further below). Even so, outcomes are rarely the result of a single causal factor and understanding the extent of the investor's contribution may therefore still be challenging.[118] In public markets, where the bulk of institutional investment is focused, there is likely to be more of a need to look at the level of collective sustainability impact initiatives in which the relevant investor is involved (see Box 6 above).[119]

Impact thesis/theory of change

119 The idea of an impact thesis or theory of change has been advanced as a way of thinking about the whole process through which an investor seeks to achieve a change of impact, with a particular focus on informing the planning and implementation stage. Essentially, it is a formalised attempt to articulate (a) the sustainability impact that an investor is seeking to achieve and (b) how its activities are likely to contribute to the change that is needed to realise it.[120] The first part of this concerns impact goals and assessment, as to which see above. However, the second concerns the causal difference the investor will make in realising the goals.

Contribution

120 This expression is sometimes used to describe what is, essentially, the second part of an impact thesis and sometimes outside that context. However, it tends to be used as a generic way of describing an attempt to explain the difference the investor's involvement has made. The concept is closely connected with the tools, such as stewardship, that are available to investors to influence enterprises and third parties,[121] but goes beyond the question of which tools are deployed to ask the question, 'to what effect?' 'Contribution' has been described as, 'a credible narrative, or thesis, which describes how … the

INVESTING FOR SUSTAINABILITY IMPACT

actions of the … investor will help achieve the [impact] goal' or how '… the outcome would not have occurred…' without the investor's involvement.[122]

121 This reference to a 'credible' narrative reflects the point made above: it will rarely be possible to attribute the occurrence of a particular sustainability outcome to a single activity or measure the precise difference that the activities of a single investor have made to that outcome. Because of that, the emphasis may often need to be on the basis for and quality of the investor's explanation for the difference it has made. For example, a given change may have involved collective investor action, or a combination of that with changing practice among other enterprises in the relevant sector and public policy intervention or the threat of it. Nonetheless, a credible narrative would involve developing an evidentially solid and reasonable basis for understanding how what the investor does – investment, stewardship, policy engagement or otherwise – makes a positive difference compared with the sustainability impact that would have occurred without the investor's intervention. Among other things, it may involve assessing the depth of the change that occurred and its likely duration.[123]

122 Assessing an investor's contribution is also, therefore, likely to require some attempt to develop a view on what would have happened without it. In some cases, this may be relatively straight-forward, using common sense, in others more challenging. However, again, any view needs to be based on solid reasons. What might be needed will depend very much on the circumstances. In some cases, it could include use of existing or even new scientific or professional studies (for example, based on comparison groups and randomised control trials) and market or stakeholder research, although even these have their limits.[124]

Additionality

123 Particularly within the impact investing community, investors often use the concept of 'additionality' or 'social value added', especially in thinking about a change resulting from an allocation of capital or the provision of non-financial inputs by an investor to a given enterprise which would not otherwise have happened. This concept is used to describe different sorts of assessment. However, its use in an investment context has emerged from the work of development finance institutions, where it principally concerns the role of an institution in influencing the amount of capital being made available to a given enterprise.[125] In the context of impact investing more broadly, it tends to involve assessing how far the investor's involvement adds to (rather than replacing) the existing 'inputs' to an investee enterprise resulting in greater aggregate positive sustainability 'outputs' than would otherwise have been the case.[126]

124 Again, outcomes are assessed against the situation that would have prevailed without the relevant intervention (a 'counterfactual') to establish whether there has been an increase in the quantity or quality of the positive sustainability outputs of a given enterprise. However, this approach to the question of contribution may be more valuable in some contexts than others, especially non-public investment situations.

INVESTING FOR SUSTAINABILITY IMPACT

3. WHAT PORTION OF GLOBAL AUM IS CURRENTLY SUBJECT TO INVESTMENT APPROACHES INVOLVING IFSI?

3.1 Introduction

125 The concept of IFSI has not so far been used to define research on AuM. Unsurprisingly, therefore, there is no easy answer to this question.

126 There are estimates of the level of AuM subject to sustainable investing in its various forms. However, sustainable investing is a fluid concept and is not the same as IFSI (see Part A.1.4).

127 Further, as indicated in Part A.1 and 2, an investor could engage in IFSI in various ways. Properly answering the question would therefore require qualitative assessment: the fact that assets appear to be subject to an investment approach within the scope of IFSI does not necessarily reveal much about the rigour of that approach or its outcomes. For example, an investor could use its investment powers, stewardship and public policy engagement or only one of these; it could do so intensively or not; and it could focus on only one area of sustainability or several. There is also the distinction drawn in Part A.1 between instrumental IFSI and ultimate ends IFSI, and the methodological and infrastructure challenges touched on in Part A.2 which require judgement on the part of each investor and may be addressed with varying degrees of rigour.

128 The bulk of global AuM do not currently appear to be managed in ways that fall within the scope of IFSI. Nonetheless, subject to the important caveats just mentioned, the proportion of global AuM currently managed in ways that could involve IFSI appears potentially significant and growing. This is based especially on the activities of investor coalitions, and those focused on climate change in particular, whose activities appear to involve them, at least to some extent, in pursuing sustainability impact goals. Members of the Net Zero Asset Managers Initiative and Net Zero Asset Owners Alliance control AuM of $43tn and $5.7tn respectively.

129 The increasing concentration of AuM in the hands of a small number of large investment management firms potentially gives them a particularly important role in the development of investment approaches within the scope of IFSI, subject to the terms of their mandates. For the growing portion of these assets that are passively managed, stewardship and public policy engagement are likely to be the most important means of doing so.

130 The following considers:

- the size and distribution of the institutional investment market by reference to AuM (Section 3.2);
- what portion of those assets are believed to be managed by reference to 'sustainability' factors (Section 3.3); and
- what portion of those it might be possible to regard as being subject to investment approaches within the scope of IFSI (Section 3.4).

131 The figures used are largely taken from assessments by established third parties and we have not sought to verify them. They are included here solely to provide a rough indication.

3.2 Global AuM

3.2.1 Total AuM

132 Estimates of global AuM vary and values have been in flux as a result of the COVID-19 pandemic. However, one study covering assets managed by investment managers in 44 markets in 2019 found that their AuM stood at $88.7tn.[127] Meanwhile, the total AuM of 500 of the world's largest asset managers was estimated to have been $104.4tn at the end of 2019.[128]

133 Since these are the figures for assets managed by investment managers, the absolute figure for global AuM (ie all assets managed by asset owners or managers on their behalf) is likely to be higher. For example, the aggregate AuM managed by PRI signatories (which include asset owners), adjusted to avoid double counting, was estimated to have been $103.4tn as at 31 March 2020.[129] Since not all asset owners and managers are PRI signatories, the figure for global AuM is likely to be higher still. PwC have put the figure at $110tn.[130] In a wider context, the World Federation of Exchanges estimated that the global capitalisation of cash equity markets was $109.21tn as at the end of 2020,[131] and the Bank of International

INVESTING FOR SUSTAINABILITY IMPACT

Settlements estimated in its September 2020 quarterly review that the global total of outstanding debt securities was approximately $120tn.[132] Not all of these assets are held by institutional investors. At the same time, these are not the only asset classes held in institutional investor portfolios. Estimates of the aggregate global AuM of each the three categories asset owner covered by this report are as follows: pension funds $52.5tn as at the end of 2020,[133] mutual funds $ 63 tn as at the end of 2020[134] and insurers $ 35.4 tn as at the end of 2019.[135] However, since both pension funds and insurers hold interests in mutual funds, and pension funds may enter into life contracts with insurers, the same assets may be represented more than once in these figures.

3.2.2 Who manages these assets?

134 The asset management sector is comprised of many firms. However, there has been substantial consolidation so that management of global AuM is increasingly concentrated in the hands of a smaller number of very large providers.[136] The 10 largest investment managers as at the end of 2019 were estimated to be managing in excess of $32tn or approaching a third of the global AuM figures above, while the 20 largest accounted for approximately 43 per cent ($44.9tn).[137]

135 BlackRock has for some time been the world's largest asset manager (AuM of $8.15tn) and Vanguard is the second largest (AuM of $7.1tn). State Street is the next largest with $3.4tn.[138] The three together therefore manage over $18.5tn of assets.[139] A substantial portion of those assets are passively managed. Indeed, it is thought that these companies manage about 80 per cent of all passively managed assets and that some 22 per cent in aggregate of the shares in the typical S&P 500 company are held in passive or active portfolios managed by them.[140] They and a number of other large firms therefore occupy an influential position generally and in relation to any move within the investment market towards investing for sustainability impact.

3.2.3 What portion of global AuM is passively managed?

136 The portion of global AuM that is passively managed has been growing. It has been estimated that the share of global AuM managed by investment managers using passive investment strategies stood at 21 per cent ($18tn) by 2019.[141] This seems broadly consistent with other estimates.[142] For example, the AuM in index tracking mutual funds is estimated to have stood at $11.4tn by the end of November 2019, while work by BlackRock in 2017 suggested that the AuM in passive strategies outside mutual funds could amount to $6.8tn, producing a similar aggregate figure.[143] It was estimated that in 2017 that 22.4 per cent of the AuM of 500 of the world's largest investment managers was being passively managed, and the figure was growing.[144] In the US, where the move towards passive investing is particularly pronounced, by the end of 2018, actively managed funds had an overall market share of 61.2 per cent compared with 38.8 per cent for passive funds, with the trend towards passive continuing in 2019.[145]

3.2.4 Geographic spread

137 It has been estimated that, in 2019, North American managers had the highest share of global AuM ($42tn) and experienced the strongest growth.[146] Europe, the second largest asset management region, also experienced strong AuM growth in 2019, to $22.8tn.[147] Some $6.1tn of that was managed in the UK.[148] AuM in France grew to $3.5tn.[149] In Japan and Australia, AuM grew to $6.6tn. In Asia (including China and Hong Kong but excluding Japan and Australia) AuM grew to $11.2tn. Meanwhile, AuM in Latin America grew to $1.9tn.[150] Another study has highlighted the growth in the AuM of North American investment managers relative to other jurisdictions between 2007 and 2017 from 41.59 per cent of global AuM to 53.22 per cent.[151] The same study estimated that North American clients also accounted for 59.3 per cent of global AuM, underscoring the point.[152] This concentration of assets and management firms in North America suggests that the legal frameworks within which North American asset owners and managers operate are likely to be particularly significant terms of the extent to which global AuM is subject to IFSI. That said, not all of these assets would necessarily be managed from locations in North America.

3.3 Sustainable investment AuM

138 Sustainable investment is now a major presence in investment markets. As noted in Part A.1.4, the concept covers a variety of investment approaches. Some, if not all, could be used in the course of investing

INVESTING FOR SUSTAINABILITY IMPACT

for sustainability impact. However, they do not *necessarily* involve IFSI. While there is no data on the portion of global AuM being invested for sustainability impact specifically, assessments of AuM that are managed in ways that take some account of sustainability factors ought at least to catch those that fall within the scope of IFSI as part of the total figure.

3.3.1 Total AuM managed by reference to sustainability factors

139 Since the concept of sustainable investment covers a broad range of activities, taking account of sustainability factors with varying degrees of intensity, figures for global sustainable AuM need to be approached with care. However, much-quoted research by the Global Sustainable Investment Alliance (GSIA) suggests that at the beginning of 2018 AuM of $30.7tn was subject to some sort of sustainable investment in the investment markets of US, Europe, Japan,[153] Canada and Australia/New Zealand.[154] This represented an overall increase of 34 per cent in two years.

140 The growth has continued in the three years since then. For example, it has been estimated that the total of 'sustainable investing assets' in the US at the beginning of 2020 was $17.1tn, a substantial increase from 2018.[155] A study of the European market as at the end of 2019 found that up to 45 per cent of total AuM managed by asset managers in Europe (roughly $13tn) were invested in ways that take some sort of account of ESG factors.[156] Meanwhile a survey of investors representing $25tn in AuM during 2020, undertaken by BlackRock, found that these investors plan to double their 'ESG assets' in five years.[157] In a PwC survey of European institutional investors during 2020, 75 per cent indicated that they plan to stop buying European non-ESG products within the next two years.[158] Sustainable investment has also been growing in China but is at an earlier stage.[159] For example, the number of pan-ESG mutual funds in China at the end of November 2019 was reported as accounting for just under 2 per cent by AuM of all equity/hybrid funds in the market.[160]

141 These figures seem to suggest that somewhere between a third and a half of global AuM is, or will soon be, managed in a way that somehow intentionally takes account of sustainability factors. However, the fact that AuM are not included in these figures does not mean that sustainability factors are being ignored in relation to other assets. For example, as noted above, signatories to the PRI's Principles for Responsible Investment (who therefore commit to incorporate ESG issues into their processes and practices), were managing AuM in excess of $103tn in aggregate as of April 2020.

3.3.2 Sustainable investing – use of investment powers

142 As noted, the 'sustainable investing' umbrella shelters a multitude of investment approaches. For example, GSIA's 2018 review identifies the different approaches set out in the table below which involve the use of investment powers, providing an estimate of the AuM subject to each approach. The categories are not legally defined and there could be differences of understanding as to what is involved in each. However, they provide an indication of the prominence of different sorts of sustainable investment approach in terms of AuM allocated. That said, there is a limit to what these figures reveal about levels of IFSI AuM since the defining feature of that is pursuing assessable sustainability impact goals more than the approach used to achieve them. As noted in Part A.1.4, it would potentially be possible to use any of these approaches as part of an IFSI strategy.

A. INVESTING FOR SUSTAINABILITY IMPACT

3. What portion of global AuM is currently subject to investment approaches involving IFSI?

INVESTING FOR SUSTAINABILITY IMPACT

Strategy[161]	Estimated global AuM allocated to it in US$ as at 2018	GSIA description
Negative/exclusionary screening	$19.8tn	The exclusion from a fund or portfolio of certain sectors, companies or practices based on specific ESG criteria.
Positive/best-in-class screening	$1.8tn	Investment in sectors, companies or projects selected for positive ESG performance relative to industry peers.
Norms-based screening	$4.7tn	Screening of investments against minimum standards of business practice based on international norms, such as those issued by the OECD, ILO, UN and UNICEF.
ESG integration	$17.5tn	The systematic and explicit inclusion of ESG factors into financial analysis.
Sustainability-themed investing	$1tn	Investment in themes or assets specifically related to sustainability (for example clean energy, green technology or sustainable agriculture).
Impact/community investing (see note below)	$0.4tn	Targeted investments aimed at solving social or environmental problems, and including community investing, where capital is specifically directed to traditionally underserved individuals or communities as well as financing that is provided to businesses with a clear social or environmental purpose.

Note: the last of these categories conflates two different sorts of activity. 'Impact investing' is broader than (but could include forms of) 'community investing', and the concept of IFSI is broader than both.

INVESTING FOR SUSTAINABILITY IMPACT

143 Over recent years, there has been an increase in the number and use of 'sustainability indices' – essentially, indices that comprise investments that are selected based on positive sustainability criteria. Some of the largest are the MSCI KLD 400 Social Index (launched in 1990), the STOXX Global ESG Leaders Index (launched in 2011), the Dow Jones Sustainability Indices (launched in 1999) and the FTSE4Good Index (launched in 2001). We have considered the index descriptions for a number of indices of this sort to assess whether an investor tracking the relevant index could be said to be investing for sustainability impact, and, hence, whether this could help to throw light on the level of AuM currently being invested for sustainability impact. On the basis of the index materials reviewed, the indices considered could generally be viewed as corresponding with one or other of the sustainable investment approaches mentioned in the table above. However, none of them obviously involved intentional and assessable sustainability impact.

3.3.3 Sustainable investing - stewardship

144 As noted in Part A (Section 1.2.3(b)), stewardship is one of the ways in which investors can seek to invest for sustainability impact. Stewardship activity is widespread, but it is less clear how much of it would be within the scope of IFSI. Stewardship may include addressing sustainability concerns, but not necessarily.[162] The GSIA research discussed above suggests that as at 2018, investors controlling some $9.8tn AuM were engaging in stewardship activities for sustainability purposes.[163] However, this may understate the extent to which investors are undertaking sustainability-related engagement activity. For example, signatories to the Principles for Responsible Investment commit to be 'active owners' and incorporate ESG issues into their 'ownership policies and practices' (Principle 2) and, as noted above, they were estimated to control in excess of $103tn AuM as at the end of March 2020.

3.4 IFSI AuM

145 For the reasons already given it is challenging to estimate the levels of AuM that are currently being managed in a way that would be within the scope of IFSI.[164] However, it seems reasonable to suppose that it makes up an element of the estimates of sustainable AuM discussed above.

3.4.1 'Impact investing' AuM

146 Most forms of what is often understood by 'impact investing' would fall within the scope of IFSI, although the focus of IFSI is broader (see Part A.1.3). Levels of AuM committed to impact investing could therefore help to provide a floor for the level of AuM currently being invested in ways within the scope of IFSI. However, there are no comprehensive statistics for impact investment AuM.[165] Some of the most commonly referenced figures are produced by GIIN. Their 2019 survey of 279 impact investors found that the investors surveyed were managing AuM of $404bn.[166] They estimate that aggregate AuM of those involved in impact investing as at the end of 2019 was $715bn.[167] Meanwhile, the IFC has estimated the AuM subject to impact investing to be $505bn.[168]

3.4.2 AuM within scope of IFSI more broadly

147 Since the concept of IFSI is broader than impact investing, the figure for AuM managed in ways that are within the scope of IFSI will be higher than these estimates. In terms of the use of investment powers, work undertaken by the PRI identified 465 investors that had allocated $1.3tn to 'impact-related investments' worldwide during 2016, up from 280 investors and $800bn in 2014.[169] If that rate of growth in investment has continued, the aggregate figure, including investments in prior years, could now be materially larger. Nonetheless, the IFC has recently conjectured that the total figure is somewhere in the range between $505bn and $3.5tn (including DFI assets and assets where impact is sought through stewardship).[170]

148 However, IFSI is not restricted to the use of investment powers, and these figures may not fully reflect AuM subject to stewardship within the scope of IFSI. Almost inevitably, stewardship involves some articulation of goals which become the subject of engagement. Much stewardship does not specifically concern the sustainability impact of investee enterprises. However, analysis of shareholder action and attitudes suggests that social and environmental factors are an increasingly significant area of concern.[171]

3. What portion of global AuM is currently subject to investment approaches involving IFSI?

INVESTING FOR SUSTAINABILITY IMPACT

149 The levels of AuM controlled by investors engaging in stewardship who have committed to take ESG factors into account in their activities, noted at Section 3.3.2 above, are significantly higher than the capital allocation figures just discussed (so much so that, for some, it raises the question of why there has not been more change). This may suggest that even if portfolios are not currently being invested in assets that can be classed as ‘impact-related’, other aspects of existing investment practice are nonetheless to some degree consistent with IFSI. Because of that, the AuM managed by investors that have subscribed to investor coalitions and networks that commit them to taking steps that would potentially fall within the scope of IFSI may provide a better guide. The commitments in relation to achieving net zero greenhouse gas emissions by 2050 or sooner given by signatories to the Net Zero Asset Managers Initiative and the Net Zero Asset Owners Alliance are particularly goal-orientated. Members of these coalitions control AuM of $43tn and $6.6tn respectively.[172] Climate Action 100+ signatories operating as an investor-led engagement network control AuM of $54tn.[173]

A. INVESTING FOR SUSTAINABILITY IMPACT

3. What portion of global AuM is currently subject to investment approaches involving IFSI?

INVESTING FOR SUSTAINABILITY IMPACT

4. IN WHAT WAYS DO PEOPLE WANT THEIR ASSETS INVESTED TO BRING ABOUT SUSTAINABILITY IMPACTS?

4.1 Introduction

150 This section comments briefly on an increasing body of industry, not-for-profit and government surveys and academic research investigating the attitudes of individual investors towards sustainability factors in the investment process.

151 People's views on this topic can be relevant to what legal rules require or permit asset owners to do in managing portfolios (see Part B.3). They also have a bearing on the policy options considered in Part C.3, for example, where pursuing people's sustainability aspirations could advance policy objectives.

152 We have therefore looked at much of the relevant material published since 2017 and our assessment based on those materials is summarised in Part A, Appendix 3.[174] Although we have not undertaken a full literature review, our focus has been on:

- whether, based on the available materials, individuals say they want sustainability factors to be reflected in the way their investments (or those out of which they will receive benefits) are managed (Appendix 3, Section 1);
- evidence on what *motivates* individual investors, and particularly the balance between the goals of optimising financial return and achieving sustainability impacts (Appendix 3, Section 2);
- evidence for the effect of individuals' attitudes on their investment decisions *in practice*, (Appendix 3, Section 3); and
- possible reasons for any difference between stated attitudes and practice (Appendix 3, Section 4).

4.2 Summary findings

153 The studies provide helpful insights on these matters. However, they need to be approached with care. The topic is complex. Attitudes and practice vary between individuals, and between jurisdictions and cultures, and the picture given by the materials is partial. Studies of this sort also have potential limitations, for example in terms of their methodologies and design, question framing, differences of understanding about the concepts involved, and the size and composition of the groups surveyed. Particularly with investment industry surveys, it is not always clear how these matters have been addressed. Further, many of the studies are 'attitudinal', reporting individuals' views on sustainability and investment, rather than looking at what they do in practice. There is a well-recognised difference between what people say and what they do.[175] However, studies are increasingly looking at how far the two coincide, using behavioural experiments or based on observed behaviour. A summary of some of the more obvious potential issues with the available materials is included in the Supplement to Appendix 3. In view of these issues, and given the relevance of this topic, the matters covered by this section would benefit from further in-depth work (see Part C.2).

154 Subject to these qualifications, there are nonetheless some significant recurring themes.

- Most, but not all, people covered by the studies (commonly at least half, and often nearer three-quarters), express sustainability aspirations of some sort in relation to their investments. These aspirations may be more marked among younger generations and may have strengthened in the light of the COVID-19 pandemic. Some studies also suggest that women may be more likely to consider sustainable investing.
- Both optimising financial return by integrating sustainability factors and achieving positive sustainability outcomes (or at least aligning investments with sustainability values) seem to be significant motivations. Part A.1 distinguished between instrumental IFSI and ultimate ends IFSI, in terms of the goals investors pursue in managing assets. In many surveys, a significant number of participants seem to expect that the integration of sustainability factors in the management of their investments will improve financial returns. For some, this appears to be their main reason for wanting it. However, there is evidence that many, if

INVESTING FOR SUSTAINABILITY IMPACT

not most, are also motivated by broader sustainability-related goals in relation to at least some of their assets. This would be consistent with a wider body of research on human values and on the motivations of those who have made sustainable investments. A significant group of these may be hoping to 'do good by doing (or feeling) well'. Nonetheless, in some studies, a material number of participants suggest they would be willing to accept some risk to financial return to pursue their aspirations.

- There is good reason to think that many people who say they want sustainability factors to be taken into account expect that to bring about positive changes in the sustainability impact of business activity.
- The precise extent to which people's sustainability aspirations are related to financial goals, the time period people have in mind, and the level of any trade-off people are prepared to make to pursue sustainability goals, and which ones, and in relation to what portion of their assets, remains unclear. It is likely that there are motivational overlaps and spectrums in terms of strength.
- Nonetheless, the level of AuM committed to sustainable investment approaches has been growing sharply, and there is evidence of a correlation between positive sustainability attitudes and the investment decisions people take in practice. Some of it also seems to confirm that some investors are prepared to risk lower financial returns to pursue sustainability goals.
- In spite of the growth in sustainable investment AuM, the levels of assets committed to 'sustainable' investment approaches are lower than might be expected based upon the expressed preferences described above. There may be various reasons for this, including the commonly encountered difference between what people say and do, and investor inertia (since achieving greater alignment could involve revising existing investment arrangements). However, there is also a possibility that investors are not being given adequate information or prompted to consider their sustainability aspirations in the process of selecting investments.

155 If borne out by further work, these findings could lend support to policy moves, among other things, to encourage (a) investment approaches within the scope of IFSI and (b) greater attention to reflecting individual investors' views on sustainability in the regulatory framework for institutional investors who manage their assets.

A. INVESTING FOR SUSTAINABILITY IMPACT

4. In what ways do people want their assets invested to bring about sustainability impacts?

INVESTING FOR SUSTAINABILITY IMPACT

APPENDIX 1

Brief summary of the historical origins of sustainable and impact investing

156 Religious groups have long espoused ethical or faith-based investment approaches. Efforts by US Methodist and Quaker groups in the 18th century to refrain from investment in companies profiting from war or slavery are widely cited as early examples of ethical investment.[176] The use of divestment as a tool of opposition against corporate connections to the Vietnam War, apartheid in South Africa, and other political situations in the 1960s–1980s led to the development of a contemporary socially responsible investment movement. Religious coalitions, NGOs and other concerned investors used screening and shareholder activism to exert influence over corporate conduct. In the 1990s and early 2000s, socially responsible investment became infused with a greater regard for environmental issues, transitioned to a more professionalised practice, and began to become integrated into mainstream investment practice.[177]

157 This move was aided by the developing view in parts of the investment sector that integration of ESG factors could be important in protecting, and potentially even enhancing, the financial performance of investment portfolios. One of the earliest attempts to understand the financial materiality of ESG factors was undertaken by a working group set up in 2003 by the UNEP FI. Together with a number of finance firms, it published a series of research reports in 2004 which were influential in focusing attention on the matter.[178] Also in 2004, in the UN Global Compact's report *Who Cares Wins*, a coalition of leading financial institutions endorsed the view that companies that consider ESG issues are more equipped to manage their risks and deliver shareholder value.[179] Following that and the 2005 Freshfields Report on the integration of ESG factors in the investment process as a legal matter,[180] ESG gained traction as a strategy, with an increasing number of institutional investors stating they integrate ESG considerations into their pursuit of financial return.[181] Part of the impetus for this was a joint PRI, UNEP FI project, *Fiduciary Duty in the 21st Century*, supported by The Generation Foundation, which identified the integration of ESG issues as an increasingly standard part of the regulatory and legal requirements for institutional investors.

158 Impact investing, a term reportedly coined at a conference convened by the Rockefeller Institute in Bellagio, Italy, in 2007,[182] emerged as a disruptive practice on the border between philanthropy and investment.[183] At first it was largely confined to foundations, development finance institutions, and family offices as a specialist investment approach.[184] As recently as 2015, the OECD described the social impact market as being in its early stages.[185] However, while accurate data is in short supply (see Part A.3), there are signs that it has begun to move into the investment sector mainstream. It is also becoming more sophisticated as an investment approach.[186] Among other things, these developments have been fostered by the various impact investing bodies mentioned in Part A.1.3, and a number of specific impact-focused initiatives, including from the G8 during the UK's presidency in 2013[187] and, around the same time, from the World Economic Forum.[188] Indeed, recent years have seen the beginnings of a confluence between ESG integration and a more holistic approach to realising economic goals and positive social and environmental outcomes. Proponents of ESG integration have increasingly emphasised the importance of moving beyond a 'do no harm' risk-based approach to ESG to a more proactive notion of business activity where enterprises (and investors without an explicit impact investing mandate) seek to create shared financial and societal value.[189]

159 The Sustainable Development Goals, and the Paris Agreement, by identifying common goals, have helped to focus attention on the social and environmental outcomes of human activity, including investment, in addition to investment return. At the same time, governments have increasingly recognised that achieving them lies beyond the scope of government action alone, so have begun to look towards private finance and investment. Meanwhile, the investment market is changing rapidly and there are now strong indications of a growing desire among investors to discharge their duties in ways that further sustainability goals.[190]

INVESTING FOR SUSTAINABILITY IMPACT

APPENDIX 2

Key sustainable investment concepts

Sustainable investment-related concept	Example of definition
ESG (Environmental, Social and Governance) investing/integration	The explicit inclusion by asset managers of ESG risks and opportunities into traditional financial analysis and investment decisions based on a systematic process and appropriate research sources.[191]
Ethical investing	Broadly, the integration of personal values, social considerations and economic factors into the investment decision.[192]
Responsible investment	A strategy and practice to incorporate environmental, social and governance (ESG) factors in investment decisions and active ownership.[193]
Socially responsible investment	A generic term covering sustainable, responsible, socially responsible, ethical, environmental, social investments and any other investment process that incorporates environmental, social and governance issues.[194] An investment is considered socially responsible because of the nature of the business the company conducts. Common themes for socially responsible investments include avoiding investment in companies that produce or sell addictive substances (like alcohol, gambling and tobacco) and seeking out companies engaged in social justice, environmental sustainability and alternative energy/clean technology efforts.[195]
Sustainable investing	Sustainable investment practices share the concept of a long-term oriented investment approach, which integrates ESG factors in the research, analysis and selection process of securities within an investment portfolio. It combines fundamental analysis and engagement with an evaluation of ESG factors in order to better capture long term returns for investors, and to benefit society by influencing the behaviour of companies.[196] Sustainable investing is an investment approach that considers environmental, social and governance (ESG) factors in portfolio selection and management. For … articulating our shared work in the broadest way, GSIA uses an inclusive definition of sustainable investing, without drawing distinctions between this and related terms such as responsible investing and socially responsible investing.[197]

INVESTING FOR SUSTAINABILITY IMPACT

APPENDIX 3

In what ways do people want their assets invested to bring about sustainability impacts?

160 An increasing body of industry, not-for-profit and government surveys and academic research has investigated the attitudes of individual investors towards sustainability factors in the investment process. We have looked at much of the relevant material published since 2017 and our assessment based on those materials is summarised in this Appendix. Although we have not undertaken a full literature review, our focus has been on:

- whether, based on the available material, individuals say they want sustainability factors to be reflected in the way their investments (or those out of which they will receive benefits) are managed (Section 1);
- evidence on what *motivates* them, and particularly the balance between the goals of optimising financial return and achieving sustainability impacts (Section 2);
- evidence for the effect of individuals' attitudes on their investment decisions *in practice*, (Section 3); and
- possible reasons for any difference between stated attitudes and practice (Section 4).

161 The studies provide helpful insights on these matters. However, they need to be approached with care. A summary of some of the more obvious potential issues with the available materials is included in the supplement to this Appendix.

1. What do individual investors say they want?

162 Essentially, there are two issues from the point of view of this report. Do those covered by the studies indicate:

- that they want sustainability factors to be taken into account in the way their assets (or the assets out of which their benefits will be paid) are managed (see Section 1.1 below); and
- that they want this to happen in a way that achieves positive or reduces negative *sustainability impacts* (see Section 1.2 below)?

1.1 Taking sustainability factors into account

163 In most of the surveys seeking views on the point, at least half of the participants, and often nearer three-quarters, indicate that they have some interest in sustainability factors being taken into account in how their money is invested.[198] For example, the UK Department for International Development surveyed 6,000 UK individuals for its 'Investing in a Better World' project. 70 per cent of respondents said they wanted their investments 'to avoid harm and achieve good for people and the planet', and 64 per cent said financial institutions should avoid investing in companies that harm these.[199] A survey of US individuals with investible assets of at least $100,000 for the Morgan Stanley Institute for Sustainable Investing found that 85 per cent were interested in sustainable investing.[200] Another sustainable investment survey of US individuals by Allianz found that 79 per cent were positive about investing in a company that cares about the same issues as they do.[201] A survey of Dutch pension fund beneficiaries found approximately 75 per cent in favour of sustainable investment.[202] In a survey of French retail investors, 72 per cent of participants wanted 'integration of sustainability issues in their savings funds to be mandatory',[203] while another survey of French and German investors, by the 2° Investing Initiative, indicated that between 65 and 85 per cent wanted to invest more sustainably.[204] In a poll of Australians, 9 in 10 participants expected their money to be invested 'responsibly' and 'ethically'.[205] Two cross-jurisdictional studies present a similar picture, covering the jurisdictions above but also jurisdictions in Asia, the Middle East and South America.[206]

164 These attitudes may have strengthened as a result of the COVID-19 pandemic, especially in relation to social sustainability.[207] Significantly, in terms of future investment decision makers, interest may be particularly strong among Millennials.[208]

1.2 Do the studies suggest that individuals want to achieve a sustainability impact?

165 Surveys generally do not address *how* investors wish sustainability factors to be reflected in the way money is invested. Wanting them to be taken into account is not necessarily the same as wanting

INVESTING FOR SUSTAINABILITY IMPACT

to make a positive difference to the sustainability impact of an investee. For example, a person may simply be seeking risk mitigation. However, the survey materials tend to suggest that a significant portion of participants want to improve business sustainability impacts through their investment decisions.

166 For instance, in the survey of French retail investors mentioned above, around half of participants said that they 'care about the environmental and social impacts of their decisions.'[209] In one international study, 80 per cent considered it important to invest in 'ethically' run companies, and 72 per cent wanted to invest in companies with a 'positive social impact and … good environmental records.'[210] In another study of 25,000 individual investors internationally, 60 per cent of respondents considered that their individual choice of investment can make a difference for building a more sustainable world.[211] 84 per cent of US investors covered by the Morgan Stanley Institute for Sustainable Investing survey mentioned above said that they wanted to receive an 'impact report'.[212] 75 per cent of US individuals surveyed on behalf of the Natixis Center for Investor Insight said that it was 'important to make the world a better place while growing their personal assets.'[213] In one survey of UK individuals, only 8 per cent disagreed with the statement: 'I would like my investments to do some good as well as provide me with a financial return.'[214] In another, 57 per cent of participants thought it important to take account of a company's social and environmental impact, rather than just the potential financial gain,[215] in deciding whether to invest, while in another, 61 per cent of participants said that for the economy to succeed in the long term 'investors need to support progressive businesses tackling the big issues we face.'[216] In a survey of German mutual fund investors, 86.4 per cent of those who had invested in 'socially responsible' funds and 80.8 per cent of those who were interested thought that an 'ethical fund' should influence companies through engagement to achieve greater social responsibility.[217] In an academic survey of Swedish individuals who had invested in 'ethical funds', when asked whether ethical funds should 'try to make the world a better place' by influencing companies, only 9.5 per cent answered 'no'.[218]

167 However, in some cases, survey questions address the matter of impact more explicitly. Again, responses suggest that a significant portion of those surveyed wished to achieve a positive impact through the way their money is invested. The survey of French and German retail investors mentioned above found that as many as 40 per cent of participants wanted to achieve positive outcomes, with a further 20 per cent more moderately inclined towards action to achieve similar outcomes.[219] The survey report also suggests that the clearer the link between investing and achieving specific impacts on behaviour, the stronger the motivation is likely to be.[220] A separate survey of German individuals found a similar association.[221] The 70 per cent of UK individuals covered by the UK government survey mentioned above who wanted their investments 'to avoid harm and achieve good for people and the planet' seem to have been contemplating some sort of impact. The study also found that most people would be motivated to save more if they knew their savings and investments made a positive difference: 52 per cent on average, rising to 60 per cent for those with investible assets of over £25,000 and 67 per cent for Millennials.[222] 80 per cent of the affluent US individuals participating in a survey by Nuveen said that their investments should strive to make a positive impact on society.[223] Meanwhile, in one of the studies of Dutch pension fund beneficiaries mentioned above, 67.9 per cent were in favour of 'increasing the pension fund's engagement to increase the sustainability of the companies in which it invests'.[224]

2. What motives lie behind expressed preferences?

168 Many of the survey participants seem to have wanted sustainability factors to be taken into account. However, there is a separate question as to *why* they might want this. The answer could be relevant both to asset owners in seeking to discharge their duties or exercise discretions (Part B.3) and to policy options in relation to IFSI (Part C.2).

169 Part A.1 made a key distinction between two sorts of IFSI, depending upon investors' goals: instrumental IFSI involving the pursuit of sustainability impacts with a view to achieving an investor's financial

INVESTING FOR SUSTAINABILITY IMPACT

goals; and ultimate ends IFSI involving the pursuit of sustainability impact goals as ends in themselves. A similar difference of motivation was highlighted in Part A.1.4 in relation to sustainable investing more broadly, with investors wishing to have sustainability factors reflected in the management of their portfolios either to optimise their financial return or to align them with their wider values.

170 Survey responses also reflect these two sorts of motivation while much of the academic research seeks to clarify the relationship between the two. Together, they suggest that optimising financial return (see 2.1 below) and achieving positive sustainability outcomes or alignment with a person's sustainability values (see 2.2 below) are both significant motivating factors. Survey participants' responses commonly indicate that they prioritise the former, as does some of the research. However, some studies suggest that investors may be prepared to incur a degree of financial risk to achieve their sustainability goals. As noted in Part A.1.1, these motivations cannot be compartmentalised. Many people are likely to experience both simultaneously, and unsurprisingly therefore the materials reviewed do not always distinguish clearly between them or place people into neat categories.

2.1 Financial return as the goal

171 Some of those covered by the studies wanted sustainability factors to be taken into account because they thought it would improve their financial prospects. For example, in one survey of affluent US investors, 53 per cent gave performance as their main motivation for investing responsibly.[225] A survey of UK investors found that 47 per cent considered it a good way to make money (although 54 per cent also wanted to give something back to society and 53 per cent to be consistent with their values).[226] In another UK investor survey, 68 per cent believed that companies with more robust ESG practices would be in a better position in the long-run (although this was the study, noted above, in which 57 per cent thought it important to take account of a company's sustainability impact, not just the potential financial gain).[227] In the survey of French and German investors mentioned previously, 10 to 15 per cent wished to optimise returns using ESG.[228]

2.2 Sustainability goals: doing well by doing (or feeling) good, and beyond

172 The surveys are generally more ambiguous about the relationship between the financial and wider motivations of those concerned. However, the responses discussed at 1.2 above suggest that survey participants often regarded sustainability goals as important.

173 The presence of 'pro-social' motivations of this sort is consistent with academic research on the motivations of those investing in 'socially responsible' or 'sustainable' investments. There is consistent evidence of a positive association between stronger social values and the likelihood of people holding investments of this sort.[229] A similar correlation has also been found among those who were simply *interested* in investing 'sustainably', but had not yet acted on their interest.[230] As noted at 1.2 above, there is reason to think that these motivations may be stronger where people believe that they can make a positive social or environmental impact with their investments.

174 Some academic studies have suggested that these social values are, at least in part or for some investors, characterised by the 'warm glow' derived from performing the act of investment more than the extent of any impact on the welfare issues concerned.[231] So long as an investment appears to have some impact, stronger social values may not always result in a person investing a greater proportion of their assets 'sustainably' or focusing on the level of impact of their investment.[232] This could result in a greenwashing risk, where 'sustainable' financial products are designed to provide 'warm glow' more than impact. If so, this could reduce the influence of investors' socially orientated aspirations in actually addressing sustainability goals.[233]

175 The presence of 'pro-social' or 'other-regarding' motivations also resonates with work on human values and motivations more generally both in an economic context[234] and beyond.[235]

176 Nonetheless, there is still a question about how investors prioritise between sustainability-related goals and achieving a financial return.[236] Three themes emerge from the studies:

INVESTING FOR SUSTAINABILITY IMPACT

- the possibility of 'doing well by doing good';
- people who have sustainability goals but who prioritise financial return; and
- those willing to risk lower financial return to pursue sustainability goals.

177 These three potentially overlap, for example, because a person may be willing to incur a heightened risk in relation to some but not all their assets.

(a) 'Doing well by doing good'

178 Many survey participants may have viewed 'making a positive difference' and 'earning a financial return' as connected. For example, in the Morgan Stanley Institute for Sustainable Investing survey mentioned above, 86 per cent took the view that corporate ESG practices potentially increase profitability, but 84 per cent nonetheless wanted to tailor their investments to their values.[237] Likewise in the Natixis survey mentioned above, 75 per cent of participants said it was important to make the world a better place while growing personal assets, with 74 per cent seeing 'responsible investing' as sound financial sense.[238] Similarly, the Allianz survey of US investors discussed above found that 74 per cent believed that ESG investments were both a strategy they could feel good about and one that made long-term financial sense.[239] Similar motivations seem to lie behind the survey of UK individuals in which only 8 per cent disagreed with the statement: 'I would like my investments to do some good as well as provide me with a financial return.'[240]

(b) Sustainability, but prioritising financial return

179 However, survey participants often seem to recognise that financial and sustainability goals can conflict. For many, their desire to pursue sustainability-related goals may be limited if it could negatively affect their financial goals. For example, half of the individuals surveyed in one international survey during 2019 indicated that they wanted their investments 'aligned with their values, but not at the cost of investment performance.'[241] The Allianz survey of US investors mentioned previously found that 77 per cent would reduce money in an ESG investment if it was underperforming.[242] In the survey of German mutual fund investors mentioned above, those invested or interested in investing in 'ethical' funds had limited appetite for sacrificing financial return to influence companies to become more 'socially responsible'.[243]

180 Surveys also sometimes address the relationship between financial and sustainability goals when they ask investors to rank by relevance to them financial factors alongside wider goals related to sustainability. In the Schroders 2019 Global Investor Study mentioned above, the majority of respondents were mainly focused on financial return.[244] This is in line with a BNP study covering five European jurisdictions, where the criteria 'safety' and 'returns/income' ranked top, and 'social/ethical/ecological criteria' ranked last.[245] Nonetheless, a majority of participants in all jurisdictions expressed a willingness to invest at least a small part of their portfolio in 'socially responsible investments'.[246] Several studies covering the UK have produced similar results.[247]

(c) Incurring financial risk to pursue sustainability goals

181 Finally, some surveys suggest a willingness among participants to risk a reduction in financial return, at least in relation to a part of their investments, to integrate sustainability factors. For example, in the survey of Dutch pension fund beneficiaries mentioned above in which 67.9 per cent of respondents supported greater inclusion of sustainability factors in the management of the fund through increased stewardship, among those who believed that the changes would mean lower financial returns, 58.8 per cent nonetheless supported the change. Support remained strong even after the fund had changed its engagement strategy.[248] Meanwhile, the other Dutch pension fund study mentioned above found that roughly three quarters of those members responding supported a more sustainable investment policy even if this could negatively affect their premium or pension (on a range of 1 to 6, 'completely disagree' to 'strongly agree').[249] One of the studies of UK investors mentioned previously found that a 'substantial number are prepared to trade-off finance and social outcomes.'[250] In the 2020 Schroders Global Investor Study, 77 per cent of participants indicated that they would not 'invest against their personal beliefs', although it is unclear what they meant by this since many seemed to have thought that addressing sustainability concerns and financial goals are largely

INVESTING FOR SUSTAINABILITY IMPACT

aligned. Of the remaining 23 per cent, 'the average return on their investment would need to be 21 per cent to adequately offset any guilt.'[251]

182 It is generally unclear from the surveys how much additional financial risk investors in this category are prepared to undertake. However, some academic studies have found evidence that people are prepared to act on sustainability preferences even if they perceive a potential financial risk. These are discussed at 3 below and in some cases do address the issue of how much financial loss an 'average' investor is prepared to risk.[252]

3. What do investors do in practice?

183 As noted, there is a difference between what people say and what they do. Do the sort of attitudes described above affect how people invest? There are essentially two ways of trying to answer this:

- by examining actual fund flows; and
- by undertaking behavioural experiments.

184 In both cases, there is evidence of a correlation between attitudes and action. Some of it also seems to confirm that there are investors who are prepared to risk lower financial returns to pursue sustainability goals.

185 However, the levels of assets committed to 'sustainable' investment approaches are lower than might be expected based upon the expressed preferences described above. There is therefore a question as to whether that is because what people say is not really what they want, or whether there are circumstances that result in them not realising their aspirations. The second of these possibilities is discussed further in Section 4 below. If there are circumstances of this sort, this is likely to be of interest to policymakers, especially if those aspirations align with policy goals and this is discussed further in Part C.2.

3.1 Actual fund flows towards 'sustainable investment'

Growth in 'sustainable investment'

186 The considerable growth in AuM committed to 'sustainable investment' (see Part A.3) suggests that attitudes of the sort described above do influence investment in practice. A significant portion of the assets included in these figures are managed by institutional investors, not individuals. Nonetheless, some are directly invested by individuals (as sustainability-related investment marketing to the retail market confirms), and the beneficiaries of institutional investors are often individuals whose views may have influenced their decisions. The fact that some of these investments are in funds that apply 'ethical' screening suggests that at least some investors are willing to risk financial loss to pursue broader goals.[253] In the study of Swedish 'ethical' fund investors, mentioned above, 66 per cent suggested they were willing to sacrifice at least some financial return.[254]

187 Research provides further support. A study of how US mutual fund investors responded to Morningstar's introduction of sustainability ratings in 2016 suggests that, collectively, they viewed sustainability as a positive feature. Money moved towards funds with high ratings and away from those with low ratings.[255] Experimental testing designed to illuminate the motives of the individuals involved suggested a mix of financial return and 'non-financial' considerations.[256] Morningstar subsequently introduced a 'Low Carbon Designation' for mutual funds in 2018. That was followed by a substantial increase in monthly net flows to LCD funds relative to conventional funds. Although LCD funds could be expected to have lower exposure to climate change risks, lower portfolio diversification meant that they also displayed substantially higher idiosyncratic volatility. Investment would therefore seem to have involved some form of trade-off.[257] Looking at the portfolio choices of more than 900,000 French pension fund beneficiaries, the introduction in France of a requirement on certain pension funds to operate 'solidarity funds' (with a social and ESG emphasis) as an option for beneficiaries was connected with a 2.1 per cent higher equity allocation by plan participants, driven by actual investments in responsible equity funds.[258] These solidarity funds are discussed further in the French legal memorandum, included in the annexes, and are an example of ultimate ends IFSI.

Asset flows fall short of the levels of interest suggested by the studies above

188 While the studies discussed at 1.1 above suggest a desire among a significant group of individual investors for sustainability factors to be taken into account in the way their money is managed, there is also

INVESTING FOR SUSTAINABILITY IMPACT

evidence that what happens in practice falls short. For instance, in the BNP Paribas survey mentioned above, while between 52 per cent and 80 per cent (depending on the jurisdiction) of respondents were willing to invest at least a small portion of their assets in 'socially responsible investments', only between 5 per cent and 7 per cent of those surveyed did so at the time.[259] Among respondents to the UK Department for International Development study, mentioned above, only 13 per cent said that they currently hold a sustainable investment.[260] Similarly, in a UBS study involving 5,300 high net-worth investors from 10 different jurisdictions, 65 per cent believed it was highly important to help create a better planet, but only 39 per cent had 'sustainable investments'.[261] The Allianz survey of US investors mentioned above also found that 'a significant gap exists between what people say is important and how they actually invest.'[262]

3.2 Experiments testing priorities between financial and sustainability goals

189 While the issue has so far received only limited attention from researchers, some studies have sought to test, more scientifically, what people do when investing their own money.

190 Some suggest a prioritisation of financial over sustainability concerns. For example, one experiment looked at the decisions of clients of a Norwegian bank investing in mutual funds. Some clients received communications framing decisions on whether to invest 'responsibly' in terms of financial benefits, others communications that emphasised moral concerns. 'Financial' framing had a more significant impact on investment behaviour than 'moral' framing. Yet both sorts of framing resulted in higher levels of engagement in responsible investment compared with investors in a control group who received no communication.[263]

191 However, some studies have revealed evidence of a 'willingness to pay' for sustainability, suggesting, consistent with the studies mentioned above, that there are investors who are prepared to incur some financial risk in order to pursue sustainability-related aspirations.

192 In particular, one study of a representative sample of US investors by researchers from Cambridge University found that the median investor was willing to sacrifice up to 2.5 per cent in return for a sustainable investment.[264] Another study, this time of German investors, suggested participants would be willing to sacrifice an average of 0.21 per cent in financial return for a more sustainable investment product, and that environmental and social values were strongly associated with willingness to pay.[265] Another study of individuals recruited through Amazon's Mechanical Turk suggested that participants were willing to pay $0.70 more for a share in a firm giving one more dollar per share to charities, while a company having a negative externality on a charity of a dollar per share was valued $0.90 less than a similar company with no externality.[266] The Morningstar Low Carbon Designation study mentioned above suggests that some investors were willing to accept higher volatility in the interests of reducing exposure to climate change risk or otherwise.[267] Finally, two experiments involving Dutch investors have produced evidence of a 'willingness to pay' for sustainable investments among investors, in terms of reduced financial performance or increased management charges.[268]

4. Why the difference between positive sustainability attitudes and investment practice?

193 The apparent difference between the level of investor interest in 'sustainable investing' and investment practice may suggest that there are circumstances surrounding the investment process that result in individual preferences being muted in some way. For example it is possible that investors have not received adequate information or been prompted to consider how their sustainability aspirations are relevant to investment decisions, or that there has been a shortage of suitable products.[269] Once investments have been made there is then a range of behavioural and structural factors that could create inertia for those wishing to reflect their sustainability aspirations in how their money is invested.[270]

194 The materials reviewed do indeed suggest that the difference can at least partly be explained by structural factors of this sort.

INVESTING FOR SUSTAINABILITY IMPACT

Awareness of the relationship between investment and sustainability

195 First, while awareness of a potential relationship between investment and sustainability appears to be growing, the picture is mixed. For example, the BNP study mentioned above found that awareness of the concept of 'socially responsible investment' had increased by at least 8 per cent between 2017 and 2018 in Italy, France, Belgium and Germany.[271] However, some surveys suggest confusion and limited awareness of forms of investment related to sustainability factors.[272] One recent study of the Japanese market identified a substantial information deficit about sustainable investments, suggesting that sustainable investing in Japan remains in its infancy.[273]

Lack of information

196 Some surveys also suggest that inadequate information may be an obstacle. For example, while most of the investors covered by the BNP survey had received information about socially responsible investment, it had come through the media, whereas they would have preferred more and in-depth information, preferably from their bank advisers. Meanwhile, participants in Schroders' 2018 global investor survey felt there was a lack of information about sustainable investments which was limiting how much they invested, with Asian individuals being most affected (61 per cent) and percentages in all jurisdictions in excess of 50 per cent.[274] The UK government survey discussed above found that 58 per cent would be more likely to invest in sustainable investments if they had more information about them.[275] There have been similar findings in other surveys of UK investors.[276] Conversely, the examples investor responses to Morningstar ratings, discussed at 3.1 above, provide an indication of the impact that sustainability-related information can have on investor behaviour.[277]

Prompts in the investment process

197 Investors have not been routinely prompted to consider their sustainability preferences when making investment decisions. This recognition lies behind changes to the EU rules for investment advisers and managers requiring them to gather information on, and take account of, suitability goals in advising their clients or making investment decisions.[278] A 'mystery shopper' exercise in France for the survey of French and German investors mentioned above found that questions about sustainability preferences were 'almost never asked', and when raised by the client, the recommendations were often not suitable.[279] One of the UK studies mentioned above found that 73 per cent of respondents had never been offered 'ethical' investment opportunities.[280] In another study during 2020, 83 per cent of advised investors indicated that they would value a conversation about investing sustainably but, on average, only 45 per cent of advisers were having these conversations.[281] This divergence may reflect an assumption on the part of advisers that their clients are not interested, which does not sit comfortably with the surveys discussed above.[282] An FT Adviser survey in 2019 found that over one-third of the UK advisers who responded would never offer an ESG fund and only 22 per cent always considered them.[283] However, more UK advisers now seem to be moving towards recommending them, partly prompted by client demand.[284] Nonetheless, a 2020 adviser survey by Schroders found that only 17 per cent would rate their confidence as very high when speaking to clients about investing sustainably.[285]

198 The role of financial intermediaries may be important in enabling people to act on their environmental preferences. One study of Swedish households suggests that those with strong environmental values were relatively financially disengaged, but that there may be a connection between greater financial literacy and the likelihood that those with strong environmental values will invest accordingly.[286] In the German mutual fund investor study mentioned above, the two main reasons given by investors who were interested in 'socially responsible' funds for not yet having invested were feeling insufficiently informed and that their bank did not offer them. They also felt that they had insufficient knowledge.[287] Financial intermediaries may be able to help in closing gaps of this sort.

INVESTING FOR SUSTAINABILITY IMPACT

SUPPLEMENT TO APPENDIX 3

Potential limitations of studies on investor attitudes

199 The studies considered in this Appendix provide helpful insights on investors' attitudes and behaviour. However, they also have potential limitations.

- The concept of IFSI has been developed for use in this project. There is therefore little research on investors' attitudes to investment approaches specifically within the scope of IFSI.[288] In view of that, we have looked at evidence on whether investors want sustainability factors (variously described) to be taken into account in the way their investments are managed. As noted in Part A.1.1.4, this is not necessarily the same as wanting the relevant investments managed in a way that would fall within the scope of IFSI. That said, as discussed in Section 1 of this Appendix, survey reports often suggest that participants want to make a positive difference through their investments.
- Many of the studies are based on relatively small sample sizes. In addition, the group surveyed may not always be representative of investors generally, within the jurisdiction concerned or otherwise. The initial selection of participants for a study, or subsequent self-selection, can affect the results.[289] For example, in some cases a survey may have been focused on contacts of the firm undertaking the survey or a particular sector of the market (such as 'mass affluent' or 'high net worth'). In others, there may have been some self-selection among respondents (ie the type and number of participants that respond), such as where those with an interest in sustainability were more motivated to participate and so have been disproportionately represented.
- Most industry surveys rely heavily on self-reporting of attitudes.[290] As noted, there is often a difference between what people say and do, including how they invest. Further, a correlation between what people say and how they invest does not necessarily show there is a causal connection.
- More generally, the research approach can have an important bearing on its outcome and reliability. The surveys considered appear to have deployed a range of approaches involving varying levels of robustness. Since studies have been prepared using varying methodologies, they are not necessarily easily comparable.
- Research on subjective matters, such as investor attitudes, requires considerable judgement, for example, as to what questions to ask, the context in which they are asked and how they are framed (for example, whether sustainability information about an investment is presented positively or negatively[291]). These factors can significantly affect responses. It is, in any event, difficult to separate out different motivations, for example, to establish whether people support the integration of sustainability factors because they consider them financially material or because they believe it can help in achieving sustainability goals, or the balance of motivations between the two. Studies of this sort therefore involve an element of artificiality.
- As discussed in Section 1, the ways in which sustainability factors can be integrated into investment decisions differ widely and there is a variety of ways of describing them ('sustainable investment', 'ESG', 'responsible investment', etc). They also have different outcomes. It is unlikely that many of the investors covered by surveys and research are aware of these distinctions or their significance, making it potentially challenging to understand what they wanted in practical terms.[292]
- Even where two or more studies use the same sustainability-related expression, the way it is described or explained may nonetheless vary. As discussed in Section 1, 'sustainability' is a broad concept, so individuals may vary as to exactly what they understand by the language used.[293] It is sometimes not clear whether survey participants were provided with definitions. The interpretation of key terms may have been left largely to the individuals concerned, again affecting the reliability of outcomes and comparability. For these reasons, the terms used in this section when describing particular surveys reflect those used in the referenced source and should not be

INVESTING FOR SUSTAINABILITY IMPACT

understood as referencing expressions defined elsewhere in this report.

- Similarly, given differences of financial literacy, it is unlikely that all survey participants fully understood the financial implications of different options.
- Survey methodologies and scope reflect the research interest or goals of the relevant actor. Surveys undertaken by commercial organisations are likely to have been intended to assist with business development, for example, to establish a firm's profile in a given area.
- Most of the studies focus on specific jurisdictions, especially the US, UK and EU member states. Asia, Africa and South America have been largely neglected by researchers.[294] However, there are several global studies by finance firms covering a broad range of jurisdictions, some of which also highlight relevant differences.[295]

INVESTING FOR SUSTAINABILITY IMPACT

1 Influence might be brought to bear directly on enterprises or policymakers or indirectly through engagement with third parties, such as scientific bodies, which can influence enterprises and policymakers.

2 Recognising that significant portion of many institutional investors' assets is allocated to sovereign bonds and assets such as real estate.

3 Among others, investing that integrates ESG issues into investment practice has been a focus for PRI and UNEP FI work culminating in their Fiduciary Duty in the 21st Century project from 2016-2019, available at: https://www.unepfi.org/fiduciary-duty/.

4 Based on the definitions in the Oxford English Dictionary.

5 In addition to those discussed below, the word 'sustainable' is also sometimes used in relation to investing and finance in ways more focused on the investment and financial activities themselves in the sense of whether those activities will endure over time and are in some way defensible. These uses may be connected with the meaning of sustainability discussed here, but are distinct. Where that distinction is not recognised it can introduce further ambiguity into the discussion.

6 See the preamble of the A/RES/70/1 - *Transforming our world: the 2030 Agenda for Sustainable Development*, available at, https://sustainabledevelopment.un.org/post2015/transformingourworld. See also UNEP FI Positive Impact Manifesto in, *Positive Impact Finance – A Common Vision for the Financing of the Sustainable Development Goals (SDGs)*, UNEP FI, available at: https://www.unepfi.org/wordpress/wp-content/uploads/2017/06/POSITIVE-IMPACT-MANIFESTO-JUNE-17.pdf, 2, (accessed 13 July 2021).

7 However, international law has sometimes been used as the basis for court decisions in some jurisdictions in a way that can be described as having 'direct effect', especially in the area of human rights. See André Nollkaemper, *The Duality of Direct Effect of International Law*, The European Journal of International Law, 2014, Vol 25(1), 105-125.

8 *Report of the World Commission on Environment and Development: Our Common Future* (the Brundtland Report), 41. The report concludes that sustainable development, in essence, '*is a process of change in which the exploitation of resources, the direction of investments, the orientation of technological development; and institutional change are all in harmony and enhance both current and future potential to meet human needs and aspirations*', see 43. For related commentary on the historical development of the notion of sustainability, see Andrew Basiago, *Methods of Defining 'Sustainability'*, Sustainable Development, 1995, Vol. 3(3), 109-119.

9 Including, notably, the 1992 Rio Declaration on Environment and Development, the 2000 Millennium Development Goals, and other key outcomes from UN conferences and summits, as outlined in A/RES/70/1, clauses 10-12.

10 https://sdgs.un.org/goals

11 The Paris Agreement, available at: https://unfccc.int/process-and-meetings/the-paris-agreement/the-paris-agreement.

12 *OECD Guidelines for Multinational Enterprises*, 11th edn, OECD Publishing, 2011. See also *Responsible Business Conduct and the SDGs*, OECD, 2, available at: https://mneguidelines.oecd.org/RBC-and-the-sustainable-development-goals.pdf, accessed 9 February 2021.

13 *The Ten Principles of the UN Global Compact*, available at: https://www.unglobalcompact.org/what-is-gc/mission/principles, accessed 9 February 2021.

14 *Guiding Principles on Business and Human Rights: Implementing the United Nations 'Protect, Respect and Remedy' Framework*, developed between 2005 and 2011, endorsed by the UN Human Rights Council in 2011, available at: https://www.unglobalcompact.org/library/2 and https://www.business-humanrights.org/sites/default/files/media/documents/un-human-rights-council-resolution-re-human-rights-transnational-corps-eng-6-jul-2011.pdf. The UN Guiding Principles incorporate, by reference, key international human rights instruments, namely: the International Bill of Rights (the Universal Declaration on Human Rights, the International Covenant on Civil and Political Rights, and the International Covenant on Economic, Social and Cultural Rights); the principles in the eight International Labour Organization (ILO) core conventions as set out in the ILO Declaration on Fundamental Principles and Rights at Work; and, where relevant, rights relating to specific groups or populations that may be at heightened risk of becoming vulnerable or marginalised.

15 We recognise that what we are calling ultimate ends IFSI could also be pursued instrumentally, for example, to enhance reputation. However, we have used the expression to distinguish it clearly from activities that are financially instrumental and to reflect the more specific focus on achieving sustainability objectives in the way activities within the scope of ultimate ends IFSI tend to be described.

16 This ambiguity among investors is implicit, for example, in Max M. Schanzenbach and Robert H. Sitkoff, *Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee*, Stanford Law Review, 2020, Vol. 72, 381-454.

17 Zvi Bodie, Alex Kane and Alan J. Marcus, *Investments*, 12th edn (McGraw-Hill Education 2021), G-13, use the expression 'systematic risk' distinguishing it from 'systemic risk' (the risk of a breakdown in the financial system, especially due to a malfunction in one part of the system adversely affecting other parts of the system).

18 *Enhancing banks' and insurers' approaches to managing the financial risks from climate change*, Supervisory Statement SS3/19, Bank of England Prudential Regulation Authority, April 2019.

19 There are other ways of exerting an influence, for example, through how investors engage with counterparties and beneficiaries or non-governmental standard-setters and, for pension funds, their corporate sponsor. However, the project has focused on investment, stewardship and policy engagement as the core means available in order to establish the basic legal framework for investment approaches within the scope of IFSI.

20 Albert Hirschman, *Exit, Voice and Loyalty: Responses to Decline in Firms, Organizations and States* (Harvard University Press 1970).

21 *From Ideas to Practice, Pilots to Strategy: Practical Solutions and Actionable Insights on How to Do Impact Investing*, A report by the World Economic Forum Investors Industries, December 2013.

22 Joseph A. McCahery, Zacharias Sautner and Laura T. Starks, *Behind the Scenes: The Corporate Governance Preferences of Institutional Investors*, Journal of Finance, 2016, Vol. 71(6), 2905-2932.

23 Julian F. Kölbel, Florian Heeb, Falko Paetzold and Timo Busch, *Can Sustainable Investing Save the World: Reviewing the Mechanisms of Investor Impact*, Organization and Environment, 2020, Vol. 33(4), 554-574.

24 See for example, Eleonora Broccardo, Oliver Hart and Luigi Zingales, *Exit vs. Voice*, Working Paper, Revised, December 2020, available at https://scholar.harvard.edu/files/hart/files/exit_vs_voice_1230.pdf, accessed 10 July 2021; Dirk Schoenmaker and Willem Schramade, *Principles of Sustainable Finance* (Oxford University Press 2019), 21; *Creating Impact: The Promise of Impact Investing*, IFC, 2019, 8-9.

25 *Creating Impact: The Promise of Impact Investing*, IFC, 2019, 14.

26 This is particularly the case where the investor carries a high level of social capital. See, for example, Chris Flood, 'Oxford University partners with BlackRock on sustainable investment fund', *Financial Times*, 10 November 2020.

27 Indices themselves are measurement mechanisms, not capital allocation mechanisms. However, they can be used as a way of allocating capital, which is the basis of passive investment management. See Part B.4. While tracking an ESG index may not itself fall within the IFSI net, it could nonetheless form part of a broader approach to the use of the investor's powers that does. It could also foster outcomes similar to those covered by the concept of IFSI.

28 See for example, Lyubov Pronina and Tom Freke, 'As green bonds boom, so do 'greenwashing' worries', *Bloomberg*, 14 October 2019.

29 Gillian Tett, 'Olive is the new green in fighting climate change', *Financial Times*, 28 January 2021; Gaia Balp and Giovanni Strampelli, *Institutional Investor Collective Engagements: Non-Activist Cooperation vs Activist Wolf Packs*, Ohio State Business Law Journal, 2020, Vol. 14, 135.

30 McCahery, Sautner and Starks, *Behind the Scenes: The Corporate Governance Preferences of Institutional Investors*. In some contexts, such as private equity investment, an investor may even have a right to appoint a member of the governing body so that they are more directly involved in management decisions.

31 See, for example, John C. Coates, IV, *The Future of Corporate Governance Part I: The Problem of Twelve*, Harvard Public Law Working Paper No. 19-07, available at SSRN: https://ssrn.com/abstract=3247337.

32 Recognising, however, that the impact of stewardship activity will depend upon various factors, such as the holding structure of business enterprises in the jurisdiction concerned. See, for example, Dan W. Puchniak, *The False Hope of Stewardship in the Context of Controlling Shareholders: Making Sense Out of the Global Transplant of a Legal Misfit*, ECGI Law Working Paper No 589/2021, June 2021.

33 In the case of equity investment, see *The Kay Review of UK Equity Markets and Long-Term Decision Making, Interim Report*, February 2012 and Final Report, July 2012 (available at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/31544/12-631-kay-review-of-equity-markets-interim-report.pdf, 10, 22 *et seq*.

34 That said, where stewardship results in changes in the sustainability exposure or impact of an enterprise, that may in turn influence investors' investment decisions; in this way, stewardship focused on sustainability impacts might be expected to increase the number of enterprises in which an investor applying certain sustainability parameters is prepared to invest.

35 However, it is possible that stewardship in this context could be more effective when combined with some passive investment strategies, such as those using forms of sustainability-based

INVESTING FOR SUSTAINABILITY IMPACT

screening, as compared with others.

36 *A Matter of Purpose*, Larry Fink's 2018 Letter to CEOs, (available at https://www.blackrock.com/corporate/investor-relations/2018-larry-fink-ceo-letter, accessed 29 January 2021).

37 Schoenmaker and Schamrade, *Principles of Sustainable Finance*, 21, 89.

38 Balp and Strampelli, *Institutional Investor Collective Engagements: Non-Activist Cooperation vs Activist Wolf Packs*.; Lucian A. Bebchuk, Alma Cohen and Scott Hirst, *The Agency Problems of Institutional Investors*, Journal of Economic Perspectives, 2017, Vol. 31, 89-102.

39 See, for example, Jennifer Thompson, 'Pension funds raise concern over index manager stewardship', *Financial Times*, 23 June 2019.

40 For example, in its 2019 Active Ownership Report, Legal & General Investment Management notes that it chooses to engage with investee companies that can set an example in their sector: *Active Ownership Report 2019*, Legal & General Investment Management, 2020, 50.

41 Elroy Dimson, Oğuzhan KarakaşXi Li, *Coordinated Engagements*, ECGI Finance Working Paper No. 721/2021, January 2021; Balp and Strampelli, *Institutional Investor Collective Engagements: Non-Activist Cooperation vs Activist Wolf Packs*.

42 Examples include Climate Action 100+ (see https://climateaction100.wpcomstaging.com) and the Dutch Pension Funds Agreement on Responsible Investment to which more than 80 pension funds have now committed (available at https://www.imvoconvenanten.nl/en/pension-funds/convenant/-/media/6B9D0FF0577E44F29DBF2EDB58767AAE.ashx, accessed 24 September 2020). See also Schoenmaker and Schamrade, *Principles of Sustainable Finance*, 106 *et seq*.

43 See, for example, *Building a Regulatory Framework for Effective Stewardship: Feedback to DP 19/1*, Financial Conduct Authority, Feedback Statement 19/7, October 2019, paragraphs 3.34-3.36.

44 See *Taking Stock: Sustainable Finance Policy Engagement and Policy Influence*, PRI, 2019.

45 *Policy Frameworks for Long-term Responsible Investment: The Case for Investor Engagement in Public Policy*, PRI, November 2014.

46 https://thegiin.org

47 https://impactmanagementproject.com

48 https://www.impactprinciples.org

49 https://www.weforum.org/platforms/shaping-the-future-of-investing

50 https://www.oecd.org/dac/financing-sustainable-development/development-finance-topics/social-impact-investment-initiative.htm

51 https://gsgii.org

52 https://www.unepfi.org/positive-impact/positive-impact/

53 We have undertaken a high-level review for the purposes of this Report.

54 Impact investors may be more likely to pursue ultimate ends IFSI than other categories of investor, but their activities could include both instrumental and ultimate ends IFSI.

55 Alternatively, some impact investors may treat not losing the capital invested as a base line. That would not be usual for the type of asset owners covered by this project.

56 See, for example, *From the Margins to the Mainstream: Assessment of the Impact Investment Sector and Opportunities to Engage Mainstream Investors*, A Report by the World Economic Forum Investors Industries, World Economic Forum, 2013, particularly sections 1 and 3; *Social Impact Investment: Building the Evidence Base*, OECD, 2015, 26 *et seq*. See also the profile of those participating in the GIIN Annual Impact Survey, 2020: *Annual Impact Investor Survey 2020*, Global Impact Investing Network, 2020, 1, 25 and 69 *et seq*.

57 *Social Impact Investment: Building the Evidence Base*, OECD, 2015, 16. See also the discussion of the impact investing 'demand-side' at 24 *et seq*. which talks variously of 'social enterprises' and 'social ventures', but does not consider the relationship between investing in this sort of enterprise and capital allocation to companies meeting social needs more widely, such as utilities companies.

58 See, for example, World Economic Forum, *From the Margins to the Mainstream*, 9, 15 *et seq*.; *Social Impact Investment: Building the Evidence Base*, OECD, 2015, 46 *et seq*.; *Creating Impact: The Promise of Impact Investing*, IFC, 2019, 2; and examples of impact investments given in *Social Impact Investment 2019: The Impact Imperative for Sustainable Development*, OECD, 2019. A desire to look beyond this traditional focus lies behind the PRI's *Impact Investing Market Map*, PRI, 2018. The GIIN *Annual Impact Investor Survey 2020*, 38 *et seq*. indicates that the largest share of the AuM of those surveyed (65 per cent) was invested in mature public or private companies. That was out of an aggregate amount of $400bn (objectively large, but modest by reference to global AuM, see Part A.3), and the nature of the enterprises to which the capital was allocated (as opposed to the company from which the enterprise was being run) is unclear. However, GIIN's figures nonetheless suggest that allocation to more mature companies by impact investors has been growing since 2015.

59 Descriptions based on *What is Responsible Investment?*, PRI, and *PRI Reporting Framework: Main definitions*, PRI, November 2018.

60 See, for example, Quinn Curtis, Jill E. Fisch and Adriana Z. Robinson, *Do Mutual Funds Deliver on Their Promises*, ECGI Law Working Paper No. 586/2021, June 2021 (39 *et seq*.), which finds evidence of distinctive voting in relation to ESG factors among some US mutual funds suggesting that the funds concerned are seeking to influence corporate behaviour.

61 There has been little work to date on the *impact* of sustainable investment generally: Kölbel, Heeb, Paetzold and Busch, *Can Sustainable Investing Save the World: Reviewing the Mechanisms of Investor Impact*.

62 See, for example, the Disclosure Regulation, which includes a definition of 'sustainable investment', 'sustainability risk' and 'sustainability factors', and amendments to the EU Markets in Financial Instruments Directive which introduce concepts such as 'sustainability preferences': Commission Delegated Regulation (EU) …/… of 21 April 2021 amending Delegated Regulation (EU) 2017/565 as regards the integration of sustainability factors, risks and preferences into certain organisation requirements and operating conditions for investment firms, COM(2021) 2616.

63 See, for example, *European SRI Study*, EUROSIF, 2018, 9; Anna Katharina Höchstäder and Barbara Sheck, *What's in a Name: An Analysis of Impact Investing Understandings by Academics and Practitioners*, Journal of Business Ethics, 2015, Vol. 132, 449-475; Neil. S. Eccles and Suzette Viviers, *The Origins and Meanings of Names Describing Investment Practices that Integrate a Consideration of ESG Issues in the Academic Literature*, Journal of Business Ethics, 2011, Vol. 104, 389-402; Joachim Sandberg, Carmen Juravle, Ted M. Hedesström and Ian Hamilton, *The Heterogeneity of Socially Responsible Investment*, Journal of Business Ethics, 2009, Vol. 87, 519-533. See also *Performing for the future: ESG's place in investment portfolios. Today and tomorrow*, State Street Global Advisors, 2018, 17 (https://www.ssga.com/investment-topics/environmental-social-governance/2017/esg-institutional-investor-survey-us.PDF) which suggests that 56 per cent of institutional investors adopting ESG-investment believe that there is a lack of clarity over ESG terminology.

64 *The State of Impact Measurement and Management Practice*, 2nd edn, GIIN, 2020.

65 What are sometimes called 'primary rules': Hart, H. L. A., *The Concept of Law*, 3rd edn (Oxford University Press 2012), especially chapters III and V.

66 Impact Frontiers Collaboration, 'How Investors Can Integrate Social Impact With Financial Performance to Improve Both', Stanford Social Innovation Review, 15 May 2020.

67 As noted in Part A.1.4, this sort of investing is not necessarily the same as IFSI but could be combined with IFSI strategies.

68 Gunnar Friede, Freddy Busch and Alexander Bassen, *ESG and Financial Performance: Aggregated Evidence From More Than 2000 Empirical Studies*, Journal of Sustainable Finance and Investment, 2015, Vol 5(4), 210-233. See also, Hortense Bioy, 'Do sustainable funds beat their rivals', Morningstar, 16 June 2020 (https://www.morningstar.co.uk/uk/news/203214/do-sustainable-funds-beat-their-rivals.aspx, accessed 13 February 2021), reporting on a Morningstar study of 4,900 mutual funds, finding that 58.8 per cent of sustainable funds that existed over a ten year period through to 2019 out-performed their average surviving traditional peers, although this pattern was not the same across all asset classes.

69 *Global Financial Stability Report*, International Monetary Fund, 2019, 85-87.

70 Gary Cundill, Palie Smart and Hugh N. Wilson, *Non-financial Shareholder Activism: A Process Model For Influencing Corporate Environmental and Social Performance*, International Journal of Management Reviews, 2017, Vol. 20(2), 606-626.

71 Elroy Dimson, Oğuzhan Karakaşand Xi Li, *Coordinated Engagements*, ECGI Finance Working Paper No. 721/2021, January 2021; Tamas Barko, Martijn Cremers and Luc Renneboog, *Shareholder Engagement on Environmental, Social and Governance Performance*, ECGI Finance Working Paper No. 509/2017, August 2017.

72 See, for example, *How ESG Engagement Creates Value for Investors and Companies*, PRI, 2018; Andreas Hoepner et al., *ESG Shareholder Engagement and Downside Risk*, ECGI Working Paper Series in Finance, Working Paper No. 671/2020.

73 By contrast, some sustainability goals are likely to fall largely outside the influence of mainstream investors so cannot obviously be addressed through IFSI. For example, the SDG target of providing legal identity for all (SDG 16.9), principally requires government action. That said, business activity is likely to have some role in achieving most sustainability goals; even in the case of providing legal identity, solutions may be facilitated by new technologies.

74 See https://www.climateaction100.org/news/views-from-around-the-world-an-interview-with-andrew-gray-from-australiansuper/

INVESTING FOR SUSTAINABILITY IMPACT

(accessed 6 March 2021).

75 https://www.iigcc.org/news/climate-action-100-issues-its-first-ever-net-zero-company-benchmark-of-the-worlds-largest-corporate-emitters/ (accessed 23 June 2021).

76 See, for example, the summary of the evolution of the TCFD's disclosure recommendations and guidance in *Forward-looking Financial Sector Metrics*, Task Force on Climate-Related Financial Disclosures, October 2020, 1.

77 In the case of climate-related risk alone, see *FSB Roadmap for Addressing Climate-Related Financial Risks*, Financial Stability Board, 7 July 2021.

78 *Annual Impact Investor Survey 2020*, GIIN, 2020, 44 *et seq.*; IFC, *Growing Impact*, 21.

79 https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32020R0852

80 See https://www.gov.uk/government/news/chancellor-sets-out-ambition-for-future-of-uk-financial-services (accessed 16 February 2021).

81 *Inaugural 2025 Target Setting Protocol*, the UN Convened Net Zero Asset Owner Alliance, 2021; *Net Zero Investment Framework: Implementation Guide*, Institutional Investors Group on Climate Change, March 2021.

82 *Climate Action 100+ Sector Strategy: Aviation – Recommended Expectations*, Climate Action 100+, January 2021.

83 PRI, *Impact Investing Market Map*, 6.

84 See https://impactmanagementproject.com/impact-management/impact-management-norms/, accessed 13 February 2021.

85 *Overview of the Impact Management Project*, Impact Management Project 1, available at https://29kjwb3armds2g3gi4lq2sx1-wpengine.netdna-ssl.com/wp-content/uploads/Investor_s-Perspective_-A-Shared-Convention-for-Impact-Management.pdf (accessed 8 October 2020).

86 This was, for example, identified as an issue by the World Economic Forum in 2013: *From the Margins to the Mainstream: Assessment of the Impact Investment Sector and Opportunities to Engage Mainstream Investors*, A report by the World Economic Forum Investors Industries, September 2013, 26. See also *Creating Impact: The Promise of Impact Investing*, IFC, 2019, 40, and, in the wider market *Impact Investing Market Map*, PRI, 2018, 10 and *Sustainable Signals: Growth and Opportunity in Asset Management*, Morgan Stanley Institute for Sustainable Investing/Bloomberg, 2019, 12.

87 *Creating Impact: The Promise of Impact Investing*, IFC, 2019, 44 *et seq.*

88 See, for example, *Measuring Portfolio Alignment: Assessing the Position of Companies and Portfolios on the Path to Net Zero*, The Portfolio Alignment Team, 2020 (available at https://www.tcfdhub.org/wp-content/uploads/2020/10/PAT-Report-20201109-Final.pdf, accessed 27 April 2021).

89 The concept of 'total societal impact', developed by Boston Consulting Group appears to fall within this category. See *Total Societal Impact: A New Lens for Strategy*, The Boston Consulting Group, October 2017.

90 The Harvard Business School Impact Weighted Accounts initiative is an attempt to do something of this sort at enterprise level (https://www.hbs.edu/impact-weighted-accounts/Pages/default.aspx, accessed 16 February 2021), another is the PwC Total Impact Measurement and Management Framework (https://www.pwc.com/gx/en/services/sustainability/total-impact-measurement-management.html, accessed 16 February 2021).

91 https://www.unepfi.org/publications/positive-impact-publications/corporate-impact-tool/#:~:text=The%20Corporate%20Impact%20Analysis%20Tool,across%20different%20sectors%20and%20countries.

92 Developed by the United Nations Global Compact, B Lab and others: see https://www.unglobalcompact.org/take-action/sdg-action-manager.

93 See https://www.sasb.org/standards-overview/materiality-map/, accessed 21 October 2020.

94 See https://www.globalreporting.org/about-gri/mission-history/, accessed 21 October 2020.

95 *Consultation Paper on Sustainability Reporting*, IFRS, September 2020 .

96 See, for example, https://www.iigcc.org/resource/investor-expectations-for-paris-aligned-accounts/ (accessed 25 November 2020).

97 The bodies involved are B Lab, CDP, CDSB, GIIN, the GRI, the Global Steering Group for Impact Investment, the IFC, IIRC, the OECD, the PRI, SASB, Social Value International, the UNDP, the UNEP Finance Initiative, the UN Global Compact and the World Benchmarking Alliance.

98 *Statement of Intent to Work Together Towards Comprehensive Corporate Reporting: Summary of Alignment Discussions Among Leading Sustainability and Integrated Reporting Organizations*, CDP, CDSB, GRI, IIRC and SASB, September 2020. See also *Reporting on enterprise value illustrated with a prototype climate-related financial disclosure standard*, progress towards a comprehensive reporting system, from leading sustainability and integrated reporting organisations CDP, CDSB, GRI and SASB, facilitated by the Impact Management Project, World Economic Forum and Deloitte, December 2020.

99 *Consultation Paper on Sustainability Reporting*, IFRS, September 2020. In February 2021 the trustees confirmed that work is underway to establish a new board that will 'focus on information that is material to the decisions of investors, lenders and other creditors.' It is unclear whether materiality is to be understood in exclusively financial terms. See https://www.ifrs.org/news-and-events/2021/02/trustees-announce-next-steps-in-response-to-broad-demand-for-global-sustainability-standards/, accessed 16 March 2021.

100 *Measuring Stakeholder Capitalism: Towards Common Metrics and Consistent Reporting of Sustainable Value Creation*, World Economic Forum White Paper, 2020, 6.

101 See *Forward-looking Financial Metrics Consultation – Summary of Responses*, Task Force on Climate-Related Financial Disclosures, March 2021.

102 APG, AustralianSuper, British Columbia Investment Management Corporation and PGGM. See https://www.pggm.nl/en/press/us-1-trillion-asset-owner-platform-launches-solution-for-identifying-sdg-investments/, accessed 13 October 2020.

103 https://www.fsb-tcfd.org/

104 In relation to the EU, see for example, https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52019XC0620(01).

105 https://corporatereportingdialogue.com/better-alignment-project/

106 Article 19a(1) of Directive 2013/34/EU (introduced by the Non-Financial Reporting Directive).

107 *Guidelines on non-financial reporting: Supplement on reporting climate-related information*, Communication from the Commission (2019/C-209/01), at 2.2.

108 Florian Berg, and Julian Kölbel and Roberto Rigobon, *Aggregate Confusion: The Divergence of ESG Ratings* (May 17, 2020), available at https://ssrn.com/abstract=3438533; Florian Berg, Kornelia Fabisik, and Zacharias Sautner, *Rewriting History II: The (Un) predictable Past of ESG Ratings*, ECGI Finance Working Paper N° 708/2020, November 2020. This has provided an impetus for new entrants, such as Arabesque.

109 The complex interactions between different reporting frameworks is well illustrated in a matrix prepared by the Carbon Disclosure Standards Board which only covers disclosure in those area of business that are the particular concern of the CDSB, available at https://www.cdsb.net/sites/default/files/making_the_connections_2018.pdf (accessed 21 October 2020).

110 See https://www.sasb.org/wp-content/uploads/2016/12/StdsDev-InDepth-22Sept2016_generalized_336.pdf, accessed 21 October 2020.

111 See https://www.global-value.eu/navigator.php.

112 *Impact Investing Market Map*, PRI, 2018.

113 https://iris.thegiin.org/metrics/.

114 *Measuring Stakeholder Capitalism*, World Economic Forum.

115 A set of impact management tools and measures, developed by GIIN and based on the earlier IRIS Catalog, which includes core metrics sets for use in impact measurement.

116 *Annual Impact Investor Survey 2020*, GIIN, 2020, 46.

117 *Creating Impact: The Promise of Impact Investing*, IFC 2019, 3, 5; Paul Brest, Ronald J. Gilson and Mark A. Wolfson, *How Investors Can (And Can't) Create Social Value*, Journal of Corporation Law, 2019, Vol. 44, 205-231.

118 *From the Margins to the Mainstream: Assessment of the Impact Investment Sector and Opportunities to Engage Mainstream Investors*, A report by the World Economic Forum Investors Industries, September 2013, 26.

119 See, for example, Wendy Abt, 'Almost Everything You Know About Impact Investing is Wrong', Stanford Social Review, 18 December 2018.

120 *Creating Impact: The Promise of Impact Investing*, IFC 2019, 3.

121 *Investor Contribution in Public and Private Markets, Discussion Document*, Impact Management Project, January 2019.

122 *Growing Impact: New Insights into the Practice of Impact Investing*, IFC, June 2020.

123 See, for example, the IMP's discussion of 'contribution' at, https://impactmanagementproject.com/impact-management/impact-management-norms/contribution/, accessed 19 March 2021.

124 Wendy Abt, 'Almost Everything You Know About Impact Investing is Wrong'.

INVESTING FOR SUSTAINABILITY IMPACT

125 Patrick Carter, Nicolas Van de Sijpe and Raphael Calel, *The Elusive Quest for Additionality*, Center for Global Development, Working Paper 495, September 2018.

126 Brest, Gilson and Wolfson, *How Investors Can (And Can't) Create Social Value*.

127 *BCG Global Asset Management 2020 – Protect, Adapt and Innovate*, 5 f. This study comprises assets that are managed against compensation (ie management fees) by professionals, including captive AuM for insurance groups.

128 *The World's Largest 500 Asset Managers 2020*, Thinking Ahead Institute, Willis Towers Watson, October 2020, 8.

129 *PRI Annual Report*, available at https://www.unpri.org/annual-report-2020

130 *Asset and Wealth Management Revolution: The Power to Shape the Future*, PwC, 2020, 2.

131 *2020 Market Highlights*, World Federation of Exchanges, available at https://www.world-exchanges.org/storage/app/media/FH.FY%20 2020%20Market%20Highlights%20v8.pdf (accessed 29 March 2020).

132 *BIS Quarterly Review: International Banking and Financial Market Developments*, Bank of International Settlements, September 2020, A11.

133 *Global Pension Fund Assets Study*, Thinking Ahead Institute, Willis Towers Watson, 2021, 6.

134 *2021 Investment Company Fact Book: A Review of Trends and Activities in the Investment Company Industry*, Investment Company Institute, 61st edn, 2021, 7.

135 *Global Monitoring Report on Non-Bank Financial Intermediation*, Financial Stability Board, 2020, 13.

136 *The World's Largest 500 Asset Managers 2020*, The Thinking Ahead Institute, 44 *et seq*.

137 *Ibid*, 9.

138 See, for example, *The World's Largest 500 Asset Managers 2020*, Willis Towers Watson.

139 Blackrock, $8.15tn (unaudited) as at 31 December 2020 (https://s24.q4cdn.com/856567660/files/doc_financials/2020/Q4/BLK-4Q20-Earnings-Release.pdf, 5, accessed 30 March 2021); Vanguard, passed $7tn AuM during 2020 (Chris Flood, 'Vanguard's assets hit $7tn', *Financial Times*, 13 January 2021); State Street Global Advisors, $3.4tn as at 31 December 2020 (https://www.ssga.com/us/en/institutional/ic/about-us/who-we-are, accessed 30 March 2021).

140 David MacLaughlin and Annie Massa, 'The Hidden Dangers of the Great Index Fund Takeover', *Bloomberg*, 9 January 2020.

141 BCG, *Global Asset Management 2020, Protect, Adapt, and Innovate*, 9.

142 *The World's Largest 500 Asset Managers* 2020, Willis Towers Watson, 37, suggests a lower figure but this may have been the result of a smaller sample size.

143 Robin Wigglesworth and Alex Janiaud, 'Index funds break through $10tn-in-assets mark amid active exodus', *Financial Times*, 8 January 2020.

144 *The World's Largest 500 Asset Managers 2019*, The Thinking Ahead Institute, Willis Towers Watson, 32.

145 https://www.morningstar.com/blog/2019/01/28/us-fund-flows-trends.html; https://www.morningstar.com/articles/961935/2019-fund-flows-in-9-charts (both accessed 18 September 2020). See also *The World's Largest 500 Asset Managers 2020*, Willis Towers Watson, 9, which suggests that passive investments increased by 25.3 per cent during 2019.

146 *BCG Global Asset Management 2020 – Protect, Adapt and Innovate*, 6.

147 AuM in Europe in 2019 increased by 13per cent from $20.2tn to $22.8tn (*BCG Global Asset Management 2020 – Protect, Adapt and Innovate*, 6).

148 *BCG Global Asset Management 2020 – Protect, Adapt and Innovate*, 7.

149 *Ibid*, 7.

150 *Ibid*, 7.

151 *The World's Largest 500 Asset Managers 2019*, Willis Towers Watson, 11.

152 *Ibid*, 18.

153 Data for Japan as of 31 March 2018.

154 GSIA, *Global Sustainable Investment Review 2018*, 8. The GSIA is currently working on an updated review, but it was not available at the time of going to print.

155 *2020 Report on US Sustainable and Impact Investing Trends*, US SIF, 2020.

156 *Sustainable Investment in the European Asset Management Industry: Defining and Sizing ESG Strategies*, European Fund and Asset Management Association, Market Insights, Issue 3, November 2020. Jurisdictions covered included the UK and Switzerland.

157 *Sustainability Goes Mainstream: 2020 Global Sustainable Investing Survey*, BlackRock, 2020. Covered a total of 425 corporate and public pension funds, sovereign wealth funds, insurers, asset managers, endowments, foundations and global wealth managers from 27 countries with a particular concentration in EMEA.

158 *Asset and Wealth Management Revolution: The Power to Shape the Future*, PwC, 2020, 10.

159 ChinaSIF, *China Sustainable Investment Review 2019*, 6. See also, Eric Ng, 'China begins to embrace global sustainable investment trend, but big names still missing says China-chief of UN-backed body', *South China Morning Post*, 17 February 2019; Chad Bray and Louise Moon, 'Asia behind in sustainable investing, but attitudes are changing, industry leaders say', *South China Morning Post*, 18 October 2019.

160 ChinaSIF, *China Sustainable Investment Review 2019*, 6.

161 Categories and descriptions taken from GSIA, *Global Sustainable Investment Review*, 7.

162 *Growing Impact: New Insights into the Practice of Impact Investing*, IFC, 2020, 11. For evidence that some US mutual funds with ESG objectives do engage in distinctive ESG voting patterns, see Quinn Curtis, Jill E. Fisch and Adriana Z. Robinson, *Do ESG Mutual Funds Deliver on Their Promises?* ECGI Law Working Paper No. 586/2021, June 2021, 39 *et seq*.

163 GSIA, *Global Sustainable Investment Review 2018*, 10.

164 *Social Impact Investment: Building the Evidence Base*, OECD, 2015,11 highlights the limited available data on social impact investing.

165 *Social Impact Investment 2019: The Impact Imperative For Sustainable Development*, OECD 2019, 223.

166 GIIN, *Annual Impact Investor Survey 2020*, XIII.

167 GIIN, *Annual Impact Investor Survey 2020*, 40.

168 IFC, *Growing Impact*, 13.

169 *Impact Investment Market Map*, PRI, 2018, 8.

170 IFC, *Growing Impact*, 13.

171 See, for example, *Creating Impact: The Promise of Impact Investing*, IFC, 2019, 20; *Special Report: Institutional Investors U.S. Results*, Edelman Trust Barometer 2020, Edelman, 2020.

172 https://www.netzeroassetmanagers.org/ and https://www.unepfi.org/net-zero-alliance/ (both accessed 10 July 2021).

173 https://www.climateaction100.org/ (accessed 17 June 2021).

174 A more detailed summary of the studies and surveys considered is available at SSRN: https://ssrn.com/abstract=3888570. For studies published in the period before 2017, see the literature review prepared by the Cambridge Institute of Sustainability Leadership during 2018 (available from the Institute) in connection with *Walking the Talk: Understanding Consumer Demand for Sustainable Investing*, a study by the Cambridge Institute for Sustainability Leadership, October 2019. Its findings were similar to those reported below, but more recent work (including the Institute's own study, described in *Walking the Talk*) provides valuable new insights.

175 *Walking the Talk*, Cambridge Institute for Sustainability Leadership, 8.

176 See, for example, Steve Schueth, *Socially Responsible Investing in the United States*, Journal of Business Ethics, 2003, Vol. 43, 189-194, 189; Céline Louche, Daniel Arenas and Katinka C. van Cranenburgh, *From Preaching to Investing: Attitudes of Religious Organisations Towards Responsible Investment*, Journal of Business Ethics, 2012, Vol. 110, 301-320, 302; and Kölbel, Heeb, Paetzold and Busch, *Can Sustainable Investing Save the World: Reviewing the Mechanisms of Investor Impact*.

177 Louche, Arenas, and van Cranenburgh, *From Preaching to Investing: Attitudes of Religious Organisations Towards Responsible Investment*, 303. One of the earliest funds combining an emphasis on environmental, social and governance matters combined with financial return was launched in Norway in 1995 (a joint initiative of Storebrand Asset Management and Scudder, Stevens & Clark), based on an eco-efficiency concept of the World Business Council for Sustainable Development: see Claudia H. Deutcsh, 'Investing it; for Wall Street, Increasing Evidence that Green Begets Green', *New York Times*, 19 July 1998. Sarasin Bank launched a similar fund the following year.

178 See The *Materiality of Social, Environmental and Corporate Governance Issues to Equity Pricing: 11 Sector Studies by Brokerage House Analysts at the Request of the UNEP Finance Initiative Asset Management Working Group*, UN Environment Programme Finance Initiative (2004).

179 The Global Compact, *Who Cares Wins – Connecting Financial Markets to a Changing World*, June 2004, i, available at: https://www.ifc.org/wps/wcm/connect/de954acc-504f-4140-91dc-d46cf063b1ec/WhoCaresWins_2004.pdf?MOD=AJPERES&CACHEID=

INVESTING FOR SUSTAINABILITY IMPACT

ROOTWORKSPACE-de954acc-504f-4140-91dc-d46cf063b1ec-jqeE.mD.

180 *A legal framework for the integration of environmental, social and governance issues into institutional investment*, Freshfields Bruckhaus Deringer LLP 2005, https://www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf

181 Reflected, for example, in the growing membership of the PRI. See also GSIA, *2018 Global Sustainable Investment Review* and Bailard Wealth Management, *From SRI to ESG: The Origins of Socially Responsible and Sustainable Investing*, June 2017, available at: https://www.bailard.com/wp-content/uploads/2017/06/Socially-Responsible-Investing-History-Bailard-White-Paper-FNL.pdf?pdf=SRI-Investing-History-White-Paper.

182 *Final Report of the Strategic Assessment of the Rockefeller Foundation's Impact Investing Initiative*, E.T. Jackson and Associates Ltd, 2012, 40, available at: https://www.rockefellerfoundation.org/wp-content/uploads/Impact-Investing-Evaluation-Report-20121.pdf. The Foundation has invested over $40m to develop impact investing as a field (see Jem Hudson, 'The State of Impact Investing', *The Wharton Magazine*, 26 June 2014, available at https://magazine.wharton.upenn.edu/digital/the-state-of-impact-investing/, accessed 12 March 2021).

183 As noted in Section A, the concept of investing for sustainability impact used in this report is intended to catch a broader range of activities than those commonly thought of as impact investing, but would include impact investing.

184 See, for example, *From the Margins to the Mainstream: Assessment of the Impact Investment Sector and Opportunities to Engage Mainstream Investors*, a report of the World Economic Forum Investors Industries prepared in collaboration with Deloitte Touche Tohmatsu, September 2013; *Social Impact Investment 2019: The Social Impact Imperative for Sustainable Development*, OECD 2019; *Annual Impact Investor Survey 2020*, 10th edn, Global Impact Investing Network, 2020**.**

185 *Social Impact Investment: Building the Evidence Base*, OECD, 2015, 10.

186 OECD, *Social Impact Investment 2019* (see especially Chapter 4); GIIN, *Annual Impact Investor Survey 2020; Growing Impact: New Insights into the Practice of Impact Investing*, IFC, 2020.

187 See https://www.gov.uk/government/news/social-impact-investment-forum, accessed 12 September 2020; OECD, Social Impact Investment 2019, 163-164.

188 See World Economic Forum Investors Industries, *From the Margins to the Mainstream; From Ideas to Practice, Pilots to Strategy: Practical Solutions and Actionable Insights on How to Do Impact Investing*, a report by the World Economic Forum Investors Industries, December 2013.

189 See for example, Michael Porter and Mark Kramer, *Creating Shared Value – How to reinvent capitalism – and unleash a wave of innovation and growth*, Harvard Business Review, January-February 2011, 1-17, 15.

190 See, for example, *Capital as a Force for Good: Global Finance Industry Leaders Transforming Capitalism for a Sustainable Future* (Force for Good 2020).

191 EUROSIF, *European SRI Study 2012*, 10, available at: http://www.eurosif.org/wp-content/uploads/2014/05/eurosif-sri-study_low-res-v1.1.pdf; OECD, *Investment governance and the integration of environmental, social and governance factors*, 2017, 7.

192 Joachim Sandberg, Carmen Juravle, Ted M. Hedesström and Ian Hamilton, *The Heterogeneity of Socially Responsible Investment*, Journal of Business Ethics, 2009, Vol. 87, 519-533, 524; Grant Michelson, Nick Wailes, Sandra Van Der Laan and Geoff Frost, *Ethical Investment, Processes and Outcomes*, Journal of Business Ethics, 2004, Vol. 52, 1–10, 1.

193 https://www.unpri.org/pri/an-introduction-to-responsible-investment/what-is-responsible-investment.

194 *Global Sustainable Investment Review 2016*, Global Sustainable Investment Alliance (GSIA), 26, available at: http://www.gsi-alliance.org/wp-content/uploads/2017/03/GSIR_Review2016.F.pdf.

195 https://www.robeco.com/de/unsere-expertise/sustainable-investing/glossary/socially-responsible-investing.html.

196 EU Commission, Impact Assessment, SWD (2018) 264 final, 146.

197 *Global Sustainable Investment Review 2018*, Global Sustainable Investment Alliance (GSIA), 7.

198 There are a few exceptions. See, for example, *Clean Slate, Green Slate: Public and Investor Attitudes to 'Good' Money 2020*, UK Sustainable Investment and Finance Association, 2020, 6.

199 *Investing in a Better World: Understanding the UK Public's Demand for Opportunities to Invest in the Sustainable Development Goals*, UK Department for International Development, Investing in a Better World Project, 2019, 7, 20.

200 *Sustainable Signals: Individual Investor Interest Driven by Impact, Conviction and Choice*, Morgan Stanley Institute for Sustainable Investing, September 2019, 1. The level of interest among US investors with this level of investible assets was similar in the Nuveen *Fifth Annual Responsible Investing Survey*, Nuveen, 2019. See also *Retirement Reality Check: A Generational Look at Defined Contribution Plan Participation*, Natixis 2019.

201 *Ethics and Investing: How Environmental, Social and Governance Issues Impact Investor Behavior*, Allianz Life Insurance Company of North America 2019.

202 Lei Delsen and Alex Lehr, *Value Matters or Values Matter? An Analysis of Heterogeneity in Preferences for Sustainable Investment*, Journal of Sustainable Finance and Investment, 2019, Vol. 9(3) 240-261. See also Rob Bauer, Tobias Ruof and Paul Smeets, *Get Real! Individuals Prefer More Sustainable Investments*, February 2021, available at SSRN: https://ssrn.com/abstract=3287430.

203 *The French and SRI: Results of the 8th National Survey* run by Ipsos for Vigeo Eiris and the FIR, September 2017, press release available at https://vigeo-eiris.com/wp-content/uploads/2017/09/20170921_CP_GC_Les-Français_et_lISR-ENG-1.pdf, accessed 12 April 2021.

204 *A Large Majority of Retail Clients Want to Invest Sustainably: Survey of French and German Retail Investors' Sustainability Objectives*, 2° Investing Initiative, March 2020.

205 *Growing consumer demand for ethical investing: 4 in 5 Australians prepared to switch funds*, Responsible Investment Association Australasia, press release, November 2017, available at https://responsibleinvestment.org/wp-content/uploads/2017/11/Media-release-Growing-consumer-demand-for-ethical-investing-15-Nov.pdf (accessed 25 April 2021).

206 *Global Investor Study - Under Pressure: Investors' Response to Crisis*, Schroders, 2020; *Looking for the Best of Both Worlds*, Natixis Investment Managers, 2019.

207 See for example, 'Advisers predict more ESG investing in the wake of Covid-19', Standard Life, 1 December 2020, available at https://www.standardlife.co.uk/about/press-releases/advisers-predict-more-esg-investing-in-the-wake-of-covid19 (accessed 12 April 2021); 'Interest in ESG investing boosted by Covid', Aviva, 29 October 2020, available at https://www.aviva.com/newsroom/news-releases/2020/10/interest-in-esg-investing-boosted-by-covid/ (accessed 12 April 2021). This is also reflected in changing institutional investor attitudes: see, for example, *Survey Analysis: ESG Investing Pre- and Post-Pandemic*, Institutional Investor Services, Inc, 2020. See also Ola Mahmoud and Julia Meyer, *Social Responsibility in the Time of Uncertainty: A Natural Experiment*, 28 January 2021, available at SSRN: https://ssrn.com/abstract=3774995.

208 In the case of US investors, see for example *Sustainable Signals: New Data from the Individual Investor*, Morgan Stanley Institute for Sustainable Investing, 2017; *Walking the Talk*, The Cambridge Institute for Sustainability Leadership, 7; *Insights on Wealth and Worth*, US Trust, 2018 (available at https://scholarworks.iupui.edu/bitstream/handle/1805/17666/high-net-worth2018-summary.pdf, accessed 13 April 2021); *Fourth Annual Responsible Investing Survey*, Nuveen, 2018. However, the findings of surveys are not consistent on this: see for example *Global Investor Study. Are People Compelled to Invest Sustainably?*, Schroders, 2019, 5.

209 *The French and SRI*, run by Ipsos for Vigeo Eiris and the FIR, September 2017.

210 *Trust, Transparency and the Quest for Clarity*, Natixis Investment Managers, 2017, 6 (covering 8,300 individuals with a minimum of $100,000 in investable assets).

211 *Global Investor Study*, Schroders, 2019, 5. Note, however, that the survey asked participants to rank the importance of three sorts of sustainable investing which did not obviously include approaches that would fall within the definition of IFSI, 13.

212 *Sustainable Signals*, Morgan Stanley Institute for Sustainable Investing, September 2019, 2.

213 *Retirement Reality Check*, Natixis 2019, 7.

214 *SII Attitudinal and Behavioural Research*, Greg B Davies and Centapse, 2017, 14.

215 *Consumer Survey*, AXA Investment Managers UK, 2018, 19.

216 *Annual Triodos Bank Impact Investing survey: Socially Responsible Investing market on the cusp of momentous growth*, press release 5 September 2018 (https://www.triodos.co.uk/press-releases/2018/socially-responsible-investing-market-on-cusp-of-momentus-growth, accessed 13 April 2021).

217 Anett Wins and Bernard Zwergel, *Comparing Those Who Do, Might and Will Not Invest in Sustainable Funds: A Survey Among German Retail Fund Investors*, Business Research, 2016, Vol. 9, 51-99.

218 Joakim Sandberg and Jonas Nilsson, *Do Ethical Investors Want Purity or Effectiveness? An Exploratory Study on the Ethical Preferences of Mutual Fund Investors*, Journal of Financial Services Marketing, 2015, Vol. 20, 34-45, 40.

219 *A Large Majority of Retail Clients Want to Invest Sustainably*, 2° Investing Initiative, March 2020, 30.

220 *Ibid*. 9.

221 Brodback, Guenster and Mezger, *Altruism and Egoism in*

INVESTING FOR SUSTAINABILITY IMPACT

Investment Decisions, Review of Financial Economics, 2019, Vol. 37(1), 118-148.

222 *Investing in a Better World*, UK Department for International Development, 7.

223 *Fourth Annual Responsible Investing Survey*, Nuveen, 2018.

224 Bauer, Ruof and Smeets, *Get Real! Individuals Prefer More Sustainable Investments*, 5.

225 *Fifth Annual Responsible Investing Survey*, Nuveen, 2019, 2.

226 *Understanding the Positive Investor*, Ethex 2017.

227 *Consumer Survey*, AXA Investment Managers UK, 2018, 19.

228 *A Large Majority of Retail Clients Want to Invest Sustainably*, 2° Investing Initiative, March 2020, 30. See also Trond Døskeland and Lars Jacob Tynes Pedersen, *Investing with the Brain or Heart? A Field Experiment on Responsible Investment*, Management Science, 2016, Vol. 62(6), 1632-1644 (Scandinavian individuals).

229 See, for example, Ann-Christine Brunen and Oliver Laubach, *Do Sustainability-Conscious Individuals Prefer Socially Responsible Investments? A Study Among the Users of Robo Advice*, 3 February 2021, available at https://ssrn.com/abstract=3778610 (German individuals); Samuel M. Hartzmark and Abigail B. Sussman, *Do Investors Value Sustainability? A Natural Experiment Examining Ranking and Fund Flows*, Journal of Finance, 2019, Vol. 74(6), 2789-2837 (US individuals); Daniel Brodback, Nadja Guenster and David Mezger, *Altruism and Egoism* in Investment Decisions, Review of Financial Economics, 2019, Vol.37(1), 118-148 (German individuals); Mariacristina Rossi, Dario Sansone, Arthur van Soest and Costanza Torricelli, *Household Preferences for Socially Responsible Investments*, Journal of Banking and Finance, 2019, Vol. 105, 107-120 (Dutch investors); Arno Riedl and Paul Smeets, *Why do Investors Hold Socially Responsible Investment Funds?* The Journal of Finance, 2017, Vol. 72(6), 2505-2550 (Dutch investors); Mortiz Wiesel, Kristian Ove R. Myrseth and Bert Scholtens, *Social Preferences and Socially Responsible Investing: A Survey of US Investors*, Working Papers in Responsible Banking and Finance, No. 17-002, University of St Andrews, 2017 (US individuals); Sandberg and Nilsson, *Do Ethical Investors Want Purity or Effectiveness?* (Swedish individuals); Jonas Nilsson, *Investment with a Conscience: Examining the Impact of Pro-social Attitudes and Perceived Financial Performance on Socially Responsible Investment Behaviour*, Journal of Business Ethics, 2008, Vol. 83, 307-325; Nicolas P. B. Bollen, *Mutual Fund Attributes and Investor Behavior*, The Journal of Financial and Quantitative Analysis, 2007, Vol. 42(3), 683-708 (US mutual fund investors).

230 Wins and Zwergel, *Comparing Those Who Do, Might and Will Not Invest in Sustainable Funds* (German individuals); Wiesel, Myrseth and Scholtens, *Social Preferences and Socially Responsible Investing: A Survey of US Investors* (US individuals).

231 See, for example, Brunen and Laubach, *Do Sustainability-Conscious Individuals Prefer Socially Responsible Investments?*; Ola Mahmoud, *Doing well while feeling good*, March 2020, available at SSRN: https://ssrn.com/abstract=3458277; Wiesel, Myrseth and Scholtens, *Social Preferences and Socially Responsible Investing*.

232 Although there is evidence to suggest that investors with 'pro-social' preferences consistently prefer options that are likely to have the most impact if given several options to compare: Florian Heeb, Julian F. Kölbel, Falko Paetzold and Stefan Zeisberger, *Do Investors Care About Impact?*, 25 February 2021, available at SSRN: https://ssrn.com/abstract=3765659.

233 Heeb, Kölbel, Paetzold and Zeisberger, *Do Investors Care About Impact?* (Dutch individuals); Mahmoud, *Doing well while feeling good* (Swiss individuals); Wiesel, Myrseth and Scholtens, *Social Preferences and Socially Responsible Investing: a survey of US investors* (US individuals).

234 Most obviously Adam Smith in his *Theory of Moral Sentiments*, but see also for example Timothy Besley and Maitreesh Ghatak, *Prosocial Motivation and Incentives*, Annual Review of Economics, 2018, Vol. 10, 411-438; *Samuel Bowles, The Moral Economy: Why Good Incentives Are No Substitute for Good Citizens* (Yale University Press 2016); Roland Bénabou and Jean Tirole, *Individual and Corporate Social Responsibility*, Economica, 2010, Vol. 77, 1-19.

235 See for example, Shalom H. Schwartz, *Les Valeurs de Base de la Personne: Théorie, Mesures et Applications*, Revue Française de Sociologie, 2006, Vol 47(4), 929-969, and Daniel C. Batson, *Altruism in Humans* (Oxford University Press 2010). For a discussion of this topic in the context of financial markets, see David Rouch, *The Social Licence for Financial Markets: Reaching for the End and Why it Counts* (Palgrave Macmillan 2020), especially 88-90.

236 See, for example, Jonas Nilsson, *Segmenting Socially Responsible Mutual Fund Investors: The Influence of Financial Return and Social Responsibility*, International Journal of Bank Marketing, 2009, Vol. 27(1), 5-31.

237 *Sustainable Signals*, Morgan Stanley Institute for Sustainable Investing, 2019, 5, 9.

238 *Retirement Reality Check*, Natixis 2019.

239 *Ethics and Investing*, Allianz Life Insurance Company of North America 2019, 1.

240 *SII Attitudinal and Behavioural Research*, Greg B. Davies and Centapse, 2017, 14.

241 *Looking for the Best of Both Worlds*, Natixis Investment Managers, 2019, 6.

242 *Ethics and Investing*, Allianz Life Insurance Company of North America 2019, 3.

243 Wins and Zwergel, *Comparing Those Who Do, Might and Will Not Invest in Sustainable Funds*.

244 The top three factors considered most important by respondents for investment decisions were (i) avoiding monetary loss, (ii) meeting total investment return expectations, and (iii) generating the expected income level. Investing in sustainable investments ranked fifth. See *Global Investor Study. Are people compelled to invest sustainably?*, Schroders, 2019, 11.

245 *Attitudes towards socially responsible investment in Europe*, BNP Paribas Asset Management, 2019, 8.

246 *Ibid*, 4.

247 For example, according to the study by the UK Department for International Development, 71 per cent of the respondents ranked return, 65 per cent ranked risk and 30 per cent ranked impact of an investment among the five most important investment factors, see *Investing in a Better World*, UK Department for International Development, 2019, 11, 42. In a poll by Good Money Week, UK investors were asked about their investment concerns: 39 per cent answered that they only care about making money, 1 per cent stated that they only want to achieve a 'positive difference to the world.' 22 per cent ranked both objectives as equally important. For 26 per cent, both aspects play a role, of which 22 per cent state that they mainly care about financial return, see *Attitudes to Ethical and Sustainable Investment and Finance in the UK*, Good Money Week Public Polling, 2017, 2 (https://www.goodmoneyweek.com/sites/default/files/download/public_polling_report_2017_gmw.pdf).

248 Bauer, Ruof and Smeets, *Get Real! Individuals prefer more Sustainable Investments*. While the respondents represented only about 6 per cent of the membership of the relevant pension fund, the authors describe how they sought to establish the extent to which the respondents were nonetheless a representative sample. The group of individuals that responded to the second survey was not identical to the first, but there was an overlap. There appears to have been some moderation in support overall for the pension fund's engagement strategy in the second survey. However, support remained well above 50 per cent and, significantly, 98.8 per cent of those responding who had supported it in the first survey remained supportive in the second and 76.8 per cent of those who had previously been against it nonetheless indicated their agreement in 2020 with the steps the fund had taken.

249 Delsen and Lehr, *Value Matters or Values Matter?*, 240, 252. The usable response rate was 49.38 per cent and the authors sought to ensure that the sample was representative, 249.

250 *SII Attitudinal and Behavioural Research*, Greg B Davies and Centapse, 16.

251 *Global Investor Study*, Schroders 2020, 4, 7, 9.

252 See especially, *Walking the Talk*, the Cambridge Institute for Sustainability Leadership, 15.

253 Harrison Hong and Marcin Kacperczyk, *The Price of Sin: The Effects of Social Norms on Markets*, Journal of Financial Economics, 2009, Vol. 93(1), 15-36.

254 Sandberg and Nilsson, *Do Ethical Investors Want Purity or Effectiveness?*, 40.

255 Although mutual funds attract both institutional and retail money, a portion of these fund flows directly or indirectly represents individual investor assets, and the authors looked both at institutional and non-institutional share classes finding a similar pattern.

256 Hartzmark and Sussman, *Do Investors Value Sustainability?*.

257 Marco Ceccarelli, Stefano Ramelli and Alexander F. Wagner, *Low-carbon Mutual Funds*, ECGI Finance Working Paper no 659/2020, February 2021.

258 Marie Brière and Stefano Ramelli, *Responsible Investing and Stock Allocation*, Amundi Working Paper 104-2021, January 2021.

259 *Attitudes Towards Socially Responsible Investment in Europe*, BNP Paribas Asset Management, 2019, 4.

260 *Investing in a Better World*, UK Department for International Development, 24.

261 *Global Insights: What's on investors' minds, Return on Values*, UBS Investor Watch Volume 2, 2018, 4, 9 *et seq*.

262 *Ethics and Investing*, Allianz Life Insurance Company of North America 2019, 2019, 3.

263 Døskeland and Pedersen, *Investing with the Brain or Heart?*

264 *Walking the talk*, The Cambridge Institute for Sustainable Leadership, 8, 14, 16 et seq. The 2,096 US individuals who

participated in the experiment were asked to make certain investment decisions, with some of them, randomly selected, receiving a real investment worth $1,000 in their chosen fund. Therefore, the participants were told and encouraged to treat all their choices as if they were investing their own assets. Given information about financial returns and sustainability on a fact sheet, the participants were asked to choose one of two offered funds to invest in.

265 Gunnar Gutsche and Andreas Ziegler, *Are Private Investors Willing to Pay for Sustainable Investments? A Stated Choice Experiment*, MAGKS Joint Discussion Paper Series in Economics, No. 40-2016, 16.

266 Jean-François Bonnefin, Augustin Landier, Parinitha Sastry and David Themsar, *Do Investors Care about Corporate Externalities? Experimental Evidence*, 23 September 2019, HEC Paris Research Paper No. FIN-2019-1350, available at SSRN: https://ssrn.com/abstract=3458447.

267 Ceccarelli, Ramelli and Wagner, *Low-carbon Mutual Funds*.

268 Heeb, Kölbel, Paetzold and Zeisberger, *Do Investors Care About Impact?*; Riedl and Smeets, *Why do Investors Hold Socially Responsible Investment Funds?*.

269 See, for example, Wins and Zwergel, *Comparing Those Who Do, Might and Will Not Invest in Sustainable Funds*.

270 As at least one author of this report can attest.

271 *Attitudes Towards Socially Responsible Investment in Europe*, BNP Paribas Asset Management, 2019, 3, 6.

272 Only 15 per cent of Americans covered by the Allianz survey, mentioned above, knew what the expression 'ESG' stood for in an investment context: *Ethics and Investing*, Allianz Life Insurance Company of North America 2019, 1. In relation to the UK, see *Clean Slate, Green Slate: Public and Investor Attitudes to 'Good' Money 2020*, UK Sustainable Investment and Finance Association, 2020, 5, 6. In relation to France, 66 per cent of respondents in a study covering French individuals owning at least one financial product stated that they had never heard of Socially Responsible Investment: see *The French and SRI*, Ipsos for Vigeo Eiris and the FIR.

273 Gunnar Gutsche, Miwa Nakai and Toshi H. Arimura, *Revisiting the Determinants of Individual Sustainable Investment – The Case of Japan*, Journal of Behavioral and Experimental Finance, 2021, Vol. 30, issue c.

274 *Global Investor Study*, Schroders 2018, 5.

275 *Investing in a Better World*, UK Department for International Development, 24.

276 Another UK survey conducted among 2,020 individuals revealed that there is a high motivation to tackle the 'big issues' by supporting progressive businesses to improve economic success in the long term (61 per cent). However, the same survey found that 61 per cent would not know where to go for more information: *Annual Triodos Bank Impact Investing survey*, press release 5 September 2018.

277 This is also supported by a study of the impact of 'climate labelling' on investors from six European countries which showed that it is particularly effective as a 'nudge' towards climate-friendly investing among 'intuitive' decision makers: see Alexander Bassen, Katrin Gödker, Florian Lüdeke-Freund and Josua Oll, *Climate Information in Retail Investors' Decision-Making: Evidence From a Choice Experiment*, *Organization & Environment*, 2019, Vol. 32(1), 62-82.

278 See *MiFID II Sustainability Delegated Regulation*.

279 *A Large Majority of Retail Clients Want to Invest Sustainably*, 2° Investing Initiative, March 2020, 5.

280 *Annual Triodos Bank Impact Investing Survey*, press release 5 September 2018.

281 See for example, 'Advisers predict more ESG investing in the wake of Covid-19', Standard Life, 1 December 2020, available at: https://www.standardlife.co.uk/about/press-releases/advisers-predict-more-esg-investing-in-the-wake-of-covid19 (accessed 12 April 2021).

282 For example, one survey of UK advisers found that 78 per cent of those polled thought that less than 50 per cent of their clients would wish to invest in a portfolio with 'an ESG steer or positive impact', with 46 per cent claiming that less than 25 per cent would wish to do so: *ESG Survey Results*, Square Mile Investment and Consulting Research Limited, April 2020.

283 Saloni Sardana, 'One third of advisers never consider ESG funds', *FT Adviser*, 12 June 2019.

284 *Surfing the Wave*, FE Fundinfo, 2020; Mike Webb, 'Investors are past the tipping point on ESG', *FT Adviser*, 19 January 2021.

285 'Schroders UK Financial Adviser Survey: Optimism returns to UK equities as advisers increasingly embrace ESG', press release, Schroders, 20 November 2020, available at https://www.schroders.com/de/media-relations/newsroom/all_news_releases/schroders-uk-financial-adviser-survey-optimism-returns-to-uk-equities-as-advisers-increasingly-embrace-esg/, accessed 19 April 2021.

286 Anders Anderson and David T. Robinson, *Financial Literacy in the Age of Green Investment*, Swedish House of Finance Working Paper 19-6, December 2020, available at: https://ssrn.com/abstract=3353534.

287 Wins and Zwergel, *Comparing those who do, might and will not invest in sustainable funds*.

288 Some of them do however cover forms of impact investing, for example, *SII Attitudinal and Behavioural Research*, Greg B Davies and Centapse, 2017, using the term 'social impact investing', and *An Evolving Landscape, 2019 Responsible Investing Survey*, RBC Global Asset Management, 2019, dealing, among other things, with 'impact investing'.

289 Many of the academic studies in particular seek to counter this effect or assess the extent of any potential impact on the results.

290 *Walking the Talk*, The Cambridge Institute for Sustainability Leadership, 11.

291 For an overview of studies on this point alone, see the Cambridge Institute for Sustainability Leadership literature review referred to at endnote 174.

292 See, for example, the work undertaken by the research team in *Walking the Talk*, the Cambridge Institute for Sustainability Leadership study, mentioned above, to ensure that sustainability options were clearly described to participants. However, even they highlight the impact that the method of presentation may have had on the results.

293 However, some studies do seek to break this down. See for example *Standard Chartered Sustainable Investing Review 2020*, Standard Chartered Private Bank, 2020.

294 Anjum Ubaid Siddiqui, *The Demography of Socially Responsible Investors across Countries and Time: A Systematic Review*, Asian Journal of Managerial Science, 2018, Vol. 7(2), 7-15.

295 See for example *Global Investor Study*, Schroders 2020.

THE EXTENT TO WHICH THE LAW REQUIRES OR PERMITS IFSI

INTRODUCTION

1 A key objective of this project has been to assess how far the law requires or permits IFSI. That is the subject of this Part B. As noted previously, what legal rules require or permit turns not just on their 'black letter' (ie what they 'say'), but also the circumstances in which those rules are applied. For example, in the case of IFSI these circumstances may circumscribe what is possible as a technical matter or in terms of cost (see Part A.2). In view of that, Part B looks both at the substance of the relevant legal rules, and the interrelationship between that and the circumstances in which they are followed.

2 It is in four sections:

- Section 1 explains our methodology.
- Section 2 deals with common themes we have identified across all jurisdictions concerning the *sort* of legal rules that apply to different categories of investor, even though the *content* of those rules varies between jurisdictions. It also considers circumstances that investors will commonly need to take into account in complying with legal rules even though investors' specific situations will vary. It therefore explains how it is possible to reach a generally applicable view on what 'the law' requires or permits in spite of this diversity.
- Section 3 summarises our findings across the 11 jurisdictions covered by the project on what the 'black letter' of the law provides. The full jurisdictional assessments are included as annexes to this report.
- Section 4 turns to the circumstances in which legal rules relevant to IFSI are applied in practice. As noted, these can have just as much impact on the practical outcomes that result from following rules as what the rules actually 'say'. In particular, the section looks at a possibility that has frequently been raised with us in preparing this report: whether aspects of the way investment markets currently operate create a risk that sustainability factors are given insufficient weight in complying with legal duties.

THE EXTENT TO WHICH THE LAW REQUIRES OR PERMITS IFSI

1. METHODOLOGY

3 This section explains the methodology applied in undertaking this project. It outlines how the project was scoped so as to cut through the complexity of investment markets, focusing the analysis on those jurisdictions, areas of market practice and market operators that should provide a reasonable picture of the whole. It also explains the process followed.

1.1 Project scope

1.1.1 'Hard' and 'soft' law and wider industry practice

4 This report concerns whether *legal rules* facilitate or confine IFSI. This requires an analysis not just of the 'black letter' of statutes, regulations and legal judgements (ie the substance of the rules themselves), but also of non-legally binding standards and codes of practice, regulatory guidance and formal industry initiatives where these concern the discharge of investors' duties since these could be relevant to what the rules require or permit in practice. Sources of this sort are sometimes termed 'soft law'. Even where these sources have no formal legal status, they may nonetheless express standards of accepted conduct that may be taken into account by courts and regulators in their decisions about what investors are legally required or permitted to do (see Part B.4, Box 5).

1.1.2 Jurisdictions covered

5 The jurisdictions included in our review are intended to represent a cross-section of investment hubs, cultures and legal traditions, while capturing most of the world's largest centres for investment management. Factors considered in selecting them included GDP, the size of the institutional investment market by AuM, industry interest and recent relevant regulatory and policy developments. For a high-level indication of the distribution of global AuM by investment location, see Part A.3.2.4.

6 The following jurisdictions were selected:

- Australia;
- Brazil;
- Canada;
- China;
- the European Union;[1]
- France;
- Japan;
- the Netherlands;
- South Africa;
- the United Kingdom (considering the laws of England and Wales);
- the United States of America.

1.1.3 Relevant investors

7 International investment markets are comprised of many different sorts of operators, with distinct but often overlapping roles, including asset owners, investment managers, investment advisers, broker-dealers acting as principal and/or as agent, investee companies accessing the markets for funding and a host of service providers ranging from investment consultants, index and research providers and rating agencies to lawyers and accountants. Each of these groups is subject to different sets of legal rules. The activities of each group can influence investment management practice and among other things, the way legal rules are understood and applied.

8 However, it is not necessary to look at every part of this investment ecosystem to reach a view on the key question for this project. That is because, at its core, the answer depends on legal rules as they apply to two groups of market operators: asset owners and the investment managers they appoint to manage assets on their behalf. The project has therefore focused on the legal position of these two groups (see (a) and (b) below) while nonetheless recognising the important role of investment consultants and fiduciary managers (as discussed at (c) below).

(a) Asset owners

9 The position of institutional asset owners is key in establishing how far the law requires or permits sustainability factors to be taken into account in the investment management process. That is because they legally hold and are responsible for investing a significant portion of the world's investment assets, whether in the form of equities, debt (including fixed income instruments such as bonds), other types of financial instruments (including units in collective investment funds and derivative instruments such as options, futures and swaps) or real estate and other non-financial assets.[2]

THE EXTENT TO WHICH THE LAW REQUIRES OR PERMITS IFSI

10 Asset owners' legal powers over those assets and the duties and discretions that apply in managing them are fundamental to our analysis. What asset owners are required or permitted to do is not just relevant to them. It also shapes the obligations and discretions of all other financial operators who assist or advise them in managing their assets. An asset owner delegating investment management discretion is not generally able to empower the manager to do something it could not do itself. Similarly, to discharge their own legal duties, investment consultants and others advising an asset owner will need to understand the extent of the asset owner's legal powers, duties and discretions to decide how best to advise. In other words, there is a legal 'cascade effect' from asset owners to all those who directly or indirectly provide services to them.

11 Various categories of asset owner are active in financial markets. Each category is subject to different legal rules, even within the same jurisdiction. For the purposes of this project, we have focused on the three largest categories of asset owner by global AuM:[3] pension funds, mutual funds authorised for public distribution and insurance undertakings (collectively termed Asset Owners in this report).

12 A broad range of other types of asset owners are also active in investment markets, including sovereign investment funds, unregulated funds, charitable institutions and family offices. Some hold significant amounts of AuM. To keep the analysis sufficiently focused, this report does not consider the position of these other categories.

Pension funds

13 Broadly, these are pools of assets that are invested to produce a return to provide income in retirement for individuals or their surviving dependants. Pension funds may be pre-funded by an employer and/or by employee contributions (occupational pension funds) or by private individuals (personal pension funds).[4] Pension funds generally have a duty to provide financial benefits to beneficiaries. The time horizons of those beneficiaries may vary widely, depending upon how close they are to their retirement date. In some cases, the benefits are defined so that investment risk lies with the pension fund ('defined benefit'). However, it is increasingly common for investment risk to lie largely with beneficiaries ('defined contribution'), but this does not detract from the fund's obligations to act in the financial interests of their beneficiaries as a whole. Pension funds are usually legally required to seek to ensure that no one cohort of beneficiaries is unfairly prejudiced to benefit another: they need to seek to generate both near and longer-term financial returns in ways that balance the interests of different cohorts. As noted in Part A.3, estimated pension fund AuM globally stood at $52.5tn as at the end of 2020.[5]

Regulated mutual funds

14 Regulated mutual funds allow investors to pool their funds with those of other investors and to invest in accordance with specific investment objectives, so spreading risks and sharing investment costs. In contrast with pension funds, mutual funds usually have a relatively specific financial investment objective and associated investment policy which may reference particular markets, sectors or benchmarks. The objective and policy of a mutual fund will be set out in its constitution or prospectus and the fund will be legally obliged to adhere to them. Open-ended mutual fund AuM globally stood at an estimated $63tn as at the end of 2020.[6] A significant portion of mutual funds' shares or units are owned by pension funds and insurers.[7]

15 The jurisdictional analysis set out in the annexes focuses on mutual funds, rather than listed investment trust companies. Units in the former are generally available for subscription and redemption from the fund or its agent (ie the fund is 'open-ended') whereas shares in the latter are dealt through brokers. An exception to this is exchange-traded funds (or 'ETFs'). These are open-ended mutual funds the units of which are listed and can be dealt through brokers (with subscription and redemption of units generally being handled between the fund or its agent with large broker-dealers). This report covers the rules that apply to ETFs as mutual funds, but not any listing rules.

THE EXTENT TO WHICH THE LAW REQUIRES OR PERMITS IFSI

Insurance undertakings

16 The project covers both non-life and life insurers. Legal assessments generally assume that the relevant insurer is established as a body corporate.

17 In its origins, insurance is a financial risk management tool in which the insured party transfers the risk of a potential financial loss as a result of a specified insured event to the insurance undertaking, under an insurance policy. The insurance company assumes the risk in exchange for monetary compensation, known as an insurance premium. Premiums are pooled and invested pending the payment of claims. This most accurately describes general insurance activities where the insurer writes policies that provide policyholders with a payment up to a specified amount upon the occurrence of a defined event (for example, flood or weather damage, or damage to a property or vehicle). Long-term insurance products such as life insurance or pension products are, on the other hand, generally[8] more akin to investment arrangements under which premiums paid by the policyholder are invested by the insurer with a view to the insurer making a payment to the policyholder at some point in the future based on the investment return it has managed to generate by investing the premiums. In some cases, the amount payable is guaranteed or subject to a guaranteed minimum. However, it is now more common for life contracts to provide for payments on maturity that vary depending on the investment performance of the assets in which the premiums are invested, often by reference to the value of units in investment funds managed by the insurer or by other investment managers. Insurance company global AuM stood at an estimated $35.4tn by the end of 2019.[9]

(b) Investment managers

18 The most significant service provider relationship for most asset owners, at least in the day-to-day management of their portfolios, is with investment managers (also referred to as 'investment advisers' (especially in the US), 'asset managers' or 'fund managers'). Most asset owners routinely delegate the management of some or all of their assets to one or more external investment management firms,[10] and Part A.3.2.2 provides an indication of the substantial value of assets now under external management. The investment, stewardship and policy engagement practices of these firms are therefore also of key importance in considering the extent to which the law requires or permits IFSI. Consolidation in the investment management sector means that some of these firms have now grown to have significant influence over the activities of investee enterprises.

19 Asset owners may appoint multiple investment managers. The investment management market is diverse and firms' business models fall across a broad range. Some firms may specialise in particular asset classes, jurisdictions or investment strategies. The growth in AuM committed to passive investment management strategies is particularly notable (see Part A.3.2.3), with potentially significant implications for the extent to which legal rules could require or permit IFSI and what that might mean in practice.

20 Investment managers, particularly the largest, are therefore potentially important in the context of IFSI. Among other things, as individual firms, they can effectively perform an aggregating role in relation to their clients' assets, with possible implications, for example, in terms of the cost and likely effectiveness of their decisions. Further, where a number of these firms act in a common way towards investment selection or stewardship (either co-incidentally or intentionally), this could have an even more significant influence on investee enterprises and hence the realisation of sustainability impact goals. Equally, however, it has been suggested to us by some that growing consolidation in the sector may leave asset owners with less scope to define the services they receive from their managers, including in relation to areas relevant to IFSI.

(c) Other service providers not covered by this report

21 As noted, investment managers are not the only service providers to asset owners whose activities could affect the extent of IFSI. While there are variations between jurisdictions, two of the other most important categories of service provider are investment consultants and fiduciary managers.

22 Service providers such as these play a key role in the investment process. However, their legal duties are ultimately largely derived from those of the asset owners

THE EXTENT TO WHICH THE LAW REQUIRES OR PERMITS IFSI

they act for. In some ways, therefore, their legal position is similar to that of investment managers. In view of that, in the interests of picking out the key legal principles applicable to IFSI across the jurisdictions covered, it was decided not to undertake a detailed assessment of their legal position at this stage. For the reasons noted, however, the findings of this report are clearly potentially relevant to how they should go about providing their services in order to discharge their duties.

Investment consultants

23 Investment consultants are a key service provider for many asset owners. The market is dominated by a relatively small group of firms. They generally provide strategic advisory services, potentially covering a wide range of areas, such as funding decisions, asset allocation and selection of investment strategies, stewardship strategy, manager selection and relationship management, and performance reporting. They may train asset owners on investment approaches and current market issues and trends. Their influence on investment practice, including attention given to sustainability factors and the use of approaches that would involve IFSI, is therefore potentially significant. Having considered an investment consultant's advice, the asset owner ultimately takes any decisions, and retains accountability to its beneficiaries for the decisions it makes.[11]

Fiduciary managers

24 Fiduciary managers are a more recent addition to the investment landscape but are nonetheless an important part of it in some jurisdictions.[12] One of the main differences between them and investment consultants is that fiduciary managers combine advisory and implementation services. Whereas investment consultants provide advice, fiduciary managers put some of their views into action, making decisions on the asset owner's behalf.[13] The precise scope of their implementation powers can vary considerably between the asset owners that use them, each relationship being bespoke.

1.1.4 The meaning of 'beneficiaries' in this report

25 In this report, beneficiaries are the persons who derive a financial benefit from asset owners' investment activity. The expression should therefore not be understood as referring to a beneficiary relationship in the strict legal sense. It includes, for example, the members of pension schemes, unitholders of mutual funds and long-term insurance policyholders. It may also include wider categories of person entitled to receive benefits in relation to these investment arrangements, such as dependents of pension scheme members and nominated recipients of benefits (for example, on the death of a life insurance policyholder).

26 In the case of insurance undertakings, we have also treated the idea of a 'beneficiary' as including shareholders. While shareholders do not have a direct interest in the assets of the company, they nonetheless have an interest in the success of the company, including its capital growth and the dividends it is able to pay. These are both partly dependent upon how the company manages its assets, both those held in relation to its insurance activities and other 'house' assets. Many insurance company shareholders will be asset owners and are therefore likely to want to see the company run in ways that will help them to discharge the duties considered in this report and in a manner consistent with any goals they set in exercising their discretions.

1.1.5 Types of investment activity covered

27 The report focuses on investment management activity across all asset classes. As discussed in Part A.1.3 there is already a group of investors that engage in 'impact investing'. However, what have traditionally been regarded as impact investors are not the focus of what follows.

28 Consistent with the description of IFSI in Part A.1 the legal teams that have prepared the jurisdiction-specific memoranda have considered the legal framework applicable to investment and divestment decision-making, stewardship of portfolio assets and public policy engagement, in each case, as relevant to IFSI. In the past, legal attention to investors' duties has tended to focus on the first of these. Decisions on portfolio composition are clearly of great importance in discharging investors' duties. However, investors' stewardship activities in relation to their assets are also potentially relevant to portfolio outcomes

THE EXTENT TO WHICH THE LAW REQUIRES OR PERMITS IFSI

and there has been an increasing emphasis on it in recent years from policymakers, legislators, regulators and industry.

29 Investors deploy a considerable variety of investment strategies. The strategies selected may have implications for an investor's scope to engage in IFSI (see Part B.2, Box 3). It is not feasible to consider the treatment of all of the possible strategies in an exercise of this sort. Consequently, the base analysis assumes a reasonably 'standard' active investment approach. However, given the growing importance of passive investment strategies, the report also addresses the relevance of IFSI to investors using these.

1.2 The process followed in preparing this report

30 Producing this report has been an iterative process involving legal expert teams in each jurisdiction covered and a reference group established by the UNEP FI, PRI and the Generation Foundation. Each legal team undertook an initial assessment of the relevant legal frameworks. The scope of the review and the topics to be covered in the jurisdictional analysis for inclusion in the report were then refined in the light of that with the assistance of the reference group and the jurisdictional legal teams. The legal teams then prepared the jurisdiction-specific memoranda, annexed to this report. These provide an assessment of the extent to which the law in each jurisdiction requires or permits IFSI. While they are the product of a thorough exercise, and are substantial, they should not be treated as legal advice or an exhaustive statement of the law on the areas they cover. Rather, their principal purpose has been to provide a solid basis for understanding the way investment approaches within the scope of IFSI are generally treated as a legal matter internationally. Our overall conclusions on what the black letter of the relevant legal rules requires or permits are set out in the legal assessment summary in Part B.3.

31 The suggested areas for legal reform in Part C.2 have also been tested with the legal teams in each jurisdiction.

THE EXTENT TO WHICH THE LAW REQUIRES OR PERMITS IFSI

2. INVESTING FOR SUSTAINABILITY IMPACT: DIFFERENT LEGAL REGIMES BUT COMMON THEMES

32 The legal rules that apply to different types of investor vary considerably between jurisdictions.[14] Their content, interpretation and application reflect the social, economic and political history of the jurisdiction concerned.[15] Even within a jurisdiction, there are different rules for different categories of investor, and the circumstances of each investor are unique. Because of these differences, precisely what an investor is legally required or permitted to do in relation to IFSI will be specific to that investor so that investors need to consider their position on a case-by-case basis.

33 Nonetheless, the answer to the question of whether an investor is required or permitted to engage in IFSI depends upon, broadly, four things:

- what power the investor has been given by law over relevant assets;
- the legal duties that apply to it in exercising that power (which will be derived from and directed at achieving the purpose of the power);
- any legal discretions the investor has in discharging its duties; and
- the investor's specific circumstances.

The first three concern the legal rules that apply to the investor, and the fourth the practical reality within which those rules apply. Practical circumstances are important; as noted previously, what a legal rule requires or permits in practice depends as much upon the circumstances to which the rule is applied as the rule's 'black letter' (ie what it 'says').

34 In spite of this diversity, the following highlights four common themes, across jurisdictions, in how legal rules differ between investor types (see Section 2.1). It also outlines a number of factors that just about any investor will probably need to consider in applying those rules, even if circumstances differ from other investors (see Section 2.2). Because of these common themes, it is possible to arrive at some broad conclusions about what legal rules generally require or permit in relation to IFSI across the jurisdictions covered by this report (see Part B.3).

2.1 Categories of difference in legal treatment between different investors within a given jurisdiction

35 Four of the main categories of variation in investors' legal powers, duties and discretions within a given jurisdiction are as follows.

2.1.1 Different rules for different categories of asset owner

36 While there are functional overlaps between the categories of asset owner covered by this report, the purpose pursued by each category is different. Consequently, each tends to be subject to legal rules that are specific to that category. Pension funds are committed to providing retirement finance, whereas insurers are commercial enterprises designed to make a profit. Insurers benefit shareholders, among others, by providing various forms of benefit to policyholders. Some pension funds and insurers offer defined benefits, and therefore retain the associated investment risk themselves, while others leave the investment risks principally with their beneficiaries. Meanwhile, mutual funds are designed to generate an investment return set out in the fund's prospectus in the form of an investment objective, elaborated in its investment policy.

2.1.2 Different rules for asset owners within the same category

37 The legal rules for asset owners are likely to vary even between asset owners in the same category. That is because asset owners tend to be established under legal instruments (such as contracts, articles of association and trust deeds) which set out their purpose and what they can do. While there is a degree of standardisation, these instruments are specific to the relevant asset owner.

2.1.3 Different rules for investment managers

38 Investment managers operate under a different legal framework from asset owners. Asset owners have the ultimate power to make investment decisions. However, as noted in Section A, all but the largest usually delegate implementation of their investment strategy to investment managers who are therefore agents of the asset owners. While the overall legal requirements are largely the same for all investment managers in a particular jurisdiction, the investment management agreements under which managers are appointed (while they have some fairly standard features) impose duties

THE EXTENT TO WHICH THE LAW REQUIRES OR PERMITS IFSI

on the manager which are bespoke to each delegation. How far an investment manager is obliged or entitled to engage in IFSI will be governed principally by the relevant agreement. Generally, an asset owner can only confer powers on an investment manager which it has itself.

2.1.4 Different investment objectives

39 The fourth area of legal difference emerges from the second and third but is so important that it needs a separate mention; it concerns the investment objectives investors are required to pursue in managing relevant assets. Investment objectives are legally binding in the sense that they are established under the legal frameworks previously mentioned. Critically, they define the *goal* or goals an investor is legally empowered to achieve, consistent with fulfilling its *purpose* – its investment objective. Consequently, the precise nature of an investor's investment objective will affect whether an investor is required or permitted to engage in IFSI. It is possible, but currently unusual, for investment objectives to include sustainability impact targets in addition to financial targets.

40 Two areas of variation between financial investment objectives are particularly important for current purposes:

- the financial return which is targeted and the level of risk that can be accepted in pursuing it (see (a) below); and
- the period over which the return is to be generated (see (b) below).

The appointment of an investment manager by an asset owner will normally affect both (see (c) below).

(a) Financial return

41 In terms of the targeted financial return, for example, a mutual fund may have a precisely articulated financial investment objective, referenced to a given benchmark, whereas the investment goals of pension funds are generally determined based on the financial needs of beneficiaries (involving different generations of beneficiaries whose needs and interests will differ depending upon their proximity to retirement). Investment arrangements offering a form of 'guaranteed' or pre-determined financial return have particularly precise financial return targets, for example, defined benefit pension arrangements and guaranteed insurance products. With these, it is not unusual for additional legal rules to stipulate asset classes in which the supporting assets can be invested in order to minimise the risk that obligations are not met, an example being the EU Solvency II regulatory capital regime for insurance undertakings. Investment objectives may target generating income, capital growth, or a mixture of both.

(b) Time horizon

42 The investment objectives of some investors may be to generate a particular type of return on an ongoing basis (a prime example being a passive investment fund). In other cases (especially for pension funds and the directors of insurance companies), the duty may span both the short-term needs of some groups of beneficiaries (or shareholders) and the longer-term needs of others, so that the interests of different groups need to be carefully balanced. Where economic systems are at risk from declining environmental and social sustainability, the effects will be felt by those who invest in enterprises that are dependent on those systems. The nature of these sustainability risks means that the longer the period by reference to which an investment objective must be met, the more likely it is that an investor will need to take them into account in deciding how to discharge its duties. This is not to say that sustainability factors cannot also have an impact in the short-term, as seen, for example, in the case of climate change and the steps taken to address it as a result of the Paris Agreement.

(c) Investment objectives where there is delegation to investment managers

43 Where, as is common, day-to-day investment management has been delegated to one or more investment managers, individual managers will have agreed investment objectives with their client. While those objectives are designed to assist the asset owner in achieving its ultimate investment objectives, the ultimate investment objective and the investment objective set for the manager will not necessarily be the same, either in terms of the return objective or the time period for achieving it. This is particularly so where the manager is appointed by a pension fund. There is usually greater

THE EXTENT TO WHICH THE LAW REQUIRES OR PERMITS IFSI

alignment where the manager is appointed by a mutual fund or is managing various types of insurance assets. There is therefore a risk (which must be carefully managed) that a manager's shorter performance horizon could cause its perception of the financial impact of sustainability factors to diverge from that of the asset owner (see Part B.4.2.4).

2.2 Circumstances that investors commonly need to consider in deciding how to apply legal rules

44 In all jurisdictions, institutional investors generally need to consider all relevant factors in deciding how to manage their portfolios in accordance with applicable legal rules. As sustainability factors pose financial risks and opportunities for individual enterprises, they can clearly be relevant to investment decisions. Moreover, many sustainability factors also concern the long-term health of social and environmental systems on which businesses and financial markets depend: these factors therefore potentially constitute a risk to whole markets and the investment return on all portfolios that are exposed to them. As noted in Part A.1, risks of this sort are referred to in this report as 'systemic risks'.

45 Where risks or opportunities of this sort are relevant to investors in achieving their investment objectives, investors will need to consider what, if anything, they can do by way of response (see Box 1). They will want to consider the possible use of all available avenues including investment powers (whether at the level of capital or asset allocation, investment strategy or individual investment selection), stewardship and policy engagement. In addition, where an asset owner relies on third parties such as investment managers, investment consultants and fiduciary managers in running its portfolio, it will need to be confident that the relevant third parties have the necessary experience and capacity to deliver an effective sustainability solution and that the terms of their appointment reflect their obligation to do so.

Box 1

Taking account of sustainability factors in the investment process: what is 'financial materiality' and by reference to which time period should it be judged?

This question is relevant both to what the law requires or permits in relation to IFSI and the integration of sustainability factors in the investment process more widely.

The background to the question is the Freshfields Report of 2005 in which, based on the law and practice as it stood at that time, we stated as follows:

'Conventional investment analysis focuses on value, in the sense of financial performance. ... the links between ESG factors and financial performance are increasingly being recognised. On that basis, integrating ESG considerations into an investment analysis so as to more reliably predict financial performance is clearly permissible and is arguably required in all jurisdictions.'[16]

We indicated that investors discharging duties to secure a given financial return should take ESG factors into account where those factors could be reasonably expected to have a 'material' impact on financial performance, an approach which has been confirmed in numerous jurisdictions since then.

Time period

The question of the time period by reference to which materiality should be assessed has attracted some limited regulatory attention as it concerns investors' stated investment objectives. However, the issue is potentially multi-layered depending upon the precise circumstances of each investor.

Very broadly, regulatory provisions or guidance tend to focus on the time period by reference to which the relevant portfolio must be managed – i.e. the period up to the point at which the investor must discharge its duty to seek to meet its overarching investment objective. In most cases, therefore, the time period is likely to be derived from the investor's investment objective itself, such as paying retirement income at a particular point in time. However, representations made to beneficiaries about the period by reference to which a given fund will be managed could also be relevant, for example, where a mutual fund prospectus gives an expected holding period for those acquiring units in the fund. As noted in at Section 2.1.4, some investors have longer-term investment objectives, others short-term objectives and others, particularly pension funds, a mixture of both, so that the interests of different cohorts of beneficiary need to be balanced.

Yet in practice investment is a continuous process. Investors do not settle on a particular portfolio at the outset and stick with it throughout the relevant time period, regardless of interim performance. Progress towards an objective is periodically reassessed, investment portfolios are re-balanced and investment approaches changed as circumstances develop. Judgements on the financial materiality of factors relevant to the investment process are needed throughout.

THE EXTENT TO WHICH THE LAW REQUIRES OR PERMITS IFSI

The starting point is that those judgements should be made primarily by reference to the ultimate time-horizon of the relevant portfolio, as described above. However, an investor may need to set shorter-term investment objectives as part of a plan for realising its longer-term objective, and against which progress can be measured. This is likely to be acceptable as long as the shorter-term objective is consistent with meeting its ultimate objective. For example, it should not result in inadequate weight being given to risks that are not likely to become material within that shorter-term but which are nonetheless material in the context of the ultimate time horizon. Here, a particular challenge is that the bases for portfolio construction and performance measurement may not adequately reflect longer term risks (see Part B.4).

Investors may therefore face a challenging balancing act. [17] They need to keep their longer-term objectives (and the risks and opportunities that may emerge in that longer-term) clearly in mind. They also need to make sure that the needs of any beneficiaries with shorter-term horizons are catered for, and to be reasonably satisfied that any comparative short-term portfolio under-performance that cannot be avoided, for example, by careful asset allocation, [18] or that is unlikely to be offset by market repricing to reflect a more sustainable outlook, will not affect their ability to achieve their longer-term objective. They will need to bear in mind the possibility that it may not be possible accurately to predict when and how some financial risks created by sustainability factors could materialise. Investors may nonetheless be concerned that short-term under-performance could leave them open to criticism, or worse, even if it is not necessarily inconsistent with achieving their long-term objectives.

Financial materiality

The law and associated guidance in the jurisdictions covered by the project has relatively little to say about what should be regarded as financially material for these purposes. Concepts of materiality do appear in other investment contexts, in particular, corporate disclosure, market abuse and insider dealing regimes. However, it is not appropriate to apply a simple read-across from those to the investment rules considered by this project. Those regimes focus on the materiality of unpublished information to a potential buyer or seller of an investment (and hence its market price), and do not generate (either in theory or in practice) precise numerical tests. From the perspective of financial return, this project concerns the potential risks and opportunities created by sustainability factors for the performance of a portfolio as a whole over a particular time period and that is no more susceptible to precise testing.

Ultimately, the question of what is financially material as a legal matter within the time periods considered above must be a decision for each investor based on its own particular circumstances, taking account, among other things, of the factors outlined in Section 2.2, as relevant. However, the key legal consideration will be the investor's investment objective. In our view, a sustainability factor is likely to be material if a reasonable investment professional would conclude that there is a reasonable prospect of it having (alone or in combination with other factors) a significant impact on the investor's ability to achieve its investment objective(s) over the relevant period(s). This judgement would include both an assessment of the probability of the impact occurring within the relevant period and the financial consequences for the portfolio if it did.

It is reasonable to suppose that the longer the period by reference to which materiality is assessed, the more likely it is that some sustainability-related systemic risks (such as those arising from climate change, resource scarcity or biodiversity loss) will need to be treated as financially material. That is not to suggest that they cannot also have financial impacts within a shorter period or that the timing is easily predictable.

46 As noted, no two investors are alike, so the outcome of one investor's assessment may differ from that of another. However, most investors are likely to need to consider the following in determining how they should act, in addition to their particular investment objective:

- the size and composition of the portfolio;
- the extent of the investor's ability (or that of its investment manager(s)) to influence particular areas of sustainability impact (for example, how much 'voice' does it have in the affairs of investee enterprises);
- the relative likelihood of different approaches achieving an impact (for example, as noted in Part A.1.2, in some cases stewardship may be more effective than investment/divestment, and vice versa);
- the variety of potential stewardship styles and techniques, ranging from simply engaging in public votes (for example, pursuing a policy of always supporting shareholder resolutions

THE EXTENT TO WHICH THE LAW REQUIRES OR PERMITS IFSI

encouraging companies to disclose sustainability risk assessment and transition plans) to deep engagement with company boards;

- the expenses for the portfolio of any proposed action (for example, the cost of maintaining a team of analysts) and whether these are justified given the anticipated benefits, recognising that expenses and benefits may not always be easy to quantify and a simple cost-benefit approach may not be feasible or appropriate (see Part A.2);
- any direct or indirect impact of the proposed action on investment performance in the portfolio (for example, where pursuing a long-term sustainability goal, such as convincing companies to commit to carbon neutrality, could impair shorter-term financial results of those companies);
- the extent and timing of any positive or negative portfolio performance impact (including the relative likelihood of it occurring within an asset owner's time horizon), and whether one approach results in it being more equitably shared between different cohorts of relevant beneficiaries than another;
- where an investor's performance in seeking to meet its financial objectives is likely to be assessed against common market benchmarks and models, the fact that stewardship activities do not generally affect the *composition* of an investment portfolio, so that they may therefore be less likely than the use of investment powers to affect portfolio performance measured against those benchmarks and models (see Part B.4);
- the dynamic nature of investment risks and opportunities created by sustainability factors, among other things, as a result of:
  - the methods selected by businesses and societies generally to pursue key sustainability targets (for example where these end up relying on one kind of technology more than others); and
  - the extent to which those sustainability targets are likely to be fully achieved (ie there is a wide range of possible transition pathways towards a more sustainable equilibrium some of which may involve societies achieving their sustainability targets more fully than others, with their likelihood changing over time);
- whether the investor can enhance the prospects of realising a desired impact, reduce its expenses and minimise negative performance impact on the portfolio (or ensure that it is distributed more evenly between cohorts), by stimulating or engaging in collective action to address the issue concerned (see Box 2); and
- the investor's particular market environment including the way in which sustainable investing in general is becoming more prevalent (see Part A.3.3), the factors that are driving this (see Box 3), and whether these may make it more likely that IFSI activities will achieve their goal.

47 An investor's strategic and policy decisions will also affect the way sustainability factors may subsequently be taken into account in 'lower-level' decisions about how those strategies and policies are implemented. While strategic and policy decisions of this sort generally need to be kept under review, an assessment by one investor of its circumstances (including sustainability factors) may properly lead it to pursue a different strategy or investment policy from another investor in seeking to achieve its financial goals. Box 4 looks further at the case of strategy selection.

THE EXTENT TO WHICH THE LAW REQUIRES OR PERMITS IFSI

Box 2

The importance of collective action to achieve sustainability impact

Collective action to achieve sustainability impact goals can strengthen the voice of the investors concerned, allow for a more strategic approach and help to spread the cost of engagement reducing the unit costs for individual investors. Importantly in the context of any decision to engage in IFSI, it can also increase the likelihood that the sustainability impact goal being aimed for will actually be achieved. It can involve any of the types of activity considered in this report: the use of investment powers, stewardship and policy engagement. It can also take other forms, such as providing investment analysis that can support the IFSI activities of other investors[19] or working with third parties whose activities may assist or encourage investee enterprises or policymakers in seeking to achieve sustainability impacts.

Taking the case of stewardship, while each situation needs to be considered on its own facts, the larger the enterprise and the smaller an asset owner's investment in that enterprise, the less likely it is that individual stewardship will influence enterprise behaviour. That, and other factors such as the costs involved and 'free-rider' issues, could tend to militate against individual investors engaging in stewardship activity.[20] This is particularly the case where action is needed to address systemic risk, and not simply to deal with sustainability risks and opportunities that are specific to an individual enterprise: systemic risks tend to be the result of what are sometimes called 'collective action problems' which require widespread coordination to resolve, whereas individual investors and investee enterprises are single actors. For example, in the case of climate change, one study suggests that only half of the negative portfolio impact of policy and market reactions can be offset by asset allocation and diversification strategies; more broad-based approaches are needed in an attempt to manage the rest.[21]

What investors' duties may require with regard to collective action will depend on their circumstances. Some large investors may be in a position to catalyse wider collective action because of the way their portfolio is exposed to sustainability risk, their broader influence or their different cost base. Where effective collective action is already underway, smaller investors may conclude that supporting it is a cost-effective way to serve beneficiaries whose interests may be threatened by declining sustainability.

There are now numerous examples of collective action of this sort, and growing evidence that they do have an impact.[22] It is often facilitated or supported by forums, such as the PRI, the Global Investor Coalition on Climate Change,[23] Ceres[24] and the UK's Investor Forum, or by UN bodies.[25]

In some cases collective action involves a formal alliance including, for example, Climate Action 100+[26], the Net-Zero Asset Owners Alliance,[27] the Net Zero Asset Managers Initiative,[28] the Investor Alliance for Human Rights,[29] FAIRR (addressing the sustainability of protein supply chains),[30] the Global Investors for Sustainable Development Alliance,[31] and the Dutch Responsible Business Conduct Agreement on responsible investment by pension funds.[32]

In other cases, collective action involves less formalised joint initiatives. Examples include, the investor statement on deforestation,[33] investor action on biodiversity,[34] Investor Action on Antimicrobial Resistance,[35] the Investor Mining and Tailings Safety Initiative,[36] and investor action on corporate human rights due diligence.[37][38]

Any collective stewardship activity must take account of a number of legal regimes that control certain sorts of collective activity in relation to business enterprises. These are discussed further in Part B.3. They will generally not prevent it, but may impose constraints and cannot be ignored.

THE EXTENT TO WHICH THE LAW REQUIRES OR PERMITS IFSI

Box 3

Responsible/sustainable investing and the wider market environment for IFSI

Investor demand has driven significant growth in the level of AuM committed to sustainable/responsible investment strategies (see Part A.3.3). At least in part, this seems to be based on a belief that ESG investing does not necessarily harm investment returns and may even provide superior returns as compared with non-ESG investing (see Part A.2, Box 5).

As noted in Section 2.2, what an investor must do to comply with its legal duties needs to be considered by reference to all relevant surrounding circumstances. Part A.1.4 noted the conceptual mist that surrounds some forms of sustainable/responsible investment and, as with all market practice, investors need to think for themselves and not simply follow market trends. Nonetheless, the striking growth in sustainable/responsible investing is potentially relevant to investors considering whether their duties require or permit them to pursue sustainability impact goals. Certainly, the factors that seem to have driven this growth suggest that investors would need to have good reasons to justify a view that sustainability factors are irrelevant to their decisions about managing their portfolios.

Among other things, as noted in Part A.1.4, even though common forms of sustainable/responsible investing may not usually involve pursuing sustainability impact goals, they could nonetheless encourage changes in investee enterprise practice that are consistent with IFSI outcomes.

Factors that have focused investors' attention on sustainability include the following:

- ever-greater awareness of the risks that sustainability factors can pose to portfolio performance, particularly in the area of climate change (the recognition that lies behind the TCFD), and conversely the opportunities they can provide;
- a growing recognition of the speed with which some sustainability risks (and/or their financial impact) may be materialising;
- significantly more active government intervention in the primary economy to secure sustainability goals, with potential implications for the value of investee enterprises;
- heightened public, policy and regulatory expectations on business enterprises and the commencement of an increasing number of sustainability-based legal actions against business enterprises and others which have alerted investors to the possibility that investees may be vulnerable to litigation and other sources of loss if they do not address sustainability risks that they have contributed to;
- heightened public, policy and regulatory expectations that investment processes should take account of sustainability factors, which are likely to affect the way investment duties are understood and applied in practice;
- the possibility of strategic litigation against investors that are considered not to be taking sufficient account of sustainability factors;[39]
- improving corporate disclosure and reporting regimes, making it potentially more feasible to understand the role of individual enterprises in helping to realise or undermine sustainability goals (although, as discussed in Part A.2.2, significant issues remain around the quality and quantity of the information);
- the availability of increasingly reliable investment analysis of the business and investment impact of sustainability factors;
- growing expertise and developing conceptual frameworks in (a) sustainability assessment and (b) the investment management processes needed to address sustainability risks and opportunities, both helping to bring sustainability factors into the investment professional mainstream where, among other things, they could influence the way courts or regulators apply legal rules (see Part B.4, Box 5);
- the development of investor alliances and coalitions focusing on various areas of sustainability risk, making it easier for investors to conclude that there are ways in which they can make an impact on those risks by cooperating with others (see Box 2 above); and
- growing evidence that individuals want their money to 'do good' as well as earning a good return, and initiatives that are emerging to help them to act on that (see Part A.4).[40]

THE EXTENT TO WHICH THE LAW REQUIRES OR PERMITS IFSI

Box 4

The impact of investment strategy selection on the scope for IFSI

Another key area of difference between investors, which will also affect how far they are legally required or permitted to pursue IFSI, is their chosen investment strategies. Investors may select from a range of different investment approaches in seeking to achieve their financial investment objectives. The most obvious difference in strategies is between passive and active investment management. However, active management, especially, can come in various forms. These range from approaches that 'hug' an index to those that are highly activist, and from those that are more concerned with the underlying value of investee enterprises (particularly 'value investing' and 'growth investing') to those that are more like trading strategies based on anticipated movements in investment prices (such as 'momentum investing'). Investors may also use quantitative and algorithmic strategies the first of which relies on investment transactions based on fixed rules and reversion to the mean, with the latter commonly used as a trading more than investment strategy (especially short-term or high frequency trading).[41] Strategies may be pursued by investing in the instruments issued by a business enterprise, in units in funds that do the same, or synthetically by entering into derivative contracts (directly or indirectly through funds) that provide exposure to underlying securities.

Investors need to consider all factors that are material to achieving their investment objectives, potentially including sustainability factors, in determining which strategy or strategies to use (see Box 1). With just about any strategy selected, in principle, there is scope to pursue sustainability impacts by undertaking stewardship and public policy engagement.[42] Further, most types of strategy can be pursued in ways that take account of sustainability factors in the process of investment selection, even in the case of passive strategies, for example, by choosing to replicate an index which does so. Some passive strategies may also be pursued in ways that allow for a degree of discretion over precisely what is held in the relevant portfolio (for example, where the manager engages in sampling). Nonetheless, having taken account of all relevant factors in deciding which strategy to pursue, an investor might properly select a strategy which then restricts its scope for taking sustainability factors into account in the context of investment selection in the course of pursuing the strategy. The investor would nonetheless need to keep the continuing appropriateness of its strategy selection under review, with sustainability factors, again, potentially being a relevant consideration.

While differences of strategy such as these might be thought most relevant to the use of investment powers to engage in IFSI, they could in practice have implications for the attention an investor devotes to stewardship and policy activities (see Part B.4, Box 6 which concerns the impact of diversification on stewardship decisions).

THE EXTENT TO WHICH THE LAW REQUIRES OR PERMITS IFSI

3. IFSI IN ELEVEN JURISDICTIONS - SUMMARY OF FINDINGS

3.1 Introduction

48 The following:

- provides an overview of common characteristics of Asset Owners' and their investment managers' duties, as relevant to IFSI, across the eleven jurisdictions (Section 3.2);
- summarises our findings on how far Asset Owners are required or permitted to use investment powers, stewardship and policy engagement to pursue sustainability impact goals (Sections 3.3 to 3.5);
- summarises our findings on the legal position of investment managers and IFSI (Section 3.6);
- looks at whether Asset Owners and investment managers could incur legal liability to third parties for any negative sustainability impact of investee enterprises (Section 3.7).

49 There has been significant growth in new legislation and regulations addressing the relationship between investors and sustainability goals. More is in progress. What follows is based on the law as at 31 January 2021 but does draw on forthcoming changes to the law where sufficiently certain and material to the analysis.

3.2 Common characteristics of investor duties relevant to IFSI in the jurisdictions covered

50 While the law in each of the jurisdictions surveyed is unique, there are nonetheless similarities in the way different jurisdictions categorise and regulate investors (see Part B.2). Beyond that, however, there are also some common features in the substantive duties that apply to Asset Owners and their investment managers.

51 In all jurisdictions, relevant legal rules involve:

- requirements as to the objectives that Asset Owners and their investment managers must pursue (eg achieving a particular financial outcome); in this context, we look specifically at how IFSI can contribute to achieving a financial return objective (Section 3.2.1 and 3.2.3);
- duties concerning the *way* Asset Owners and their investment managers should seek to achieve those objectives (eg to exercise powers with a prescribed level of care or skill and rules on managing conflicts of interest) (Section 3.2.2; and
- often, more specific requirements and restrictions about what they must do (eg on the type of investment that can be included in a portfolio).

52 The following section looks further at the first and second of these. Investors may be given some discretion as to the precise outcomes they should seek in the first category and generally have discretion as to how they go about discharging duties in the second category.

53 Where an Asset Owner takes the form of a legal vehicle, such as a company, a distinction must be made between:

- the legal purpose of the legal vehicle and the duties that vehicle owes to others in pursuing it, especially those who are intended to benefit from its investing activity; and
- the legal duties of the officers of that legal vehicle, those who make decisions on its behalf, which are generally owed to the vehicle itself.

Where an Asset Owner does not take the form of a legal vehicle, for example a contractual or trust structure, there is little distinction, so that the individuals operating the arrangements will likely owe duties directly to those intended to benefit from the arrangements.

54 When discharging their duties, there are a number of considerations that are relevant to the decisions of investors and their officers across all legal frameworks covered in this report (see Section 3.2.4 below).

3.2.1 The purpose of investment activities and the relevance of financial return

55 As noted, in some cases investors have a degree of discretion as to some of the objectives they can pursue. However, in all jurisdictions, the principal purpose of the investment activities of Asset Owners and their investment managers is generally regarded (by lawmakers, courts and investors themselves) as generating financial returns, within acceptable levels of risk. In no jurisdiction is there a requirement to exercise investment powers to maximise financial return at all costs.

THE EXTENT TO WHICH THE LAW REQUIRES OR PERMITS IFSI

Rather, duties generally require decision-makers to consider both risks and potential returns, subject to applicable laws.

56 Particularly for pension funds, the goal of financial return tends to be expressly established in legislation, at least in broad terms, with Asset Owners being left to define what it means in their particular circumstances.[43] For mutual funds, the goal will be defined by the investment objective and policy of the fund, established when the fund was launched (as amended thereafter) and set out in the fund's offering documents. It is for the directors of an insurer to determine its goals, including its financial goals, within the context of its overall purpose. They are generally likely to have the greatest discretion out of the three types of Asset Owner as to what these goals should be, but it is usually understood that they should seek to achieve a certain level of financial return. The terms of investment products issued by long-term insurers will also likely impose particular requirements for a large proportion of their assets.

57 The financial goals of investment managers are set by the terms of their investment management agreement with their client but should reflect the financial goals of the relevant Asset Owner client.

58 The upshot of this is that for most pension funds, regulated mutual funds and, in practice, insurers, investment decision-makers will generally need to act primarily to secure optimal financial returns, within acceptable risk levels, over the appropriate investment timeframe of the portfolio. In some jurisdictions and for some types of Asset Owner this should be the sole purpose.[44]

59 Where that is the case, the Asset Owner would not be able to engage in ultimate ends IFSI but might still conclude that instrumental IFSI is required or permitted. Other jurisdictions allow certain types of investor to pursue additional purposes in parallel with financial goals, even where not expressly set out in the terms of the investment arrangement. Where those wider purposes are consistent with pursuing sustainability impact goals, then those investors would potentially be able to engage in ultimate ends IFSI and to give their investment managers the discretion to do the same.

3.2.2 General duties of Asset Owners and investment managers as to the way they pursue their objectives

60 As a preliminary observation, it has become common in the investment sector to refer generally to the duties that investors owe in managing their portfolios as 'fiduciary duties', regardless of the sort of investor concerned or the jurisdiction in which it is located. For various reasons[45] this is not technically accurate, so this report generally avoids using the expression 'fiduciary duties', referring instead to the standard of behaviour or goal set by the duty.

61 Similarities in the most important investment-related duties owed by Asset Owners and their investment managers are as follows:

- Asset Owners and investment managers generally owe duties to exercise an appropriate **level of care and skill** in seeking to achieve their legally defined purpose. Precisely what standard of care is required and how it is articulated will vary between investors, but duties of this sort tend to reference what a reasonable or prudent person or investor in their situation would do in similar circumstances. These duties can arise under legislation, general law (such as tortious duties in common law jurisdictions) or in the express or implied terms of the relevant investment arrangement.[46] Sometimes they can be altered by agreement between the relevant parties.
- Duties owed by individuals in their capacity as officers of legal vehicles, as described above, also involve requirements as to applying an appropriate **level of care and skill**, but those duties are ordinarily owed to the legal vehicle and must be exercised in the interests of the vehicle.[47] In this report, this is particularly relevant for insurers established as companies. Their directors generally have to discharge their duties in the interests of the insurer.
- In many cases, decision-makers have a duty to consider whether their personal interests or the duties they owe to others conflict with their duties to the beneficiaries or the legal vehicle on whose behalf they are acting and, if so, how to manage those conflicts so that they do not disadvantage the relevant legal vehicle or beneficiaries, or so

THE EXTENT TO WHICH THE LAW REQUIRES OR PERMITS IFSI

that they are treated fairly. Conflicts of interest might arise, for example, if a pension fund pursued investment goals for the benefit of one set of beneficiaries which harmed the interests of other beneficiaries, as might happen where it puts undue emphasis on short-term financial return at the expense of steps to secure longer-term value growth or vice versa. Common law **fiduciary duties of loyalty** are a prime example of this sort of duty. Among others, they apply to the relationship between a trustee and its beneficiaries, an investment manager and its clients and a director and the director's company. However, financial services regulatory rules often impose similar standards and there are duties that are similar to this duty of loyalty in civil law jurisdictions.

62 Legal duties of the sort outlined above are usually concerned with *how* investors seek to achieve their legally defined goals, including whether they pursue a proper objective and follow a proper process, rather than whether, with the benefit of hindsight, they succeed in achieving the optimal result.[48] Where investors have, in good faith, aimed for a proper objective and followed a proper process, courts or other relevant authorities are usually reluctant to review the merits of commercial decisions. So, an Asset Owner or investment manager is unlikely to be automatically liable to those to whom it owes its duties simply because its portfolio underperforms. Rather, a court would consider, among other things, the objective or objectives the investor was required to pursue and the process the investor followed in seeking to do so, assessing whether these were consistent with the relevant standard of care and any other process-related requirements. If so, then it is unlikely that the relevant duty will have been breached.

63 Following a correct process usually requires decision-makers to have regard only to factors which they have, or ought to have, identified as relevant to the decision, and to use their powers only for the purposes for which they are intended. What is a proper purpose will be shaped by the terms of the particular investment arrangement, and especially the investment objectives that the Asset Owner or investment manager is legally required or permitted to pursue.

3.2.3 Financial return and instrumental IFSI

64 Negative sustainability outcomes can clearly be a threat to the long-term prosperity of any business. Indeed, some sustainability crises, such as climate change, pose systemic risks that are likely to damage the prosperity of whole business sectors and societies. This is the main reason for a potential obligation to consider engaging in instrumental IFSI.

65 There is no doubt that Asset Owners and investment managers have a duty to understand sustainability risks relevant to their ability to achieve the financial goals they are required to pursue and to take these into account as appropriate in their investment process. We consider that this would be accepted as the position in all the jurisdictions surveyed and is the starting point for our discussion of IFSI.

66 Notwithstanding the relative absence of court decisions specifically on the question, we consider that based on its general duties an Asset Owner would, if one or more sustainability factors posed a material risk to meeting its investment objective over the timeframe that is relevant to it, be legally obliged to consider what steps it can take to mitigate the risk. An Asset Owner would generally have a legal obligation to consider (within the range of options open to it) whether there are reasonable steps it can take to bring about specific sustainability impact goals that can reasonably be expected:

- to help influence the relevant sustainability factor(s) or the exposure of investee enterprises to it/them; and
- to do so in ways that mitigate the financial risk for the portfolio, or even create potential for value growth;

and, if so, to act accordingly. Possible approaches might include use investment powers, stewardship activities and/or policy engagement.

67 In this report (and the underlying contributions from each jurisdiction) a distinction is drawn between obligations to engage in IFSI and discretions to do so. However, in the case of instrumental IFSI where a legal obligation arises, this obligation is to consider the use of IFSI as a possible response to material risks to, or opportunities for, the investor's goal of achieving its financial investment objective created by sustainability-related factors. Where IFSI could be an

THE EXTENT TO WHICH THE LAW REQUIRES OR PERMITS IFSI

effective response to these risks, Asset Owners and investment managers who are subject to this obligation must still exercise judgement on whether to engage in IFSI and, if so, how, to what extent, and on what terms. In that sense, they need to exercise discretion as to how to discharge their duty. However, having undertaken a proper assessment and reached a conclusion on what they should do, they will need to act accordingly.

68 This exercise of discretion can be contrasted with situations where the sustainability factor in question is not material to the investor's financial goal so there is no legal obligation to consider the use of IFSI in seeking to achieve it, but the investor is still legally entitled or free to pursue sustainability impact goals – what we are calling ultimate ends IFSI – where a positive sustainability impact is being pursued as an end in itself. Here the discretion concerns whether to pursue sustainability impact goals in addition to the financial investment objectives the investor has a duty to pursue. This in turn contrasts with the admittedly rare position where an investor is subject to an obligation to pursue sustainability impact goals independent of any financial goals.

69 The presence of a legal obligation of this sort in relation to instrumental IFSI has been confirmed generally by all jurisdictions covered by this report and we anticipate that it is most likely to be relevant where sustainability factors create systemic risks. However, it is also possible to imagine that there could be other circumstances in which an Asset Owner would have a discretion, rather than an obligation, to engage in instrumental IFSI; for example, if it were to conclude that particular sustainability improvements were likely to flow through to higher returns (consistent with its financial objectives) and then worked with a selection of investee enterprises to deliver those sustainability improvements.

70 In practice, the legal standard for determining whether a sustainability factor constitutes a material financial risk for these purposes differs a little from jurisdiction to jurisdiction (see Part B.2, Box 1). Ultimately, the question of what is financially material as a legal matter must be a decision for each investor based on its particular circumstances (see further in Part B.2.2). However, the key legal consideration will be the investor's investment objective. In our view, a sustainability factor is likely to be material if a reasonable investment professional would conclude that there is a reasonable prospect of it having (alone or in combination with other factors) a significant impact on the investor's ability to achieve its investment objective(s) over the relevant period(s). This judgement would include both an assessment of the probability of the impact occurring within the relevant period and the financial consequences for the portfolio if it did.

71 In deciding how best to respond to the financial risks and opportunities posed by a sustainability factor, investors will need to balance the costs and risks of various alternatives against their chances of success and the benefits for the portfolio if successful (bearing in mind that the nature of some of the relevant portfolio risks and the benefits of reducing them are systemic and may not therefore reduce to simple monetary quantification or cost-benefit analysis – see the discussion of assessing the impact of IFSI on financial performance and of collective action in Part A.2, Boxes 5 and 6 respectively). They may also need to ensure fairness as between different cohorts of beneficiaries.

72 Partly because of this, we anticipate that stewardship and public policy engagement may be a particular focus for an investor considering whether it should pursue a particular sustainability impact goal, as compared with, for example, investment in unproven new technology. This is particularly the case where there is a possibility of acting collectively with other investors, given that this is likely to enhance the effectiveness of these activities. However, the use of stewardship and public policy engagement would need to be considered in the context of any other means of influence available to the investor, including using investment powers. Investors may conclude that they should use (or threaten to use) their powers of investment and divestment to strengthen 'voice' in stewardship activities.

73 In current conditions, it would usually be unlikely that an individual investor in secondary markets, acting alone and considered in isolation from wider market dynamics, would be able meaningfully to influence the sustainability impact of an investee enterprise solely through the use of its investment powers. However, it is

THE EXTENT TO WHICH THE LAW REQUIRES OR PERMITS IFSI

arguably not realistic to consider investors as isolated actors in this way since their activities take place in a wider context, and very large Asset Owners may be able to influence that context. Nonetheless, it would seem more likely that a group of investors, acting collectively and holding in aggregate a substantial portion of the securities of relevant investee enterprises, or proposing to invest at scale, could achieve an impact of this sort, especially if their proposed action is aligned with wider market movements.

3.2.4 Considerations potentially relevant to more than one duty or discretion

74 Various considerations are likely to be relevant to more than one of the duties or discretions considered in what follows. This section looks at a number of the more significant: (a) the use of all available means in discharging duties and exercising discretions; (b) the question of costs and expenses; (c) collective action; and (d) managing conflicts of interest.

(a) Use of investment powers, stewardship and policy engagement interconnected

75 The legal teams in each jurisdiction have considered separately the use of investment powers, stewardship and public policy engagement in discharging investors' duties and exercising their discretions. However, in practice, the relevant legal duties and discretions are likely to lead investors to consider their use together.

(b) The need to take account of all relevant circumstances, including costs and expenses

76 In deciding whether and how to pursue a given sustainability impact goal, investors will need to consider all relevant circumstances (see Part B.2.2). In the context of instrumental IFSI, Section 3.2.3 touched on the need to balance the costs and risks of various alternatives against their chances of success and the benefits to the portfolio if successful. However, these considerations are relevant to any sort of IFSI. Where an investor has discretion to engage in ultimate ends IFSI, they will normally have to pursue a financial return objective and even where this is moderated in some way (for example, in the case of a mutual fund specifically established to pursue sustainability impacts as well as financial return), ensuring an appropriate balance between costs and expenses and financial return will still be relevant to an investor in determining how best to discharge its duties.

77 Among other things, as noted in Part B.2.2, Box 1, investors may need to seek to ensure fair treatment between different cohorts of beneficiaries (see further below at Section 3.2.4(d)).

(c) The role of collective action

78 As discussed in Part B.2.2, Box 2, where an investor is seeking to achieve a sustainability impact goal, in many cases collaboration with other investors is likely both to reduce the costs and to increase the likelihood of a better sustainability outcome, whether the investor is making use of its investment powers, engaging in stewardship or undertaking public policy engagement. The possibility of acting collectively is therefore potentially relevant to achieving both the financial goals of instrumental IFSI investors and the sustainability goals of ultimate ends IFSI investors: lower cost and increased likelihood of success are likely to favour a decision to act, whether in pursuit of a duty or the exercise of a discretion.

79 It is clear that cooperation of this sort is possible in all jurisdictions and a significant number of collaborative ventures are already underway at both national and international levels. However, those engaging in collective activity need to do so in a way that does not breach competition, insider dealing and market manipulation, and takeover (and other relevant) rules. At the level at which much collective stewardship is currently undertaken, these regimes do not generally create material impediments. Indeed, regulators in a number of jurisdictions have noted the importance of investor cooperation in the context of stewardship activity in particular, or have made clear that the intention of these restrictions is not to prevent legitimate stewardship activities.[49] However, if collective activities were to become more intensive and coordinated, competition regimes in particular might need to be reassessed to ensure that they do not impede legitimate sustainability stewardship.

THE EXTENT TO WHICH THE LAW REQUIRES OR PERMITS IFSI

80 In China, competition law provides an exemption for collaboration arrangements that are intended to realise public interests such as energy efficiency and conservation, environment protection and provision of disaster relief and assistance, all of which may concern joint efforts designed to achieve sustainability impact. Exempt arrangements must also allow consumers a fair share of the resulting benefits, and must not significantly restrict competition in the market (Section 3.1.5 China Report)

81 In the EU, agreements or coordination between parties that restrict competition are prohibited under EU competition law. The parties to a collaboration therefore need to consider whether what they envisage could fall within the scope of the prohibition of anti-competitive agreements. Collaborations between investors to bring a common influence to bear on investee companies is unlikely of itself to be considered anti-competitive, and it is also helpful that an understanding of the importance of clear competition rules for collective action for sustainability impact is growing among European competition authorities. The Dutch national competition authority has recently published draft guidelines that are intended to provide guidance on, including examples of, the types of sustainability-focused agreements that are permitted under Dutch and EU competition law. The EU Commission has subsequently noted that it 'fully supports the need for clear guidance' on sustainability-focused agreements and emphasised that it is currently looking into the same issues and, on 13 October 2020, issued a call for contributions for a 'Competition Policy supporting the Green Deal', that also aims to 'identify whether there are remaining barriers to desirable agreements supporting Green Deal objectives and if so, how such barriers can best be addressed.'[50] (Section 3.1.6(c) EU Report, Section Netherlands Report)

(d) Conflicts of interest and duties to act in beneficiaries' interests

82 As noted in Section 3.2.2, Asset Owners and investment managers are generally required to act only in the interests of those to whom they owe their duties or on whose behalf they are acting and to avoid conflicts of interest. Duties of this sort are relevant both to investors engaging in instrumental IFSI and those engaging in ultimate ends IFSI.

Instrumental IFSI

83 In the case of instrumental IFSI, the example of Asset Owners who may need to ensure fair treatment for different cohorts of beneficiaries in determining whether and how to pursue sustainability impact goals was touched on above. They may need to satisfy themselves that in pursuing goals for the benefit of one set of beneficiaries they do not put undue emphasis on short-term financial return at the expense of steps to secure longer-term value growth for beneficiaries whose interests will only crystallise in the long-term, or vice versa.

84 Consider, for example, the position of a pension scheme, with pensions in payment, but also with members who will not receive a pension for 30 or 40 years. An insurer's position is potentially similar, with policies already in payment or maturing in the short-term and policies under which payments will not be due for decades. Those with long-term interests are likely to want steady long-term growth (whether from increasing market value or accumulated income or a mixture) and the concern of those with shorter-term interests is in the security of the payments due to them. Such conflicts must be addressed and resolved not only in relation to strategic asset allocation and investment decisions, but also in relation to stewardship and public policy-related decisions because the anticipated benefit of those decisions may well not accrue to the same beneficiaries as will bear any direct and indirect costs[51] of actions taken now.

85 In practice, these conflicts may be less acute than might immediately appear, because the interests of those members or policyholders with shorter-term horizons may, in fact, be provided for by investment to a greater extent in fixed income or other investments that may be less affected. Asset Owners will also need to bear in mind that it may not be possible accurately to predict when and how some financial risks created by sustainability factors could materialise. They could crystallise in the short-term, or earlier than expected: 'If poorly managed, [the physical and transition risks related to climate change] could be the source of consumer harm and potentially a future financial crisis stemming from financial losses and sudden

THE EXTENT TO WHICH THE LAW REQUIRES OR PERMITS IFSI

adjustments in asset values. COVID-19 has demonstrated more than ever the need for firms to be prepared for the rapid crystallisation of global risks.'[52] Further, the board of the investee enterprise itself is first in line in seeking to balance the interests of its current and future shareholders and may therefore resist stewardship efforts that it considers do not strike this balance appropriately.

Ultimate ends IFSI

86 Conflicts between cohorts and between the interests of beneficiaries and third parties could also arise where a sustainability impact goal is pursued as an end in itself, for example, for the good of society as a whole (ie ultimate ends IFSI) rather than as a means to enhance the quality of long-term investment returns (ie instrumental IFSI). However, where there is a clear legal requirement or discretion to engage in ultimate ends IFSI, the fact that this may benefit non-beneficiaries is not likely to be an actionable conflict of interest.

3.3 Asset Owners' legal obligations and discretions to use investment powers to pursue sustainability impact goals

87 The following section looks first at Asset Owners' legal obligations to use investment powers to pursue sustainability impact goals (Section 3.3.1) and second at available discretions which would allow them to do so (Section 3.3.2).

3.3.1 Legal obligations to use investment powers for IFSI

88 We have identified three categories where a legal obligation may arise: (a) the case of instrumental IFSI; (b) rules explicitly aimed at achieving environmental or social objectives; and (c) investment arrangements set up specifically to achieve environmental or social goals.

(a) Instrumental IFSI

89 Section 3.2.3 described circumstances in which investors may conclude that they are obliged to pursue sustainability impact goals, including by using their investment powers. It particularly highlighted two cases based on current circumstances: where the use of investment powers is part of a wider move by investors into or out of a company or sector which is aligned with bringing about the sustainability impact sought and where an investor uses or threatens to use its investment powers to strengthen its 'voice' in stewardship activities.

90 In Japan, the guidelines the Government Pension Investment Fund (GPIF), the largest asset owner in Japan, provide that 'investment of pension reserves must be made for the benefit of participants and safely and effectively from a long-term perspective to ensure the Welfare Pension Insurance's stability into the future'[53] and 'based on the understanding that sustainable growth of investee companies and the market is necessary to increase long-term gain by investing pension reserves, a management institution shall consider investment based on ESG (environmental, social, and governance matters).'[54] These requirements provide for investing for sustainability impact if GPIF reasonably believes it will lead to achieving a higher investment return in the middle to long term, even if it compromises investment return in the short term. (Sections 2.2.6; 2.2.12 Japan Report)

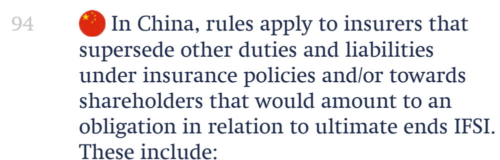
(b) Rules that explicitly aim at achieving environmental or social goals

91 Legal systems in all jurisdictions prohibit investment in certain anti-social activities. Examples include anti-money laundering and anti-terrorist financing rules, anti-bribery rules, and bans on investment in cluster munitions.[55] All of these are consistent with SDG 16 (peace, justice and strong institutions), and while it would not be usual to think of compliance with these as IFSI, these prohibitions do have an impact equivalent to a collective 'ultimate ends IFSI' decision by investors to use their powers to achieve a reduction in these activities.

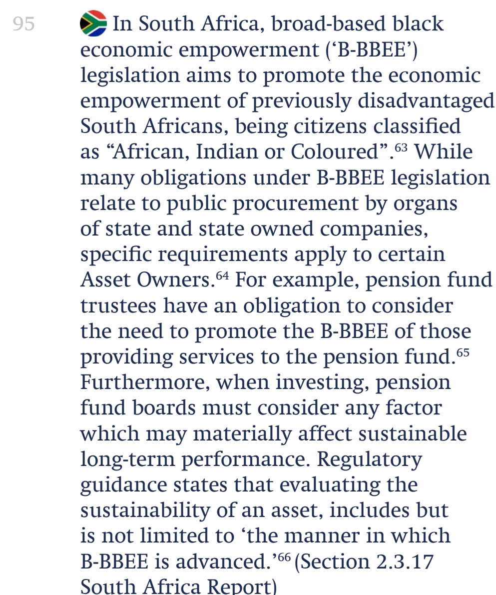
92 There are also cases where the law goes further to impose, or potentially impose, *positive* obligations to promote certain beneficial social outcomes in or through the use of investment powers.

93 In Brazil, (a) all assets are subject to the 'social function of ownership', and (b) all contracts governed by and construed in accordance with Brazilian law are subject to the 'social function of the contract.' These principles[56] provide for a duty to respect and promote social justice, fair labour, best balance for the natural environment and economic freedom. (Section 1.4 et seq. Brazil Report)

THE EXTENT TO WHICH THE LAW REQUIRES OR PERMITS IFSI

94  In China, rules apply to insurers that supersede other duties and liabilities under insurance policies and/or towards shareholders that would amount to an obligation in relation to ultimate ends IFSI. These include:

- for equity investment, insurers may only choose target companies that are in compliance with national industrial policies, which exclude high energy consumption and high pollution;[57]
- for equity investment in the long-term rental market, target projects must be of positive economic and social benefit;[58]
- for investment by means of collective trusts, target projects or target enterprises must be in compliance with national general policies and industrial policies;[59]
- for debt investment, target projects must be of positive social effect and in compliance with national and local policies on industry, land, environmental protection, energy saving and others; and[60]
- insurers that are listed companies have additional obligations, including the duty to actively practice the concept of green development, to add ecological and environmental protection requirements into strategy development and corporate governance processes, to actively participate in the construction of the 'ecological civilization',[61] and to play an exemplary and leading role in pollution prevention, resource conservation, and ecological protection.[62] (Section 2.4.9 China Report)

95  In South Africa, broad-based black economic empowerment ('B-BBEE') legislation aims to promote the economic empowerment of previously disadvantaged South Africans, being citizens classified as "African, Indian or Coloured".[63] While many obligations under B-BBEE legislation relate to public procurement by organs of state and state owned companies, specific requirements apply to certain Asset Owners.[64] For example, pension fund trustees have an obligation to consider the need to promote the B-BBEE of those providing services to the pension fund.[65] Furthermore, when investing, pension fund boards must consider any factor which may materially affect sustainable long-term performance. Regulatory guidance states that evaluating the sustainability of an asset, includes but is not limited to 'the manner in which B-BBEE is advanced.'[66] (Section 2.3.17 South Africa Report)

(c) Investment arrangements set up specifically to invest for sustainability impact

96 In some cases, an investment arrangement such as a mutual fund or investment-based life product will have been set up with the objective of achieving sustainability impact as well as a financial return. Pension funds may also in some cases be able to offer investment options of this sort. In these cases, the Asset Owner will be required to seek to meet the sustainability impact objective in the way it manages the associated assets. This would be a form of ultimate ends IFSI.

97 The Asset Owner, or distributor of the investment arrangement, will generally be required clearly to disclose its purpose and investment strategy so that beneficiaries can select the product on an informed basis.

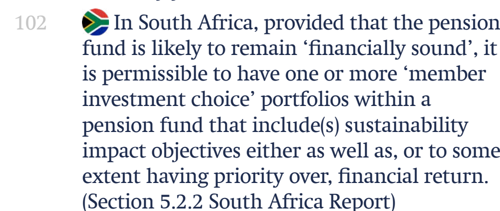
98 While there are variations between jurisdictions products of this sort can, broadly, be offered as follows.

Pensions (including those provided by insurers)

99 There are instances in some jurisdictions where it may be possible to offer pension investment options which expressly involve sustainability impact objectives.

100 However, in some jurisdictions, including China and Japan, although there is no legal prohibition, options of this sort would be novel and it is unclear whether regulators would be accommodating. Offering these options is mostly confined to private sector defined contribution schemes where beneficiaries are given a choice of funds. It is less likely to be practicable for public or private sector defined benefit schemes.

101 Given the social importance of secure retirement income, the extent to which returns can be sacrificed to pursue other objectives is limited. The extent of those limitations and the way they are expressed varies by jurisdiction.

102  In South Africa, provided that the pension fund is likely to remain 'financially sound', it is permissible to have one or more 'member investment choice' portfolios within a pension fund that include(s) sustainability impact objectives either as well as, or to some extent having priority over, financial return. (Section 5.2.2 South Africa Report)

THE EXTENT TO WHICH THE LAW REQUIRES OR PERMITS IFSI

Regulated mutual funds

103 In all jurisdictions, subject to consumer protection safeguards, it is possible to offer regulated mutual funds which expressly involve sustainability impact objectives.

104 Regulated mutual funds are premised on the ability and freedom of beneficiaries to select the fund they wish to invest in on the basis of informed choice. In principle, it is therefore usually possible to offer investors regulated mutual funds with objectives which include goals other than financial return, including objectives that should take precedence over financial return goals. However, most legal systems require a product to be intended to achieve some level of financial return to qualify as regulated mutual fund.

105 Consumer protection rules which usually apply to the marketing of mutual funds could make it more challenging to incorporate some types of sustainability impact objective, particularly where it is difficult to measure impact in a meaningful way, and so report on performance.

106 In Brazil, investment funds are allowed to state in their by-laws that the portfolio should be managed with a sustainability impact objective. While financial return must also be an objective, sustainability impact can be prioritised. (Section 5.3 Brazil Report)

107 In Canada, mutual funds may be set up for sustainability impact objectives. Fundamental standard investment restrictions (such as asset concentration limits) under Canadian securities laws in no way prohibit a mutual fund from adopting an investment objective or investment strategy that is geared towards ultimate ends IFSI. Such investments are available to both retail and institutional investors through financial institutions, asset management firms and credit unions, and require appropriate disclosures as to investment objectives, strategies and risks. (Section 2.3.15 Canada Report)

108 In the EU, establishing a UCITS that pursues a sustainability impact objective (either equal to or with priority over financial return) is neither prohibited nor restricted under EU legislation, as long as the general obligations concerning a UCITS' investment policies are observed. A management company must also use fair, correct and transparent pricing models and valuation systems which may prove complex if measuring sustainability impact is difficult. Guidance in some jurisdictions seeks to make clear that environmental or social objectives for UCITS are permitted. For example, guidance from the UK Financial Conduct Authority on the UK UCITS regime, which is based on that in the EU, states that: 'Sometimes funds set out non-financial objectives, for example environmental or social objectives, or state that they are aiming to achieve a non-financial return. We expect, if a fund has such objectives, that it will set them out in its prospectus and its KIID/KID'. (Section 2.3.17 EU Report, Section 2.3.20 UK Report)

109 In France, AMF rules and guidance have since 2007 acknowledged the possibility of using non-financial criteria in the process of selecting financial instruments for investment by French funds. In addition, other AMF guidance has long provided for disclosure requirements associated with socially responsible funds (referred to as 'fonds ISR'). The growing number of Greenfin-certified funds reflects the creation of funds on the French market that pursue IFSI. The Greenfin certification is based on financial management transparency and environmental impact indicators. It is limited to certified funds that genuinely finance activities with measurable environmental benefits. (Sections 2.3.13; 5.3.2 France Report)

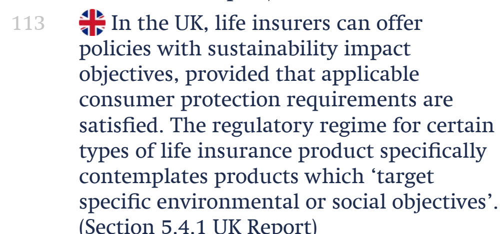
110 In the US, mutual funds can be set up with sustainability impact objectives. There must be appropriate disclosures in the fund's prospectus about the fund's strategy and attendant risks. (Section 5.3.1 US Report)

Non-pensions life insurance

111 In a number of jurisdictions, subject to consumer protection safeguards, it would be possible to offer a least some types of life insurance investment product which involve sustainability impact goals, including in priority to financial return. However, in some jurisdictions, although there is no legal prohibition on such products, they may be regarded as novel and could meet with hesitancy from regulators and other practical difficulties.

THE EXTENT TO WHICH THE LAW REQUIRES OR PERMITS IFSI

112 In the Netherlands, life insurers are permitted to create products with an investment objective to invest for sustainability impact, provided that the applicable consumer protection requirements, including product design and marketing requirements, are satisfied. Regulation applicable to certain types of life insurance products specifically contemplates products which 'target specific environmental or social objectives'. Policy terms and marketing materials should address the prioritisation between the objectives of financial return and sustainability impact. (Section 5.1.9 Netherlands Report)

113  In the UK, life insurers can offer policies with sustainability impact objectives, provided that applicable consumer protection requirements are satisfied. The regulatory regime for certain types of life insurance product specifically contemplates products which 'target specific environmental or social objectives'. (Section 5.4.1 UK Report)

114 In most cases it is also, in principle, possible to amend the terms of existing investment arrangements to incorporate sustainability impact objectives, where the inclusion of such an express objective in that type of product is permitted by law. However, commonly, amendment would require the consent of a majority (or even all) beneficiaries and potentially regulatory consent. Pension fund objectives can sometimes be amended without beneficiary consent. However, several jurisdictions have indicated that it may be challenging for a pension scheme trustee or manager to reconcile unilaterally amending a pension scheme with their legal duties.[67]

3.3.2 Discretion to use investment powers to pursue sustainability impact goals

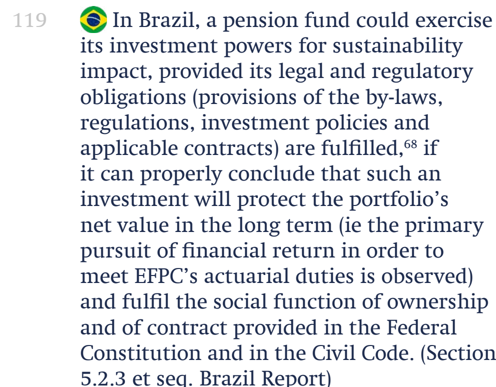
115 In every jurisdiction surveyed, some types of Asset Owner have a degree of discretion to use their investment powers to pursue sustainability impact goals. We consider in what follows four possible categories of legal discretion: (a) in the context of instrumental IFSI; (b) basic discretions available (expressly or inherently) for particular types of Asset Owner; (c) where pursuing sustainability impact goals is permitted based on beneficiaries' views; and (d) where duties relating to beneficiaries' interests extend beyond their financial interests.

116 The first would be for the purpose of discharging duties to seek to secure a financial return. However, discretions within (b) to (d) would operate in parallel with seeking to meet financial return objectives. They would therefore represent a form of ultimate ends IFSI. In most cases, unless an individual investment arrangement permits something broader, they would only be permitted provided that the relevant Asset Owner has prioritised its duty to seek to meet its financial investment objectives.

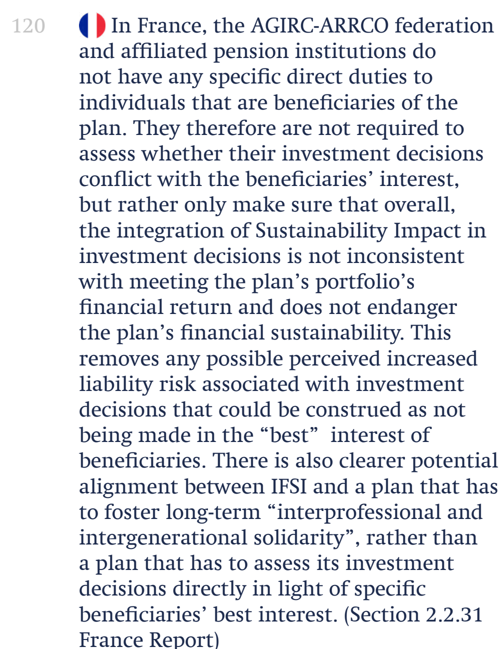
117 As discussed at Section 3.4.2(d) above, most Asset Owners and investment managers are subject to a duty to act exclusively in the interests of the person or persons to whom they owe their duties. In some cases and in some jurisdictions this duty means it is difficult to make decisions that are motivated by objectives that will deliver benefits more widely. However, where there is a clear legal discretion to engage in ultimate ends IFSI it is unlikely that this would be regarded in law as giving rise to a conflict of interest merely because non-beneficiaries may benefit.

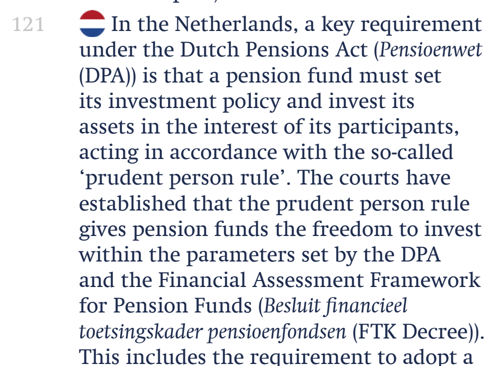
(a) Instrumental IFSI

118 As mentioned in Section 3.2.3 it is possible to imagine circumstances in which an Asset Owner is not legally obliged to consider engaging in instrumental IFSI but might conclude that it has the discretion to use investment powers to do so. An example might be where it has identified particular sustainability improvements that are likely to flow through to improved financial returns, leading it to invest in and work with investee enterprises to achieve those sustainability improvements so as to achieve value growth.

119  In Brazil, a pension fund could exercise its investment powers for sustainability impact, provided its legal and regulatory obligations (provisions of the by-laws, regulations, investment policies and applicable contracts) are fulfilled,[68] if it can properly conclude that such an investment will protect the portfolio's net value in the long term (ie the primary pursuit of financial return in order to meet EFPC's actuarial duties is observed) and fulfil the social function of ownership and of contract provided in the Federal Constitution and in the Civil Code. (Section 5.2.3 et seq. Brazil Report)

THE EXTENT TO WHICH THE LAW REQUIRES OR PERMITS IFSI

120 
In France, the AGIRC-ARRCO federation and affiliated pension institutions do not have any specific direct duties to individuals that are beneficiaries of the plan. They therefore are not required to assess whether their investment decisions conflict with the beneficiaries' interest, but rather only make sure that overall, the integration of Sustainability Impact in investment decisions is not inconsistent with meeting the plan's portfolio's financial return and does not endanger the plan's financial sustainability. This removes any possible perceived increased liability risk associated with investment decisions that could be construed as not being made in the "best" interest of beneficiaries. There is also clearer potential alignment between IFSI and a plan that has to foster long-term "interprofessional and intergenerational solidarity", rather than a plan that has to assess its investment decisions directly in light of specific beneficiaries' best interest. (Section 2.2.31 France Report)

121 
In the Netherlands, a key requirement under the Dutch Pensions Act (*Pensioenwet* (DPA)) is that a pension fund must set its investment policy and invest its assets in the interest of its participants, acting in accordance with the so-called 'prudent person rule'. The courts have established that the prudent person rule gives pension funds the freedom to invest within the parameters set by the DPA and the Financial Assessment Framework for Pension Funds (*Besluit financieel toetsingskader pensioenfondsen* (FTK Decree)). This includes the requirement to adopt a longer-term strategic investment policy in line with the fund's objectives and policy principles, including its attitude to risk, as part of which the fund must also consider the environment, the climate, human rights and social relationships (Article 18 FTK Decree). (Sections 2.1.7; 2.1.22 Netherlands Report)

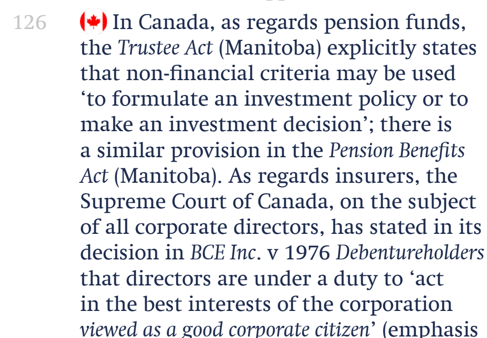
(b) Discretion to use investment powers for ultimate ends IFSI as between types of Asset Owner

122 General insurers, and life insurers investing funds that are not linked to their policyholders' policy returns, generally have the most flexibility to use their investment powers to engage in ultimate ends IFSI. This is because, provided they make sufficient returns to pay policyholder claims and meet regulatory requirements (for example, prudential requirements to maintain certain levels of capital or in relation to the asset classes in which they may invest[69]), they are typically accountable to shareholders, rather than policyholders, for investment returns. This may mean that they have greater scope to invest with the long-term success of the insurer in mind, including for example, taking account of reputational benefits of sustainable business practices and, in some jurisdictions, with appropriate regard to 'stakeholders' more broadly.

123 By contrast, pension funds and insurers investing funds they manage in connection with investment-based life insurance contracts will usually have less flexibility to use investment powers to engage in ultimate ends IFSI, at least where it could damage financial returns for beneficiaries. There is a broad variety of insurance policies available in the various jurisdictions, and the particular features of different policy types, and the basis on which they were marketed, will affect the legal analysis. Many will have prescriptive terms regarding investment objectives or strategy which may limit whatever flexibility there might otherwise have been to use investment powers to pursue sustainability impact goals.

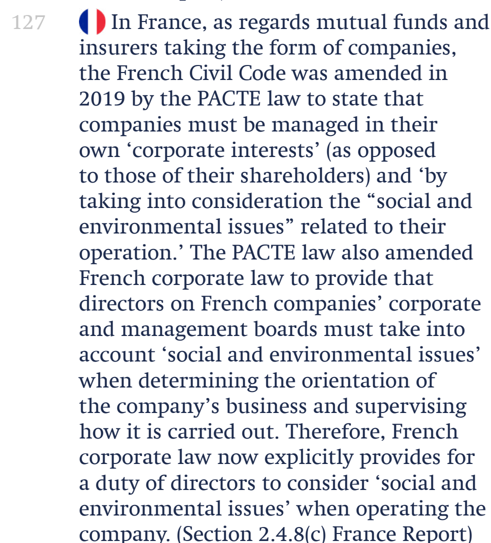
124 Regulated mutual funds generally have the least flexibility due to typically prescriptive investment objectives and policies, supported by strong consumer protection requirements. These leave asset owners with little to no flexibility to engage in ultimate ends ISFI where this is not specifically provided for in the product terms (as to which see Section 3.3.1(c) above).

125 The extent of the discretion available varies significantly by jurisdiction and Asset Owner and so we provide some examples of the differences in approach below.

126 
In Canada, as regards pension funds, the *Trustee Act* (Manitoba) explicitly states that non-financial criteria may be used 'to formulate an investment policy or to make an investment decision'; there is a similar provision in the *Pension Benefits Act* (Manitoba). As regards insurers, the Supreme Court of Canada, on the subject of all corporate directors, has stated in its decision in *BCE Inc.* v 1976 *Debentureholders* that directors are under a duty to 'act in the best interests of the corporation *viewed as a good corporate citizen*' (emphasis

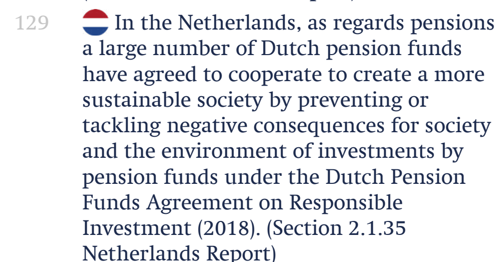
THE EXTENT TO WHICH THE LAW REQUIRES OR PERMITS IFSI

added) and it has been argued that such an understanding 'furthers the broader social purpose of fiduciary duties by requiring fiduciaries not to undertake unethical actions that would shake public confidence and trust in fiduciaries and the services they provide.'[70] (Sections 2.2.23; 2.4.11 Canada Report)



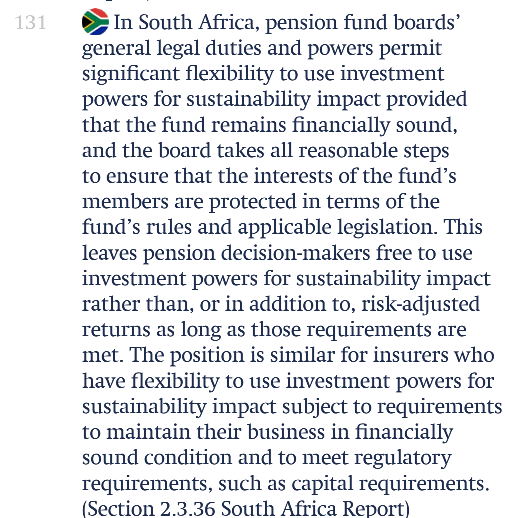
127 In France, as regards mutual funds and insurers taking the form of companies, the French Civil Code was amended in 2019 by the PACTE law to state that companies must be managed in their own 'corporate interests' (as opposed to those of their shareholders) and 'by taking into consideration the "social and environmental issues" related to their operation.' The PACTE law also amended French corporate law to provide that directors on French companies' corporate and management boards must take into account 'social and environmental issues' when determining the orientation of the company's business and supervising how it is carried out. Therefore, French corporate law now explicitly provides for a duty of directors to consider 'social and environmental issues' when operating the company. (Section 2.4.8(c) France Report)

128 The *fonds de réserve pour les retraites* (FRR) is responsible for investing with a view to creating reserves for the French basic pension system. The FRR considers that as a public investor and 'vector for intergenerational solidarity', it must factor ESG principles into the investment management of its assets. In its 2013-2017 responsible investment strategy, the FRR expressly stated that, as part of 'a new approach for the FRR', it 'will also help to finance companies the corporate mission of which is to preserve the environment or are beneficial to society.' The FRR has implemented an ambitious policy aimed at reducing its portfolio's CO_2 emissions through low carbon management. In the latest version of its responsible investment strategy, investment policy guidelines, the FRR states that it will 'continue to rely on its value as a long-term public investor to take into account and measure the impact of its investments while seeking to safeguard its enduring objective of financial performance.' Under that policy, to 'develop its investments' responsible dimension', the FRR notes that it will seek to 'pursue impact' and will 'define indicators and tools to measure its impact'. (Section 5.2.5 France Report)



129 In the Netherlands, as regards pensions a large number of Dutch pension funds have agreed to cooperate to create a more sustainable society by preventing or tackling negative consequences for society and the environment of investments by pension funds under the Dutch Pension Funds Agreement on Responsible Investment (2018). (Section 2.1.35 Netherlands Report)

130 As regards insurance companies, the Dutch Corporate Governance Code requires the management board of companies whose shares are listed on a regulated market or a comparable system to focus on long-term value creation for the company and its affiliated enterprises. In doing so, the management board should formulate a strategy that reflects this focus. When developing the strategy, attention should be paid to, among other things, the interests of the stakeholders and any other aspect relevant to the company and its affiliated enterprise, such as the environment, social and employee-related matters. (Section 2.1.67 Netherlands Report)



131 In South Africa, pension fund boards' general legal duties and powers permit significant flexibility to use investment powers for sustainability impact provided that the fund remains financially sound, and the board takes all reasonable steps to ensure that the interests of the fund's members are protected in terms of the fund's rules and applicable legislation. This leaves pension decision-makers free to use investment powers for sustainability impact rather than, or in addition to, risk-adjusted returns as long as those requirements are met. The position is similar for insurers who have flexibility to use investment powers for sustainability impact subject to requirements to maintain their business in financially sound condition and to meet regulatory requirements, such as capital requirements. (Section 2.3.36 South Africa Report)

(c) Discretion to engage in ultimate ends IFSI based on beneficiaries' views

132 Other than investment products expressly set up to pursue sustainability impact objectives, in many jurisdictions there are examples where there is some scope for Asset Owners to take account of beneficiaries' views about pursuing IFSI. Generally, beneficiaries' views may be significant as to whether an Asset Owner

THE EXTENT TO WHICH THE LAW REQUIRES OR PERMITS IFSI

can pursue sustainability objectives, but not so as to override Asset Owners' duties to pursue financial returns. So, some types of Asset Owner in some jurisdictions may have discretion to engage in ultimate ends IFSI based on beneficiaries' views, but only to the extent that financial return objectives will permit this.

133 Asset Owners in a number of jurisdictions surveyed do undertake consultation exercises to ascertain beneficiary views. How far it is safe from a legal perspective to rely on these will be a matter of judgement which may need to take account of various factors such as the degree of discretion the Asset Owner is considering exercising (for example, whether it could create a material risk of beneficiaries experiencing worse financial outcomes, or merely that sustainability can be one of the lenses through which investments are considered), the percentage of beneficiaries whose views have been sought and who have responded, and the degree of consistency in the views they have expressed.

134 In Japan, decision-makers of certain types of pension funds (mutual aid associations and DB Plans in particular) are permitted by their 'mandatary's duty' (a duty of care and loyalty similar to duties in common law countries) to reflect beneficiaries' views on the use of investment powers for sustainability impact in the objective of the portfolio, even to the extent of making financial return a secondary objective if the beneficiaries' view is so clear as to support that, although this is regarded as unlikely in practice. (Section 2.2.16(c) Japan Report)

135 In the UK, there is a well-supported view that pension fund trustees can, to some extent, consider 'non-financial' factors on the basis of beneficiaries' views. Beneficiaries' views could conceivably include their preferences to have investment powers used for sustainability impact. Regulatory guidance provides that non-financial factors may be taken into account where: a) pension fund trustees have good reason to think that beneficiaries would share the concern; and b) the decision does not involve a risk of significant financial detriment. There are important questions as to how these conditions would operate in practice, for example, how trustees should determine what is an acceptable level of detriment and what would amount to a 'good reason to think'. The UK's FCA has also recently introduced similar guidance for life insurers in relation to policies held by individuals. (Sections 2.2.44-48; 2.4.37-40 UK Report)

136 In some jurisdictions, relevant regulators seem to consider that beneficiaries' desires to pursue objectives other than financial return should be addressed by offering 'choice' products which beneficiaries can select, rather than, or in addition to, trying to ascertain and reflect these preferences in more general investment arrangements.

137 In Australia, regulatory guidance for Australian pension funds provides that consideration of beneficiaries' views, 'may result in an [APRA-regulated trustee] offering an "ethical" investment option to beneficiaries'. (Section 2.2.33 Australia Report)

138 In France, as from 1 January 2022, unit-linked insurance contracts will have to include at least one underlying asset for each of three categories of ESG investments and insurance companies will be required to inform their clients of the percentage of underlying assets within each contract meeting these conditions, before they decide to invest. The aim of this provision is to better inform clients of the possibility of investing in ESG assets. French law applicable to operators of occupational pension plans expressly allows them to take account of beneficiaries' preferences inasmuch as beneficiaries must be offered the possibility of selecting at least one alternative asset allocation, including, for employer-sponsored plans, an allocation allowing them to invest in social impact funds (*fonds solidaires*) that invest in specific social impact companies (*entreprises solidaires d'utilité sociale*). (Sections 2.2.21; 2.4.8(d) France Report)

(d) Consideration of beneficiaries' interests beyond their financial interests in the outcome of the relevant investment arrangement

139 As noted above, legal regimes tend to converge around legal standards requiring portfolios to be managed in the 'interests' of beneficiaries. This raises the question of whether those 'interests' are restricted to their financial interest in the outcome of the relevant arrangement or include a broader set of beneficiary interests, such as living in a habitable environment, their own health, quality of life and wellbeing and that of their families.

THE EXTENT TO WHICH THE LAW REQUIRES OR PERMITS IFSI

140 In at least some cases, directors of insurance companies, discussed at Section 3.3.2(b) above, are likely to have this freedom since the interests of a company do not generally reduce exclusively to monetary outcomes.

141 However, more broadly, in most of the jurisdictions surveyed, these wider interests have generally not been held, as a legal matter, to be a relevant consideration for Asset Owners in their investment decisions. So, while Asset Owners are usually required to invest in the 'best interests' of their beneficiaries, those interests are commonly limited to the beneficiaries' financial interests in the outcome of the relevant investment arrangement. However, there are some limited exceptions.

142 In Canada, based on rulings of the Supreme Court of Canada, it has been suggested, in relation to pension funds, the duty of loyalty requires the fiduciary to consider both the pecuniary interests of the beneficiary and their 'status as a responsible member of society'.[71] (Section 8.1.3 Canada Report)

143 In the UK, the Law Commission expressed the view in its 2017 report on pension funds and social investment that trustees cannot simply refuse to take account of 'non-financial factors' that may affect members in all circumstances, however serious the potential non-financial harm to their members because to do so would amount to an impermissible fetter on the trustees' discretion. However, the Law Commission thought it would be rare for trustees to reach the conclusion that they must take account of non-financial factors for this reason. (Sections 2.2.38-40 UK Report)

3.4 Asset Owners' use of stewardship activities to pursue sustainability impact goals

144 The goal of stewardship is generally to secure some sort of change in behaviour on the part of the investee enterprise so that, where it directly or indirectly concerns sustainability factors, it could well constitute a form of IFSI.

145 The following section starts by making some preliminary observations concerning Asset Owner engagement in stewardship (Section 3.4.1). It then looks at Asset Owners' legal obligations and discretions to engage in stewardship to achieve sustainability impact goals (Section 3.4.2).

146 The position in relation to stewardship broadly resembles that for the use of investment powers. However, the practical circumstances in which stewardship could be required or permitted are likely to differ, for example, because stewardship does not have the same implications for portfolio composition and value as using investment powers.

3.4.1 Preliminary observations on Asset Owners' engagement in stewardship

147 Before outlining our findings in relation to engagement in stewardship, it is worth making some general points concerning (a) the growth in investor, policymaker and wider attention to stewardship; (b) the factors that investors may need to take into account in their decisions on stewardship; and (c) the role of collective action.

(a) Growing attention to stewardship among investors, policymakers and more widely

148 Irrespective of legal obligations to do so, there is no doubt that in many jurisdictions (such as the EU, South Africa and the UK) there is both governmental and industry momentum behind an increasingly active stewardship approach, with sustainability as a prominent feature, while in others the industry may be ahead of government in advocating for this approach. In some cases, this is reflected in legislation. For example, measures, such as the EU SSRD, aim to discourage undue focus on short-term returns and instead foster long-term shareholder engagement.[72] This has also resulted in the development of stewardship codes.

149 In nine out of the jurisdictions covered, there is some form of 'stewardship code' that describes good or best practice for engagement with investee companies. The jurisdictions which do not have one are China and France. In the EU, there is an EU-wide stewardship code published by the European Fund and Asset Management Association (EFAMA), but stewardship codes have been adopted in some of its member states. The precise legal status of these codes differs between jurisdictions, but they are generally maintained either by industry bodies, or at least bodies that are either wholly or largely distinct from government. Adherence to the codes is voluntary in each case, and there are varying levels of adoption between codes.

THE EXTENT TO WHICH THE LAW REQUIRES OR PERMITS IFSI

In a number of jurisdictions (such as the EU, Japan, the Netherlands, South Africa and the UK) adoption is on a 'comply or explain' basis. In some cases, there is a degree of official encouragement for investors to adhere to the relevant code. For example, in the UK the FCA requires investment managers to state the nature of their compliance with the UK Stewardship Code. As noted in Part B.4, Box 5, while there are differences between jurisdictions, where an investor is accused of breaching its duties, courts would be likely to take account of established industry practice in assessing whether the investor has acted in a manner consistent with the relevant legal standard. In some cases, a stewardship code, or associated industry guidance developed in connection with it, could be referenced in assessing that.

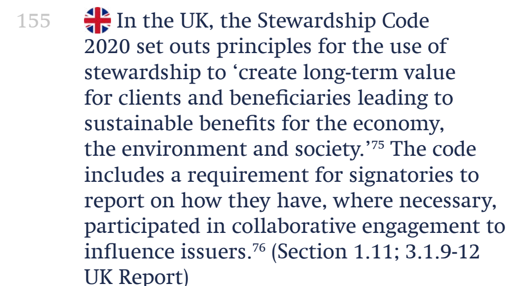
150 The content and level of detail of the stewardship codes examined in preparing this report and associated guidance also varies between jurisdictions. However, the codes typically relate the purpose of stewardship to long-term financial return to beneficiaries and often recognise that this is likely to mean that sustainability risks should be a key focus of engagement activities and that wider benefits flow from this (see, for example, the UK stewardship code below).

151 All the codes surveyed also draw attention to the benefits of collaboration with other investors, although with differing levels of emphasis or focus. For example, in Brazil, Canada, the EU, South Africa and the UK, collaborative engagement is established as a central principle. In Australia, the Netherlands and Japan, the codes include collective or collaborative engagement in secondary guidance but it is not presented as a key principle.

152 In Australia, many of the country's largest Asset Owners are signatories to the Australian Council of Superannuation Investors Stewardship Code. The code requires signatories to report publicly on stewardship activities, including collaborative engagement practices. The code states that stewardship benefits companies, asset owners, beneficiaries and the economy as a whole. (Section 3.5.1 Australia Report)

153 In the Netherlands, the Dutch Stewardship Code provides eleven non-binding principles for stewardship by asset owners and investment managers towards Dutch listed investee companies that have to be complied with on a 'comply or explain' basis. The first requires them to have a stewardship policy aimed at preserving and enhancing value for their beneficiaries and/or clients and to promote long-term value creation at Dutch listed investee companies. Monitoring investee companies on amongst others social and environmental impact is also one of the principles under the Dutch Stewardship Code. (Sections 3.2.14 et. seq. Netherlands Report)

154 In South Africa, the voluntary Code for Responsible Investing in South Africa (CRISA) sets out five key principles on how institutional investors should execute investment analysis and investment activities. A revised draft CRISA, published for comment in November 2020,[73] proposes a move from an 'apply or explain' regime to an 'apply and explain' regime, and includes among its objectives, 'to build a common awareness of stewardship and responsible investment throughout the investment value chain and across all asset classes as universally relevant (shifting away from perceptions of limited applicability to listed equity).' The revised draft recommends that, 'investment arrangements and activities demonstrate the acceptance of ownership responsibilities (where applicable) and enable diligent discharge of stewardship duties through purposeful engagement and voting.' It also sets out eight draft practice recommendations for implementation and reporting on the diligent discharge of stewardship activities.[74] (Section 1.15.2-3 South Africa Report)



155 In the UK, the Stewardship Code 2020 set outs principles for the use of stewardship to 'create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society.'[75] The code includes a requirement for signatories to report on how they have, where necessary, participated in collaborative engagement to influence issuers.[76] (Section 1.11; 3.1.9-12 UK Report)

156 In the US, the Investor Stewardship Group (ISG) is an investor-led effort that includes over 60 US-based institutional investors and global asset managers, including some of the most significant pension funds and mutual funds. The ISG began as an initiative to establish a framework of basic investment

THE EXTENT TO WHICH THE LAW REQUIRES OR PERMITS IFSI

stewardship and corporate governance standards for both investors and companies. The ISG put together a set of stewardship principles for institutional investors and governance principles for US public companies. The ISG seeks commitments from its institutional investor members to seek to implement the ISG's stewardship principles, in a manner appropriate for the relevant investor. (Section 3.1.7 US Report)

(b) Impact, cost and expense of stewardship activities

157 As discussed in Part A.1.2.3, particularly where investment is through public markets, stewardship may often be a more practical and effective way to pursue sustainability impact goals than the use of investment powers. However, stewardship is not free of cost. Pursuing sustainability impact goals involves seeking to achieve changes in investee enterprise behaviour. It is possible that these changes could have significant financial consequences, positive or negative, for the company concerned and therefore, potentially, the Asset Owner, over various time periods. These potential consequences therefore need to be taken into account in the Asset Owner's decisions, so as to ensure fair treatment between different cohorts of beneficiaries (see Sections 3.2.3 and 3.4.4(b) above). Most forms of stewardship also involve some level of expense. How much depends on the form of stewardship. In some cases, it may be relatively modest. However, maintaining a team that is capable of deep engagement can be materially more expensive. Again, an Asset Owner would need to take account of these expenses in its stewardship-related decisions.

(c) Collective action and stewardship

158 Some Asset Owners may be sufficiently influential for their own stewardship activities to have a sufficient chance of success to justify their cost. However, generally more formal collaboration is likely to be key both for stewardship activities to be successful and to limit the costs (eg through the sharing of applicable expertise and research). Even large Asset Owners typically own only a small percentage of financial instruments issued by a particular enterprise. Therefore, where Asset Owners work alongside other investors to influence investee companies, the likelihood of achieving their objective is increased, and the likelihood of success will be an important consideration in deciding whether to incur cost in stewardship activity. There is already a significant number of these initiatives at both national and international level (see Part B.2, Box 2).

159 Since Asset Owners frequently delegate stewardship activities to their investment managers, the extent to which stewardship is undertaken and to what ends depends, in principle at least, on what delegating Asset Owners require of their managers. The legal position of investment managers in relation to IFSI is considered at Section 3.6 below. However, delegation to investment managers can have a similar aggregating effect to collective stewardship activity (for example, in terms of potential for increased effectiveness and reduced aggregate cost) since the manager generally takes a single stewardship approach in respect of all assets under management.

160 The legal restrictions, discussed at Section 3.2.4(c), that need to be taken into account where investors engage in collective action are particularly relevant to stewardship activity.

161 ● In Japan, the Stewardship Code, to which many Asset Owners are signatories, ties (collective) engagement to long-term financial return by stating that 'an institutional investor should increase mid- to long-term investment return […] by prompting increases in the corporate value and sustainable growth of an investee company through […] constructive "purposeful dialogue" (engagement) based on consideration of sustainability (mid- to long-term sustainability including ESG elements).'[77] The code also states that, 'when an institutional investor engages an investee enterprise, it may do so alone, but if necessary, it could be beneficial to engage in collaboration with other institutional investors (collective engagement).'[78] (Sections 3.1.3; 3.3.3 Japan Report)

3.4.2 Legal obligations to pursue sustainability impact goals through stewardship

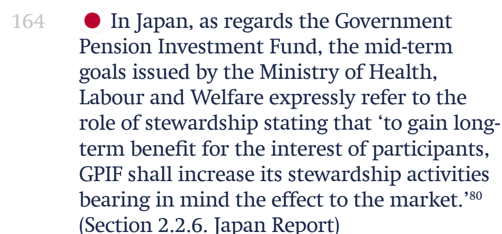
162 A legal obligation to engage in stewardship may arise in the context of (a) instrumental IFSI; (b) legal rules that explicitly aim at achieving environmental or social goals; and (c) investment arrangements set up specifically to achieve environmental or social goals (of a sort considered at Section

THE EXTENT TO WHICH THE LAW REQUIRES OR PERMITS IFSI

2.3.1(c) above, subject to the terms of the particular arrangement. The following comments briefly on (a) and (b).

(a) Instrumental IFSI in pursuit of financial goals

163 Where an Asset Owner has concluded that one or more sustainability factors create financial risks for its portfolio that may prevent it from achieving its financial objectives within the relevant time frame, stewardship activity (alone or as part of a larger group of similarly affected asset owners) is something that it must at least consider.[79] Having done so, taking account of the factors outlined at Section 3.2.3, an Asset Owner may also conclude that it has a legal obligation to act.



164 In Japan, as regards the Government Pension Investment Fund, the mid-term goals issued by the Ministry of Health, Labour and Welfare expressly refer to the role of stewardship stating that 'to gain long-term benefit for the interest of participants, GPIF shall increase its stewardship activities bearing in mind the effect to the market.'[80] (Section 2.2.6. Japan Report)

(b) Specific legal requirements for ultimate ends IFSI

165 We have identified one case in which there is a specific requirement on Asset Owners to undertake a form of IFSI through their stewardship activities.

166 In China, Chinese law imposes an obligation on Chinese insurers to comply with legislation which pursues socially desirable goals when conducting stewardship (see Section 3.4.1 b) above). They would not in principle be able to exercise their engagement powers in contravention of such rules. (Sections 3.4.1; 3.4.3. China Report)

3.4.3 Discretion to pursue sustainability impact goals through stewardship

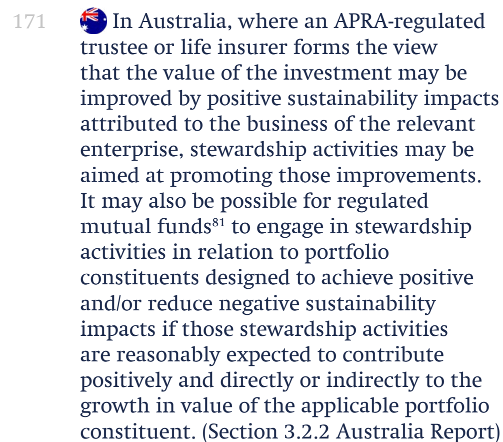
167 In every jurisdiction surveyed, some types of Asset Owner have a degree of discretion to engage in stewardship to pursue sustainability impact goals. The sorts of discretion correspond with those available where investors are using their investment powers.

168 Discretion in the context of instrumental IFSI would be exercisable for the purpose of seeking to secure a financial return (see (a) below). Others would operate in parallel with seeking to meet financial return objectives (see (b) below). They would therefore represent a form of ultimate ends IFSI and, unless an individual investment arrangement permits something broader, would be subject to the relevant Asset Owner prioritising its duty to seek to meet its financial investment objectives.

169 Our comments at Section 3.3.2, on Asset Owners' duties to act in the interests of the person or persons on whose behalf they exercise their powers or to whom they owe their duties, apply similarly here.

(a) Instrumental IFSI

170 We gave an example in Section 3.3.2(a) of where an investor may have a discretion rather than an obligation to engage in instrumental ISFI and inherent in that example would be the use of stewardship to influence investee enterprises to improve their performance in relation to the targeted sustainability factors in order to increase value.



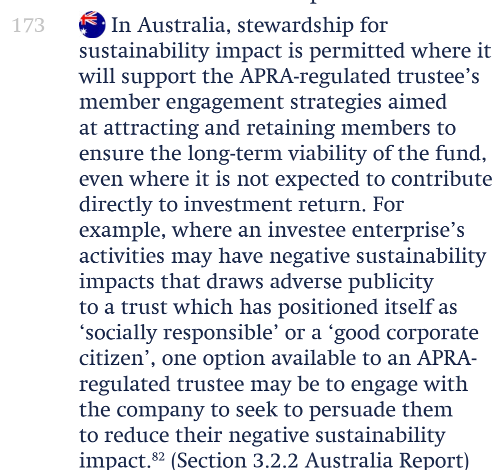
171 In Australia, where an APRA-regulated trustee or life insurer forms the view that the value of the investment may be improved by positive sustainability impacts attributed to the business of the relevant enterprise, stewardship activities may be aimed at promoting those improvements. It may also be possible for regulated mutual funds[81] to engage in stewardship activities in relation to portfolio constituents designed to achieve positive and/or reduce negative sustainability impacts if those stewardship activities are reasonably expected to contribute positively and directly or indirectly to the growth in value of the applicable portfolio constituent. (Section 3.2.2 Australia Report)

(b) Ultimate ends IFSI

172 Section 3.3.2 above looked at circumstances where Asset Owners may have a discretion to use investment powers for ultimate ends IFSI. As a general matter where they do, they will also be permitted to engage in stewardship to similar ends. As the costs and risks of stewardship may be lower than for the use of investment powers and the likelihood of achieving aa assessable sustainability impact may be higher, there

THE EXTENT TO WHICH THE LAW REQUIRES OR PERMITS IFSI

may be greater scope for the investors concerned to engage in stewardship than to use their investment powers.

173  In Australia, stewardship for sustainability impact is permitted where it will support the APRA-regulated trustee's member engagement strategies aimed at attracting and retaining members to ensure the long-term viability of the fund, even where it is not expected to contribute directly to investment return. For example, where an investee enterprise's activities may have negative sustainability impacts that draws adverse publicity to a trust which has positioned itself as 'socially responsible' or a 'good corporate citizen', one option available to an APRA-regulated trustee may be to engage with the company to seek to persuade them to reduce their negative sustainability impact.[82] (Section 3.2.2 Australia Report)

174 In the Netherlands, the vast majority of Dutch pension funds have developed an ESG investment policy which covers stewardship activities as well as the use of powers of investment and divestment. For example, both ABP (*Stichting Pensioenfonds ABP*) and PMT (*Stichting Pensioenfonds Metaal en Techniek*) have included in their respective stewardship policies that they will actively use their voting and meeting/discussion rights to enter into conversation with companies in which they invest, to influence the companies' strategy and impact on the policy and behaviour of such companies. (Sections 3.2.3-5 Netherlands Report)

3.5 Asset owners' use of public policy engagement to pursue sustainability impact

175 The following section looks at Asset Owners' legal obligations and discretions to undertake policy engagement to achieve sustainability impact goals.

176 Before doing so, it is important to note that each jurisdiction will have its own tolerance for private organisations becoming involved in policy advocacy, particularly where a policy may be politically divisive. So, while in many jurisdictions Asset Owners are (individually, or through industry groups) already involved in public policy engagement relevant to sustainability impact,[83] and in some jurisdictions relevant regulators have endorsed this,[84] in others there are those who question its appropriateness.

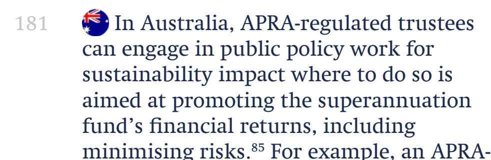
177 In every jurisdiction surveyed, some types of Asset Owner have a degree of discretion to undertake policy engagement to pursue sustainability impact goals.

178 Obligations and discretions available in the context of instrumental IFSI would be for the purpose of discharging duties in seeking to achieve a financial return (see Section 3.5.1 below). Others, more likely discretions, would operate in parallel with seeking to meet financial return objectives (see Section 3.5.2 below). Exercising these discretions would therefore represent a form of ultimate ends IFSI.

179 Our comments at Section 3.3.2, paragraph [135] (in the context of discretions to engage in ultimate ends IFSI when using investment powers) on Asset Owners' duties to act in the interests of the person or persons on whose behalf they exercise their powers or to whom they owe their duties, apply similarly here.

3.5.1 Instrumental IFSI in pursuit of financial goals

180 As with investment powers and stewardship, once an Asset Owner has concluded that its ability to achieve its financial objectives over the relevant time period is likely to be threatened by a sustainability risk, it will be legally obliged to consider what options are available to mitigate the risk, which would include the possibility of policy engagement, and act accordingly. In considering policy engagement, Asset Owners would need to be satisfied, on reasonable grounds, that there is a reasonable prospect that they will be able to influence policy outcomes and that those policy outcomes will have sustainability impacts that support the realisation of their financial objectives. As for stewardship, cost and effectiveness considerations suggest that collaboration with other Asset Owners is likely to be desirable. Many national and international industry initiatives involve public policy engagement and trade associations often engage in such activities on behalf of their members to consolidate their voices.

181  In Australia, APRA-regulated trustees can engage in public policy work for sustainability impact where to do so is aimed at promoting the superannuation fund's financial returns, including minimising risks.[85] For example, an APRA-

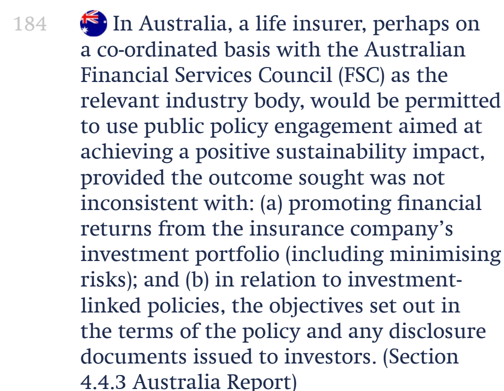
THE EXTENT TO WHICH THE LAW REQUIRES OR PERMITS IFSI

regulated trustee's assessment may be that the government's policy position (or lack of a policy position) is adversely impacting, or is likely to adversely impact, returns of the superannuation fund, or returns of asset sectors that the APRA-regulated trustee invests in (or would invest in). Before commencing public policy work, responsible entities are required, under their duty of care and diligence, to consider and evaluate the costs, benefits, potential risks and the likelihood of potential positive and negative outcomes to the members of the scheme. (Section 3.4.3 Australia Report)

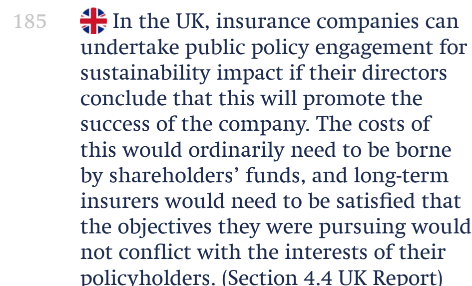
3.5.2 Ultimate ends IFSI

182 As a general matter, we would expect that investors which are of a type, or in a situation, where they have a discretion to use stewardship powers for ultimate ends IFSI, would be similarly entitled to use public policy engagement. In practice however, because this sort of engagement is not an 'ordinary course' activity for investors, in contrast to the use of investment and stewardship powers, the involvement of investors in this activity (except indirectly, through the activity of industry associations) does vary from jurisdiction to jurisdiction.

183 As with discretionary stewardship activity for ultimate ends IFSI, an Asset Owner that was otherwise permitted to use public policy engagement for this purpose would need to be satisfied that the public policy outcome it was seeking (and the costs of the public policy engagement) would not be detrimental in terms of realising its financial objectives.



184 In Australia, a life insurer, perhaps on a co-ordinated basis with the Australian Financial Services Council (FSC) as the relevant industry body, would be permitted to use public policy engagement aimed at achieving a positive sustainability impact, provided the outcome sought was not inconsistent with: (a) promoting financial returns from the insurance company's investment portfolio (including minimising risks); and (b) in relation to investment-linked policies, the objectives set out in the terms of the policy and any disclosure documents issued to investors. (Section 4.4.3 Australia Report)



185 In the UK, insurance companies can undertake public policy engagement for sustainability impact if their directors conclude that this will promote the success of the company. The costs of this would ordinarily need to be borne by shareholders' funds, and long-term insurers would need to be satisfied that the objectives they were pursuing would not conflict with the interests of their policyholders. (Section 4.4 UK Report)

3.6 Investment managers and IFSI

186 Given the significant extent to which Asset Owners outsource management of their portfolios, the role of investment managers is critical in the extent to which assets are likely to be managed in a way that falls within IFSI.

187 The following section starts by making some preliminary observations on the role of investment managers in the context of IFSI in the light of the nature of their relationship with Asset Owners (see Section 3.6.1 below). It then considers investment managers' legal obligations and discretions to use investment powers, stewardship and policy engagement to achieve sustainability impact goals (see Section 3.6.2-4 below).

3.6.1 The role of investment managers and IFSI

188 The key sources of investment managers' legal duties and powers are generally a combination of:

- the terms of their contractual relationship with the Asset Owner, normally set out in an investment management agreement;
- duties of care arising either under the contract with the Asset Owner or in the general law, eg in common law jurisdictions, duties of care in tort which can also be modified (at least to some extent) in the contract with the Asset Owner;
- statutory requirements, including regulatory rules; and
- potentially, duties implied by law from the nature of the relationship with the Asset Owner, such as duties of loyalty to the client requiring the investment manager to avoid conflicts of interest.

189 An Asset Owner cannot confer on its investment manager any greater requirement or freedom to pursue sustainability impact goals than it has itself, and any investment management agreement it enters into with its investment managers should reflect this (likewise any sub-delegations by the investment managers).[86] Consequently, however many layers there may be in

THE EXTENT TO WHICH THE LAW REQUIRES OR PERMITS IFSI

the investment chain, it is ultimately the duties and powers of the Asset Owner which will determine whether investment managers must, or can, pursue sustainability impact goals.

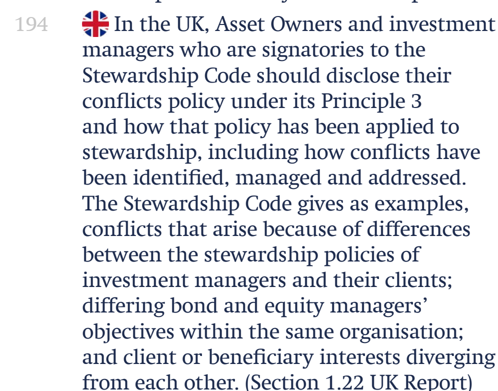
190 The introduction of investment managers into the investment process can have an impact on the use of IFSI. The following highlights: (a) the potential it can create for influence to be concentrated in the hands of investment managers, and its significance for IFSI; (b) the way that Asset Owners may need to approach the matter of sustainability impact goals in appointing managers; and (c) the extent to which an investment manager may be able to pursue sustainability impact goals where the terms of its appointment are silent on the subject.

(a) The potential for concentrated influence in the hands of investment managers and its implications

191 The concentration of assets from a number of Asset Owners in the hands of investment managers can mean that, in some cases, investment managers are at least as influential in their investment and stewardship activities as the larger Asset Owners, and potentially more so. This concentration can help to reduce the costs and improve the efficacy of these activities compared to individual Asset Owners acting alone. Subject to some of the conflict considerations discussed below, this may in turn tip the balance in favour of pursuing sustainability impact goals where, as noted previously, cost-efficiency and confidence in success are factors in determining whether IFSI is legally required or permitted. Investment managers are also active in public policy engagement, at least in some jurisdictions, and the level of their assets under their management may strengthen their influence in that context.

192 However, this sort of concentration can create potential issues for Asset Owners who may find that it reduces the scope for their particular concerns to be addressed through their investment managers. Looking especially at stewardship activities, it is not practicable for an investment manager to apply a different stewardship approach for each client. Consequently, an Asset Owner that has concluded that it should use stewardship activities to pursue sustainability impact goals, if it is to rely on the investment manager for this, will want to ensure, among other things, that the manager's stewardship policy is sufficiently aligned with the Asset Owner's objectives, that the manager has the resources and expertise to undertake stewardship as required, and that the manager is not subject to unmanageable conflicts that could prejudice its ability to pursue the Asset Owner's objective.

193 That said, stewardship is only one aspect of an investment manager's overall services. An Asset Owner may therefore conclude that a manager's other services are sufficiently strong to outweigh minor divergences between the manager's stewardship approach and its own, recognising also that one reason for appointing a manager is to be able to rely on the manager's judgement. However, if there were material divergences the Asset Owner might need to consider its options. These might include, for example, withdrawing stewardship of its assets from the manager and undertaking the activities in-house, or doing so selectively in areas where it considers that the investment manager's stewardship activity is not sufficiently consistent with its own investment goals. External engagement service providers may also be an option.



194 In the UK, Asset Owners and investment managers who are signatories to the Stewardship Code should disclose their conflicts policy under its Principle 3 and how that policy has been applied to stewardship, including how conflicts have been identified, managed and addressed. The Stewardship Code gives as examples, conflicts that arise because of differences between the stewardship policies of investment managers and their clients; differing bond and equity managers' objectives within the same organisation; and client or beneficiary interests diverging from each other. (Section 1.22 UK Report)

(b) Appointment of investment managers by Asset Owners

195 Across the jurisdictions surveyed, if an Asset Owner is legally required or permitted to pursue sustainability impact goals, it would likely need to satisfy itself when appointing an investment manager, so far as reasonable, that, among other things:

- the terms of the investment management agreement and supporting documentation are clear about what is needed in terms of investment and

THE EXTENT TO WHICH THE LAW REQUIRES OR PERMITS IFSI

stewardship services to enable the Asset Owner to achieve those goals;

- the period and terms of the appointment (including performance measurement and monitoring) do not create incentives that cannot be effectively managed, for the investment manager to act in a way that is inconsistent with achieving those goals; and
- the investment manager is not subject to any conflicts of interest which could prejudice its ability to help in achieving those goals which cannot be adequately managed.[87]

196 In some jurisdictions, investment managers have a duty to ensure that their services are suitable for their client's investment goals. These requirements seem generally to have been understood as referring to financial goals, although they are not always drafted in ways that are restricted to that. Even where they are understood as being limited to financial goals, it is not clear that this would preclude consideration of the client's needs in relation to instrumental IFSI, since that is connected with realising financial goals. Currently, few of the jurisdictions surveyed expressly require that client's sustainability preferences are specifically considered in this context, but it is clear that many investment managers are already raising this as part of their client onboarding and renewal processes.[88]

197 The EU has recently amended the regime operating under its Markets in Financial Instruments Directive in a way that places specific requirements on EU-regulated investment managers to establish their clients' 'sustainability preferences' and to be able to explain how 'sustainability factors' have been taken into account in the investment process.[89] (Section 6.2.2 EU Report)

(c) Investment managers pursuing sustainability impact goals where the investment management contract is silent

198 It seems likely that it will become rare that an investment management contract is silent on sustainability issues. Even where that is the case, it is likely in most jurisdictions that, in principle, an investment manager with broad powers could nonetheless legitimately reach a conclusion on behalf of the Asset Owner that it should pursue sustainability impact goals within the scope of instrumental IFSI, and to act accordingly. Indeed, that may be happening in practice in the context of some stewardship activities. However, we anticipate that managers may be reluctant to take steps that could create a material risk of adverse financial impact in the short term, even where investment powers were being used to enhance influence from a stewardship perspective, unless expressly agreed with the Asset Owner.

3.6.2 Use of investment powers to pursue sustainability impact goals

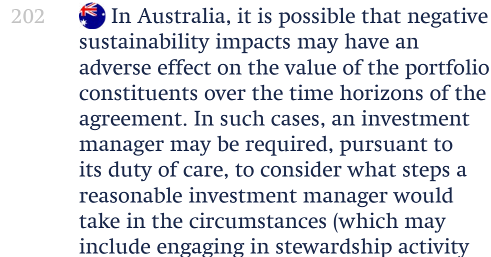
(a) Requirements to use investment powers to pursue sustainability impact goals

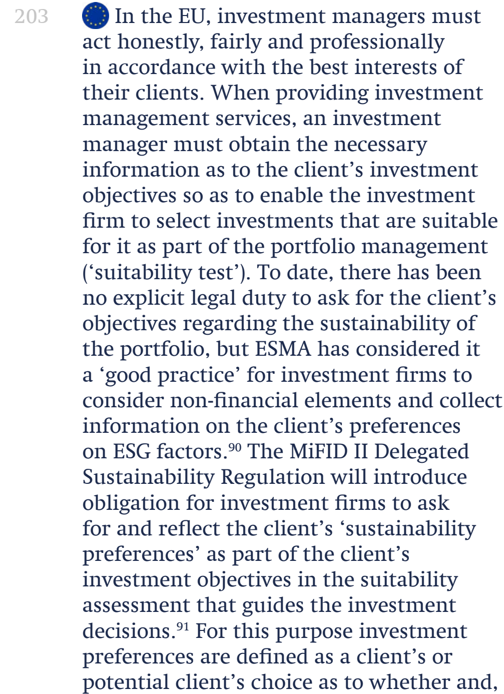
199 Whether an investment manager is required to use its investment powers to pursue sustainability impact goals in seeking to realise financial objectives (ie instrumental IFSI) will depend on similar factors to those for the Asset Owner appointing it (see Section 3.3.1), but be also subject to the terms of the relevant investment management agreement and especially the investment objective the investment manager is set. That said, it is important to recognise that various market features may tend to militate against investment managers using their investment powers (in particular) in this way (see Part B.4.2.3 and 4). While there have been policy and industry initiatives in some jurisdictions to address these, potential issues remain. Investment management agreements are usually for much shorter periods than the time horizon of their clients. Financial performance tends to be monitored by Asset Owners and those who advise them on a periodic basis against industry-wide benchmarks. Even if this is not the case, the primary or only means by which the Asset Owner rates the performance of its manager, short-term under-performance is uncomfortable for both parties. Asset Owners who want their investment managers to prioritise the longer term will need (if their own duties permit it) to agree on measures of success that reflect that.

THE EXTENT TO WHICH THE LAW REQUIRES OR PERMITS IFSI

200 As with Asset Owners, investment managers will need to comply with rules that exist in all jurisdictions that are designed to prevent various anti-social activities (see Section 3.3.1(b)). As noted, these regimes have an effect that is similar to a collective 'ultimate ends IFSI' decision by investors to achieve a reduction in the relevant activities, although it would not be usual to think of them in that way.

201 Where an Asset Owner has discretion to pursue sustainability impact goals alongside its financial return objectives (ie ultimate ends IFSI) and wishes to require its investment manager to do this (ie potentially making it a legal obligation for the investment manager), the details of, and prioritisation between, objectives to achieve financial returns and sustainability impact goals should as a practical matter be set out expressly in the investment management agreement. However, it may be difficult to define the balance, and to measure whether it has been achieved, given the variable extent to which it is possible to assess the sustainability impact of investee companies and to weigh the value of that against financial goals (see Part A.2).

202  In Australia, it is possible that negative sustainability impacts may have an adverse effect on the value of the portfolio constituents over the time horizons of the agreement. In such cases, an investment manager may be required, pursuant to its duty of care, to consider what steps a reasonable investment manager would take in the circumstances (which may include engaging in stewardship activity for sustainability impact), even where the investment management agreement is silent on investing for sustainability impact. In doing so, the investment manager should have regard to the magnitude of the risk and the degree of the probability of its occurrence, along with the expense, difficulty and inconvenience of taking alleviating action and any other conflicting responsibilities which the investment manager may have. (Section 6.1.7 Australia Report)

203  In the EU, investment managers must act honestly, fairly and professionally in accordance with the best interests of their clients. When providing investment management services, an investment manager must obtain the necessary information as to the client's investment objectives so as to enable the investment firm to select investments that are suitable for it as part of the portfolio management ('suitability test'). To date, there has been no explicit legal duty to ask for the client's objectives regarding the sustainability of the portfolio, but ESMA has considered it a 'good practice' for investment firms to consider non-financial elements and collect information on the client's preferences on ESG factors.[90] The MiFID II Delegated Sustainability Regulation will introduce obligation for investment firms to ask for and reflect the client's 'sustainability preferences' as part of the client's investment objectives in the suitability assessment that guides the investment decisions.[91] For this purpose investment preferences are defined as a client's or potential client's choice as to whether and, if so, to what extent, one or more of the following financial instruments shall be integrated into his or her investment

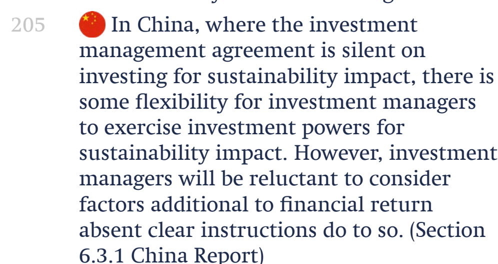
- a financial instrument for which the client or potential client determines that a minimum proportion shall be invested in environmentally sustainable investments as defined in Article 2, point (1), of SFDR;
- a financial instrument for which the client or potential client determines that a minimum proportion shall be invested in sustainable investments as defined in Article 2, point (17), of SFDR;
- a financial instrument that considers principal adverse impacts on sustainability factors where qualitative or quantitative elements demonstrating that consideration are determined by the client or potential client. (Section 6.2.2 EU Report)

(b) Discretion to use investment powers to pursue sustainability impact goals

204 Investment managers may in some cases theoretically have the power, even if not provided for in the relevant investment management agreement, to use their investment powers to invest for sustainability impact on behalf of the Asset Owner in circumstances where the Asset Owner would have the flexibility to do so. However, we are doubtful that investment managers will do so unless this has been specifically agreed with the Asset Owner, particularly where doing so may have some negative impact on financial returns. It is unlikely that doing so in a manner

THE EXTENT TO WHICH THE LAW REQUIRES OR PERMITS IFSI

that is inconsistent with pursuit of the financial objectives set in the investment management agreement would ever be permissible unless there was express and valid authority to do so in the agreement.

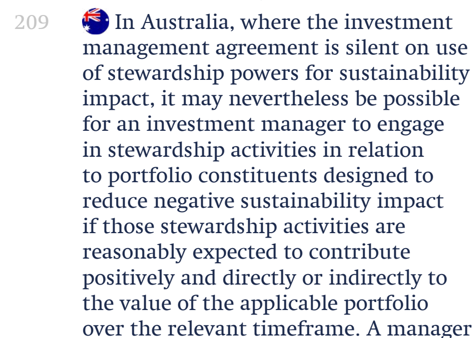
205  In China, where the investment management agreement is silent on investing for sustainability impact, there is some flexibility for investment managers to exercise investment powers for sustainability impact. However, investment managers will be reluctant to consider factors additional to financial return absent clear instructions do to so. (Section 6.3.1 China Report)

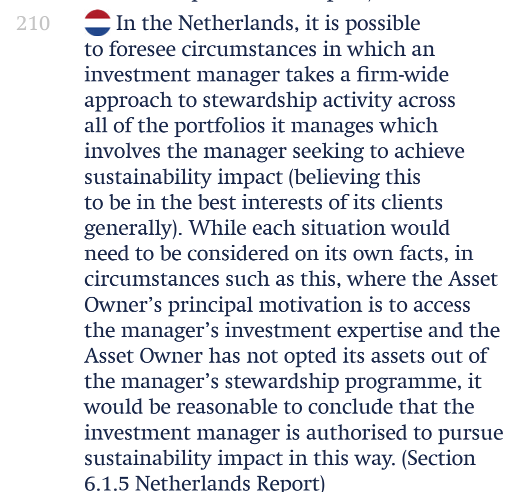
3.6.3 Legal obligations and discretion to engage in stewardship and public policy to pursue sustainability impact goals

206 Investment managers' stewardship activities are by their nature undertaken on behalf of all their Asset Owner clients collectively. As discussed at Section 3.6.1(a), it is rarely, if ever, practicable for a single manager to offer a differentiated stewardship approach depending on which client it is acting for.

207 Ideally, an investment management agreement will expressly address the stewardship approach that will be adopted. Although this is understood to not be especially common at the moment, in some jurisdiction there is pressure for Asset Owners to pay more attention to this matter. At present, there may be cases where stewardship has been delegated to the investment manager by a client knowing that the manager has a house-wide stewardship policy, but the agreement is otherwise silent on stewardship. If so, subject to the manager properly concluding that the stewardship policy it intends to pursue is in the best interests of its clients, it is unlikely to be in breach of its duties to clients where its stewardship activities are designed to achieve sustainability impact goals that are reasonably likely to be financially beneficial or neutral for its clients (for example, by reducing the potential for adverse investment impacts from systemic sustainability risk and transition risk).

208 Section 3.6.1(b) above mentioned various market features that could tend to militate against investment managers using their investment powers to pursue sustainability impact goals. Since stewardship is less likely to have a direct impact on portfolio composition than a manager's investment decisions, the influence of some of these factors may be less pronounced in relation to stewardship activities. Others could nonetheless create incentives for managers not to devote resources to stewardship (see further in Part B.4).

209  In Australia, where the investment management agreement is silent on use of stewardship powers for sustainability impact, it may nevertheless be possible for an investment manager to engage in stewardship activities in relation to portfolio constituents designed to reduce negative sustainability impact if those stewardship activities are reasonably expected to contribute positively and directly or indirectly to the value of the applicable portfolio over the relevant timeframe. A manager is unlikely to be permitted to engage in stewardship activities in relation to portfolio constituents designed to achieve sustainability impacts without that contributing to investment return. (Section 6.2.1 et. seq. Australia Report)

210  In the Netherlands, it is possible to foresee circumstances in which an investment manager takes a firm-wide approach to stewardship activity across all of the portfolios it manages which involves the manager seeking to achieve sustainability impact (believing this to be in the best interests of its clients generally). While each situation would need to be considered on its own facts, in circumstances such as this, where the Asset Owner's principal motivation is to access the manager's investment expertise and the Asset Owner has not opted its assets out of the manager's stewardship programme, it would be reasonable to conclude that the investment manager is authorised to pursue sustainability impact in this way. (Section 6.1.5 Netherlands Report)

3.6.4 Policy engagement

211 As regards policy engagement, investment managers are more likely to undertake public policy engagement on their own behalf (although potentially in support of their market profile with clients and potential clients), and at their own cost. A manager engaging in activities of this sort is likely to need to satisfy itself that the policy positions it advocates for are consistent with the interests of its clients, or that its clients are aware of and have accepted any potential conflict.

B. THE EXTENT TO WHICH THE LAW REQUIRES OR PERMITS IFSI

3. IFSI in eleven jurisdictions - Summary of findings

THE EXTENT TO WHICH THE LAW REQUIRES OR PERMITS IFSI

3.7 Legal liability to third parties for negative sustainability impact of investee enterprises

212 This section looks at Asset Owners' potential liability for any negative sustainability impact of the companies in which they invest, where negative sustainability impact violates relevant laws and/or causes harm to third parties.[92] It also looks at whether investment managers are likely to be legally liable for the negative sustainability impact of the companies they cause Asset Owners to invest in. [93]

213 The following discussion does *not* deal with Asset Owners' and investment managers' liability to their beneficiaries and clients for the consequences of pursuing or not pursuing sustainability impact goals. Their basic legal duties in that regard are, essentially, addressed in the analysis above.

214 Where an enterprise causes certain environmental or social damages (eg pollution of a river with toxic wastewater from a nearby battery factory or a misleading advertisement by a pharma company contributing to a widespread harm to patients) most jurisdictions will impose civil/administrative or criminal liability on that enterprise and, often, on the individuals who manage it, or who took the decisions leading to the damages in question. The question is whether an Asset Owner that is an investor in the enterprise, or the investment manager who caused the Asset Owner to make that investment, may also incur criminal liability (see Section 3.7.1), or a liability to pay compensation to those affected (see Section 3.7.2), or an administrative liability, eg to implement remediation measures or to pay for them (see Section 3.7.3).

215 Neither Asset Owners nor investment managers will incur liability in any jurisdiction if the local laws do not impose liability for the negative sustainability impact of an investee enterprise. While certain negative sustainability outcomes do expose the investee enterprises to legal liability, this is not always the case.

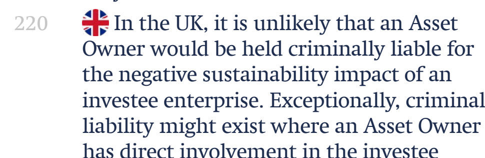
216 All jurisdictions recognise a possible legal risk in certain circumstances for Asset Owners and, generally to a lesser extent, for investment managers. However, the likelihood of any form of liability is currently remote in most jurisdictions. In general, an Asset Owner would need to have the ability to exercise substantive control over an investee enterprise before the acts or omissions of the investee company could be laid at the Asset Owner's door.

3.7.1 Criminal liability

217 The systems of criminal liability differs across the jurisdictions surveyed. In some jurisdictions, both individuals and corporations can be criminally liable.[94] In other jurisdictions, only individuals can be criminally liable, but other sanctions can be applied to corporations.[95]

218 For an Asset Owner or investment manager (or its directors and other managing personnel) to be held criminally liable for the negative sustainability impact of a company in which an Asset Owner has invested, at least two requirements need to be met. First, the investee company's activity which causes the negative sustainability impact would need to be considered a criminal offence under the applicable legal framework, as is the case under, among others, environmental laws in a number of jurisdictions.[96] Second, the Asset Owner's or investment manager's investment in the enterprise concerned would need to be deemed sufficient to invoke criminal liability. Depending on the legal framework, this would require the Asset Owner or manager to, for example, have 'direct involvement in' or 'be in control of' the investee company's activities, or 'act as a shadow or de facto director of the investee company'. As these standards generally require substantial involvement in the day-to-day management and/or the internal decision-making of the investee company, they will only rarely be applicable to the Asset Owners and investment managers with which this survey is concerned, who generally only hold minority stakes or debt securities in their investee companies and whose ordinary course stewardship activities do not come close to the exercise of significant control or influence.

219 Thus, while in many jurisdictions there is a theoretical risk of criminal liability for Asset Owners, or their investment managers, the risk is currently considered very remote.

220 
In the UK, it is unlikely that an Asset Owner would be held criminally liable for the negative sustainability impact of an investee enterprise. Exceptionally, criminal liability might exist where an Asset Owner has direct involvement in the investee

THE EXTENT TO WHICH THE LAW REQUIRES OR PERMITS IFSI

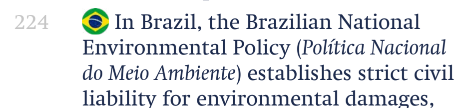
company's activities or operations, and where those are determined to be criminal under the relevant legislation. In normal circumstances the arm's length nature of relationships between an Asset Owner and the activities of the enterprises included in its portfolio makes such a liability highly unlikely. The risks would be higher if an Asset Owner had close day-to-day involvement in and direction over the activities of the investee company. Liability is also theoretically possible, for example, if a nominee director appointed by an Asset Owner assumed managerial responsibility over relevant activities of the investee company. However, only exceptionally would an Asset Owner exercise the required level of engagement in an investee enterprise's operations. (Section 7.2.2 UK Report)

3.7.2 Civil liability

221 Asset Owners or their investment managers could theoretically incur civil liability to third parties who have suffered harm as a result of a negative sustainability impact caused by an investee enterprise. However, usually that would only happen in circumstances similar to those in which criminal liability might arise; where the Asset Owner, or its investment manager, has de facto control of the enterprise concerned. Even then, the claimant would most likely need to show both that its loss had been caused by the acts or omissions of the Asset Owner or investment manager, that the Asset Owner or investment manager owed them a legal duty of care in the way that they exercised their rights with respect to the enterprise, and that the harm caused to the claimant was a reasonably foreseeable consequence of the acts or omissions of the Asset Owner or investment manager.

222 For civil liability to arise, the Asset Owner or investment manager's own acts or omissions (and not merely those of the enterprise concerned) in relation to the negative sustainability impact would thus need to be found to have a sufficient causal link to the harm suffered by the third party.[97] Depending on the legal regime this might require the Asset Owner or manager to 'exert a sufficient degree of control or influence' over the investee company in a situation where the harm to the claimant was 'reasonably foreseeable', 'wilfully or negligently prompt the investee company to commit a tort', be 'in control of the investee company or its activity', or have 'a significant level of involvement and control in the day-to-day operations of the investee company and decision-making'. These standards generally require substantial involvement in the day-to-day management and/or the internal decision-making of the investee company, which will very rarely be the case with Asset Owners or their investment managers.

223 Thus, while in all jurisdictions civil liability for Asset Owners could theoretically arise, the risk is currently considered very remote except for entities in which the Asset Owner holds, or the investment manager's clients have (and exercise), a controlling interest. However, there is one notable exception in relation to Brazil.

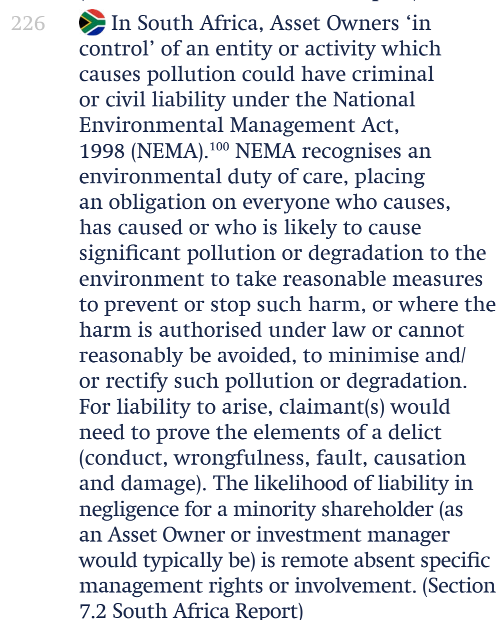


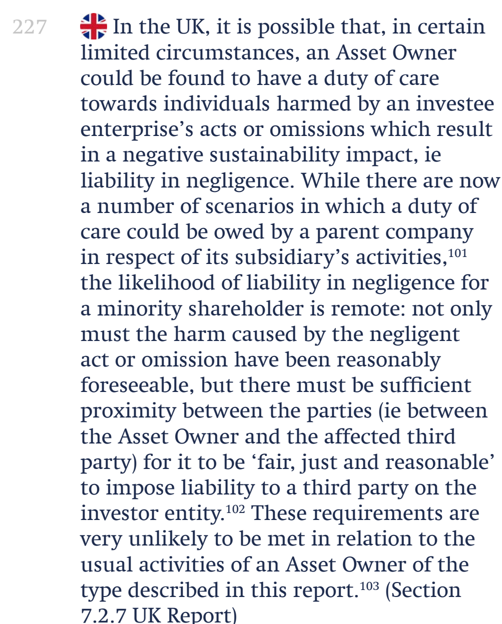
224 In Brazil, the Brazilian National Environmental Policy (*Política Nacional do Meio Ambiente*) establishes strict civil liability for environmental damages, meaning that only the chain of causation between the activity performed by the polluter and the environmental damage needs to be verified. The Brazilian High Court of Justice (*Superior Tribunal de Justiça – STJ*) held that any party that (a) fails to prevent, or acts with indifference to, polluting activities; (b) fails to report such activities to authorities; (c) finances those that carry out such activities; or (d) benefits from such activities, is deemed to be an indirect polluter. In other relevant case law, the STJ clarified that the indirect polluter concept encompasses all those who have a duty to prevent an environmental degradation and fail to do so, profiting, even if indirectly, from third-party actions that lead to environmental harm. This far-reaching concept could, in theory, comprise all Asset Owners which contribute to companies or projects that result in environmental damages. So far, the legal rules have only been tested with regard to financial institutions. (Sections 7.2.7 et. seq. Brazil Report)

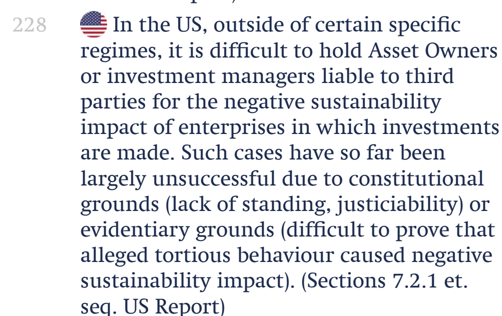
225 In the Netherlands, recent case law indicates that liability for negative sustainability impact could potentially be attributed to business enterprises or the Dutch State on the basis of the duty of care in the context of the tort article in the Dutch Civil Code (*Burgerlijk Wetboek*), Article 6:162. In addition, the approach of the courts in the *Milieudefensie/RDS*[98] and *Urgenda*[99] cases highlights the importance of 'soft law' (such as commonly recognised industry standards of good practice) in determining the scope and content of the duty of care, specifically in the context of climate cases. Even though we have not

THE EXTENT TO WHICH THE LAW REQUIRES OR PERMITS IFSI

seen such civil cases against Asset Owners or investment managers, this does increase the risk of direct tortious liability for investors for negative sustainability impact in the relatively limited circumstances in which such direct liability could arise. (Section 7.2.25 Netherlands Report)

226  In South Africa, Asset Owners 'in control' of an entity or activity which causes pollution could have criminal or civil liability under the National Environmental Management Act, 1998 (NEMA).[100] NEMA recognises an environmental duty of care, placing an obligation on everyone who causes, has caused or who is likely to cause significant pollution or degradation to the environment to take reasonable measures to prevent or stop such harm, or where the harm is authorised under law or cannot reasonably be avoided, to minimise and/or rectify such pollution or degradation. For liability to arise, claimant(s) would need to prove the elements of a delict (conduct, wrongfulness, fault, causation and damage). The likelihood of liability in negligence for a minority shareholder (as an Asset Owner or investment manager would typically be) is remote absent specific management rights or involvement. (Section 7.2 South Africa Report)

227  In the UK, it is possible that, in certain limited circumstances, an Asset Owner could be found to have a duty of care towards individuals harmed by an investee enterprise's acts or omissions which result in a negative sustainability impact, ie liability in negligence. While there are now a number of scenarios in which a duty of care could be owed by a parent company in respect of its subsidiary's activities,[101] the likelihood of liability in negligence for a minority shareholder is remote: not only must the harm caused by the negligent act or omission have been reasonably foreseeable, but there must be sufficient proximity between the parties (ie between the Asset Owner and the affected third party) for it to be 'fair, just and reasonable' to impose liability to a third party on the investor entity.[102] These requirements are very unlikely to be met in relation to the usual activities of an Asset Owner of the type described in this report.[103] (Section 7.2.7 UK Report)

228  In the US, outside of certain specific regimes, it is difficult to hold Asset Owners or investment managers liable to third parties for the negative sustainability impact of enterprises in which investments are made. Such cases have so far been largely unsuccessful due to constitutional grounds (lack of standing, justiciability) or evidentiary grounds (difficult to prove that alleged tortious behaviour caused negative sustainability impact). (Sections 7.2.1 et. seq. US Report)

229 The risk of civil liability for investment managers is even more remote than for Asset Owners. While it is true that investment managers often take decisions with respect to the exercise of votes attaching to the Asset Owners' portfolios and engage in stewardship more broadly, this will rarely be the case except in the exceptional situations where an Asset Owner has a controlling interest in an enterprise.

3.7.3 Responsibility *vis-à-vis* governmental authorities

230 This section deals with obligations of private persons including corporate entities *vis-à-vis* governmental authorities; such as the obligations of a polluter to implement or pay for remediation measures are administrative legal obligations.[104] In civil law jurisdictions this is known as 'administrative liability'; in common law jurisdictions, those would be categorised as civil (as opposed to criminal) liability.

231 In principle, Asset Owners or investment managers could be subject to such a liability for the negative sustainability impact caused by an investee enterprise in legal systems and in circumstances where the state can look through a corporate entity and pursue those who control it for a remedy ('piercing the corporate veil'). Pollution of land is a particular example.

232 While EU law does not directly govern administrative liability for negative sustainability impacts, Directive 2004/35 on environmental liability (Environmental Liability Directive)[105] has established a framework of strict environmental liability based on the 'polluter-pays'

THE EXTENT TO WHICH THE LAW REQUIRES OR PERMITS IFSI

principle for certain cases.[106] Under the Directive, member states are to oblige 'operators' of certain activities which have caused environmental damage to, *inter alia*, implement remedial measures and bear the costs for those measures.[107] It does not, however, provide for claims by private parties against the polluters.[108] An 'operator' is broadly defined as, 'any natural or legal, private or public person who operates or controls the occupational activity or, where this is provided for in national legislation, to whom decisive economic power over the technical functioning of such an activity has been delegated, including the holder of a permit or authorisation for such an activity or the person registering or notifying such an activity.'[109] Asset Owners or investment managers could in theory, depending on the size of their investment relative to other shareholders in the relevant investee enterprise, be regarded as either controlling its activity or as having decisive economic power over the technical functioning of such an activity.[110] (Sections 7.1.6-7 EU Report)

233 In South Africa, certain environmental statutes require the development of certain infrastructure to be authorised prior to development and failure to obtain the requisite authorisation would attract significant sanctions. If a person fails to comply with the duty of care or permitting obligations imposed by these statutes, the environmental perpetrator may have to pay a fine and/or remedy the harm done to the environment. The term 'administrative liability' is not specifically used in South African legislation, however administrative fines are imposed in terms of NEMA (ie officials impose fines administratively without the intervention of the court). Separately, direct clean-up/remediation liability can be incurred where a person causes or negligently fails to prevent pollution. However, there would need to be some element of 'control' or involvement at operational level by the Asset Owner or investment manager to incur liability (Section 7.2.4 South Africa Report)

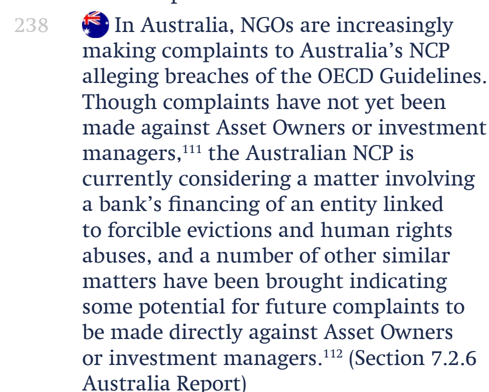
3.7.4 OECD Guidelines

234 There is currently a developing trend of complaints being made by NGOs to regulatory bodies on the basis of alleged breaches of the OECD Guidelines for Multinational Enterprises (OECD Guidelines). The OECD Guidelines are recommendations addressed by governments to multinational enterprises operating in or from adhering countries. They provide non-binding principles and standards for responsible business conduct in a global context consistent with applicable laws and internationally recognised standards.

235 Complaints of this sort, usually allegations of non-disclosure or contribution to environmental damage, are not part of a legally binding process but have the potential to cause significant reputational damage, and the usual outcome is for the parties to reach agreement on addressing the conduct concerned.

236 Governments adhering to the OECD Guidelines are required to set up a National Contact Point (NCP). These are intended to provide a mediation and conciliation platform for resolving practical issues that may arise with the implementation of the OECD Guidelines or their non-observance.

237 There are examples of complaints against financial investors under these guidelines, and they could be a source of reputational risk for Asset Owners or investment managers, either directly or indirectly if they are identified as a significant investor in the offending enterprise. They do not, however, carry any direct risk of financial exposure for Asset Owners and investment managers, and there are no examples to date of specific complaints being made against non-controlling shareholders in multinational enterprises, as opposed to the enterprises themselves.

238  In Australia, NGOs are increasingly making complaints to Australia's NCP alleging breaches of the OECD Guidelines. Though complaints have not yet been made against Asset Owners or investment managers,[111] the Australian NCP is currently considering a matter involving a bank's financing of an entity linked to forcible evictions and human rights abuses, and a number of other similar matters have been brought indicating some potential for future complaints to be made directly against Asset Owners or investment managers.[112] (Section 7.2.6 Australia Report)

THE EXTENT TO WHICH THE LAW REQUIRES OR PERMITS IFSI

239 In the Netherlands, there have been three complaint procedures under the OECD Guidelines initiated by NGOs against Dutch banks – one against Rabobank and two against ING Bank.[113] The complaints mainly focus on the banks' financing role in relation to business enterprises, which evidences that complaints of this sort could also be levelled at Asset Owners if their involvement in negative sustainability impact enterprises were sufficiently significant.

- The basis for one of the complaints against ING by a number of NGOs was that ING continued to provide significant investment to parties in the fossil fuel sector (eg the coal industry), breaching the OECD principles relating to environment and climate. The NGOs argued that ING should publish its total carbon footprint (including indirect emissions as a result of ING's loans and investments) and ambitious, concrete and measurable emission reduction targets for its loans and investments. The procedure before the Dutch NCP resulted in a statement by the NCP that a further dialogue between the NGOs and ING was justified.
- The other two complaints procedures relate to Rabobank's and ING's business operations in relation to palm oil plantations. In short, a number of NGOs argued that financial institutions such as Rabobank and ING should make more effective efforts to mitigate or prevent the adverse impact of palm oil plantations through their business (lending) operations. In its final statement in the complaint procedure against Rabobank the NCP *inter alia* stated that financial institutions have a responsibility of their own to exercise individual leverage to seek to prevent or mitigate the impact of their business conduct and respond to identified adverse impacts through engagement or potentially divestment. [114]

240 The complaint procedure against ING is still ongoing and in January 2020, the NCP issued a statement that this complaint merits further consideration and that it will facilitate a dialogue to bring parties to agreement on possible improvements to ING's due diligence policies and practices regarding palm oil business financing, and to assess its involvement with actual or potential adverse impacts to determine the appropriate responses.[115] (Sections 7.2.27-33 Netherlands Report)

THE EXTENT TO WHICH THE LAW REQUIRES OR PERMITS IFSI

4. DO EXISTING MARKET FEATURES CREATE A RISK THAT SUSTAINABILITY FACTORS ARE GIVEN INSUFFICIENT WEIGHT BY INVESTORS IN COMPLYING WITH LEGAL DUTIES?

241 As noted previously, what legal rules require or permit in relation to IFSI turns not just on what they 'say' (their 'black letter'), but also the circumstances in which they are applied. Among other things, these circumstances may limit what is possible, for example, as a technical matter or in terms of cost (see Part A.2). However, the surrounding circumstances can also influence decisions that get made about how to follow rules in practice by affecting what is thought to be relevant to those decisions.

- First, the circumstances in which rules are applied can frame the decisions of those to whom they apply about what the rules require or permit. If existing market features do draw attention away from sustainability factors, then it could mean that investors do not pay sufficient attention to them in complying with duties or exercising discretions, including decisions on whether to engage in investment activities within the scope of IFSI.
- Secondly, in considering whether an investor has complied with its legal duties, a court or regulator may, among other things, assess the investor's actions by reference to established professional practice (see Box 5). Where an investor has reached conclusions and done what would be considered appropriate by a respected body of professional practice, then a claim is less likely to succeed. Consequently, if sustainability factors are being inappropriately underweighted in the course of existing market practice, then *legal duties* could unintentionally add impetus to that because of the way those duties interact, or are believed to interact, with market features.

Box 5:

How accepted market practice can affect the way legal rules apply

The role of accepted market practice in official construction of legal rules

While there will be differences of emphasis between jurisdictions, if an investor were accused of breaching its duties, a court or regulator would be likely to consider all relevant circumstances including many of those outlined in Part B.2.2. However, in addition to these, the court or regulator may also assess the actions of the investor by reference to established professional practice. Where an investor has reached conclusions and done what would be considered appropriate by a respected body of professional practice, then a claim is generally less likely to succeed.

This means that legal obligations are likely to adjust in the light of changes in professional practice. For example, a greater professional consensus that more account should be taken of sustainability factors could lead to a stronger obligation to do so. Conversely, professional practice could also create inertia; for example, if the professional mainstream were to remain focused on short-term financial factors it could result in investors feeling less confident from a legal perspective that they are complying with their duties by giving weight to longer-term sustainability factors.

However, in taking account of professional practice, courts and regulators are likely to recognise that there are various schools of professional thought, that different groups of professional opinion may favour some approaches over others in a given situation, and that current market practice may not in fact be appropriate or should only be relied upon discerningly. Consequently, investors should be careful to understand the limitations of professional theory and practice and not follow it in ways that are inappropriate. They also need to be aware of how it may be changing. This Section 4 highlights a number of ways in which current market practice and investment theory could potentially exert an influence on investors that is not necessarily aligned with their duties as they concern the pursuit of sustainability impact goals.

Market practice and the market application of legal rules

Investors may also sometimes mistakenly believe that legal rules require them to follow a particular market practice or theory in a way that those rules do not. Some of the prolonged debate surrounding the integration of 'material' ESG factors in the investment process as compared with the pursuit of 'risk-adjusted return' (understood in terms of portfolio theory and performance against traditional benchmarks) may be an example of this. Indeed, the expression 'risk-adjusted return' is associated with contemporary portfolio theory (the risk being referenced is, essentially, volatility risk and does not cover, for example, systemic risk). While sometimes used in discussing compliance with legal duties, the expression is rarely used in articulating the duties themselves, which tend to be more neutrally drafted; in other words, legal rules requiring investors to seek to achieve a financial return do not necessarily require investors to do so by applying modern portfolio theory even if language used by some market participants to describe investor duties might be taken to suggest otherwise.

THE EXTENT TO WHICH THE LAW REQUIRES OR PERMITS IFSI

242 If existing market features do create a risk that sustainability factors are given insufficient weight in investors' decisions, investors need to understand the issue and ensure that they nonetheless comply with their duties. There may also be a role for policymakers (Part C.2).

243 In the many discussions we have had with market professionals while working on this project, it has frequently been suggested that there are certain market features that result in sustainability factors being underweighted. We are not investment professionals and this is a legal project, so the following is not based on an in-depth review of market practice or investment theory and our conclusions are necessarily somewhat tentative. However, for the reasons outlined below, it does seem plausible that the market features described do create a risk that sustainability factors are not given sufficient weight in by investors in practice. That said, we anticipate that there will be a range of views on this topic.

244 If there is such a risk, the issue merits further attention from policymakers, investment theorists, and asset owners, investment managers and their respective consultants (including lawyers) to ensure that institutional investment is achieving its goals and that those taking investment decisions comply with their duties. We have been told on a number of occasions while working on this project that the risk of sustainability factors not receiving sufficient weight in the investment process results from 'modern portfolio theory'. The assumptions behind current portfolio theory may indeed be involved and need more scrutiny. However, a more complex interplay of informational, behavioural, commercial and legal factors seems to be at work.

245 The following outlines potential issues that have been drawn to our attention. However, we start with a brief look at the critical connection between investment objectives and the weight given to any factor in pursuing them.

4.1 Relationship between investment objectives and the weight given to sustainability factors

246 The idea of a particular factor not receiving sufficient weight in a decision only makes sense by reference to the objective of the person making the decision – their *goal* or *purpose*. This determines which factors are relevant to the decision and their degree of relevance. A person visiting a shop to buy breakfast cereal does not need to check out the cheese counter to come to a decision. However, they might consider the contents label on different cereal boxes, as well as price, to select the cereal that most suits their goals. For some, the sugar content or whether the ingredients are organic may be more relevant to their objective than for others. A person may not make a good decision if a box does not give them the necessary information.

247 This report has identified two broad sets of objectives that investors might be pursuing when investing for sustainability impact: first, IFSI could be a step in delivering a financial return (instrumental IFSI) and, secondly, an investor could be seeking to realise a sustainability impact goal partly for its own sake (ultimate ends IFSI). The following section principally considers whether market features create a risk in relation to the first: taking in isolation legal duties to secure a financial return, could market features lead to sustainability factors being underweighted in discharging those duties including, for example, duties to treat fairly different cohorts of beneficiaries some with shorter and others with longer-term interests in the relevant investment arrangement? In particular, the issue is:

(a) whether certain market features result in the near-term financial performance of investment portfolios being prioritised over longer-term performance (on the understanding that it is in the longer-term that sustainability factors are more likely to have a material impact on financial performance); and

(b) whether these market features could also limit attention to sustainability factors which could have an impact within a shorter timeframe, by narrowing the range of factors that are commonly taken into account in investment decisions.

248 If market features do create these risks, it is reasonable to suppose that they may also militate against the exercise of any discretion which may exist to engage in ultimate ends IFSI.

249 The market features concerned bear most directly on investors' use of investment powers. However, they are also relevant

4. Do existing market features create a risk that sustainability factors are given insufficient weight by investors in complying with legal duties?

THE EXTENT TO WHICH THE LAW REQUIRES OR PERMITS IFSI

to investors' decisions to address sustainability issues in their stewardship and public policy activities. For example, if investors are unaware of the potential impact of sustainability factors they cannot address it. Further, improved sustainability outcomes through stewardship and policy activity are only likely to be achieved over the long-term, and a short-term focus is not well aligned with this.

4.2 Market features and the risk that sustainability factors are given insufficient weight in complying with legal duties

250 A number of market features are considered individually below, but they are inter-related.

4.2.1 Transparency and uncertainty about potential impact of sustainability factors on investee enterprises

251 Most investors are likely to accept that sustainability factors can be a source of risk both to the financial performance of particular investee enterprises and to the systems on which those enterprises and whole markets depend. However, it is not possible for investors to assess and address sustainability risks and opportunities without adequate reliable information both as to the nature and severity of the risks for the system as a whole and in relation to individual portfolio investments. There are various interlocking issues here including (a) whether the information is available but not being adequately disclosed, (b) the possibility that relevant data may not yet exist and needs to be generated, (c) the fact that some sustainability-related risks do not lend themselves to easy quantification, and (d) the fact that the long-term consequences of some risks are not easily foreseeable.

252 Climate change is currently the most obvious and pressing sustainability issue for most investors. Yet, even in relation to this widely recognised risk, it is acknowledged that markets currently have insufficient information either as to the nature and severity of the ultimate risks if carbon emissions are not reduced as agreed in the Paris Agreement or as to the financial and business implications of the transition to carbon neutrality.[116] For example, there may be ways of predicting how sea levels could rise at certain degrees of global warming, but the extent of that warming may not be easily predictable and the secondary implications, such as those resulting from potential social disruption and 'climate migration' are even less so. However, climate change is not the only sustainability risk.

253 In recognition of the need for better information, as noted in Part A.2, considerable work is underway to enhance and standardise corporate disclosure on sustainability issues more broadly. However, this will not necessarily address the kind of uncertainties mentioned above. In any event, as things stand, without adequate information or consensus on the sustainability risks confronted by investee enterprises and their strategy for responding, it is reasonable to suppose that sustainability factors are not receiving sufficient attention from investors or those providing services and advice to them and are not reflected adequately, or at all, in share prices. The issue concerns the quality and usefulness of available information (including the ability to compare data from individual investee companies) as much as or more than its quantity.

4.2.2 Indices and benchmarks

254 If the price of individual investments systematically takes insufficient account of sustainability factors, then those factors will also not be fully reflected in the value and performance of indices in which those investments appear. There are potentially strong incentives on investors to 'follow the market's lead', as represented by these indices, creating a risk that sustainability factors will also therefore receive insufficient attention in the management of their portfolios.

255 The level of an investment index is a number showing the variation in the market prices/values of some specified set of investments or other financial factors since a chosen 'base' period. Traditionally, the purpose of indices was to provide a guide to the economic performance of and sentiment in a particular market or economic sector. The selection of index constituents is typically based on pre-determined rules.

256 Indices are commonly used as benchmarks in the investment sector. Benchmarks perform an additional function as a point of reference for performance measurement and evaluation, in particular, in assessing progress towards achieving a given investment goal or objective.[117]

4. Do existing market features create a risk that sustainability factors are given insufficient weight by investors in complying with legal duties?

THE EXTENT TO WHICH THE LAW REQUIRES OR PERMITS IFSI

257 Consequently, if an index measures the price-based performance of a market or sector in which the market prices of index constituents do not adequately reflect the exposure of the relevant businesses to sustainability factors, and that index is used as a portfolio benchmark, the benchmark will provide a basis for action and measurement that also does not give sufficient weight to sustainability factors. If, as a result, the portfolio comes to reflect the composition of the index, the return on the portfolio will have a similar exposure to the risks created by sustainability factors so that it is potentially unsustainable over the longer term.

258 Indices and benchmarks are extremely important in investment practice, particularly in decisions on portfolio composition. Modern portfolio theory (see further below) has had a major influence on this. However, they would have a role in investment practice even without that. The potential implications for how sustainability factors are taken into account in the context of two of the main functions of indices and benchmarks are as follows.

(a) **Passive investment management**. Indices provide a basis for running passive investment portfolios, investing in the index constituents in the proportions represented in the relevant index. Consequently, an investor will be financially exposed to sustainability risks where its portfolio tracks an index that does not adequately reflect those risks. Whether that also creates legal risks for the investor will depend on the nature of its legal duties. However, there could be legal risk even for those obliged to do no more than track the relevant index unless they have made clear to beneficiaries that this means the beneficiaries have a financial exposure to sustainability risks. While index tracking leaves an investor with little or no discretion to use its investment powers to pursue sustainability impact goals, it does not prevent the investor from undertaking stewardship or public policy engagement, although the extent of portfolio diversification involved may affect incentives to do so (see Box 6).

(b) **Active investment management**. Benchmarks have a key role in active portfolio construction and performance measurement. Where the benchmark index does not adequately reflect the potential impact of sustainability factors, those factors may also, therefore, not receive sufficient weight in the way the portfolio is managed, at least in relation to investment decision-making: effectively, it creates a pressure to over-weight short-term profit-taking even though the crystallisation of sustainability risks could result in short-term gains proving to be illusory. However, again, an investor can still engage in sustainability-related stewardship or public policy work to address the risk. Depending on the precise approach of the relevant investor, the benchmarks it adopts or against which its performance is measured may effectively function as a starting point for portfolio selection. Benchmarks are also used as a way of targeting and assessing the level of 'active risk' an investor is undertaking (ie broadly, the additional risk of diverging from the benchmark in the interests of outperforming the benchmark). As a result, risk measurement in an investment context can become too closely associated with the risk of not performing against benchmarks rather than the risk of not providing an appropriate investment return for beneficiaries, with insufficient regard to the role of sustainability factors in that.

259 Consequently, unless it is possible to conclude that market prices/values underlying a benchmark index already take sufficient account of the impact of relevant sustainability factors, there is a weakness in one of the investor's key tools to assist it in realising its objectives. Especially for investors with longer-term investment objectives, the idea that the most commonly used benchmarks do adequately factor in relevant sustainability risks requires one to believe that the market in all material respects perfectly anticipates the nature and extent of the risks. Given the problems highlighted above with the quality and usefulness of sustainability related information and fundamental uncertainties, that does not seem a reasonable belief. Yet, for some of the reasons highlighted below, market factors and portfolio theory may nonetheless create an environment in which investors are reluctant to diverge from benchmarks.

4. Do existing market features create a risk that sustainability factors are given insufficient weight by investors in complying with legal duties?

THE EXTENT TO WHICH THE LAW REQUIRES OR PERMITS IFSI

260 The level of *diversification* involved where portfolios are closely aligned with mainstream market benchmarks could reduce investor attention to sustainability factors in other ways. This is considered further in Box 6.

4.2.3 Investment time horizons and performance measurement periods

261 The longer the period by reference to which a portfolio is being managed, the more likely it is that sustainability factors will be relevant in some way. Yet it is often suggested that there is an issue of short-termism in investment markets.[118] Focus on short-term investment performance could be driven by a combination of factors.

262 For example, in some cases legal duties, some reflecting structural factors, may prioritise investment with a shorter-term focus:

(a) where there is an extreme adverse market event, investors may conclude that they are legally required to take short-term decisions to protect the value of their portfolio whatever their overarching investment time-horizon;

(b) investment objectives may be framed in ways that emphasise shorter-term investment performance; for example, the investment objective of a mutual fund could be referenced to a particular market benchmark (as to which, see Section 4.2.2 above);

(c) investors, such as pension funds, with duties to beneficiaries in the long-term are likely also to have beneficiaries with shorter-term financial needs which they are also under a legal duty to meet; as noted in Part B.2, Box 1 they may need to perform a challenging balancing act;

(d) where an investor with longer-term financial investment objectives appoints an investment manager, it is unlikely as a legal matter to be able to bind itself to use that manager throughout that longer term, regardless of its performance. It is usual to appoint for much shorter periods. This and the other legal terms of the manager's appointment are likely to mean that the manager's investment objective and the periods by reference to which its investment performance will be measured are shorter than those that apply to the investor (see further on the challenges created by intermediation, below);[119] and

(e) in some cases, investment restrictions that apply to asset owners, for example, that are designed to ensure liquidity so that beneficiary entitlements can be paid when due or to limit investment management expenses, may mean it is difficult to make investments that are illiquid in the short-to-medium term or which may also involve higher levels of management expenses.[120]

263 Further, even where an investor has long-term financial objectives, it may not be easy in practice to assess its performance in progressing towards them, as compared with considering its shorter-term historic performance. Unless short-term under-performance can be explained by reference to investments that will pay off in the longer-term (and which could not have been secured but for the decisions that have led to the shorter-term under-performance) how can one be confident that short-term under-performance is not a sign of mismanagement?

264 In addition, simply as a matter of human nature, an investor's performance in generating a financial return will inevitably be compared with the performance of relevant investment markets, other investors and similar funds, even if there is little obvious reason to do so considered from the perspective of its long-term investment objectives. Regardless of their legal duties, the individuals or firms responsible for managing a portfolio may therefore fear that their appointment will be terminated where performance falls short by reference to these shorter-term criteria. This would give them an incentive not to stray too far from common performance benchmarks and approaches adopted by other investors, diverting attention from the fundamental value of enterprises and sectors in which they invest.

4.2.4 The challenges created by intermediation in the investment process

265 The difference between asset owners' overarching investment objectives and the shorter-term investment objectives they have to set for their investment managers was highlighted above (Section 4.2.3). Investment managers are generally appointed for periods that are shorter than

4. Do existing market features create a risk that sustainability factors are given insufficient weight by investors in complying with legal duties?

THE EXTENT TO WHICH THE LAW REQUIRES OR PERMITS IFSI

the overarching financial objectives of the asset owner and, consequently, their performance is assessed by reference to that shorter timeframe and periodically during the term of their appointment.

266 It seems inevitable that these shorter time horizons could tend to result in managers focusing on their short-term performance relative to other managers, rather than working to increase the long-term value of portfolio assets. In addition, investment managers' fees are often set as a percentage of the value from time-to-time of the assets under their management. This could incentivise them not to select assets they believe may underperform in the short term even if there is potential for longer-term upside consistent with their client's long-term investment horizon.

267 Likewise, there is an argument that investment managers may not be sufficiently incentivised to undertake stewardship or policy engagement if the benefits (in terms of portfolio value enhancement or protection) are likely to be realised long after the period of their appointment. Investment managers may also face client conflict issues in relation to stewardship, in particular if different clients are best served by differing engagement approaches.

268 That said, investment managers generally aspire to be reappointed so that the aggregate period of their appointment could effectively be long-term. Further, we are told by asset owners that the quality of an investment manager's sustainability stewardship and wider engagement activities is emerging as a distinguishing competitive feature in the award of future mandates as more clients recognise the need for this capability.

269 For these reasons, asset owners should recognise that investment managers are unlikely to be naturally focused on the longer term, and so will need to take extra care to ensure that the terms of the manager's appointment (or, where the manager's expertise is accessed by investment in a mutual fund, the way the fund is operated), the way the relationship runs in practice and the commercial incentives involved are, so far as possible, aligned with the asset owner's financial objectives and legal duties. In addition to the manager's expertise in investment selection, asset owners may to need to consider its stewardship and policy engagement capacity where these are needed in pursuing the asset owner's investment objectives. Asset owners should recognise that the mismatch in time horizons between them and their investment managers has the potential to create a structural obstacle (which asset owners need to work to overcome) to effectively addressing systemic risks of a sort that could impact portfolio performance in the long term.

4.2.5 Short-term trading activity

270 Even if markets were perfectly informed about sustainability exposures, short-term investment prices and their volatility are not necessarily the result of fundamental assessments of enterprise value.

271 A significant portion of the turnover in public investment markets involves short-term trading. There are conflicting views about whether this activity results in a truer valuation of the underlying enterprises, but it is doubtful that much of it is focused on longer-term issues such as sustainability factors.

272 Nonetheless, prices formed in this way influence wider investment activity, for example, because they are reflected in common portfolio benchmarks (see section 4.2.2 above) or price and volatility data is used in portfolio modelling (see section 4.2.6 below). Investors of the sort covered by this project would not routinely engage in short-term trading. It is nonetheless reasonable to suppose that it could drive a greater focus on shorter-term factors.[121]

4.2.6 Portfolio theory

273 Prevailing portfolio theory has tended to focus attention on managing risk and return at investment portfolio level, structuring the portfolio as a whole to realise the most efficient 'risk-adjusted return'. This is fundamentally important for investors. Nonetheless, in addressing risk at a portfolio level there is a question as to whether it could result in insufficient attention to risks posed at individual enterprise level by sustainability factors and to the systemic risks to which a portfolio is exposed.

4. Do existing market features create a risk that sustainability factors are given insufficient weight by investors in complying with legal duties?

THE EXTENT TO WHICH THE LAW REQUIRES OR PERMITS IFSI

274 Current investment practice and risk management has been heavily influenced by various models and theories, which can loosely be described as 'portfolio theory' or 'modern portfolio theory'.[122] The expression 'modern portfolio theory' harks back to the work of Harry Markowitz, the key insight of which has been that portfolio diversification can (as long as the portfolio constituents are not correlated) reduce investment risk at portfolio level without reducing the expected investment return.[123]

275 Portfolio theory has since built out considerably from that. Elements of contemporary portfolio theory include:

(a) the 'efficient market hypothesis', which is based on the common-sense observation that investors tend to act on available information so that it is reflected in the price of securities, but which, in some forms, takes that further to propose that market prices reflect all relevant information (with the implication that it is difficult for an investor to outperform 'the market' consistently over the longer-term);[124]

(b) the 'capital asset pricing model' or 'CAPM', which seeks to predict, using a formula, the relationship between the risk of an asset and its likely return, allowing an investor to assess whether the return it has achieved is appropriate given the risk undertaken (risk being taken as the volatility of the returns on an investment relative to those of other investments in the market, the greater the price variations the more risky the investment); and

(c) 'value at risk', which seeks to assess the loss that could be incurred upon the occurrence of an event that could result in a material change in investment prices.

276 Applied discerningly, these sophisticated theories and models provide a powerful set of investment tools. This helps to account for their widespread use. However, they also suffer from well-known limitations, some of which were brutally exposed by the 2008 financial crisis.[125] They therefore need handling with care. Some of those we have spoken to over the course of the project have suggested that market operators are not always doing that.[126] If so, this is potentially important for the subject of this report in particular, if it leads to sustainability factors being underweighted in investment decisions in a way that is inconsistent with discharging legal duties. Limitations that seem relevant to that include:

(a) the assumption that all investors are 'financial utility maximisers', rationally seeking to earn a given financial return at the lowest possible risk to themselves, with little interest in the wider impacts of their investments (for example, on sustainability factors). At least as regards their rationality, and probably their motivations more generally (see Part A.4), this is clearly not always the case;

(b) the equation of the 'risk' of an investment with the volatility of its return relative to the market:

(i) volatility risk tells us little of the impending risk to investment performance of sustainability factors. Indeed, it is likely that much volatility can be accounted for by market sentiment, which may have little to do with the underlying value of investee enterprises (so that, to some extent, it is a measure of emotion more than enterprise or performance risk);

(ii) the use of volatility also makes it necessary to identify markets by reference to which volatility and investment success can be measured (so giving impetus to benchmark usage based on market capitalisation-weighted indices, as to which, see above).[127] It also then carries a further possible implication: that 'success' for an investor (ie the investor's objective) should be to outperform the benchmark-defined market when compared with other investors taking similar levels of risk (or at least track the market) rather than being based on what is needed to achieve the investment outcomes that the investor may be legally obliged to target in the interests of beneficiaries and which may not be met if investee enterprises are exposed to, and are not addressing, wider sustainability risks;

B. THE EXTENT TO WHICH THE LAW REQUIRES OR PERMITS IFSI

4. Do existing market features create a risk that sustainability factors are given insufficient weight by investors in complying with legal duties?

THE EXTENT TO WHICH THE LAW REQUIRES OR PERMITS IFSI

(c) an over-dependence on the historic price and volatility of investments, so that modern portfolio theory may not cope well with new or unusual factors such as long-term sustainability risks, a shortcoming highlighted by the 2008 financial crisis and climate change;

(d) the fact that, even if it were correct that current market prices reflect all available information, it is unlikely that all relevant sustainability information is currently available to the market; and

(e) the fact that modern portfolio theory does not address systemic (or 'non-diversifiable') risk unless the relevant risks have been reflected in market prices – in other words, MPT helps in addressing the impact on a portfolio of risk that is idiosyncratic (ie specific to investment in an individual enterprise) and can be 'diversified away', but does not help in managing the risks presented by exposure to economic systems as a whole from factors like environmental and social sustainability. It essentially assumes that these are beyond the control of investors.

277 The added impetus given by CAPM to the use of mainstream indices and benchmarks in the investment process helps to embed dynamics of the sort already discussed in relation to indices and benchmarks (see Section 4.2.2 above). The assumption underlying the efficient market hypothesis has also underpinned the move towards seeking exposure to those benchmarks through passive investing (on the basis that active managers assessing fundamental enterprise value, including potentially sustainability risk, are supposedly unlikely consistently to 'beat the market').

278 In consequence, it seems likely that these models and theories could result in insufficient attention to:

(a) sustainability factors that could be relevant to short- or long-term investment performance at enterprise level (for example, because those factors are incorrectly assumed already to be reflected in the price, because they are entirely novel and are therefore not reflected in past performance information, or because they can be 'diversified away'); and

(b) systemic, non-diversifiable, risk which due to its system-wide nature could do material damage across an investment portfolio and to all portfolios invested in a given market (since the models do not address this kind of risk).

279 Some of the growth in sustainable investing can be seen as an attempt to address the first of these especially. Common forms of sustainable/responsible investing involving, essentially, under- or overweighting investments in enterprises based on their sustainability profile may help to address sustainability risks at investee enterprise level even if they are not deliberately deployed to pursue sustainability impact goals (see Part A.1.4).

280 As regards the second, systemic factors are potentially some of the most important determinants of investment return and, as indicated, modern portfolio theory assumes that these are not manageable risks. Reliance purely on portfolio theory may therefore lead investors to fail to recognise the possibility of engaging in instrumental IFSI (in particular, through stewardship and public policy work, see Box 6) to address risks of this sort, so as to discharge investment duties. Widespread over-reliance on modern portfolio theory could, ironically, therefore contribute to the materialisation, or at least exacerbation, of the very systemic risks that it assumes cannot be managed by discouraging investors from attempting to address wider environmental and social sustainability factors that will ultimately damage financial performance.[128] Clearly, systemic risks are system-wide and cannot necessarily be addressed exclusively by investors or by individual investors acting alone (see Part A.2, Box 6). However, in practice, a growing number of investors appear to accept that investment processes can be part of the solution and are engaging in collective action to address some of these risks (see Part B.2, Box 2).

B. THE EXTENT TO WHICH THE LAW REQUIRES OR PERMITS IFSI

4. Do existing market features create a risk that sustainability factors are given insufficient weight by investors in complying with legal duties?

THE EXTENT TO WHICH THE LAW REQUIRES OR PERMITS IFSI

Box 6

Portfolio diversification, stewardship and public policy engagement

Portfolio diversification is an important way of avoiding over-exposure to the risk posed by investing in any single enterprise – ie firm-specific risk. Diversifiable risk is risk that can be managed or eliminated in this way. Non-diversifiable risk refers to systemic risk.[129] Addressing diversifiable risk therefore has important implications for investment selection within a portfolio. Indeed, the most diversified portfolios are those that track the composition of broad-based investment indices, so that the portfolio is comprised of their multiple constituent investments.

However, diversification may also influence investors' attitudes towards stewardship activity, especially if it rests on the assumption that diversifiable risk is within the control of investors while non-diversifiable risk is not. The more diversified a portfolio, the less logical it may be to engage in stewardship to secure enterprise specific value protection or enhancement. Diversification is specifically intended to minimise idiosyncratic impacts on portfolio performance. In addition, the greater the number of investee enterprises, the more time-consuming and expensive is the challenge of achieving effective engagement. These considerations are relevant in deciding what legal duties require or discretions permit.

Yet diversified portfolios remain exposed to non-diversifiable risks, for example where declining environmental or social sustainability undermines the performance of whole markets or sectors. Even for investors with diversified portfolios, therefore, they may still need to consider whether to undertake stewardship, and indeed policy engagement, with a view to addressing systemic risks of this sort. Indeed, for investors who are likely to hold diversified portfolios in the long-term, the question is particularly pressing since these are likely to be the main ways in which they may be able to make a difference.[130] Since systemic change is largely beyond the control of any single actor, the possibility of collaborating with other investors with the same goals is also an important consideration in this (see Part A.2, Box 6 and Part B.2, Box 2).

In view of this, it is unsurprising that some of the world's largest passive investors have become active in their stewardship activities. Since the portion of global AuM managed by these investors is already high and looks set to grow further, they have considerable potential influence.

B. THE EXTENT TO WHICH THE LAW REQUIRES OR PERMITS IFSI

4. **Do existing market features create a risk that sustainability factors are given insufficient weight by investors in complying with legal duties?**

THE EXTENT TO WHICH THE LAW REQUIRES OR PERMITS IFSI

1 As set out in its founding treaties, the EU is competent to adopt legally binding rules to exercise its competences, which also cover the matters relevant for this report. The EU is therefore treated as a jurisdiction for purposes of this report.

2 There are some exceptions. For example, Brazilian investment funds take the form of a 'condominium' of assets and, therefore, have no legal personality. All investment powers and other powers related to the exercise of ownership rights connected with portfolio assets are exercised by the investment manager, as provided for by regulation. The fund's by-laws and the investment management agreement can only limit those powers, not grant them, and often do, eg where the fund's objective is defined by reference to a particular sort of financial return for investors.

3 See, for example, *Institutional Investors as Owners: Who They Are and What They Do?*, OECD, 2013, 9.

4 Personal pension plans are frequently structured as insurance products. For the position in relation to these, see discussion on insurers.

5 *Global Pension Fund Assets Study*, Thinking Ahead Institute, Willis Towers Watson, 2021, 6.

6 *2021 Investment Company Fact Book: A Review of Trends and Activities in the Investment Company Industry*, Investment Company Institute, 61st edn, 2021, 7. Since a portion of the units in these funds are held by pension funds and insurance undertakings, there is likely to be some double counting as between this figure and those for pensions and insurance undertakings.

7 For example, at the end of 2017, pension funds and insurance companies held 41.7 per cent of European investment fund units (*Ownership of Investment Funds in Europe*, Efama, 2019, 12 Fig. 3.2).

8 Some types of life insurance product, such as term life policies, simply provide for the payment of a certain amount on death during the term of the policy, and do not constitute a vehicle for savings or investment.

9 *Global Monitoring Report on Non-Bank Financial Intermediation*, Financial Stability Board, 2020, 13. Again, a portion of these assets are managed in connection with life contracts entered into with pension funds. Further, in some cases, assets held in connection with unit-linked insurance policies are invested in mutual funds. There is therefore potential for double counting.

10 See, for example *Investment Consultants Market Investigation, Final Report*, UK Competition and Markets Authority, 2018, 35, 41; Scott D. Stewart, Christopher D. Piros and Jeffrey C. Heisler, *Portfolio Management: Theory and Practice* (Willey 2019), 270.

11 *Investment Consultants Market Investigation, Final Report*, UK Competition and Markets Authority, 2018, 40 f.

12 For example, it has been estimated that in the UK investment consultants advise on approximately £1.6tn of pension scheme assets and fiduciary managers manage approximately £110bn of UK pension scheme AuM (Competition and Markets Authority, *Final Report, Investment Consultants Market Investigation*, 2018, 34).

13 *Investment Consultants Market Investigation, Final Report*, UK Competition and Markets Authority, 2018, 48.

14 UK, France and the Netherlands are much influenced by the EU regulations, but there are still material local differences.

15 Examples include South Africa, after the end of apartheid and the subsequent Broad-Based Black Economic Empowerment legislation; China and its concept of 'ecological civilisation', developed in the mid-1980s and anchored in Chinese tradition; and the US where changing policy towards certain sustainability issues, such as the Paris Climate Agreement, influences the context in which investment powers are exercised.

16 *Freshfields Report*,13.

17 *Balancing Act: Managing Risk across Multiple Time Horizons*, FCLTGlobal, December 2018.

18 For example, an investor might perhaps seek to maintain a portfolio comprised of a mixture of investments focused on the short and long term, pursuing what is effectively a form of long/short-term diversification. Similar to the way risk and rewards are balanced in a portfolio in seeking to find an optimal relationship between the two depending upon the investor's need for a financial return and appetite for risk, so a portfolio and broader investment strategy might also be diversified among short- and long-term rewards and risks.

19 For example, the Sustainable Development Investments Asset Owner Platform established by APG, AustralianSuper, British Columbia Investment Management and PGGM during 2020 (see https://www.pggm.nl/en/press/us-1-trillion-asset-owner-platform-launches-solution-for-identifying-sdg-investments/, accessed 29 January 2021).

20 Gaia Balp and Giovanni Strampelli, *Institutional Investor Collective Engagements: Non-Activist Cooperation vs Activist Wolf Packs*, Ohio State Business Law Journal, 2020, Vol 14(2), 135.

21 *Unhedgeable Risk*, Cambridge Institute for Sustainability Leadership 2015. More recently, see *The Inevitable Policy Response*, (available at https://www.unpri.org/inevitable-policy-response/what-is-the-inevitable-policy-response/4787, article, accessed 4 May 2021).

22 See, for example, Elroy Dimson, Oğuzhan Karakaş Xi Li, *Coordinated Engagements*, ECGI Finance Working Paper No. 721/2021, January 2021; Balp and Strampelli, *Institutional Investor Collective Engagements: Non-Activist Cooperation vs Activist Wolf Packs*.

23 See https://globalinvestorcoalition.org

24 See https://www.ceres.org

25 See https://www.investorforum.org.uk/wp-content/uploads/securepdfs/2019/11/The-case-for-collective-engagement-211119.pdf (accessed 2 January 2021)

26 https://www.climateaction100.org

27 https://www.unepfi.org/net-zero-alliance/

28 https://www.netzeroassetmanagers.org

29 https://investorsforhumanrights.org

30 https://www.fairr.org

31 https://gisdalliance.org

32 https://www.imvoconvenanten.nl/en/pension-funds

33 See https://d8g8t13e9vf2o.cloudfront.net/Uploads/r/q/s/investorstatementondeforestationandforestfiresintheamazon_29_oct_2019_665598.pdf coordinated by the PRI and Ceres, accessed 21 January 2021.

34 https://www.mirova.com/en/news/European-investors-rally-around-biodiversity, accessed 2 January 2021.

35 https://amrinvestoraction.org, accessed 29 January 2021.

36 https://www.churchofengland.org/about/leadership-and-governance/church-england-pensions-board/old-pensions-board-investments-0

37 https://investorsforhumanrights.org/sites/default/files/attachments/2020-04/The%20Investor%20Case%20for%20mHRDD%20-%20FINAL_3.pdf, accessed 2 January 2021.

38 See also Gillian Tett, 'ESG investors are taking on Big Tech', *Financial Times*, 19 December 2019.

39 See, for example, a recent legal action in Australia taken by a pension fund beneficiary against the pension fund (*Mark McVeigh v Retail Employees Superannuation Pty Ltd* CAN 001 987 739 (NSD 1333/2018)). In a public statement about the settlement, the pension fund acknowledged that, 'Climate change is a material, direct and current financial risk to the superannuation fund across many risk categories, including investment, market, reputational, strategic, governance and third-party risks. Accordingly, Rest, as a superannuation trustee, considers that it is important to actively identify and manage these issues…' (see https://rest.com.au/why-rest/about-rest/news/rest-reaches-settlement-with-mark-mcveigh, accessed 10 November 2020).

40 For example, the UK initiative, Make My Money Matter (https://makemymoneymatter.co.uk/) and in Germany, My Fair Money (https://www.meinfairmögen.de/infomaterial).

41 Quantitative investment is investment driven by quantitative rather than a qualitative assessment of individual investments. It uses statistical tools to assess the behaviour of the price of investments over time. This information is used to create a set of rules for identifying investments that have an above average likelihood of outperforming a given benchmark. The portfolio is then invested and periodically rebalanced in a manner that reflects those rules.

Algorithmic trading is computerised trading where trades are entered into using a programme that follows a set of pre-defined rules or instructions based on mathematical models or other factors such as the price, trade size or timing of transactions. While much algorithmic trading is 'high-frequency trading' (where the trading strategy involves dealing rapidly at scale to profit from small movements in the price of investments) it can also be used in executing longer-term investment strategies. By contrast, quantitative trading is not necessarily automated. It nonetheless involves transacting on the basis of various quantitative (as compared with qualitative) criteria.

42 High-frequency trading strategies may leave little scope for addressing sustainability concerns.

43 For example, in Australia, in 2019, a specific statutory duty was introduced requiring an APRA-regulated pension trust to 'promote the financial interests of beneficiaries' (Treasury Laws Amendment (Improving Accountability and Member Outcomes in Superannuation Measures No. 1) Act 2019, Section 52(12). In Canada, The Pensions Benefits Standards Act (British Columbia), SBC 2012, c 30, s 60 (1) refers to 'financial best interest'.

44 In the US, most state laws contain language that require trustees of public pension funds to act in the "sole interest" of the beneficiaries and a similar rule applies to trustees of private pension and retirement plans governed by the Employee Retirement Income Security Act of 1974 ("ERISA"). Under this rule, the trustee "has a duty to the beneficiaries not to be influenced by the interest of any third person or motives other than the accomplishment of the purposes

THE EXTENT TO WHICH THE LAW REQUIRES OR PERMITS IFSI

of the trust". "Interest" has been interpreted by the US Supreme Court in the context of ERISA plans to mean financial interests. see *Fifth Third Bancorp v. Dudenhoeffer*, 573 U.S. 409, 420-21 (2014). In Australia, in 2020, draft legislation (Treasury Laws Amendment (Measures for a Later Sitting) Bill 2020: Best Financial Interest Obligation) was released to potentially require superannuation funds to act only in the 'best financial interest' of the beneficiaries.

45 First, the legal concept of a fiduciary duty tends to be associated with common law rather than civil law jurisdictions. That said, civil law jurisdictions generally have legal rules covering analogous situations the purpose of which is broadly similar to fiduciary duties. Second, even in jurisdictions that do have such a concept, not all investment relationships are 'fiduciary'. Third, even where a relationship is fiduciary (the prime case being the relationship between a trustee and beneficiaries of the trust, the legal vehicle often used for pension funds in common law jurisdictions), not all of the duties that attach to the relationship are 'fiduciary duties' even though they may be owed by someone who is a fiduciary.

46 See for example the prudent person principle that applies in Canada (see section 2.2.6 et seq. of the Canada Report) in the Pensions Benefits Act.

47 See for example, the statutory prudent person standard in Canada (see section 2.4.3 et seq Canada Report); in Australia, a director is required to act with a reasonable degree of care and diligence and in the 'best interests' of the company (Subsections 180(1) and 181(1) Corporations Act 2001 Commonwealth). In Brazil, an officer or director is required to fulfil fiduciary duties to the company, including a duty to pursue the company's interest and objectives, provided that the social function is satisfied. In China, a director is required to exercise the professional knowledge, skill and experiences of a prudent person under similar circumstances (Article 9 of the PRC Securities Investment Funds Law, Articles 147 and 149 of the PRC Company Law; Article 25 of the PRC Trust Law; Article 929 of the PRC Civil Code). In Japan, a director is required to perform their duties for a company in a loyal manner (Article 355 of the Companies Act), a duty which is owed to the company. In South Africa a director is required to act in the 'best interests' of the company (Section 76(3) of the Companies Act, 2008). In the UK, a director must act in the way the director considers 'in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole' (Section 172(1) Companies Act 2006). In the US under the 'business judgment rule' a court will uphold the decisions of a director and not second-guess business judgments so long as they are made in good faith, with the care that a reasonably prudent person would use and with the reasonable belief that the director is acting in the 'best interests' of the corporation.

48 For example, see the Australian Supreme court, *Australian Prudential Regulation Authority* (APRA) *v Kelaher* [2019] FCA 1521, [49].

49 For example, in Australia see ASIC's Regulatory Guide 128: Collective Action by Investors, 23 June 2015. In Japan, see section 2 of the "Clarification of Legal Issues Related to the Development of the Japan's Stewardship Code" (accessible via https://www.fsa.go.jp/en/refer/councils/stewardship/20140226.pdf). In South Africa, see the approach to collaboration under CRISA. In the UK, see the approach to collaboration under the Stewardship Code 2020.

50 European Commission Daily News, 13 October 2020, p. 4 (accessible via https://ec.europa.eu/commission/presscorner/api/files/document/print/en/mex_20_1891/MEX_20_1891_EN.pdf).

51 These could include, for example, diminution in income from, or to the market value of, one or more investee companies.

52 CFRF 2020 Guide, Summary chapter 3.

53 Article 1, Item 1 of the Basic Guideline. The Basic Guideline is also applicable to Welfare Pension Insurance scheme run by mutual aid associations; for GPIF, see also 'Mid-term goals' Section 3, Article 7, Provisions 1-2 which are based on the understanding that sustainable growth of investee companies and the market is necessary to increase long-term gain by investing pension reserves.

54 Section 3, Item 12 of the Basic Guideline.

55 For example, in the Netherlands, subject to limited exceptions, financial institutions must take adequate measures to ensure that they do not invest in companies that produce, sell or distribute cluster munitions (Market Abuse (Financial Supervision Act) Decree, Article 21A).

56 See Gabriel Ondetti, *The social function of property, land rights and social welfare in Brazil*. Land Use Policy, Jan. 2016, 29-37, referring to the social function of ownership in Brazil: 'The right of private ownership includes an obligation to use property in ways that contribute to the collective or common good' and owners are 'obligated to refrain from using their property in ways that harm others.'

57 Article 12 of the PRC Insurance Funds Equity Investment Measures.

58 Article 1(1) of the Notice of the China Banking and Insurance Regulatory Commission on Matters concerning the Participation of Insurance Funds in the Long-term Rental Market.

59 Article 4 of Notice of the General Office of the China Banking and Insurance Regulatory Commission on Matters concerning the Investment in Collective Trust Funds with Insurance Funds.

60 Article 10 of the Interim Provisions on the Management of Debt Investment Schemes in Infrastructure Facilities.

61 'Ecological civilization' has been written into China's constitution as the ideological framework for its environmental policies, laws and education. In general, this means a new stage in the development of human civilization after the current industrial civilization, a sum of material and spiritual results to be achieved by mankind following the rule of the harmonious development of man, nature, and society.

62 Articles 86 and 87 of the Code of Corporate Governance of Listed Companies.

63 Broad Based Black Economic Empowerment Act, 1998 and the related Codes of Good Practice.

64 Although there are limited 'hard law' requirements for private entities under B-BBEE legislation, from a commercial perspective, any company wishing to do business in the South African environment must consider and develop its B-BBEE position as, in addition to the pressures from government, an entity that does not have a good B-BBEE rating, or does not strive to improve its B-BBEE rating, may be hampered in the conduct of its day-to-day business with government, organs of state and private sector customers.

65 Regulation 28(2)(c) to the Pension Funds Act 1956.

66 FSCA, Guidance Notice 1 of 2019 on Regulation 28 to the Pension Funds Act 1956.

67 For example, Canada, South Africa, the US, China.

68 In other words, transparency, solvency, liquidity and financial, economic and actuarial balance are ensured, as well as the legal requirements of CMN Resolution No. 4,661/18 and PREVIC Rule No. 6/18 are met.

69 For example, due to liquidity requirements, in may be challenging for an insurer to invest significant amounts in illiquid infrastructure or real estate projects, although some investment in such assets is likely to be possible.

70 Supreme Court of Canada, *BCE Inc. v. 1976 Debentureholders*, [2008] 3 SCR 560 [Debentureholders].

71 Supreme Court of Canada, *Hodgkinson v Simms*, [1994] 3 SCR 377 [Simms], para. 419.

72 Cf. Recital 1-3 of Directive (EU) 2017/828 of 17 May 2017 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement, OJ L 132, 20.5.2017, 1.

73 CRISA Committee, CRISA Code for Responsible Investment in South Africa: 2020 Revision Consultation Draft, (available at: https://cdn.ymaws.com/www.iodsa.co.za/resource/collection/1D7CF73B-B95B-453F-A8E3-D19829D18FBD/CRISA_2.0_Draft_for_public_comment_November2020__00000004_.pdf).

74 See Revised draft CRISA Principle 2 and the practice recommendations thereunder.

75 The FCA has similarly described the purpose of stewardship as to, 'improve market quality and integrity, and help create sustainable, long-term value for clients and beneficiaries. Effective stewardship is also expected to have wider economic, environmental and societal benefits.' (*Building a regulatory framework for effective stewardship*, FCA, Feedback Statement FS19/7, 2019, para. 1.1).

76 Principle 10, *The UK Stewardship Code 2020*, Financial Reporting Council, 2020, 19.

77 Guidance 1-1 regarding Principle 1 of the Code.

78 Guidance 4-5 regarding Principle 4 of the Stewardship Code (accessible via https://www.fsa.go.jp/en/refer/councils/stewardship/20200324/01.pdf).

79 As regards mutual funds, BlackRock, State Street Global Advisors and Vanguard Group are among the most significant in the US, both in terms of size of investments and stewardship influence. Each company releases stewardship reports, detailing its respective focus and efforts on stewardship with companies. BlackRock has been vocal about its view that sustainability considerations are inseparable from its role as a fiduciary to its clients' assets due to BlackRock's view that these issues drive long-term sustainable performance. State Street has declared that it believes stewardship is a fiduciary responsibility and one of the ways State Street can add value to portfolio companies and clients. Vanguard disclosed that it raised relevant environmental and social issues at companies across a variety of sectors and regularly asks companies how the company's sustainability strategy integrates with corporate strategy. These institutions link sustainability objectives to improved economic return (see US Report for details).

80 See Section 3, Article 7.1 of the Mid Term Goals.

81 The Australian analysis considers registered and managed investment schemes and listed investment companies.

82 Anecdotally, the hearings conducted by the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry were seen as contributing to severe reputational damage for Australia's major banks, and their subsidiaries that are APRA-

THE EXTENT TO WHICH THE LAW REQUIRES OR PERMITS IFSI

regulated trustees, which resulted in significant outflows from their superannuation funds.

83 For example, *Our Partnership for Sustainable Capital Markets*, Government Pension Investment Fund, March 2020 (accessible via https://www.gpif.go.jp/en/investment/Our_Partnership_for_Sustainable_Capital_Markets.pdf).

84 For example, in the UK guidance from The Pensions Regulator for defined contribution trust-based pensions schemes provides that pension trustees should, 'consider how engagement could be used to mitigate systemic, macro-economic risks such as climate change' and pension trustees, 'may need to take action to ensure that [their] policies are being applied; possibly including active public policy engagement, collaborative initiatives and advocacy', TPR, Investment Governance (accessible via https://www.thepensionsregulator.gov.uk/en/trustees/managing-dc-benefits/investment-guide-for-dc-pension-schemes). The guidance goes on to provide an example of language for a trustee's statement of investment principles which sets out in relation to the consideration of climate change as a financial factor: 'given the systemic nature of climate change, we will also seek to discharge our duties by robust engagement with investee companies to encourage alignment with a low carbon economy and with policy-makers and governments to advocate for the same.'

85 See for a recent discussion about whether it is appropriate for APRA-regulated pension trustees to engage in lobbying and policy discussions in relation to climate change risks; Joanna Mather, 'Put members' returns ahead of activism, Samuel tells super funds', *Australian Financial Review* (online), 11 September 2019 (accessible via https://www.afr.com/companies/financial-services/put-members-returns-ahead-of-activism-samuel-tells-super-funds-20190911-p52q7l)..

86 Note that Asset Owners may have multiple Investment Managers, so that this would not necessarily preclude an Asset Owner appointing a manager to invest a portion of its assets in a sustainability impact strategy, such as investments in impact funds, based on diversification benefit.

87 Asset owners sometimes access the investment expertise of an investment manager by acquiring units in a fund managed by that investment manager or by entering into a life policy the supporting assets of which are managed by the investment manager, rather than appointing the manager to manage a segregated portfolio. Where that happens, the asset owner needs to consider whether the interposition of this additional legal structure could adversely impact the ability of the manager to assist it in achieving any sustainability impact goals (since the investment manager will owe its duties to the relevant investment fund or life company and not to the asset owner).

88 For example, in the EU, see ESMA Guidelines on certain aspects of the MiFID II suitability requirements (2018), para. 28, and also statement from the European Commission that firms 'Should ask about their clients' preferences (such as environmental, social and governance factors) and take them into account when assessing the range of financial instruments and insurance products to be recommended.' In South Africa, the voluntary Code for Responsible Investing in South Africa (CRISA) recommends that institutional investors and investment managers (as service providers, 'should incorporate sustainability considerations, including ESG, into its investment analysis and investment activities as part of the delivery of superior risk-adjusted returns to the ultimate beneficiaries' (CRISA, principle 1). In the UK, see the Investment Association's Responsible Investment Framework.

89 See MiFID II Sustainability Delegated Regulation.

90 ESMA, Guidelines on certain aspects of the MiFID II suitability requirements, 6 November 2018, ESMA35-43-1163; para. 28.

91 See MiFID II Sustainability Delegated Regulation.

92 On the related question of lender liability see *Lenders and Investors Environmental Liability – How Much is Too Much*, UNEP Inquiry Working Paper 16/07, April 2016, with a discussion of investor liability at p. 22 et seq.

93 The reason this aspect is relevant is that were potential liability to exist this could provide a justification for instrumental IFSI where the investment portfolio might be exposed to this.

94 For example, Australia, South Africa, the UK.

95 For example, Brazil (generally only for individuals, but exceptions for environmental crimes).

96 For example, in South Africa, such criminal liability is provided for in several laws (Section 49 of the National Environmental Management Act, 1998; Section 151(1) of the National Water Act, 1998; sections 51 and 52 of the National Environmental Management: Air Quality Act, 2004; section 67 of the Hazardous Substances Act, 1973; and the Asbestos Prohibition Regulations).

97 In this context, the concept of (piercing the) corporate veil might also be relevant in many jurisdictions, which generally sets high thresholds for shareholders to assume civil liability for actions of the investee company.

98 The Hague District Court 26 May 2021, *Friends of the Earth and others v. Royal Dutch Shell plc*, (ECLI:NL:RBDHA:2021:5337 and ECLI:NL:RBDHA:2021:5339); (accessible via https://uitspraken.rechtspraak.nl/inziendocument?id=ECLI:NL:RBDHA:2021:5339)

99 Supreme Court of the Netherlands, *Urgenda Foundation v. Government of the Netherlands*, 20 December 2019, ECLI:NL:HR:2019:2006.

100 The NEMA allows a person or group of persons to seek appropriate relief for any breach or threatened breach of statutes concerned with environmental protection or the use of natural resources, whether in their own interest, the public interest, the interest of a class of persons (class actions are recognised in South Africa), or in the interests of the environment itself. Section 32 of NEMA provides for *locus standi* in respect of any breach or threatened breach of any statutory provision concerned with the protection of the environment or the use of natural resources. A similar duty of care applies under the National Water Act, 36 of 1998 in relation to water pollution.

101 These include where a parent company issues '[g]roup guidelines about minimising the environmental impact of inherently dangerous activities […] contain[ing] systemic errors which, when implemented as of course by a particular subsidiary, then cause harm to third parties.'

102 Supreme Court of the United Kingdom, *Caparo Industries PLC v Dickman* [1990], UKHL 2, [1990], 2 AC 605.

103 Where an Asset Owner is involved directly in lending activity (so-called 'shadow banking'), there may be a closer nexus between the Asset Owner (as lender) and the activities of the investee company, which may have a negative sustainability impact. This may increase the possibility of a successful claim in negligence – for example, where a loan for a particular activity which ultimately caused a negative sustainability impact was given negligently, on the basis that it was reasonably foreseeable that the activity for which the loan was granted would result in a negative sustainability impact.

104 In Brazil, administrative liability is enforced by administrative entities through the application of sanctions, such as fines, partial or total suspension of activities, forfeiture or restriction of tax incentives or benefits, and forfeiture or suspension of credit lines made available by official credit establishments. Remediation measures are usually addressed in the civil liability sphere, in which private or public entities could claim for that against the polluter.

105 Directive 2004/35/EC of the European Parliament and the Council of 21 April 2004 on environmental liability with regard to the prevention and remedying of environmental damage, OJ L 143, 56-75.

106 Article 1 ELD. The polluter-pays principle is part of EU primary law, see article 191(2) TFEU: 'Union policy on the environment […] shall be based on the precautionary principle and on the principles that preventive action should be taken, that environmental damage should as a priority be rectified at source and that the polluter should pay.'

107 Articles 6 to 9 Environment Liability Directive.

108 Article 3(3) Environment Liability Directive.

109 Article 2(6) Environment Liability Directive.

110 On the possibility of a broad interpretation of the term 'operator', see the *Study on Environmental Liability of Companies*, May 2020, commissioned by the European Parliament's Policy Department for Citizens' Rights and Constitutional Affairs, 31 et seq.; *Lenders and Investors Environmental Liability – How Much is Too Much*, UNEP Inquiry Working Paper 16/07, April 2016, 6 and 22; Lucas Bergkamp, *The Environmental Liability Directive and Liability of Parent Companies for Damage Caused by Their Subsidiaries*, European Company Law, 2016, Vol. 13(5), 183-190, 184 et seq.

111 Cf. National Contact Point, 'View a closed complaint', 15 July 2020 accessible via https://ausncp.gov.au/complaints/view-closed-complaint).

112 For example, OECD Watch Case Database, *EC and IDI v Australia and New Zealand Banking Group*, 6 October 2014 (accessible via https://www.oecdwatch.org/complaint/ec-and-idi-vs-australia-and-new-zealand-banking-group).

113 OECD Watch Case Database, *Milieudefensie et al. vs. ING*, 5 July 2019 (accessible via https://complaints.oecdwatch.org/cases/Case_543).

114 OECD WatchCase Database, *Milieudefensie et al. vs Rabobank*, 15 January 2016 (accessible via https://www.oecdguidelines.nl/documents /publication/ 2016/1/15/fs-foe-milieudefensie-rabobank).

115 National Contact Point for the OECD Guidelines for Multinational Enterprises, *Milieudefensie et al. vs. ING*, 20 January 2019 (accessible via https://www.oesorichtlijnen.nl/documenten/publicatie/2020/01/20/initial-assesment-friends-of-the-earth-vs.-ing).

116 https://www.fsb-tcfd.org

117 Based on the Oxford English Dictionary definitions.

118 See, for example, the EU Capital Markets Action Plan (Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, A Capital Markets Union for people and businesses – new action plan, European Commission, COM(2020)

THE EXTENT TO WHICH THE LAW REQUIRES OR PERMITS IFSI

590 final, Brussels 24 September 2020) and associated workstreams. In the case of equity investment, see *The Kay Review of UK Equity Markets and Long-Term Decision Making*, Interim Report, February 2012 and Final Report, July 2012 (available at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/31544/12-631-kay-review-of-equity-markets-interim-report.pdf and https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/253454/bis-12-917-kay-review-of-equity-markets-final-report.pdf, accessed 11 December 2020). These reports were focused on the UK equities markets. Steps have been taken in the UK to seek to address the issues identified, but they have not entirely resolved them.

119 For evidence of extent to which time horizons diverge between asset owners and their managers, see *The Investment Enlightenment*, State Street Corporation 2017, especially 21-23.

120 See, for example, *The future for business investment in the age of Covid and the role of financial services*, speech by Andrew Bailey, Governor of the Bank of England, 17 November 2020.

121 See, for example, *The Kay Review of UK Equity Markets and Long-Term Decision Making*.

122 See, for example, *New Frontiers of Risk: Revisiting the 360° Manager*, BNY Mellon, 2014 (available at https://fundspeople-repository.s3.amazonaws.com/system/audio_document/file/122/a8c1035313addf2d.pdf, accessed 8 January 2021); Mark Rubinstein, *Markowitz's 'Portfolio Selection': A Fifty-Year Retrospective*, Journal of Finance, 2002, Vol. 57(3), 1041-1045; Zvi Bodie, Alex Kane and Alan J. Marcus, *Investments*, 12th Edn (McGraw Hill), 275.

123 Starting with Harry Markowitz, *Portfolio Selection*, Journal of Finance 1952, Vol. 7(1), 77-91.

124 Zvi Bodie, Alex Kane and Alan J. Marcus, *Investments*, 12th Edn (McGraw Hill 2021), G-4.

125 In the words of Alan Greenspan, '… the models failed at a time when we needed them most … To me it suddenly seemed that the whole idea of taking the maths as the basis of pricing that system failed. The whole structure of risk evaluation – what they call the 'Harry Markowitz approach' – failed…': Gillian Tett, 'An interview with Alan Greenspan', *Financial Times*, 25 October 2012.

126 We are not the first to pick this up. See, for example, *The Kay Review of UK Equity Markets and Long-Term Decision Making*, 34

127 Portfolio theory takes the 'market portfolio' as minimising the trade-off between risk and return. The market portfolio is the portfolio comprising all assets in the investible universe in which each asset is held in proportion to the market value of the investment (price per share multiplied by the number of shares outstanding) divided by the sum of the market value of all investments in the investible universe: Zvi Bodie, Alex Kane and Alan J. Marcus, *Investments*, 12th Edn (McGraw Hill 2021), 277. However, there is no easy way to represent this for modelling purposes, so broad-based capitalisation weighted indices are used instead.

128 Steve Lydenberg, *Integrating Systemic Risk into Modern Portfolio Theory and Practice*, Journal of Applied Corporate Finance, 2016, Vol 28(2), 56-61.

129 As noted in Part A.1, Box 4, these risks are sometimes referred to as being systematic. However, usage has not been standardised across different disciplines and so in this report we are using the word 'systemic'.

130 Jeffrey N. Gordon, *Systematic Stewardship*, ECGI Law Working Paper No. 566/2021, February 2021.

AREAS FOR LEGAL REFORM

INTRODUCTION

1 We have been asked to comment on options for policymakers[1] wishing to facilitate IFSI.

2 In what follows:

- Section 1 summarises potential impediments to IFSI which policy measures might address; and
- Section 2 outlines possible options.

3 Investment markets are complex. The interconnections between them, the economy, wider society and overarching sustainability outcomes are deep and multi-layered. In addition, each jurisdiction is unique. Because of that, any policy intervention would require situation-specific assessment and consultation going well beyond the scope of this exercise. It is therefore important to emphasise that Section 2 provides no more than a high-level indication of options that may be worth consideration, not proposals. It is also not exhaustive.

Policymakers' goals and the impact on legal rules

4 Where policymakers decide to intervene, they need to make their purpose clear. The importance of clarity about the goal of investment activity has been a key theme in this report. It is similar with policy. The overarching purpose of policy intervention drives a host of subsequent decisions, for example, in selecting areas for intervention and the means for doing so. In many jurisdictions, the purpose of a legal rule will also be taken into account in its judicial or regulatory interpretation, with obligations interpreted in the light of the purpose of the overall legal framework of which they are a part.[2] Hence, the question of why policymakers would want to facilitate IFSI is not just political but has legal implications.

5 We have assumed that policymakers:

- are likely to intervene to help ensure that investment arrangements of the sort covered by this report achieve their financial goals, and to secure financial and economic goals relevant to their jurisdiction; and
- will often be motivated to intervene to achieve overarching sustainability outcomes, consistent with international commitments and legal undertakings and wider social values.

6 This echoes the distinction between instrumental and ultimate ends IFSI made in this report concerning investors' goals. Policy responses to both categories could make use of both sorts of IFSI, except that steps to ensure that investment arrangements meet their financial goals would probably be largely confined to instrumental IFSI.

Why public policy intervention might be needed

7 From an economic perspective, the case for policy intervention tends to be viewed through the lens of 'market failure'. Market failure describes a situation where the result of individuals acting rationally in their financial or material self-interest is not consistent with a rationally optimal outcome for the group. The market failure framework is a powerful and extensively used theoretical tool for deciding when intervention is needed and certainly provides a justification for intervention in relation to some sustainability challenges. However, even markets have their limits; it may not be 'failure' that prevents market delivery of a desirable outcome, but the fact that it is not fully within the capacity of a market to do so. Further, economically optimal outcomes are not always those that societies ultimately value most highly, even where economic wellbeing is integral to those broader goals.

8 Other reasons why policy intervention might be needed include:

- the challenge of balancing the social implications of pursuing or not pursuing overarching sustainability outcomes, since these raise questions of justice that need to be resolved through political processes (for example, should beneficiaries' financial returns ever be put at risk?), see Box 1;
- the systemic nature of many sustainability challenges, making some degree of coordination and cooperation necessary to address them. Coordination can be provided privately and Part B2, Box 2 considered the many collective investor initiatives now under way to do that. However, the other main source is public policy;
- the fact that institutional investors often operate through legal entities (such as companies) that have been constituted and defined by law, the characteristics of which can therefore only be changed by law, and the fact that some benefit from public fiscal or other support, making them, and what activities are within their capacity, partly the product and concern of public policy.[3]

AREAS FOR LEGAL REFORM

Box 1: Institutional investment and core social goals

The issue of whether institutional investors should pursue sustainability impact goals beyond those relevant to discharging investors' duties in relation to financial return (ie instrumental IFSI), raises important policy questions about how to achieve outcomes aligned with core social values.

Institutional investors operate within a wider social context. The question of how far societies should pursue overarching sustainability outcomes, and the role of institutional investors in that, is not one that institutional investors can answer on their own. Ultimately, it requires resolution by those societies through a political process, and justice describes an appropriate balance between varying needs and interests. Whatever the answer, there could be implications, financial and otherwise, for beneficiaries, those within the societies and beyond, and future generations.

Pursuing one set of sustainability goals (for example, tackling water scarcity so as to avoid political and social unrest) may affect how far the goals of others can be realised (for example, those reliant upon the short-term profitability of companies that are causing resource depletion). Both deciding to pursue a given sustainability goal and not doing so, intentionally or by default, have potential consequences. In that sense, there is no 'neutral'.

The role of institutional investors in achieving overarching sustainability goals concerns the relationship between them and their beneficiaries on the one hand, and those in wider society on the other. It potentially involves balancing financial and other socially valued goals. How people are to support themselves financially is itself a sustainability issue, but so is the wider environmental and social state of the world in which they will do so and in which, more widely, people and institutions must operate. It may be possible to place a monetary value on some sustainability outcomes in trying to balance these needs. Certainly, many have financial implications. However, the value of positive sustainability outcomes ultimately rests in the life that depends on them and is not solely financial.

Coming back to the question posed at the start of this report, what is the role or purpose of institutional investment in all this? For example:

- Should investors be expected to contribute to achieving socially valued goals beyond the financial benefits they provide?
- How far should investors be permitted to earn a financial return from economic activities which may not be aligned with overarching sustainability outcomes? For example, should investment be in some way conditional upon an enterprise progressively aligning with overarching sustainability outcomes (and, if so, to what extent and which outcomes), and if that led to reduced financial returns for beneficiaries, would that ever be acceptable?
- Where investors are required or permitted to pursue sustainability impact goals:
  - Should it be subject to prioritising existing financial goals?
  - Would it be acceptable for an investor to incur heightened financial risks to pursue sustainability impact goals, and if so, in what circumstances, what level of risk, and how is the risk to be determined?
  - Which sustainability goals should be covered and how are they to be determined?
  - Are some sustainability goals so important as to justify putting beneficiaries at greater financial risk by requiring investors to pursue them?
- Policymakers wishing investors to pursue sustainability goals as ends in themselves would need to consider facilitating some form of ultimate ends IFSI.

AREAS FOR LEGAL REFORM

1. POTENTIAL IMPEDIMENTS TO IFSI INVESTMENT APPROACHES

9 Before looking at policy options, it is useful to summarise some of the potential impediments to IFSI investment approaches highlighted in this report. That is not least because, as noted, the options in Section 2 are not exhaustive, making it important for policymakers to understand the underlying issues so that they can consider whether there may be additional options. The precise nature of any impediments varies depending on the jurisdiction, the sort of investor and investment activity concerned, and the features of the relevant investment arrangement. However, we have identified some common factors which may prevent or deter investors from adopting IFSI investment approaches. They fall into the following broad groups:

- limits arising from legal rules on investors' powers and duties;
- lack of clarity or understanding about what the law requires or permits;
- possible impediments to collective action;
- lack of 'market infrastructure' for impact goal setting and assessment, including investee companies' disclosure obligations;
- challenges of navigating the relationship between achieving financial return and sustainability impact;
- uncertainty about what beneficiaries want;
- lack of suitable investment opportunities;
- potential for confusion over the substance of different forms of sustainable investing to undermine confidence in IFSI-orientated investment approaches;
- market features that may lead to sustainability factors being underweighted; and
- limited track record for IFSI investment approaches.

1.1 Limits arising from legal rules on investors' powers and duties

10 Legal rules concerning investors' powers and duties may prevent or deter investors in various ways from engaging in IFSI.

1.1.1 Scope of basic duties – are they broad enough to allow for IFSI?

11 Investors' investment duties, and associated duties such as requirements to act in beneficiaries' best interests, are nearly always based on the premise that investors' primary, if not sole, objective is financial. This may lead them to pursue sustainability goals within the scope of instrumental IFSI but leaves little room for ultimate ends IFSI unless the law also requires or permits investors to pursue sustainability impact goals more broadly.[4] See Part B.3.2.1.

12 There has been a growth in legislative, regulatory and industry initiatives that are potentially relevant to whether investors can engage in IFSI. However, they tend not to address specifically the underlying question of whether investors have a legal duty or discretion to do so.

13 For example, a number of recent initiatives concern disclosure of sustainability information by investors, such as their sustainability policies or the sustainability impact of their activities. This may be on the assumption that transparency can help to correct market failures, or that disclosure can 'nudge' investors to pay greater attention to sustainability factors in their investment process. Nudges of this sort can be effective in encouraging change, but do not establish or, in themselves, change, legal duties and discretions. IFSI is not possible if investors' duties and discretions are not broad enough to allow it.

1.1.2 Legal standards do not encourage innovative approaches

14 The standard of care investors must apply in performing their duties is often linked to the standard of a 'reasonable' or 'prudent' investor, which tends to be referenced, at least in part, to accepted market practice (see Part B.3.2.2 and 4, Box 5). Because of that, these standards are inevitably somewhat backward-looking; this could tend to discourage some investors from stepping too far 'out of the box' or taking more innovative approaches.

1.1.3 Prudential regulation and financial reporting

15 The requirements of prudential regulation and financial reporting may create limits, at least in using investment powers to pursue sustainability impact goals. Pension funds and insurance companies

AREAS FOR LEGAL REFORM

in many jurisdictions are subject to strict accounting and valuation rules that can be a significant disincentive to making, or even prevent, investments that are not liquid, or which are difficult to value in the short term.[5]

1.1.4 Existing product terms governing investment powers

16 Particularly with regulated mutual funds and investment-related insurance contracts, the terms of existing arrangements may have been drafted with little reference to the possibility of pursuing sustainability impact goals or that beneficiaries might want this. In principle, product terms can usually be amended to allow for greater flexibility. However, doing so is likely to be onerous, requiring the consent of a significant proportion, if not all, beneficiaries so that product providers are likely to be reluctant to try. See Part B.3.3.1(c).

1.1.5 Cultural and political expectations concerning policy engagement by investors

17 In some jurisdictions, the cultural and political context in which investors operate may lead them to understand their duties in ways that may limit their public policy engagement on sustainability issues. See Part B.3.5.

1.2 Lack of clarity or limited understanding about what the law requires or permits

1.2.1 Uncertainty generally

18 Despite the focus on financial returns noted above, it is clear from our assessment:

- that there are likely to be circumstances in which the law may lead an investor to act in a way that falls within the scope of IFSI to discharge its duties, in particular where this is reasonably necessary to preserve the value of a portfolio or generate financial return; and
- that in some cases investors have a degree of discretion to pursue sustainability impact goals for reasons other than financial return, usually as a secondary objective.

19 There has been considerable attention to the integration of ESG factors in the investment process, where these are material financial considerations.[6] However, that has tended to focus on using investment powers to avoid exposure to companies with elevated ESG risks. Generally, investors and their advisers seem not to have devoted the same attention to whether they may be able to influence the sustainability impacts of third parties and how that might relate to the discharge of their duties. Investors may therefore be less conversant with the circumstances in which duties to exercise an influence could arise or within which discretions may be exercised, or even be aware that such circumstances exist. That could result in hesitancy in adopting IFSI approaches.

20 Furthermore, the applicable legal rules have often developed and been applied with a primary focus on investment allocation and selection. Their application to stewardship activities, public policy engagement and investor participation in collective action in all spheres of their activities has received less attention.

1.2.2 Collective action and the causal link to an investor's actions

21 Many sustainability challenges result from the activities of a multitude of different actors and require action from many different parties to resolve them (see Part A.2, Box 6). Collective action by investors and between investors and other third parties to secure sustainability impacts may therefore be important in advancing solutions.

22 Where investors, and potentially other third parties, are acting in a coordinated way to achieve sustainability impacts consistent with those sought by a particular investor, this can increase the likelihood of success and reduce the cost of pursuing them, both of which are likely to weigh in favour of a decision to act.

23 Part A.2, Box 6 looked at how courts could be expected to approach participation in activities of this sort. Nonetheless some investors may still have questions as to when cooperation with other investors and third parties is appropriate.

AREAS FOR LEGAL REFORM

1.3 Possible impediments to collective action

24 In all jurisdictions there is scope for investors to work together to achieve sustainability impact goals. In doing so they need to comply with various rules on collective action to influence or control the activities of business enterprises, for example, takeover rules on acting in concert and competition law. Information investors receive as a result of collective activities may also sometimes be price sensitive so that it must be handled in accordance with insider dealing rules.

25 Most collective action of the sort carried on at present can operate effectively within these rules as currently understood, and regulators in most jurisdictions have made reassuring statements to that effect. However, the more far-reaching collective investor action becomes the greater the possibility that it could affect the markets for certain goods and services with some potential for antitrust regulations, in particular, to be engaged. There are signs that competition regulators recognise the need for antitrust regimes not to inhibit activities that are legitimately designed to avert systemic sustainability risks. However, at present antitrust regulations do not generally include 'safe harbours' for activities of this sort.

1.4 Lack of 'market infrastructure' for impact goal-setting and assessment

26 Part A.1.2.1 discussed definitional challenges around the concept of 'sustainability'. Part A.2 looked at the emergent nature of available frameworks for setting sustainability impact goals and the difficulties of assessing the impact of businesses and other third parties on overarching sustainability outcomes. Part A.2 also looked at how investors are to understand or measure their own contribution in achieving a goal or outcome, especially in view of the collective dimension to many sustainability challenges (as to which, see Section 1.2.2, above).

27 As noted in Part A.2, these limitations make it likely that investors pursuing sustainability impacts will focus on areas, such as climate change, where the necessary infrastructure is more complete, neglecting those where it is less developed.

1.5 Challenges of navigating the relationship between achieving financial return and sustainability impact

1.5.1 Financial return in the short- and long-term

28 Many, if not most, Asset Owners have duties to generate financial returns over the long-term, and the risks posed by sustainability factors could be particularly significant in this context. However, often they also have duties to generate short-term returns, particularly where there are different generations of beneficiaries.

29 IFSI investment approaches may, in principle, be an effective response to protecting financial performance from risks created by sustainability factors. However, Asset Owners generally need to discharge their duties to all categories of beneficiaries, so that no generation of beneficiaries is unfairly disadvantaged if IFSI activity reduces investment return (as, for example, might be the case where investees are encouraged by Asset Owners to transition away from activities that are causing biodiversity loss if that weakens the return on relevant investments). The challenge of setting this balance could deter Asset Owners from engaging in investment approaches within the scope of IFSI, notwithstanding potential implications for beneficiaries whose interests might otherwise be better protected. That said, as noted previously, the risks to portfolio performance created by sustainability factors can also crystallise in the short-term, and institutional investors are used to balancing shorter- and longer-term financial goals so that various approaches may be available to manage this issue (see Part B.2, Box 1).

1.6 Financial return and sustainability impact

30 Where an investor has discretion to seek to achieve sustainability impacts but must still prioritise financial return, it may be challenging to establish with confidence in advance the possible impact on financial performance of pursuing a sustainability impact goal.

31 Weighing the benefit of pursuing a given sustainability impact goal against the possible effects on financial performance in the short or long term may not be straightforward.[7] Among other things, the value of achieving sustainability goals does not necessarily easily reduce to monetary measures and the challenges of defining

AREAS FOR LEGAL REFORM

and assessing progress towards them was noted in Part A.2, Box 4.

1.6.1 Uncertainty about what beneficiaries want

32 In some jurisdictions, Asset Owners have some discretion to engage in ultimate ends IFSI activities where this reflects beneficiaries' preferences (see Part B.3.3.2(c)). There is growing experience of assessing these. Nonetheless, some may feel it is too challenging or expensive to do so effectively.

33 It may also be unclear to Asset Owners what proportion of beneficiaries must share a particular view before they can act on it, how to deal with differing beneficiary sustainability preferences, and how far beneficiaries would be willing to sacrifice returns to pursue sustainability impact goals.

1.6.2 Lack of suitable investment opportunities

34 Some investors might make more use of their investment powers to pursue sustainability impact goals if more suitable investment opportunities were available.[8]

1.7 Market discipline and investor confidence in the light of uncertainty over different sorts of sustainable investing

35 Part A.1.4 looked at uncertainties over what different sorts of sustainable investing involve and how they are described. It particularly highlighted the difference between:

- investment approaches that involve under- or overweighting investee enterprises based on the extent to which the enterprises are exposed to or take account of sustainability factors (but with no explicit intention to change how they are run); and
- those that fall within the scope of IFSI because they involve intentionally seeking assessable change in the sustainability impact of those enterprises or relevant third parties.

36 This difference is not well recognised. Some beneficiaries may therefore currently believe that their investment is being managed in ways that fall within the scope of IFSI, when that is not the case, and investors who want their money to be deployed in achieving sustainability impact goals may find it difficult to identify appropriate products. In consequence, market discipline may not be working as effectively as it might to ensure that product providers apply a rigorous and transparent approach in the way they pursue sustainability impact goals and describe the goals of their sustainability products. It may also mean that the use of IFSI investment approaches is not receiving adequate attention from regulators and decision-makers in the investment chain.

37 In view of the different ways in which investors may seek to achieve sustainability impact goals and address the kind of infrastructure challenges described in Part A.2, it may also be difficult to understand and compare investment arrangements that are presented as pursuing sustainability impact. If so, those considering investment in products designed to achieve sustainability impacts could be deterred from doing so, dampening demand.

1.8 Market features that may lead to sustainability factors being underweighted

38 Part B.4 highlighted various ways in which existing market features may:

- result in sustainability factors being underweighted in the investment process, so that investors may be less inclined to adopt any form of sustainable investing, including those within the scope of IFSI; and
- focus investor attention on decisions concerning portfolio composition, and away from use of stewardship and public policy engagement, both of which have been identified as potentially important ways of securing sustainability impact goals.

39 Among the factors highlighted were lack of transparency and uncertainty about the impact of sustainability factors on investee enterprises (also part of the 'infrastructure' issue highlighted at Section 1.4 above), the benchmarks, investment time horizons and periods used to measure investment performance, issues arising from the intermediation of the investment process (including the structure of relationships between asset owners and investment managers) and the impact of 'portfolio theory' (which, as the name suggests, may concentrate attention on the use of

AREAS FOR LEGAL REFORM

diversification to manage investment risk at portfolio level, but neglect market-wide risks posed by systemic factors which are non-diversifiable).

40 There may be pressures on asset owners to prioritise securing a financial return for near-term beneficiaries, for example, as a result of the profile of their funds or because those beneficiaries might be more likely to claim against asset owners if their investment returns are reduced or threatened. That said, there is also evidence of pressures on asset owners to take a longer-term perspective, including, for example, publicity campaigns,[9] shareholder resolutions and even litigation.[10]

41 In addition, although many asset owners purport to be reflecting a longer-term view in the terms on which they appoint their investment managers, typical mandate lengths and remuneration structures may nonetheless create incentives for managers to focus on shorter-term financial performance. This may draw attention away from sustainability factors that are perceived to be longer-term.

1.9 Limited track record for IFSI investment approaches

42 Investors are likely to feel more confident about some of the issues highlighted above if they can identify other investors with an established track record and find examples of market practice (see Part B.4, Box 5). The growing number of collective initiatives by investors (see Part B.2, Box 2) may help to provide that. However, investors seeking to use IFSI investment approaches could still feel exposed were their funds also to experience short-term costs or underperformance.

AREAS FOR LEGAL REFORM

2. REFORM OPTIONS

2.1 Introduction to reform options

43 This section outlines options that those wishing to facilitate IFSI could consider. As noted above, it is not exhaustive. Nor does it cover every area of impediment highlighted in Section 1, above. There has already been relevant policy activity in some jurisdictions. Some of the options draw on that.

44 Since sustainability challenges are often systemic and international, the impact of policy change is likely to be heightened if policymakers can coordinate their activities to ensure, as far as practicable, a harmonised international approach. Coordination may also be needed at a national level between regulators responsible for different categories of institutional investor, to ensure a consistent approach.

45 Options have been grouped into the following categories:

- those that concern clarifying and changing the scope of investors' duties and discretions or the legal frameworks within which investors must operate (Section 2.2 below);
- steps to build the 'infrastructure' for IFSI investment approaches (Section 2.3 below);
- steps to influence aspects of investment markets which may affect the likelihood of investors adopting IFSI investment approaches (Section 2.4 below); and
- steps to enhance transparency and strengthen market discipline in relation to IFSI investment approaches (Section 2.5 below).

46 Nonetheless, many of the options are interlinked. For example, if there was an effective, globally accepted, way to assess the progress of an enterprise in addressing sustainability challenges, and the valuation impact of sustainability factors, these might be expected to be more fully reflected in investment prices. That would probably also incentivise further and deeper investment analysis of sustainability risks and opportunities, create incentives for change at enterprise level, and facilitate a greater focus on sustainability impact by investors.

What legal rules require or permit: the 'black letter' of legal rules and the circumstances in which they are followed – policy implications

47 As Parts A and B of this report make clear, it is not always possible to answer the question of what legal rules on investment require or permit just by looking at what they 'say' (their 'black letter'). What rules require or permit in practice must also be worked out by reference to the circumstances in which they are applied (see Part B.2.2).

48 This has important implications for policymakers. It means that those seeking to influence investor behaviour have two broad ways of doing so.

- First, they can change the substance of investors' existing primary legal duties and discretions, to say something different from what they do today, or they can influence how those legal rules are understood.
- Secondly, they can change the circumstances within which investors seek to discharge their legal duties or exercise their discretions but, clearly, the circumstances only become relevant if the primary duties and discretions require or permit IFSI in the first place.[11]

49 The following covers both sorts of intervention. Policy options in Section 2.2 principally concern the first. Policy options in Sections 2.3-2.5 focus on the second. However, in the case of the second, it is not feasible in an exercise of this sort to cover every circumstance that could have a bearing on how investors follow legal rules. In particular, this report does not consider industrial and economic or fiscal policy, although these are fundamental, among other things, because of what they signal to investors and the investment opportunities they may generate (see Box 2).

AREAS FOR LEGAL REFORM

Box 2 – The relevance of industrial, economic and fiscal policy

An important area of policy is beyond the scope of this report. Legislators could significantly change the current context in which investors discharge their duties through industrial, economic and fiscal policies.

Requiring a price to be paid for (or even progressively prohibiting) unsustainable business practices, or financially incentivising particular sustainability objectives, is a case in point. Carbon pricing is an example of this type of approach: applying a price to carbon emissions to reflect their wider cost to current and future generations results in those costs being 'internalised' by the emitter and, consequently, passed on to those who consume the emitter's goods and services, and the emitter's investors, so influencing investment decisions. More of the cost is borne now, rather than by future generations, and money raised (whether through carbon taxes or the sale of carbon credits) can be invested in addressing the underlying issue. Another example would be the subsidisation of solar energy installations. The effectiveness of measures like these is likely to depend on a consistent approach being adopted across the major economies, and we recognise the political obstacles to this.

The investment industry can only ever be a part of the solution to sustainability challenges. Industrial, economic and fiscal policy interventions are likely to have a more direct impact on primary economic activity and to influence the assessments that third parties make in their dealings with business enterprises, including investors. If, for example, policymakers consider it important that all enterprises have a clearly defined plan to reach 'net zero' in their global operations by a given date, it is fair to ask why they do not require it, rather than relying on institutional investors to use their influence to that end. Active intervention of this kind by governments at a national level, reflecting the international commitments they have given, is also likely to generate investment opportunities for those wishing to use their investment powers to pursue sustainability impacts. The current shortage of opportunities of this sort, as noted in Section 1.6.2 above, is one of the impediments that investors have highlighted to us.

2.2 Addressing legal limits or uncertainties

50 This section covers options for clarifying or changing legal rules to broaden the circumstances in which investors are required or permitted to engage in IFSI or are likely to do so, including:

- the core content of legal rules that stipulate investors' investment duties, or which provide them with discretion to engage in investment approaches within the scope of IFSI (Section 2.2.1 below);
- increasing the likelihood of the rules leading investors to engage in *collective action* to achieve sustainability goals (Section 2.2.2 below);
- the use of concepts like 'financial' and 'non-financial' in legal rules and official guidance (Section 2.2.3 below);
- legal or accounting rules that could unnecessarily restrict use of investment powers to invest in opportunities well aligned with IFSI (Section 2.2.4 below); and
- legal rules that restrict, or could in the future restrict, the extent to which investors can undertake stewardship (Section 2.2.5 below).

2.2.1 Adjustments to core duties and discretions

51 As noted above, two key determinants of what legal rules require or permit in practice are the content of the rule, what it 'says', and the circumstances in which a person is applying it.

52 What a rule 'says', again, involves broadly two elements:

- the 'black letter' of the rule as set out in statute or in the form of judge-made law; and
- what the rule is understood (rightly or wrongly) to say.

53 In the case of the latter, there may also be uncertainty over what a rule requires or permits.

54 It follows that, if policymakers wished to require or permit more extensive use of investment approaches within the scope of IFSI than at present, they should consider:

- whether investors' existing duties and discretions need to be revised; or
- whether existing duties and discretions already require or permit the activities that policymakers would like to see but are currently understood as not doing so.

55 Which of these is relevant can be expected to vary depending on whether the policymaker wishes to facilitate instrumental IFSI or ultimate ends IFSI. In the case of instrumental IFSI, if any intervention is needed, the emphasis is likely to be on clarification and guidance

AREAS FOR LEGAL REFORM

as to the content of existing rules focused on financial return. Extending the use of investment approaches within the scope of ultimate ends IFSI is more likely to involve a mixture of legal reform and guidance. The following looks at each sort of IFSI in turn.

(a) Instrumental IFSI

(i) Changing the content of legal rules

56 As discussed in Part B.3, it is reasonably clear in all of the jurisdictions covered that most Asset Owners and their investment managers with medium and long-term financial objectives, where IFSI approaches could reasonably be expected to assist with these, are likely to be under a duty to consider whether they should pursue them and, if so, to act accordingly. On that basis, there should be no need to change substantive legal duties in any of these jurisdictions to require or permit instrumental IFSI. However, we have identified two areas below where the substance of legal rules may need changing although, in both cases, it may be that guidance on existing rules would be sufficient.

57 **Remove doubt about benefitting non-beneficiaries.** Duties owed to beneficiaries have generally been understood to require that investment powers be exercised in beneficiaries' financial interests. In some cases, this may have been treated as preventing any decision if it also benefits a third party even where that is not the decision-maker's purpose. Many investment decisions necessarily benefit third parties, for example, the investee enterprise and its customers and, in the case of stewardship, all other interested shareholders. However, where duties are understood more narrowly, one option would be to make it clear that investors' activities may also confer benefits on non-beneficiaries, including benefits derived from achieving sustainability impact goals, where the relevant investor is acting with the purpose of generating the investment return it is legally required to pursue.

58 **The case of mutual funds**. There is a question in some jurisdictions whether the investment horizon of mutual funds is focused exclusively on current beneficiaries or may require a longer-term approach, considering, as for commercial companies, the interests of shareholders (ie fund investors), 'present and future'. Where this is the case, policymakers could consider providing guidance on why a longer-term approach may be necessary, for example, because of the likelihood that some current beneficiaries will probably have longer-term time-horizons, the possibility that financial risks posed by sustainability factors could crystallise in the short-term and the perversity of the idea that as long as a particular investment objective is technically achieved, the fund and its investors are indifferent as to whether the fund achieves long-term value growth. If necessary, it would also be possible to consider introducing an obligation to manage the fund in the interests of present and future shareholders, making clear that this involves pursuing long-term financial value growth and, where appropriate, protecting the fund from systemic risks.

(ii) Changing the way legal rules are understood

59 Some investors may currently be unaware of the effect of existing duties. There seems to be wide acceptance that investors should take account of 'financially material' ESG factors. There has been less of a focus on the more specific question of whether investors' duties or powers extend to actively pursuing sustainability impact goals with a view to mitigating the financial risks created by sustainability factors or generating long-term value growth.

60 However, interest in the outcomes of investor activity has been growing, especially in the context of the attention paid by policymakers and market operators to stewardship:[12] since stewardship involves seeking to influence investee enterprise behaviour (increasingly thought of in terms of long-term value growth taking account of sustainability factors), those engaging in it may often be undertaking a form of IFSI.

61 Nonetheless, policymakers could consider providing guidance confirming that, in discharging their duties, pursuing sustainability impact goals is among the options that investors should consider.

(b) Ultimate ends IFSI

(i) Changing the content of legal rules

62 The circumstances in which legal rules require or permit ultimate ends IFSI in the jurisdictions covered are more limited and less uniform. If policymakers wish to encourage ultimate ends IFSI, legal changes will be required. In approaching this, policymakers face difficult and politically

AREAS FOR LEGAL REFORM

sensitive decisions of the sort described in Box 1 above. They may also need to consider how to ensure that any new discretions are not abused and how to provide reassurance that institutional investors will not be exposed if they pursue ultimate ends IFSI and there is underperformance in spite of their good faith management efforts (see Box 3 below).

63 Various options for legal reform are outlined below. In each case, new rules would also need to qualify any duty of an investor to act exclusively in the financial interests of its beneficiaries, since ultimate ends IFSI involves taking account of wider interests.

64 **Permit or require beneficiaries' sustainability impact preferences to be taken into account.**[13] This option could be subject to financial return objectives being prioritised. It is already possible in most jurisdictions to establish investment arrangements with explicit sustainability objectives, in which individuals can choose to invest. Further, in some jurisdictions, some asset owners may already have discretion to take account of beneficiaries' sustainability preferences in the way they manage their assets.[14] This concept could be taken further.

65 Nonetheless, this sort of approach raises some difficult issues, the first being that investors may not be able to cater for beneficiaries with differing sustainability preferences within the same fund, so should the rule perhaps be that funds may be managed having regard to the sustainability priorities of a majority (by value) of beneficiaries? And can this really be permitted if the minority are effectively locked in (as will be the case with many occupational pension schemes but recognising that there is currently a similar issue for beneficiaries who want their sustainability priorities to be taken into account) unless perhaps they are not financially disadvantaged? A second challenge is how to ascertain beneficiaries' priorities, and what should happen if these change over time? Should there be a requirement for institutional investors to ascertain beneficiaries' wishes in this area, and how often (but see Section 2.3.4 below)? It would be possible for policymakers to provide for processes that investors should undertake to establish beneficiaries' views, or at least to provide guidance on what is appropriate. Finally, how much weight should sustainability preferences receive if these could conflict with the financial objectives of the relevant investment arrangement, particularly where the arrangement offers fixed or minimum guaranteed benefits?

66 **Permit or require investors to take beneficiaries' assumed sustainability impact objectives into account.** Building on the previous option, a further option would be to require or allow investors to assume that their beneficiaries have a particular sustainability objective or objectives, unless they indicate otherwise. This 'beneficiary presumption' approach could operate in a similar way to the policy on organ donation in The Netherlands and the UK which assumes willingness to donate at death, subject to an opt out.[15] It could be particularly useful in the case of existing investment arrangements which are otherwise too narrow to permit ultimate ends IFSI, but where changing their terms is too cumbersome to be viable in practice. However, as with the previous option, various questions would still need to be resolved such as how to establish which sustainability objectives should be presumed (but see the discussion of centralised research at Section 2.3.4 below), how to manage the interests of 'dissenting' beneficiaries, and how much weight the sustainability objectives should be given. It might also be necessary to consider possible issues of retrospectivity. Some of these questions may be less pressing if the scope for ultimate ends IFSI were to be subject to prioritising minimum investment return objectives.

67 **Permit or require ultimate ends IFSI approaches if minimum investment return objectives are met.** As a variation of the previous option, investors could be required or permitted to engage in ultimate ends IFSI approaches more broadly or by reference to specific sustainability goals, provided that certain levels of financial return were being generated. Policymakers would still need to decide which sustainability goals were permissible and address a number of the questions highlighted in relation to the previous options.

AREAS FOR LEGAL REFORM

68 **Require ultimate ends IFSI in relation to particular sustainability goals regardless of impact on investment return or subject to limits.** In principle, policymakers could conclude that there are sustainability goals that are so important that investors should be required to pursue them or to refrain from activities that are inconsistent with them regardless of the financial consequences, or within limits. Requirements of this sort are potentially a blunt tool, so any use would require particularly careful assessment and may only be feasible, if at all, on a limited basis, for example, in relation to some very precise and urgent targets. However, one area that is being discussed in some quarters is a requirement to align portfolios with net zero. If widely adopted, that could lead investors to engage in IFSI since it seems unlikely that there are currently sufficient net zero aligned investments available for all investors to achieve that goal; further change is needed on the part of more carbon intensive issuers and steps by investors to secure that would likely involve IFSI.[16]

69 **Apply the above options to a certain percentage of each fund.** The options described above could also be applied to a particular percentage of investor funds, not the whole portfolio.

70 **Permitting directors to pursue investment for the long-term success of the corporate entity.** Separately, directors of corporate entities are generally required to exercise their powers in the interests of the entity concerned. However, some jurisdictions would accept that investments by a corporate entity established in that jurisdiction that are not solely motivated by narrow financial considerations can be in the interests of that entity, whereas the position in others is less clear. So, a further option, of particular relevance to insurance companies, is to amend directors' duties to make clear that these are not narrowly restricted to generating financial returns, but need to be understood by reference to a broader range of factors which may be consistent with the company successfully achieving its purpose over the long-term, including potentially pursuing sustainability impacts. Where the law already allows for this, but is currently unclear, guidance might be used as an alternative.

71 **Terms of existing investment products such as mutual funds and life policies.** Where existing rules are adjusted to allow ultimate ends IFSI, policymakers may need to consider ways to facilitate the process of amending existing investment product terms such as mutual funds and life policies to reflect this, ie relaxing the need for the relevant product providers to go through onerous and expensive investor consent processes where these might otherwise be required.

(ii) Changing the way existing rules are understood

72 In some cases, some investors may be uncertain of the extent of any discretions currently available to them to pursue ultimate ends IFSI. In view of that, policymakers may wish to provide clear guidance on the circumstances in which investors already have discretion to adopt investment approaches within the scope of ultimate ends IFSI.

AREAS FOR LEGAL REFORM

Box 3: Rules on ultimate ends IFSI: choice of sustainability objectives and relationship with financial objectives

There is clearly a risk that increased freedom for institutional investors to pursue ultimate ends IFSI becomes a licence for them to pursue their 'pet projects' regardless of whether these would be considered a priority in the jurisdiction concerned. Options for permitting ultimate ends IFSI that involve having regard to the actual or assumed views of beneficiaries might be an effective constraint. However, in all cases, policymakers may need to have some role in deciding which sustainability objectives are most important and should be in scope. Some of the options discussed in Section 2.2.1(b)(i) are effectively different ways of doing that.

This question may be approached differently in each jurisdiction, but we anticipate that international commitments given by the relevant jurisdiction on achieving sustainability goals would be one of the most important factors. This is particularly important in the case of risks such as climate change, which can only be successfully addressed by consistent efforts on a global basis. Beyond this, policymakers will need to consider how best to balance interests of the sort discussed in Box 1 above.

Ultimate ends IFSI investment approaches could potentially involve a trade-off between sustainability goals and financial objectives. Whether or not that is the case, until these approaches become more widely established there may not be a sufficient body of evidence for the relative financial returns available from the different varieties of sustainability-focused investment to convince liability-averse investors to opt for them as part of their mainstream capital allocation activities. If policymakers wish to encourage ultimate ends IFSI they may therefore need to consider rules that either: (a) permit some sacrifice of financial return, or the assumption of heightened investment risk, for the sake of a positive sustainability impact; or (b) provide some form of legal 'safe harbour' should returns undershoot a certain minimum in spite of investors' good faith management efforts.

More important than the precise content of any such rule will be how much certainty it offers to investors that good faith efforts to pursue positive sustainability impact will not expose them to compensation claims from those who are disappointed by the financial returns achieved.

2.2.2 Goals of collective action as a basis for individual decisions to pursue impact through cooperation

73 Addressing many sustainability challenges requires a multitude of actions from a host of different actors. However, in some jurisdictions, some investors could have questions about how far they are able to engage in collective action designed to help in meeting these challenges if, considered on an individualised basis, it is not possible to measure precisely what difference the investor's involvement has made to the outcome and the financial benefit of participation for their portfolio.

74 The essence of cooperation is that the results can only be achieved collectively and collective action among investors is now widespread. However, policymakers could consider issuing guidance or making rule changes to provide reassurance.

75 **Guidance**: among other things, guidance could, for example, make clear that:

- investors should not just consider their position individually, but also how they might act collectively with others in ways that can reasonably be expected to help in addressing sustainability-related risks to their objectives;[17]
- collective activities of this sort can assist in discharging duties to pursue a given investment objective, even if it is not possible to precisely quantify the benefit or what difference the investor has made, and can in principle be treated as beneficial both collectively and individually for those involved (without having to 'pro rate' the benefit in some way) since, like political stability and security, the benefit of sustainable systems is enjoyed as a whole by each person or entity that depends upon them;
- decisions on participation in a collective action concerning a particular sustainability outcome can take account of reasonably anticipated cooperative action by other third parties which is likely to further progress towards the same sustainability outcome;[18] and
- focus on the importance of the logical and evidential credibility of the investor's explanation of the difference it is seeking through collective action as relevant to the investor's legal objectives, more than the precise quantification of the investor's individual impact and portfolio outcome of involvement.

76 **Legal rules**: it would also be possible to put some of this in the form of a legal presumption so that, essentially, where a given sustainability factor reasonably

AREAS FOR LEGAL REFORM

foreseeably creates a risk to the long-term value of a particular investment arrangement, there would be a *prima facie* presumption: (a) that the relevant asset owner should not just consider its position individually, but also how it can act collectively in ways that can reasonably be expected to help in addressing the risk; and (b) that collective activities of this sort can assist in discharging duties to pursue a given investment objective even if it is not possible to precisely quantify that benefit or the difference the investor has made.

77 **Disclosure**: investors could be invited or required to disclose which sustainability factors they consider relevant to them in pursuing their investment goals and their approach to engaging in collective action concerning those factors and, if they do not act collectively, their reasons (see Sections 2.3.5 and 2.5.1).

2.2.3 Financial factors and non-financial factors

78 **Use of expressions such as 'financial factors' and 'non-financial factors'**: policymakers should consider reviewing the use of expressions such as 'financial factors' and 'non-financial factors' in connection with investor duties and corporate reporting. It can sometimes give the misleading impression that sustainability factors are somehow non-financial, which is clearly not the case for at least some sustainability factors, as growing activity in relation to the TCFD recommendations and sustainability reporting reflects. Policymakers should also address any impression: (a) that sustainability factors that only have indirect financial implications are not relevant (for example, reputational damage caused by a firm's negative sustainability impact leading to loss of business opportunities); or (b) that where the risks presented by a sustainability factor are hard to predict, that means it does not have financial implications.

79 Instead of focusing on whether a particular factor is 'financial' or 'non-financial' policymakers need to address the *objective* of the person taking the relevant factor into account, and, at least in an investment context, whether that objective is the realisation of financial goals or some other sort of goal. Where an institutional investor is required to pursue exclusively financial goals, whether a sustainability factor is taken into account would turn on the potential financial implications for achieving the investor's financial purpose (and where the investor is pursuing sustainability impact goals to do so, it would be a form of instrumental IFSI). Where the investor has discretion to pursue broader goals, whether subject to, in parallel with, or even with priority over financial goals, then taking a sustainability factor into account would be based on its implications for those goals (and where the investor is pursuing sustainability impact goals to do so, it would be a form of ultimate ends IFSI).

80 **Clarifying rules and guidance on sustainability factors**: where existing duties and associated guidance that concern achieving financial goals or managing financial risks are revised to make clear that sustainability factors may, and in some cases will, need to be considered in order to discharge those duties, any changes need to be made in a way that is clear: (a) that the amendment is only clarificatory and that any factor that is relevant to the discharge of those duties (whether sustainability-related or otherwise) needs to be taken into account; and (b) that while some sustainability factors are likely to require consideration, the range of sustainability factors is broad, so that not all of them necessarily will.

2.2.4 Regulatory rules that indirectly restrict IFSI

81 **Types of investments that asset owners can hold**: policymakers could consider reviewing rules governing the assets that investors are permitted to hold, including liquidity and portfolio requirements, and associated accounting standards to ensure that they do not unnecessarily restrict investment in enterprises likely to have positive sustainability impacts. For example, accounting rules, and, where relevant, prudential rules tend (for understandable reasons) to value early-stage investments cautiously and treat them as illiquid. Some investments, such as infrastructure investments, that could be required to address sustainability challenges such as adaption to climate change will be subject to these rules, so that this could prove to be a significant deterrent to instrumental and ultimate ends IFSI in practice. Policymakers could consider a different approach to investments they feel are the most urgent.[19]

82 **Technical operational barriers**: regulatory regimes for asset owners could be reviewed to assess whether they inadvertently

AREAS FOR LEGAL REFORM

impede IFSI investment approaches, for example, if they require valuations or performance assessments against the investment objectives of a product in ways that assume these objectives are exclusively financial and do not contemplate ultimate ends IFSI.

2.2.5 Rules that could inhibit stewardship activities

83 Effective stewardship requires frequent two-way communication by investors with enterprises, and a collective approach by as many investors in an enterprise as is practicable. Policymakers could review existing legal frameworks to ensure that they do not inadvertently inhibit legitimate stewardship activities designed to achieve sustainability impact goals.

84 **Price sensitive information**: it is possible for two-way communication of this sort to steer clear of information that is unpublished and price sensitive. However, the need to do so could potentially constrain enterprise-investor communications. Policymakers could review the extent to which existing insider dealing and market abuse rules are having this effect and whether there is scope to facilitate more in-depth conversations regarding sustainability issues. For example, where price sensitive information is communicated to investment managers, while there are potentially ways to handle it so as to minimise disruption, receipt of the information can make it difficult for them to continue to transact in affected securities for their clients. Policymakers might consider whether there are ways (in addition to existing defences) of reducing the risk of this sort of disruption to legitimate transactional activity.

85 **Concertedness/control**: in some jurisdictions, shareholders acting collectively can (if they account for more than a certain percentage of shares) incur obligations to make an offer for the remaining shares or even trigger regulatory consent requirements for controllers of a regulated entity. Most stewardship activity in relation to sustainability (at least as it has been conducted to date) is unlikely to trigger these regimes. However, not least in view of the growth of activities of this sort, policymakers could consider making exceptions where the focus of the collective action is to encourage a more sustainable approach by the enterprise concerned, or provide comfort that collective shareholder stewardship activities are not caught.[20]

86 **Competition law**: collective stewardship activity could potentially affect the markets for certain goods and services. If so, in principle this could fall foul of current antitrust laws in many jurisdictions. Competition regulators have been increasingly open to discussing sustainability initiatives and are starting to recognise the need for further and more harmonised guidance. Various consultations are ongoing that are expected to clarify and, to some degree, soften the past enforcement climate and provide a better framework to account for wider society benefits.[21] However, policymakers could consider introducing an explicit safe harbour for sustainability-related collective activity by investors and other interested third parties.

87 **Requisition of shareholder votes**: policymakers could assess whether the terms on which shareholders can requisition shareholder votes unnecessarily restrict *bona fide* stewardship activity (for example, because of the number of shareholders needed to requisition a vote, the aggregate amount of capital that they must hold, or the consequences of losing a vote).

2.3 Steps to build the IFSI 'infrastructure'

88 Governments can facilitate economic activity by ensuring that the necessary infrastructure is in place, thereby affecting what is commercially feasible. Similarly, policymakers could support the development of areas of knowledge and practice that are relevant to IFSI, increasing the likelihood of legal rules leading investors to engage in IFSI.

2.3.1 Support for the development of market-based IFSI infrastructure

89 Part A.2 noted various needs for investors engaging in IFSI: the ability to define the sustainability impact goals being targeted and link them with overarching sustainability outcomes; the ability to assess the changing impact of businesses and third parties on sustainability factors; the ability to reach a robust understanding of the investor's contribution to any outcomes; and a shared understanding, among other things, as to the long-term financial impact of particular sustainability risks and the effectiveness

AREAS FOR LEGAL REFORM

of IFSI investment approaches in achieving sustainability goals, and in preserving and generating investment value. Where navigating these is too complex or costly, this will limit what investors can do.

90 In all these cases, policymakers may be able to help build or foster the necessary infrastructure.[22] The multi-disciplinary nature of some of the challenges makes it likely that this would often need to involve financing or otherwise facilitating specialist work[23] and fora in which technical specialists, investors, enterprises and regulators can research, brainstorm and agree on effective strategies, much as is happening in the context of the TCFD and, more recently, the Task Force on Nature-related Financial Disclosures.[24] Governments and regulators also have a crucial role in ensuring that information about what works, and what does not, is widely promulgated and accepted as the 'authorised version', for example: by establishing centres of excellence which can identify and help to generate areas of emerging good practice and highlight how they could be relevant in discharging legal duties; using 'soft' regulatory signposting (through speeches and the like); and enshrining standards formally in legal frameworks (much as is now happening with the TCFD Recommendations).[25]

2.3.2 Frameworks for IFSI capability-building by investors

91 Policymakers could also consider steps to support a rigorous approach among investors to addressing the issues highlighted above.

92 **Processes, systems and controls for addressing sustainability impact**: one approach might involve establishing a framework of practical steps that investors could or should take:

- generally, in considering and responding to potential risks to their financial goals presented by sustainability factors, and
- in operating investment products or strategies specifically designed to achieve positive sustainability outcomes.

93 This would involve a form of 'process regulation'. It could help to heighten attention to and, over time, strengthen the methodologies being applied, in turn contributing to infrastructure development as more operators seriously address themselves to the issues involved.

94 The legal status of standards of this sort might range from good practice statements in relation to existing rules (for example, rules that require investors to pursue beneficiaries' best interests)[26] through to formal entity, service or product governance regimes.[27]

- In terms of risks to investment goals (or opportunities) created by sustainability factors, standards could cover, for example, investors' systems and controls for identifying and determining how to address these.
- More stringent standards may be appropriate for investment products and strategies held out in ways that suggest they have specific sustainability goals. Standards could focus on the processes and techniques used in designing, creating, documenting, operating and distributing the relevant products to ensure that rigorous and sound standards are applied in the areas mentioned at Section 2.3.1 above so that:
  - the product's sustainability goals and the way progress will be assessed are clearly defined and communicated and it is clear what contribution the product is intended to make in realising overarching sustainability outcomes;
  - investors understand any potential financial return impact of pursuing sustainability goals; and
  - investors receive adequate sustainability performance information.

95 **Disclosure**: the effectiveness of regimes of the sort described above could potentially be strengthened by requiring public disclosure of the steps investors are taking, see Section 2.5.1 below.

96 **Individual staff accountability**: it would be possible to supplement the above with personal accountability regimes, whereby particular members of staff have responsibility under the regulatory regime for the investor's compliance.

AREAS FOR LEGAL REFORM

2.3.3 Provision of assessment and decision-useful information on business enterprises

97 Internationally consistent disclosure regimes for business enterprises that generate 'decision-useful' information are a key foundation for all forms of IFSI and policymakers need to consider, as indeed they already are, how best to facilitate these and various associated matters, such as how far disclosed information should be externally validated.

98 **Disclosure regimes generally**: logically, investors pursuing sustainability impact goals could be expected to need two sorts of information:

- how the enterprise is impacted and is responding to the risks and opportunities presented by relevant sustainability factors and associated transition processes, within what timeframe (including steps plans) and with what success; and
- how the activities of an enterprise have an impact on sustainability factors, whether the company aspires to have a more positive impact, what steps it is taking and within what timeframe, and how its impact is changing.[28]

99 For investors considering how to protect their portfolios from systemic risks, these two sorts of information would seem to be connected: looking at economic systems as a whole, one of the sources of sustainability risks in the first category is likely to be the activities of other businesses, such as the sustainability impacts of enterprises referred to in the second category. The recommendations of the TCFD are a highly influential international example of a disclosure framework which is especially focused on the first sort of information, in relation to climate change.[29] At the level of national disclosure regimes, many jurisdictions have sustainability-related disclosure requirements. However, they tend not to cover both of the categories of information above[30] and there is not yet enough focus on the specific steps being taken by companies and the outcomes achieved in either case.

100 Policymaking on disclosures in the second category may need to address a number of potentially challenging questions similar to some of those highlighted in relation options for rules facilitating ultimate ends IFSI (see Section 2.2.1(b)(i)), such as what sustainability factors need to be covered and for what purpose. Those making disclosures may also face 'infrastructure' challenges of the sort discussed at Section 2.3.1 above, for example, in assessing impact. Consequently, there is likely to be a common interest among those in the investment community and investee companies in developing effective assessment and measurement methodologies.

101 **Financial quantification of costs and opportunities**: more specifically, as the costs and financial opportunities presented by sustainability factors become better understood, or perhaps to accelerate a common understanding of these, policymakers could consider requiring enterprises to estimate and publish these, such as the potential cost of certain sustainability risks if left unmanaged. Recommended TCFD disclosures on corporate strategy already move in this direction in the case of climate change, for example, in recommending disclosure of climate-related risks and opportunities for the organisation's business, strategy and financial planning.[31]

102 **Sustainability transition/action plans**: for sustainability risks that have been widely identified as creating material foreseeable systemic risks, such as climate change, policymakers could also consider requiring enterprises to develop and publish their transition plans, with estimates of anticipated costs, possible obstacles to transitioning in the envisaged timescale, and any expected revenue enhancement. Policymakers could also consider whether these plans should be: (a) put to a shareholder vote; and (b) subject to independent validation. It would also be possible to consider a similar approach in relation to action plans developed by enterprises to address other areas of sustainability impact.

2.3.4 Establishing greater clarity about investor sustainability attitudes generally: centralised coordination

103 Part A.4 commented on growing evidence that individual investors want sustainability factors to be taken into account in how their investments are managed, and the possibility that a significant number may expect that to involve positive sustainability impacts. Gaining a clearer view of investors' sustainability attitudes generally may be important for at least two reasons.[32] First,

AREAS FOR LEGAL REFORM

it is relevant to some of the options for facilitating ultimate ends IFSI discussed in Section 2.2.1(b). Secondly, Part B.3 noted cases where beneficiaries' sustainability wishes are relevant to investors in deciding whether to engage in ultimate ends IFSI.

104 Policymakers could therefore consider facilitating high-quality work, drawing on relevant expertise and disciplines, to understand individual investor attitudes in their jurisdiction to inform decisions on how far sustainability outcomes should be reflected in the investment process beyond what is needed to achieve financial goals. It would need to be kept up to date and could seek to address some of the issues with work on this topic to date (see the supplement to Part A, Appendix 3). Central coordination of this work, and making it a matter of government responsibility, should help to reduce costs and potential uncertainty for institutional investors if they are expressly permitted to rely upon the output.

2.3.5 Steps to strengthen stewardship as it concerns sustainability impact

105 Stewardship activities are likely to be key in IFSI in many jurisdictions.

106 **Stewardship codes and similar good practice statements**: in jurisdictions where there is currently no code or other similar repository of good stewardship practice, policymakers could consider introducing or facilitating one.

107 They could also encourage those who are custodians of the stewardship code in their jurisdiction to consider:

- its scope, to ensure that it is sufficiently broad, in terms of the sorts of business enterprises, investor-types and investment relationships covered (for example, not just listed equity interests but interests in debt instruments and in private vehicles);
- how the code addresses investors' approaches to the sustainability position of businesses covered including, among other things:
  - risks, systemic or otherwise, created by sustainability factors to which the relevant enterprise may be contributing or exposed;[33]
  - avoiding a simplistic bifurcation between financial and non-financial factors (see Section 2.2.3 above) and recognising the wider benefits of attention to sustainability factors;[34]
  - the possible use of sustainability impact goals by investors in working with the enterprise in seeking to enhance long-term value growth and assessing progress towards them;[35]
  - the role of collective engagement with other investors and with other third parties and policymakers as part of that process;[36] and
  - a focus in reporting under the relevant code on the results of investors' stewardship activities (including sustainability impact goals achieved), not simply the processes they have in place to engage in stewardship.[37]

108 **Adherence to stewardship codes:** policymakers could also consider steps to encourage adherence of investors to stewardship codes:

- **Industry working groups on good practice and investor forums**: they could look at encouraging industry participants or industry associations to establish working groups to develop guidance on good stewardship practice under the code.[38] It would also be possible to encourage the development of investor forums to facilitate collective action, potentially jointly funded by market operators.[39]
- **Publication of stewardship policies, expenditure and outcomes**: where not already required, policymakers could consider disclosure by institutional investors of their stewardship policies and activities (see also Section 2.5.1 below),[40] making clear what level of resources is devoted to them, how activities have been designed to serve beneficiaries' interests to the full, how the investor seeks to achieve sustainability impact goals and the outcomes it has achieved.
- **External review of stewardship standards**: policymakers could consider whether there are ways of ensuring that institutional investors' stewardship code activities are subject to independent review and reporting, to encourage compliance and so that examples of good practice can be shared.[41]

AREAS FOR LEGAL REFORM

109 **Relationship between asset owners, investment managers and consultants in relation to stewardship**: policymakers could undertake work to assess whether asset owner stewardship interests are being adequately reflected in the way investment managers and consultants provide their services or encourage industry initiatives to do so (see also Sections 2.4.2 and 2.4.3 below).[42]

110 Any shortcomings may best be addressed by industry work to establish good practice standards. However, associated regulatory regimes may also need attention since they tend to focus on investment selection more than stewardship. Possible rule changes include: (a) a new requirement for investment managers to assess whether their stewardship offering makes them suitable for particular appointments; and (b) requiring periodic client reporting (with an explanation of stewardship outcomes, sustainability orientated resolutions the manager has chosen not to support and why, how activities have added value consistent with the client's sustainability impact goals and the manager's position on joining investor coalitions, including reasons).

2.4 Addressing market features that may result in sustainability factors being underweighted in investment activity

111 The report has identified various areas in which current circumstances may influence investors in ways that could result in sustainability factors being underweighted in the investment process. The need for greater transparency about the sustainability exposures of investee enterprises was discussed in Section 2.3.3 above, which should help in valuations. However, a number of other areas may benefit from attention.

2.4.1 Portfolio theory and use of benchmarks

112 **Assessment of the impact of portfolio theory and commonly used benchmarks**: policymakers could consider facilitating high-quality cross-disciplinary work coordinated by a group of investors and international-profile academic institutions on the use of key elements of current portfolio theory and the use of benchmarks (see Part B.4) to establish whether they are resulting in insufficient attention being paid to sustainability factors, especially systemic risk, and whether this could prejudice realisation of financial goals.[43]

113 Should a sufficient consensus emerge, the next step might (depending, among other things, on the investment industry's response) be for policymakers to encourage market participants and other interested parties to develop guidance on how best to address any shortcomings identified and to work on alternative or supplementary models. Given the technical and developing nature of investment practice, we anticipate that policymakers may need to encourage the exercise of informed judgement on the part of market participants and avoid implicit or explicit prescription, for example, of specific models in performance measurement, portfolio construction, valuations or risk assessment.

114 **Investment professional training**: policymakers could consider a review of business school and other training for investment professionals to ensure that curricula adequately address the impact on investment portfolios of systemic risks from sustainability factors, possibly with a public rating system indicating the quality of the relevant training. Policymakers could also consider a continuing education requirement on sustainability risks for investor staff.

2.4.2 Basis on which investment managers selected and appointed

115 **Assessment of the role of sustainability factors in the selection of and relationship with investment managers**: policymakers could facilitate a study of asset owner due diligence on investment managers, the terms on which they are appointed and the way relationships work in practice to assess whether longer-term approaches (factoring in sustainability impact risks and opportunities to clients beyond the term of managers' appointment) are being properly reflected and incentivised. If they are not, the study could consider what can be done to change this. Asset owners may be reluctant (sometimes on legal grounds) to commit to long-term appointments because this would restrict their ability to change investment managers where they are not satisfied with their performance. However, there may be scope for lengthening appointment terms, subject to the ability to terminate the relationship based on a formalised periodic review process (as is sometimes the case where an insurer or investment manager sells a portion of its business, but continues to manage the underlying assets).

116 Part of the solution may also be to improve asset owners' and beneficiaries'

AREAS FOR LEGAL REFORM

understanding of how sustainability-focused investing can affect short term returns, so as to reduce any discomfort they may otherwise feel if short term performance is weaker than they might prefer.

117 **Good practice standards**: policymakers may be able to encourage the development of good practice standards on investment manager due diligence, appointment, monitoring and relationship management as this relates to sustainability factors, by prompting industry initiatives.[44] This could also cover the role of investment consultants and the standards they set for investment manager selection and review processes (see Section 2.4.3 below).

118 **Disclosure**: requiring disclosure by asset owners on how they seek to reflect sustainability factors in the appointment of managers may also be an effective 'nudge' to increase focus on this (see Section 2.5.1 below).[45]

119 **Stewardship**: the relationship between asset owners and investment managers in relation to stewardship is discussed at Section 2.3.5 above.

2.4.3 The role of investment consultants and fiduciary managers

120 Policymakers could consider commissioning studies on how far investment consultants and fiduciary managers adequately ascertain asset owners' sustainability risks and impact goals and reflect this in the services they provide, and to assess whether their advice and other services only place appropriate reliance upon portfolio theories and benchmarks of the sort discussed in Part A.4.

121 Any concerns could be addressed by way of guidance or new rules for asset owners on their appointment and use of consultants and fiduciary managers or through direct regulation of the firms concerned.[46]

2.4.4 Impact of trading activity

122 Policymakers could consider commissioning work of a similar quality to that described at Section 3.4.1 above, on the effect of short-term trading activity to establish when it helps achieve, is inconsistent with or is neutral with regard to positive sustainability outcomes. For example:

- does it counteract attempts to pursue long-term corporate strategy that is more likely to take account of sustainability impacts or is more receptive to long-term investor stewardship? For example, does it result in short term orientated shareholder engagement, likely to undermine attempts to get companies to take greater account of their sustainability impact?
- does it tie up a significant portion of investible assets in a way that makes them 'free floating', ie so that sustainability factors are never applied to them? For example, does it mean that there are no stewardship activities in relation to a portion of company stock and, if so, does it matter?
- what is the role of stock-lending activities and how these might relate to sustainability interests of the lending funds?

123 Policy measures, if any, would depend on the outcome of the work.

2.5 Transparency and market discipline in relation to IFSI investment approaches through helping individual investors realise their sustainability aspirations

124 This section groups a number of policy options that could:

- help to make more transparent the extent to which investment arrangements achieve sustainability impact goals; and
- help investors to pursue their sustainability-orientated aspirations (see Part A.4).

125 There is evidence to suggest that public interest in sustainability does influence investment preferences when suitable information is provided.[47]

2.5.1 Disclosure to beneficiaries on pursuit of sustainability impact goals by institutional investors

126 Policymakers could consider requiring or encouraging institutional investor disclosure of, broadly:

- how their ability to meet any applicable investment goals is impacted by relevant sustainability factors and associated transition processes, how they are responding, within what timeframe and with what success;
- to what extent their response involves pursuing sustainability impact goals, including what goals, why (whether to manage financial risks, realise financial opportunities or as ends in their own right), how and with what success; and

AREAS FOR LEGAL REFORM

- for asset owners, how this is reflected in the terms on which they appoint investment managers and run the relationship.

127 The recommendations of the TCFD and associated guidance address the first of these in relation to climate change, recommending, for example, that asset owners describe: (a) how climate-related risks and opportunities are factored into relevant investment strategies; (b) engagement activity with investee companies to encourage 'better disclosure and practices related to climate-related risks'; and (c) metrics used to assess climate-related risks and opportunities.[48]

128 It would be important for disclosures to distinguish clearly between:

- investment approaches that are essentially limited to selecting away (through screening or otherwise) from enterprises the financial value of which is particularly negatively exposed to sustainability factors and/or towards those that are not; and
- approaches that are intended to achieve sustainability impact goals (ie IFSI approaches).

129 However, given the variety of approaches that could fall within the scope of IFSI, even those designed to contribute towards addressing the same sustainability impact goal (eg use of investment powers, stewardship and policy engagement or only some, and with varying levels of intensity and using different techniques), it may be important to identify ways of helping investors understand the intensity and quality of the investor's IFSI approach (see Section 2.3.2).

130 Disclosures to pension fund beneficiaries could be made as part of the usual disclosure and reporting process for the relevant fund. Where the disclosure concerns an investment product, disclosures could be provided before any investment decision is made and on an ongoing basis thereafter. The aim would be to give investors the information they need to take decisions in pursuing both their financial and sustainability goals (see Part A.4). However, it would also assist those who advise them or make discretionary investment decisions on their behalf to take adequate account of these matters in doing so.

131 Given the need for standardisation in disclosures to facilitate comparability (conceptually and in content and presentation), disclosure regimes of this sort are likely to need some regulatory underpinning.

132 Examples of existing disclosure regimes include China's 'green investment' self-evaluation regime for securities investment funds,[49] the Regulation (EU) 2019/2088 on sustainability-related disclosures in the financial services sector (***SFDR***)[50] and the UK's new climate change disclosure and governance regime for pension funds.[51] However, they may not always prompt those making disclosures to distinguish clearly between taking sustainability factors into account as a matter of investment selection and intentionally targeting positive sustainability impact goals.

2.5.2 Sustainability impact focused investment products: encouraging greater rigour and transparency

133 There is growing recognition among policymakers internationally of the risk of 'greenwashing' or 'ESG-washing'.[52] Policymakers have a key role in ensuring that the integrity of sustainability impact focused investment approaches is not damaged by misleading claims about the 'sustainability credentials' of investment products.[53] However, responses hitherto have not always specifically addressed the risk of 'impact washing'. In terms of products that are designed to pursue an IFSI approach in managing the relevant assets the goal of policy intervention would therefore be to establish a clear distinction between, essentially, three categories: investment products generally; those that take some account of sustainability factors but do not involve intentionally pursuing sustainability impact goals; and those designed to pursue sustainability impact goals.

134 **Product labelling**: there is a case for introducing regulatory requirements that must be satisfied (much like those that exist in some jurisdictions around use of the word 'guaranteed' to describe the payout on an investment product) where words like 'sustainable', 'responsible', 'SDG compliant' or 'impact' are used to market products such as mutual funds and investment-based life products.[54] These could include, for example, minimum operating standards and the sort of information that must be made available to investors prior to their investment, and on

AREAS FOR LEGAL REFORM

an ongoing basis thereafter. An approach of this kind might also be combined with the sort of product governance regime and a disclosure regime described above at Sections 2.3.2 and 2.5.1 respectively.[55][56] It would be important to be clear on which labels can be used to describe products that involve the use of IFSI.

135 **Mandatory disclosures**: a further step might focus on investment products that do not involve the manager of the product intentionally seeking to achieve sustainability impact goals. It would be possible to require the 'key facts' sale document for investment products of this sort to include a clear statement to that effect.

136 **Rating arrangements**: policymakers might also seek to encourage the development of rating arrangements to provide effective rankings of products by reference to the rigour of their approach to achieving sustainability impact goals.[57]

137 **Investor redress**: where they do not already exist, policymakers might also consider simplified investor redress and compensation regimes in relation to product providers where sustainability-related products are not operated in a manner consistent with the way they have been held out, particularly in relation to pursuing sustainability impact goals.

2.5.3 Investment distribution: taking account of investors' sustainability aspirations

138 As discussed in Part A.4, while the investment distribution and advice process addresses investors' financial objectives, intermediaries have not generally sought to establish, and investors have not been routinely prompted to consider, their sustainability objectives for their investments. It is therefore likely that investors' sustainability aspirations have not been adequately reflected in the decisions they have made.

139 **Non-advised distribution**: where an investor is not appointing an investment manager and is not seeking advice on what product to select, policy intervention to address this issue may need to rely largely upon disclosures and product labelling of the sort discussed at Section 3.5.1 above.

140 **Advised distribution/investment management**: where an investor is seeking advice or investment management from a firm, policymakers could consider the following.

- **Suitability requirements**: investment managers, investment consultants, investment advisers (and other relevant intermediaries on whose advice or discretion investors rely) could be required to establish a client's sustainability objectives at the outset of their relationship, including their views on the pursuit of sustainability impact goals and their investment horizon, regularly update them thereafter and reflect them in the way they provide their services and in the recommendations they make.[58]
- **Investor presumption**: alternatively, firms could be permitted to presume, unless an investor specifies otherwise: (a) that the investor has a long-term investment horizon; and/or (b) that the investor wishes their money to be managed so as to help to achieve certain sustainability goals, and to reflect these in advice given. As with the approaches to amending key legal investment management duties discussed at Section 2.2.1(b) above, various issues would need resolution in relation to the second of these, including which sustainability goals should be presumed. Research of the sort described at Section 2.3.4 could inform this.

141 **Overarching duty regarding retail investor outcomes**: in principle, it would also be possible to consider introducing overarching duties towards investors that apply to all those involved in investment product and service provisions to act so as to achieve the outcomes that the end investor is entitled to expect, including sustainability outcomes.[59]

AREAS FOR LEGAL REFORM

2.5.4 Individual investor education

142 Disclosure and suitability regimes of the sort described above depend on investors understanding the significance of what they are being told or asked, for example, the difference between investment screening (in isolation) and approaches within the scope of IFSI. Facilitating ultimate ends IFSI could also create risks if investors do not grasp the possible trade-off between pursuing sustainability impact goals and their desired financial return (so that there is an important policy threshold between situations where ultimate ends IFSI is permitted but financial return is prioritised, and those where it is not).[60] Policymakers could therefore consider undertaking or encouraging others to undertake investor education campaigns to help investors understand, broadly: (a) that their money can make a difference; (b) how it can do that, especially the role of IFSI; and (c) the possible trade-offs involved.[61]

AREAS FOR LEGAL REFORM

1 Each jurisdiction has its own unique processes and institutions by which to effect changes of the sort discussed. We use the generic term 'policymakers', recognising that this may mean legislatures, executive branches of government, regulators, or even courts, depending on the context.

2 In these cases, the purpose of the legislation is often described in an introductory section, or in recitals.

3 Dionysia Katelouzou and Eva Micheler, *The Market for Stewardship and the Role of Government*, ECGI, Law Working Paper No 556/2020, December 2020.

4 For example, in Australia, the Treasury Laws Amendment (Your Future, Your Super) Bill 2021 which is awaiting Royal Assent (before coming law), imposes APRA-regulated trustees of superannuation funds act in the 'best financial interests' of beneficiaries. This may place greater focus on the financial considerations of superannuation fund trustees and result in a reluctance to engage in IFSI in circumstances when strong, short-term financial returns are not guaranteed.

5 See, for example, *Financial Stability Report*, Bank of England, August 2020, 39-43.

6 See Part A.1.4.

7 See, for example, Treasury Laws Amendment (Your Future, Your Super) Bill 2021 in Australia requiring superannuation trustees act in the 'best financial interests' of beneficiaries. The need to act in the best financial interest is not necessarily inconsistent with IFSI but trustees need to be mindful of not creating unintended outcomes that impact sustainability as they attempt to derive strong financial returns in the short and long term, creating a challenging environment to be effective fiduciaries.

8 See, for example, *Creating Impact: The Promise of Impact Investing*, IFC, 2019, 70; *From the Margins to the Mainstream: Assessment of the Impact Investment Sector and Opportunities to Engage Mainstream Investors*, a report by the World Economic Forum Investors Industries, 2013, 24.

9 For example, in the United States, BlackRock, *2019 Investment Stewardship Annual Report* 9 (2019), https://www.blackrock.com/corporate/literature/publication/blk-annual-stewardship-report-2019.pdf.

10 For example, in Australia, *McVeigh v Retail Employees Superannuation Pty Ltd* [2019] FCA 14, where a fund member commenced litigation for the trustee's failure to adequately handle climate change risk. The settlement reflects the initiative trustees should take, discharging their duties whilst actively considering climate change risk.

11 There is a considerable range of ways to do this. Some involve using other legal rules. Possible approaches range along a spectrum from, very broadly, 'hard-edged' prohibitions on particular sorts of activity, to duties governing the way certain activities are carried on, to 'process regulation' stipulating steps that need to be taken or matters taken into account in carrying on an activity, to rules requiring certain disclosures about how an activity has been carried on which may 'nudge' the person to whom the rules apply to consider more carefully how they conduct that activity. However, policymakers do not need to resort to legal rules. For example, they could stimulate the development of 'soft law' standards, such as industry codes and guidance that are typically not legally binding but may have a bearing on how legal rules are applied, (since, among other things, accepted market practice may be referenced by courts or regulators in assessing what to expect of a 'prudent' or 'reasonable' person in the relevant investor's position (see Part B.4, Box 5)). Or they could provide a catalyst for groups or fora to be established within which industry practice and collective activities can develop, or commission strategic research or investigations. More fundamentally, they could also take steps that change the investment landscape, for example, through the way they regulate investee enterprises.

12 For example, as noted in Part B.3, through the adoption of stewardship codes.

13 This sort of approach might create a potential conceptual problem for some investment arrangements since it might conflict with the overriding duty of the investment decision-maker to make its own decision about what is in the best interests of beneficiaries. However, viewed differently the decision-maker may be better placed to discharge its duty if it properly understands beneficiaries' preferences.

14 Rules for EU insurers, due to take effect in 2022, appear go a step further in requiring insurers to take account of customers' sustainability preferences established in the course of their product approval process. See Amendment Solvency II Delegated Regulation which amends existing provisions made under Solvency II to require that, 'where relevant … decisions of an insurance undertaking shall reflect the sustainability preferences of its customers taken into account in the product approval process referred to in Article 4 of Amendment IDD Delegated Regulation. While this provision principally concerns the prudent person principle under Solvency II and cross-refers to the product governance regime for insurers (see Sections 2.3.2 and 2.5.1 below), it nonetheless appears to involve a requirement to take investors' sustainability objectives identified in the course of product design into account when investing in accordance with the prudent person principle.

15 See https://www.organdonation.nhs.uk/uk-laws/, accessed 26 May 2021.

16 See Mark Carney, *Building a Private Finance System for Net Zero, Priorities for Private Finance for COP26*, 12.

17 For example, while it is not guidance on legal duties and only covers stewardship, Principle 10 of the UK Stewardship Code provides that signatories will 'where necessary, participate in collaborative engagement to influence issuers.' Similarly, the Japanese Stewardship Code provides that it can be useful if an institutional investor, where necessary, engages with an investee company in collaboration with other institutional investors. Likewise, Guidance Principle 4 of the Dutch Stewardship Code encourages groups of investors to discuss issues of common interest which they could pursue collectively towards one or several issuers.

18 Tom R. Tyler, *Why People Cooperate: The Role of Social Motivations* (Princeton University Press 2011).

19 Similarly, in most jurisdictions mutual funds that are registered for public distribution are subject to a number of portfolio concentration and other investment limits. There are important reasons for these. They could nonetheless, however, be assessed to ensure that they do not unnecessarily restrict investment.

20 For example, the Australian Securities and Investments Commission published its *Regulatory Guide 128: Collective Action by Investors* in June 2015. It notes that takeover laws can present obstacles for investors as collective action can create a need to file substantial holding notices or breach takeover provisions. However, it states that ASIC 'recognise that investors should be allowed to cooperate and coordinate their actions concerning an entity in which they have invested, in the interests of promoting long-term value for all investors. At times, this type of engagement can be more effective and efficient than individual investor engagement.' The guidance therefore aims to promote certain investor engagement by clarifying the application of takeover laws to collective action by investors by giving details of the likely legal effect of different types of collective action and indicative examples of collective actions which are unlikely to result in concerns under takeover laws, and those which are more likely to do so. Guidance of this sort has also been given elsewhere, including Japan and the UK.

21 The most progressive (draft) guidelines to date addressing the interplay of competition law and collaborations for sustainability are by the Dutch competition regulator: https://www.acm.nl/sites/default/files/documents/2020-07/sustainability-agreements%5B1%5D.pdf. The EU Commission is currently looking into the same issues as part of the review of the two Horizontal Block Exemption Regulations and the Horizontal Co-operation Guidelines. Further guidance by other major authorities, such as the US Department of Justice or the UK's Competition and Markets Authority, would contribute significantly to the debate. The latter notes in its annual report for 2020: 'We will develop our understanding of how climate change affects markets and consider how … we can act in a way that supports the transition to a low carbon economy.'

22 See, for example, the discussion of these issues in relation to climate change in Mark Carney, *Building a Private Finance System for Net Zero*.

23 Such as the UK's 'Dasgupta Review': Partha Dasgupta, *The Economics of Biodiversity: The Dasgupta Review* (HM Treasury 2021).

24 https://tnfd.info.

25 There are many examples of policy activity of this sort. The EU sustainable finance taxonomy is an example of public-private working with multiple technical specialists within a legal framework. It establishes infrastructure (specifically, that can be used in identifying activities that can be regarded as 'sustainable') that could potentially be used, for example, in goal setting or assessment. Likewise, South Africa's National Treasury, as part of the South African Sustainable Finance Initiative, has recently published a draft sustainable finance taxonomy (https://sustainablefinanceinitiative.org.za/wp-content/uploads/2021/06/Draft-Green-Finance-Taxonomy.pdf (accessed 4 July 2021) and the UK is also working on a sustainable finance taxonomy, which is intended to align with the EU taxonomy (https://www.gov.uk/government/news/chancellor-sets-out-ambition-for-future-of-uk-financial-services (accessed 4 June 2021)). Other examples include the UK's Centre for Greening Finance and Investment, funded by the UK Government in recognition that there is not enough credible detailed information on climate financial risk to support accurate and cost-effective risk-modelling (see https://www.gov.uk/government/news/leeds-and-london-set-to-become-global-centres-of-green-finance (accessed 4 June 2021)) and the UK's Climate Financial Risk Forum, co-chaired by the UK Financial Conduct Authority and Prudential Regulation Authority, which seeks to build capacity and share best practice across financial regulators and industry and to advance the finance sector's response to the financial risks from climate change (see https://www.fca.org.uk/transparency/climate-financial-risk-forum). At an international level, in December 2020 the UN-convened Sustainable Insurance Forum

AREAS FOR LEGAL REFORM

announced that insurance supervisor members are to undertake a scoping study on the financial risks of biodiversity loss (see https://www.sustainableinsuranceforum.org/biodiversity-loss-and-associated-risks-to-be-addressed-in-new-study-by-un-convened-sustainable-insurance-forum/ (accessed 9 June 2021)).

26 For example, in Australia, in relation to MySuper products (the pension funds in which certain beneficiaries are placed by default if they do not select another fund to join) superannuation trustees are required to produce an investment strategy which includes 10-year investment return targets and must publish 10-year investment returns. In 2019, the Australian prudential regulator, the APRA, produced a Heatmap Paper indicating how they would assess the performance of MySuper products, which included assessment of investment performance over three and five-year timeframes (and eventually seven and ten-year timeframes) and also the ability of the fund to 'continue to deliver quality member outcomes into the future.' An APRA Climate Paper, also from 2019, expressly recognised that 'it is imprudent for entities or regulators to ignore [climate change] risks' and encouraged 'regulated entities to consider climate risks within their risk management frameworks, consistent with APRA's risk management prudential standards.'

27 In relation to EU entity governance, for example, MiFID II and MiFID II Delegated Regulation (especially Article 21) contain requirements for firms regulated under the Directive to maintain adequate systems and controls designed to secure the proper discharge of their responsibilities. The rules have recently been revised so that they explicitly now require firms to take sustainability risks into account (see MiFID II Sustainability Delegated Regulation). In relation to EU insurance undertakings, see Amendment Solvency II Delegated Regulation which amends existing provisions made under Solvency II Delegated Regulation to require that insurers take account of sustainability factors in their risk management processes (see Article 1, Amendment Solvency II Delegated Regulation).

In relation to product governance, see for example Articles 16(3) and 24(2) of MiFID II and Article 9 of MiFID II Delegated Directive. This has recently been amended to require firms producing investment products to consider sustainability factors in their product approval process and take them into account in product governance and oversight arrangements for any financial instrument intended for distribution to those wanting to invest in a financial instrument with a sustainability-related profile (see MiFID II Sustainability Delegated Directive). In relation to EU investment-related insurance products, see a recent amendment to regulations under the IDD which has a similar effect (Amendment IDD Delegated Regulation). In relation to UCITS, see a recent amendment to legislation made under the UCITS Directive which requires management companies to operate systems and controls for identifying and managing sustainability risks (UCITS ESG Delegated Directive).

28 There could be reticence among some companies about the second, among other things, for legal liability reasons, so any policy move in that direction might need to provide reassurance to them, much as is currently being considered in the case of proposals to revise the UK listing regime to allow for greater disclosure of forward-looking financial and other trading information (UK Listing Review, March 2021, 38 *et seq*). An example of a regime that attempts to address both sorts of information is the EU's regime on corporate sustainability reporting, under the Directive 2014/95/EU of the European Parliament and of the Council of 22 October 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups, OJ L 330, 15.11.2014, 1–9. This introduced a requirement (sometimes described as a 'double materiality' requirement) for companies to report both on how sustainability factors affect their performance, position and development (the 'outside-in' perspective) and on their own sustainability impact (the 'inside-out' perspective). The EU Commission has recently published a proposal for a directive to amend this regime, having concluded that the existing framework and associated guidance has not resulted in information of the requisite quality being disclosed (see proposal for a Corporate Sustainability Reporting Directive (CSRD)).

29 *Recommendations of the Task Force on Climate-related Financial Disclosures*, Final Report, Task Force on Climate-related Financial Disclosures, 2017. While it is a disclosure framework, to make the recommended disclosures, disclosing organisations would need to consider, among other things, how they address climate risks, for example, in their governance and systems and controls. The extent to which it might apply as a legal matter to any given enterprise will depend largely on local law.

30 Other than the EU's Non-financial Reporting Directive, another exception is China. The Chinese environmental authority has issued the Measures for the Disclosure of Environmental Information by Enterprises and Public Institutions in 2014, under which companies causing heavy pollution are required to disclose their environmental information, including information relating to pollution discharge, and the establishment and maintenance of environmental protection facilities. Companies listed on the Shanghai Stock Exchange STAR Market are also required by listing rules to disclose information regarding social responsibility performance in their annual reports and prepare the social responsibility report, sustainable development report, and environmental responsibility report as appropriate.

31 *Recommendations of the Task Force on Climate-related Financial Disclosures*, 20; *Implementing the Recommendations of the Task Force on Climate-related Financial Disclosures*, Task Force on Climate-related Financial Disclosures, June 2017, 15.

32 The need to establish and act on the sustainability preferences of investors as individuals is discussed at Section 2.5.3 below.

33 For example, Guidance Principle 2 of the Dutch Stewardship Code states that 'in assessing the Dutch listed investee companies' long-term value creation opportunities, risks, strategy and performance, it is critical to consider environmental (including climate change risks and opportunities), social and governance information (including board composition and diversity) besides financial information.' Principle 1 of the revised draft Code for Responsible Investing in South Africa contemplates that 'investment arrangements and activities reflect a systematic approach to integration of sustainable finance practices, including the identification and consideration of materially relevant ESG and broader sustainable development considerations.' Likewise, Principle 4 of the UK Stewardship Code provides that signatories 'identify and respond to market-wide and systemic risks to promote a well-functioning financial system.'

34 For example: the Code for Responsible Investing in South Africa states in describing its purpose that '[i]t is no longer appropriate for institutional investors to focus on only monetary benefit to the ultimate beneficiaries of investments to the exclusion of factors that impact on long-term sustainability.' (Institute of Directors Southern Africa, CRISA Code for Responsible Investing, 7); Principle 1 of the UK's Stewardship Code provides that 'Signatories' purpose, investment beliefs, strategy and culture enable stewardship that creates long-term value for clients and beneficiaries, leading to sustainable benefits for the economy, the environment and society.'

35 In Brazil, for example, the Association of Capital Market Investors (Associação dos Investidores do Mercado de Capitais—AMEC) has compiled a voluntary Stewardship Code for asset owners and investment managers. Those who adhere to AMEC Stewardship Code have a duty to observe its Principle No. 3, which recommends that institutional investors integrate environmental, social and governance factors in their investment processes and stewardship activities, evaluating both their impact on risks and returns and their contribution to the sustainable development of the issuers of securities. The assets under management of all pension fund adherents to the AMEC Stewardship Code combined correspond to more than forty-four percent (44 per cent) of all AuM of Brazilian pensions funds.

36 For example, as noted above, Principle 10 of the UK Stewardship Code provides that signatories will 'where necessary, participate in collaborative engagement to influence issuers.' Similarly, Principle 3 of the revised draft Code for Responsible Investing in South Africa (CRISA) contemplates that 'a collaborative approach is taken where appropriate to promote acceptance and implementation of the principles of CRISA and other relevant codes and standards, to support the building of capacity throughout the investment industry and enhance sound governance practice' and makes a number of practice recommendations in support of this principle.

37 See, for example, the UK Stewardship Code, 'How To Report', 5 *et seq*. Principle 6 of the Japanese Stewardship Code requires an institutional investor to periodically report to its clients and beneficiaries how it has satisfied its stewardship responsibility including the exercise of voting rights.

38 The UK Asset Management Taskforce (Government, senior representatives from the asset management industry, regulators and other key stakeholders) is an example of this, see *Investing with Purpose: Placing Stewardship at the Heart of Sustainable Growth*, November 2020.

39 See, for example, Eumedion (https://en.eumedion.nl/) and the UK Investor Forum: https://www.investorforum.org.uk

40 For example, Article 3(g) of the SRD requires institutional investors and investment managers to develop and disclose their engagement policy describing how they monitor investee enterprises (including, among other things, on strategy, financial and non-financial performance and risk, capital structure, social and environmental impact and how they cooperate with other shareholders and communicate with stakeholders in the relevant enterprises). They must also provide annual disclosure of their voting activity.

41 See, for example, *UK Stewardship Code: Review of Early Reporting, Financial Reporting Council*, September 2020.

42 For example, in the UK the Asset Management Taskforce recently published *Investing with Purpose: Placing Stewardship at the Heart of Sustainable Growth*. Recommendations include: (a) support for the commitment by UK trade bodies for investment managers and pension funds to establish a new steering group to explore how to embed a focus on long-term factors (including stewardship) in the relationships between asset owners and investment managers; and (b) investment consultants should provide more active support to clients in raising the standard of their stewardship activities and alignment of the stewardship approach of investment managers to client stewardship needs, including client oversight of managers, client engagement with managers on

AREAS FOR LEGAL REFORM

stewardship performance, and client engagement with beneficiaries regarding stewardship priorities.

43 This builds on a recommendation made in *The Kay Review of UK Equity Markets and Long-Term Decision Making*, Final Report, July 2012 that the UK government and relevant regulators should commission an independent review of metrics and models employed in the investment chain to highlight their uses and limitations.

44 In relation to climate change see, for example, UK guidance in *Aligning your Pension Scheme with the TCFD Recommendations*, The Pensions Climate Risk Industry Group, January 2021, Part II – Trustee governance, strategy and risk management: how to integrate and disclose climate related risks, 13-14 and 37-40.

45 For example, Article 3(h)(2) of the SRD requires certain institutional investors, where they appoint investment managers (including by investment in a mutual fund) to disclose on their website, on a 'comply or explain basis', certain matters with regard to how they achieve an alignment between the interests and perspective of the investment manager and their own in relation to long-term performance.

46 In relation to climate change see, for example, *Aligning your Pension Scheme with the TCFD Recommendations*, The Pensions Climate Risk Industry Group, January 2021, Part II – Trustee governance, strategy and risk management: how to integrate and disclose climate related risks, 14-21 and *Guide for assessing the climate competency of Investment Consultants*, the UK Investment Consultants Sustainability Working Group, January 2021.

47 *Walking the Talk: Understanding Consumer Demand for Sustainable Investing*, Cambridge Institute for Sustainability Leadership, 2019, 19. See also Florian Heeb, Julian Kölbel, Falko Praetold and Stefan Zeisberger, *Do Investors Care About Impact?* 25 February 2021 (available at https://ssrn.com/abstract=3765659), which considers the effect of labelling that highlights impact.

48 *Implementing the Recommendations of the Task Force on Climate-related Financial Disclosures*, 35-36.

49 The Asset Management Association of China (AMAC), the self-regulatory body of China's securities investment fund industry, issued the Green Investment Guidelines in November 2018. Under the Green Investment Guidelines, a fund is required to conduct annual self-evaluation on its status of 'green investment' (ie the investment is related to environmental sustainability) and file the self-evaluation report with the AMAC. The self-evaluation report includes filling a form that answers a detailed list of assessment questions related to the fund's 'green investment' status, including its internal management mechanisms related to environmental sustainability and the operation of 'green investment' products. The AMAC, based on these self-evaluation reports, publishes annually the statistics and analysis regarding the overall development of China's environmental sustainability investment in the securities investment fund industry.

50 SFDR or Disclosure Regulation.

51 While not yet in force, the Occupational Pension Schemes (Climate Change Governance and Reporting) Regulations 2021 are expected to come into force on 1 October 2021, introducing new requirements on reporting consistent with TCFD recommendations. Their aim is to improve the quality of climate risk governance and the level of trustee action in identifying, assessing and managing climate risk.

52 For example, see *The Division of Examinations' Review of ESG Investing Risk Alert*, Division of Examinations of the US Securities Exchange Commission, 9 April 2021, EU SFDR/Disclosure Regulation, *Building trust in sustainable investments, a speech by Richard Monks*, Director of Strategy, UK Financial Conduct Authority, 21 October 2020, and *Recommendations on Sustainability-Related Practices, Policies, Procedures and Disclosure in Asset Management*, Consultation Report, CR 01/21, OECD, June 2021.

53 For investor behavioural risks that could result in 'greenwashing' or 'impact washing' see, for example, Florian Heeb, et al., *Do Investors Care About Impact?; Impact Washing Gets a Free Ride: An Analysis of the Draft EU Ecolabel Criteria for Financial Products*, 2° Investing Initiative, June 2019.

54 An example of this approach is China's Catalogue of Projects Supported by Green Bonds issued by the relevant Chinese financial regulators, which specifies projects for which 'green bonds' (ie bonds issued to finance projects related to environmental sustainability) can be issued, such as the manufacture of more eco-friendly equipment. Issuance of 'green bonds' will enjoy certain preferential policy treatments.

55 One regime that uses labelling in this way to underpin the credibility of investment products with explicit sustainability objectives is the Regulation (EU) No 346/2013 of the European Parliament and of the Council of 17 April 2013 on European social entrepreneurship funds, OJ L 115, 25.4.2013, 18–38 or 'EuSEFs'. EuSEFs engage in a relatively focused form of ultimate ends IFSI, involving finance provision to non-publicly traded undertakings that have the goal of achieving measurable, positive social impacts as their primary objective' (Art. 3(d)). Among other things, as a condition of carrying the EuSEF label, the relevant fund managers must comply with various operating standards, including conducting their activities so as to promote the positive social impact of the undertakings in which they invest, applying high levels of diligence in selection and monitoring, maintaining clear and transparent measurement procedures to assess the impact of investee undertakings and requirements to disclose the social goals and outcomes of the fund to investors. Articles 8 and 9 SFDR/Disclosure Regulation seek to do something similar in relation to, respectively, products that 'promote environmental or social characteristics' and which have 'sustainable investment' as their objective. Similarly, the French regulator, the AMF, released in 2020 a set of rules and guidance seeking to ensure that fund managers may only communicate the ESG-related features of their funds if they actually implement consistent investment approaches (see https://www.amf-france.org/en/news-publications/news/sustainable-finance-and-collective-investment-management-amf-publishes-update-its-investor).

56 On 1 December 2020, the Securities and Exchange Commission of Brazil (*Comissão de Valores Mobiliários—CVM*) published a Request for Comments no. 08/2020, in which it proposes a new regulatory framework for mutual funds. The CVM proposes to limit use of the expression 'sustainable' (*sustentável*) in receivables funds' names to funds that have more than half of their portfolio comprised of credit rights the issuance of which was accompanied by a positive environmental or social impact, as assessed by internationally recognised methodologies or by a third party opinion. Some of the discussions held with market participants in the context of this RFC concerned widening the list of restricted words and expressions and the types of investment funds to which these naming restrictions would apply, as an effort to combat ESG-washing.

57 For the sort of impact that ratings can have, see Marco Ceccarelli, Stefano Ramelli and Alexander F. Wagner, *Low-carbon Mutual Funds*, ECGI Finance Working Paper No 659/2020, February 2021 looking at how the introduction of Morningstar's 'Low Carbon Designation' affected fund flows.

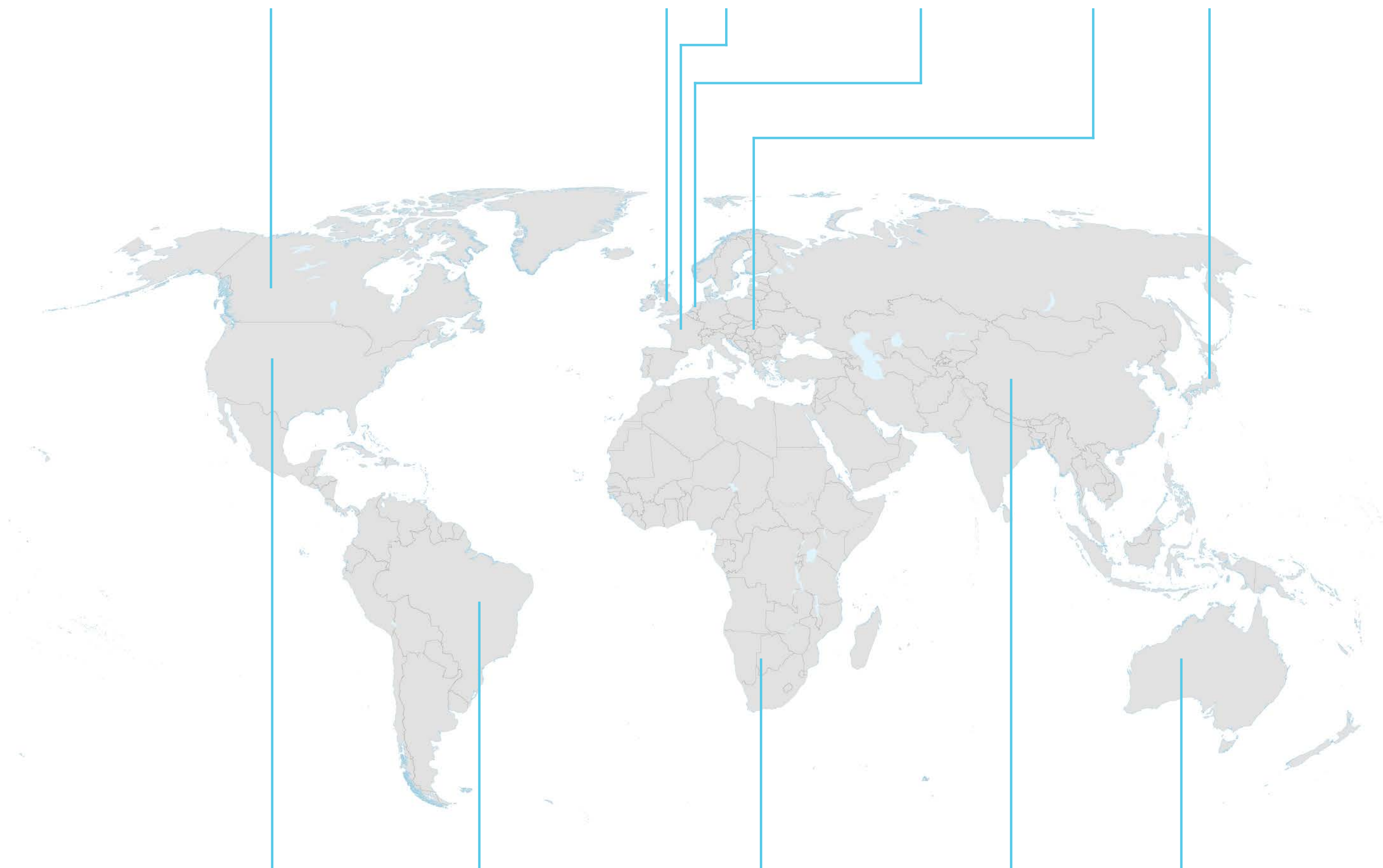
58 For example, MiFID II and MiFID II Sustainability Delegated Regulation (especially Article 54) contain requirements for firms providing investment advice and/or investment management to establish the investment objectives of their clients and to reflect these in the recommendations they provide and decisions they take on behalf of the client. These rules have recently been revised to require the relevant firms to make an assessment of sustainability preferences of clients and take them into account in selecting financial products, although they do not explicitly address positive sustainability impact goals. Firms will also be required to prepare reports for clients explaining how the recommendation meets a client's investment objectives, including sustainability preferences. In relation to EU investment-related insurance products, see a recent amendment to regulations under the IDD which has a similar effect (Amendment IDD Delegated Regulation).

59 The UK Financial Conduct Authority is currently consulting on whether to introduce a 'consumer duty' which would apply to regulated firms requiring them: (a) to ask themselves what outcomes consumers should be able to expect from their products and services; (b) to act to enable rather than hinder these outcomes, and (c) to assess the effectiveness of their actions (see *A New Consumer Duty*, Consultation Paper CP 21/13***, Financial Conduct Authority, 2021).

60 Adrian C. T. Borgers and Rachel A. J. Pownall, *Attitudes Towards Socially and Environmentally Responsible Investment*, Journal of Behavioral and Exerimental Finance, 2014, Vol. 1, 27-44, 30. See also *Walking the Talk: Understanding Consumer Demand for Sustainable Investing*, Cambridge Institute for Sustainability Leadership, 2019, 17.

61 For example, the US SEC has issued guidance on ESG and impact investing for retail investors: see https://www.sec.gov/oiea/investor-alerts-and-bulletins/environmental-social-and-governance-esg-funds-investor-bulletin (accessed 8 June 2021). Careful thought would be needed on how best to reach potential investors in ways that are intelligible and engaging. Examples of independent initiatives include the 'My Fair Money' website in Germany (https://www.meinfairmoegen.de/infomaterial) and the 'Finance ClimAct' project in France (https://finance-climact.eu). In the UK, see Make My Money Matter (https://makemymoneymatter.co.uk).

JURISDICTION REPORTS



AUSTRALIA

1. INTRODUCTION

1.1 This Annex considers the laws of Australia as at 31 January 2021. Sections 2 to 4 address the ability of Asset Owners to Invest for Sustainability Impact where the relevant portfolio does not have an express Sustainability Impact objective.

1.2 As discussed in the main body of the report, the expression '*Investing for Sustainability Impact*' is not a term of art. Rather, the expression is used here as a '*conceptual net*' to denote any power or freedom on the part of an Asset Owner or its Investment Manager to pursue one or more Sustainability Impact objectives (instead of, or in addition to, financial return).

1.3 The types of Asset Owners considered in this Annex are:

- superannuation funds;
- registered managed investment schemes and listed investment companies; and
- life insurance companies and general insurance companies.

1.4 In this Annex certain underlying key themes recur:

Best interests

Superannuation funds and registered managed investment schemes

1.4.1 Standards applying to superannuation funds and registered managed investment schemes are often expressed referring to duty to act in the '*best interests*' of the beneficiary. As discussed throughout this report, though the best interest of beneficiaries is defined with reference to their financial interest, this may not necessarily preclude IFSI (whether instrumental or ultimate ends IFSI).

1.4.2 The curial and academic consideration of the duty to act in the best interests of beneficiaries as it applies to trustees generally, and to APRA-regulated trustees and responsible entities specifically are broadly analogous.

1.4.3 When interpreting the duty to act in the best interests of beneficiaries, Australian courts have cited the English case of *Cowan v Scargill*[1] in holding that where the purpose of the trust is to provide financial benefits for the members, the best interests of the members are usually the best financial interests of the members. More recently, the High Court of Australia has held that: '[the] key factors in ascertaining the best interests of the members are the purpose and terms of the scheme.'[2] In the recent decision of *Australian Prudential Regulation Authority* (**APRA**) *v Kelaher*[3] (**Kelaher**), Jagot J accepted the submission from the respondents (citing Thomas)[4] that '*acting in the best interests of the beneficiaries is in effect synonymous with a trustee's obligation to promote and act consistently with the purpose for which the trust was established*.'[5]

1.4.4 In *Kelaher*, the view that the best interests of members of a superannuation fund for the purposes of this duty will be the best financial interests of members was submitted by APRA and accepted by Jagot J.[6] The best interests duty as it applies to APRA-regulated trustees is overlaid by the member outcomes assessment requirements (see paragraphs 2.2.16 to 2.2.18).

1.4.5 While it will depend on the terms of a specific registered managed investment scheme, given the commercial context of the establishment of many schemes, it is likely that the purpose of many schemes will be determined to comprise wholly or partly the generation of a financial return to members, and that the best interests of members for the purposes of this duty will also be, in many cases, the best financial interests of members.

1.4.6 The enquiry as to whether the responsible entity of a registered managed investment scheme or APRA-regulated trustee of a superannuation funds has acted in the best interests of the members is an objective one. Although a responsible entity is required to act in the best interests of members; it is not required to actually achieve the best outcome for members.[7] Consequently, there might be more than one course of action that is in the best interests of the beneficiaries.[8] Certain Australian commentators point to a line of cases that indicate that Australian courts '*will be loathe*' to review the merits of a trustee's decision unless the decision '*is so remarkable*' that it amounts to '*one which no reasonable trustee could make on the material before it*'.[9]

1.4.7 The duty to act in the best interests of beneficiaries does not necessarily preclude the trustee from making a decision that might also provide benefits, other than benefits to members (in that

AUSTRALIA

capacity), provided that the decision has been properly made for the purpose of advancing the financial interests of members (in that capacity).[10]

1.4.8 Despite the need to consider financial risks arising from climate change, legislation introduced by the Commonwealth Treasury, which has been passed by the Federal Parliament and is awaiting Royal Asset (before becoming law), is likely to resolve any uncertainty about whether 'best interests' means 'best financial interests' with respect to the role played by APRA-regulated trustees of superannuation funds. The legislation provides that superannuation fund trustees are required to exercise their powers and duties in the 'best financial interests of the beneficiaries'.[11] While this change may not be inconsistent with the curial interpretation of 'best interests' in the context of superannuation funds, it may place an even greater focus on the financial considerations applicable to decisions to be made by superannuation fund trustees and may result in superannuation fund trustees being more reluctant to Invest for Sustainability Impact.

1.4.9 In the same legislation the *Superannuation Industry (Supervision) Act 1993* (Cth) (**SIS Act**) is to be amended to require APRA to conduct an annual performance test for MySuper products and other products to be specified in regulations. A trustee providing such products will be required to give notice to its beneficiaries who hold a product that has failed the performance test.[12] By assessing and rating trustee performance on investment returns (and other, unlisted APRA requirements), it is possible that trustees may focus on short-term investments, resulting in positive yearly returns rather than investments focused on positive Sustainable Impacts.

Insurance companies and listed investment companies

1.4.10 Standards applying to insurance companies and listed investment companies are also often expressed referring to duty to act in the *'best interests'* of the company. As discussed throughout this report, though the best interest of beneficiaries is defined with reference to their financial interest, this may not necessarily preclude.

1.4.11 The best interests duty in subsection 181(1) of the *Corporations Act 2001* (**Corporations Act**) reflects the duty to act in the best interests of the company at general law. To discharge the best interests duty at general law, directors must 'exercise an active discretion and actually consider and act in the interests of the company as a whole'.[13] The test is whether 'an intelligent and honest director could, in the whole of the existing circumstances, have reasonably believed that the transaction was for the benefit of the company'.[14]

1.4.12 The traditional position has been that the interests of the company are synonymous with the interests of the shareholders as a general body.[15] Alongside the traditional approach, sit a range of decisions focused on the pursuit of short-term profit maximisation for shareholders.[16] However, more recently, some courts,[17] a legislative committee,[18] and academics[19] have endorsed the view that the best interests duty is better articulated as a duty owed to the company as a separate legal entity. Though the interests of shareholders will generally 'intersect'[20] or be 'contiguous' [21] with those of the company, the duty is not a duty to advance the interests of shareholders.[22]

1.4.13 Additionally, recent cases suggest that the 'best interests' of a company are not necessarily the maximisation of short-term profits. According to one recent High Court case, directors should consider broader non-economic interests – or the 'commercial context'[23] of a company — when determining what would serve the best interests of a company. In *ASIC v Cassimatis*, Edelman J (now a Justice of the High Court) observed that when calculating harm caused by a breach of a director's duty of care, skill and diligence non-financial factors, including a company's 'reputation', were relevant.[24] Another recent decision also categorised 'community' interests as interests which may be adversely affected by director's actions.[25] Case law also suggests that directors may, when making decisions, consider other interests alongside a benefit to the company: 'the law permits many interests and purposes to be advantaged by company directors, as long as there is a purpose of gaining in that way a benefit to the company'. [26] This is supported by two Commonwealth inquires which found that under the best interest duty directors can consider environmental social and governance interests and factors.[27] These developments indicate

> ANNEXES

> Australia

AUSTRALIA

that if non-financial considerations could be reasonably regarded as one which will benefit the company (in the short or, perhaps, long-term) a director may consider such other interests whilst discharging their best interest duty. These developments also indicate that it may be possible for companies to engage in instrumental and ultimate ends IFSI. Whether they can engage in any particular instrumental or ultimate ends IFSI will depend on the applicable facts and circumstances at the time and the extent to which the investment or activity can be regarded as being in the best interests of the company (whether because it advances the financial or other interests of the company, or because the financial or other interests of the company are being advanced in parallel with the IFSI).

1.4.14 Relevantly and consistently with the recent curial trends referred to in paragraphs 1.3.13 to 1.3.14, the Interim Report of the *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry*, included the following remarks by the Commissioner, Kenneth Hayne AC QC, who is former Judge of the High Court of Australia:

> *'As [a commercial enterprise], [a listed] entity … rightly pursues profit. Directors and other officers of the entities owe duties to shareholders to do that. But the duty to pursue profit is one that has a significant temporal dimension. The duty is to pursue the long-term advantage of the enterprise.*
>
> *Pursuit of long-term advantage (as distinct from short-term gain) entails preserving and enhancing the reputation of the enterprise as engaging in the activities it pursues efficiently, honestly and fairly …*
>
> *But to preserve and enhance a reputation for engaging in the enterprise's activities efficiently, honestly and fairly, the enterprise must do more than not break the law. It must seek to do 'the right thing'.*

1.4.15 Hayne J also stated, extra-judicially, that:

> *[what is in a Company's] 'Best interests' is not one-dimensional – it is not determined only by share price movement or 'total shareholder return' over a period… in Australia, a director acting in the best interests of the company must take account of, and the board must report publicly on, climate–related risks and issues relevant to the entity.*[28]

1.4.16 Essentially, although the concept of IFSI is not expressly mentioned by Kenneth Hayne J in relation to his final report for the Royal Commission, it can be strongly inferred that Mr Hayne is making a strong case that instrumental IFSI can overcome systematic risks. An interpretation of Hayne J's statements can be made that setting social impact goals and creating a culture of 'doing the right thing' can ultimately lead to improved financial performance through the removal of systematic risks. In this regard, ESG is not just a topic to be considered by the board of companies, but instrumental IFSI is in the best interests of members since it can, over the longer term, help produce a better financial position.

1.4.17 The views of Hayne J have also been echoed by other commentators in the context of public discussions involving Australia's corporate regulators and other key stakeholders, and appears to be consistent with modern legal commentary. Recently, Professor Baxt AO observed that 'in light of recent public pressure, somewhat enhanced by the operations of bodies such as the ASX Corporate Governance Council amongst others, there is clearly an expectation that directors should act with a greater awareness of the broader social context that impact on the affairs of any company'.[29] In a similar vein, Acquaah-Gaisie submits that '[c]orporate governance should focus not only on profitability. Boards should promote interests of all corporate stakeholders'.[30] In 2001, Horrigan argued that:

> *'[T]he best interests of a corporation…need not be exclusively framed in financial or continuous profit-maximisation terms…[They] are multi-dimensional, reflecting a variety of economic and non-economic factors such as maintaining industry standing, accommodating business 'best practice' guidelines, and enhancing a corporation's community reputation.'*[31]

Duty of care

1.4.18 Trustees and directors of companies are generally subject to some form of duty of care and diligence.[32]

1.4.19 In determining the scope of the duty of care and diligence of a trustee (which applies similarly to directors of companies), the courts will have regard to:

- the circumstances of the trustee's position and the trust, including the type of

> ANNEXES

> Australia

AUSTRALIA

the undertaking, the provisions of the relevant constituent documents, the size and nature of the trustee's operations, the functions to be performed, the experience or skills of the trustee and the circumstances of the specific case;[33]

- the purpose of the particular power being exercised or duty being carried out; and[34]
- the prism of the particular trust in question, having regard to its constitution and particular investment mandate, and the profile of the accepted risks and potential returns the subject of the investments that may be undertaken for the trust. A trustee is not required to eschew a high-risk investment strategy where that is the nature of the trust that has been marketed to beneficiaries. Rather, a trust is required to implement the advertised strategy prudently.[35]

1.4.20 In order to discharge this duty of care and diligence, amongst other things, the relevant person is required to have regard to foreseeable risks of harm to the beneficiaries or company's (as applicable) interests (predominantly financial, but in the case of companies, possibly broader reputational and other interests) and consider what steps a reasonable person in their position would take in the circumstances to alleviate those risks.[36] In determining what steps such a reasonable person would take, the court may have regard to the likelihood of the risk occurring, the magnitude of the risk and the seriousness of harm the beneficiaries or the company (as applicable) would suffer and the expense, difficulty and inconvenience of taking the applicable steps.[37] Whether at law a reasonable person is responsible for the harm suffered may depend on the whether the failure to discharge the duty of care and diligence caused or materially contributed to the harm.[38]

1.4.21 Negative Sustainability Impacts could conceivably be or intersect with foreseeable risks of harm to those interests, which engagement in instrumental IFSI could alleviate (eg by taking steps to influence the exposure of investees of the person to those negative Sustainability Impacts). Whether the relevant person is required to take any or certain steps and engage in instrumental IFSI in those circumstances will depend on what a reasonable trustee or director of a company would do to alleviate those risks.

Doctrine of powers

1.4.22 The general law doctrine of powers requires that donees of powers (including trustees and directors) exercise their powers for a proper purpose.[39] The Australian courts have interpreted a proper purpose to mean, namely, a purpose for which the power was expressly or impliedly granted.[40] An exercise of a power for a purpose other than a proper purpose is voidable as a fraud on the power.[41]

There does not appear to be a consistent line of curial authority as to how significant collateral or incidental benefits need to be to invalidate an exercise of the power. However, it is clear that an intention to secure collateral benefits need not be the sole or dominant purpose behind the exercise of the power for the court to intervene.[42] According to Donald, Ormiston and Charlton, the apparent consensus is that the courts will not intervene unless they believe the decision was in fact influenced by the incidental purpose or purposes to the detriment of the beneficiaries.[43]

1.4.23 The discussion above on the general law principles of the doctrine of powers also applies to the exercise of powers by the directors of the boards of listed investment companies (**LIC**) and insurance companies. That is, the directors of LICs must exercise their management and other powers consistently with the purposes for which they were conferred.[44] The duty is also reflected in the Corporations Act.[45]

1.4.24 The law on doctrine of powers suggests that donees of powers may be constrained from having parallel or significant subsidiary purposes that are not the purposes for which the relevant power is granted. We note that the law on the doctrine of powers may not in all respects be consistent with the law on the 'best interests' duty (see 1.4.13) or the 'sole purpose' test that applies to superannuation funds (see 2.2.15). While we cannot say how that inconsistency would be resolved in all scenarios, we consider it possible that if it were tested, a court may ultimately determine that, provided it could be said that the applicable power had been exercised for a 'proper purpose' (whether because the 'proper

AUSTRALIA

purpose' was the primary purpose, because it would not have exercised but for that 'proper purpose' or otherwise), the exercise of the power would not be invalidated by a subsidiary or even parallel sustainability purpose (ie ultimate ends IFSI).

1.4.25 The uncertainty as to whether the doctrine of powers would allow ultimate ends IFSI may not similarly constrain instrumental IFSI, which contemplates the sustainability goal as being a necessary step in achieving the relevant financial investment objective, which may be consistent with the purposes for which the power was granted.

Statutory requirements

1.4.26 There are a number of federal statutes that apply to all Relevant Investors that interact with the principle of IFSI. Principal among these is the *Anti-Money and Counter-Terrorism Financing Act 2006* Cth (**AML/CTF Act**) and the *Modern Slavery Act 2018* (Cth) (**Modern Slavery Act**). The AML/ZTF Act requires that an entity's AML/CTF program accommodates new and existing sanctions against countries, goods and services, people or entities. The Modern Slavery Act is a self-as sessment regime the reporting of which commenced in the second half of 2020. It does not prescribe penalties or other liabilities for negative Sustainability Impacts that are identified in the Modern Slavery Act. However, in time, it is anticipated that the reporting requirements will give rise to heightened public expectations that APRA-regulated trustees and insurance companies actively engage with their Investment Managers to reduce modern slavery risks in their portfolios.

AUSTRALIA

2. ASSET OWNERS' USE OF POWERS OF INVESTMENT AND DIVESTMENT TO INVEST FOR SUSTAINABILITY IMPACT

2.1 The following section considers the extent to which and in what circumstances, each type of Asset Owner is by law (a) required, or (b) permitted or able, to use its powers of investment and divestment to Invest for Sustainability Impact.

2.2 **Pension funds**

Types of pension fund covered

2.2.1 We consider below both accumulation and defined benefit plans in superannuation funds regulated by APRA under the SIS Act. We have excluded from consideration: (a) superannuation funds that have fewer than 5 members and are managed by a trustee regulated by APRA ('small APRA funds'); (b) self-managed superannuation funds that have fewer than five members and are personally managed by the members themselves and (c) superannuation funds for the benefit of state or federal Government employees or members of the Australian Defence Force, to the extent these funds are also regulated by other Australian legislation.[46]

2.2.2 Superannuation funds are required to be structured as trusts and do not have separate legal personality.

2.2.3 APRA-regulated trustees are required to hold an Australian Financial Services Licence (**AFS Licence**) issued by the Australian Securities and Investments Commission (**ASIC**), where the superannuation fund is a 'public offer fund' or where the APRA-regulated trustee engages in activities regulated by ASIC. A 'public offer fund' is a superannuation fund that individuals can join as members without being nominated for membership by their employer.

2.2.4 Superannuation funds are required to maintain an investment portfolio, referred to as a 'MySuper product' to which contributions of their members are allocated if a member has not submitted a written investment direction. Superannuation funds are also permitted to offer other investment options (referred to as 'choice products') that members may choose to invest in. Almost all superannuation funds offer members a facility to select from a list of choice products.

- **Asset Owner:** The trustee of the superannuation fund.
- **Beneficiaries:** Members of the superannuation fund have a beneficial interest in the fund. Other parties that may receive a benefit in certain circumstances include the member's spouse, children or person with whom the member has an interdependency relationship,[47] or the member's estate. For an employer sponsored defined benefit superannuation fund, the trustee may also need to consider the position of the employer.
- **Investment decision maker:** The trustee of the superannuation fund, or an investment manager appointed by the trustee of the fund. An APRA-regulated trustee must formulate and give effect to an investment strategy.[48] One or more investment managers may be appointed to carry out some or all of the investment management function.

Overview of investment duties and powers

Sources of legal duties and powers for APRA-regulated trustees

2.2.5 Superannuation funds are principally regulated by the SIS Act and statutory instruments made under the SIS Act, including prudential standards issued by APRA (**Prudential Standards**). Prudential Standards have legal effect as statutory instruments.

2.2.6 Other sources of legal duties and powers in relation to investment are:

- legislation of the States and Territories of Australia that applies to trustees[49] (the **State Trustee Acts**): An APRA-regulated trustee is subject to the State Trustee Act in the State or Territory that is the governing law of the trust instrument establishing the superannuation fund. An APRA-regulated trustee may also be subject to the State Trustee Act of other States and Territories in which members of the superannuation fund reside;
- general law: The law of trusts in Australia remains substantially governed by principles of common law and equity (**general law**), which are found in decisions of the Federal, State and Territory courts. Statutory rules have significantly overlaid and modified the law

ANNEXES

Australia

AUSTRALIA

of trusts as applying to superannuation funds and APRA-regulated trustee, but the general law remains applicable to the extent that it is not overridden or modified by statute; and

- other legislation applicable to an APRA-regulated trustee's business of managing the superannuation fund, for example: the Corporations Act, Modern Slavery Act and AML/CTF Act.

2.2.7 Other regulatory sources for APRA-regulated trustees include:

(a) Prudential Practice Guides and other publications issued by APRA, setting out APRA's views on the interpretation of relevant statutes and trustees' duties; and

(b) Regulatory Guides and other publications issued by ASIC, setting out ASIC's views on the interpretation of the Corporations Act.

2.2.8 Prudential Practice Guides and Regulatory Guides are normally not legally binding, but they represent APRA's and ASIC's view on the law.

The power of investment for APRA-regulated trustees

2.2.9 A trustee's power to invest the trust property is derived from the general law of trusts but is now substantially regulated by statute, in particular the State Trustee Acts. Trustee legislation includes similar terms in relation to investment powers and duties across all States and Territories.

2.2.10 Under trustee legislation a trustee *unless expressly forbidden by the trust instrument*, may invest trust funds in any form of investment, and at any time vary an investment or realise an investment and reinvest money resulting from the realisation in any form of investment.[50] These rules apply to APRA-regulated trustees and superannuation funds. As a result, while the trust instrument of the fund may include a list of authorised investments, trustees are not limited to the listed investments unless the trust instrument expressly prohibits other investments.

SIS Act general covenants and investment covenants

2.2.11 In brief summary, an APRA-regulated trustee is required to:[51]

- ensure that the superannuation fund is maintained *solely* for prescribed purposes, which are, broadly: providing benefits from the superannuation fund, to the member on the member's retirement or attaining the age of 65, or the member's dependants or estate on the member's death (and benefits in other limited circumstances) (the ***sole purpose test***);[52]
- formulate, review regularly and give effect to an investment strategy for the whole superannuation fund, and each investment option offered, taking into account a list of prescribed factors.[53] The prescribed factors include: risk and return having regard to investment objectives and expected cash flow requirements; composition and adequacy of diversification; liquidity having regard to expected cash flow requirements; reliability of valuation information; existing and prospective liabilities and tax and costs;[54]
- exercise, in relation to all matters affecting the fund, the same degree of care, skill and diligence as a prudent superannuation trustee would exercise in relation to an entity of which it is trustee and on behalf of the beneficiaries of which it makes investments.[55] A superannuation trustee is 'a person whose profession, business or employment is or includes acting as a trustee of a superannuation entity and investing money on behalf of beneficiaries of the superannuation entity';[56]
- perform the trustee's duties and exercise the trustee's powers in the best interests of the beneficiaries;[57]
- where there is a conflict of interest, amongst other things, give priority to the duties to and interests of the beneficiaries;[58] and
- formulate, review regularly and give effect to a risk management strategy that relates to: the activities, or proposed activities, of the APRA-regulated trustee, to the extent that they are relevant to the exercise of the trustee's powers, or the performance of the trustee's duties and functions, as trustee of the superannuation fund; and the risks that arise in operating the superannuation fund.[59]

2.2.12 The directors of an APRA-regulated trustee themselves owe the duty of care and skill and the best interests duty to the beneficiaries of the superannuation fund.[60]

2.2.13 Specific statutory duties and obligations that prescribe the investment approach that an APRA-regulated trustee must adopt were introduced in 2019.[61] These include:

AUSTRALIA

- the duty to promote the financial interests of beneficiaries who hold a MySuper product or a choice product, in particular returns to those beneficiaries (after the deduction of fees, costs and taxes);[62]
- the obligation to undertake an annual assessment, for each MySuper product and choice product, of whether the financial interests of the beneficiaries who hold the product are being promoted by the trustee, taking into account prescribed factors including comparisons with other funds (**member outcomes assessment**). The prescribed factors include: fees and costs that affect the return; the return for the product (for MySuper products, after the deduction of fees, costs and taxes);
- the level of investment risk; whether the options, benefits and facilities offered are appropriate to those beneficiaries; whether the investment strategy for the product, including the level of investment risk and the return target, is appropriate to those beneficiaries;[63] and
- the obligation to include in the investment strategy for MySuper products an investment return target over a period of ten years for the assets comprising the MySuper product and the level of risk appropriate to the investment of those assets.[64]

Sole purpose test

2.2.14 There is general acceptance of the proposition that the sole purpose test requires that investment decisions are confined to the interests of members in respect of their benefits from the superannuation fund, and not their interests in any other capacity.[65]

2.2.15 However, as with the best interests test, Australian courts have held that the sole purpose test does not necessarily preclude the trustee from making a decision that might also provide benefits, other than benefits to members (in that capacity), provided that the decision has been properly made for the purpose of advancing the financial interests of members (in that capacity).[66] Consequently, it seems to us plausible that the sole purpose test would not preclude the trustee from engaging in instrumental IFSI (and possibly even ultimate ends IFSI), provided that the relevant investment, activity or decision is and could be characterised as an investment, activity or decision properly made for the purpose of advancing the financial interests of members.[67]

Member outcomes assessment

2.2.16 Since January 2020, APRA Prudential Standard SPS 515 – *Strategic Planning and Member Outcomes* (**SPS 515**) has required APRA-regulated trustees to assess whether they have, or will, provide the outcomes that they seek to provide to beneficiaries, and whether and how those outcomes could be improved. We note that, in SPS 515, APRA does not indicate whether those outcomes are necessarily financial, although given the duties that apply to superannuation trustees, we expect those outcomes generally to be financial in nature. The outcomes assessment must include:[68]

- the outcomes that the trustee seeks to provide to beneficiaries;
- the metrics that the trustee uses in undertaking its assessment to measure the outcomes being provided to beneficiaries, including their calculation;
- a comparison of the calculation of those metrics with reference to objective benchmarks and targets in both absolute and relative terms; and
- tthe key factors identified by the trustee as having affected the results of those calculations, which must include a list of prescribed factors, including the investment strategy of each investment option and the basis for setting fees, and also non-investment features including insurance and the options, benefits and facilities offered to members.

APRA Information Paper – Heatmap MySuper products

2.2.17 APRA released an APRA Information Paper titled '*Heatmap – MySuper products*' on 15 November 2019 (**APRA Heatmap Paper**). The APRA Heatmap Paper describes the determination and operation of (broadly, financial) metrics that APRA has formulated to assess the performance of MySuper products offered by superannuation funds, based on data that APRA collects from them. The metrics include:

- investment performance (net investment return, risk adjusted) over three and five year timeframes; and
- sustainability including net cash flow and accounts growth rate. Use of the term 'sustainability' refers to the ongoing viability of the superannuation fund and the APRA-regulated trustee's 'likely

AUSTRALIA

ability to continue to deliver quality member outcomes into the future' (ie, the term refers to sustainability of member outcomes). APRA expresses the view that the scale of a superannuation fund can influence an APRA-regulated trustee's 'ability to optimise investment outcomes'.[69]

2.2.18 Superannuation funds' MySuper products will be assessed on the metrics and the results published at least annually on APRA's website. There is an expectation that superannuation funds that are identified as 'underperforming', based on the published results, will face increased pressure to merge with funds that have superior scores.[70]

AFS Licences for APRA-regulated entities

2.2.19 As a holder of AFS Licence, an APRA-regulated trustee is subject to specific statutory duties with respect to the financial services it provides. It is also not possible to contract out of these duties. The duties include the duty to:[71]

- do all things necessary to ensure that the services are provided efficiently, honestly and fairly;
- comply with financial services laws;
- maintain the competence to provide those services;
- ensure that its representatives are adequately trained and are competent to provide those services; and
- have adequate risk management systems.

2.2.20 The 'efficient' in the duty to do all things necessary to ensure that the services are provided efficiently, honestly and fairly includes the duty to ensure that the services are adequate, produce the desired effect, and are provided capably and competently.[72]

Timeframe for net returns

2.2.21 For APRA-regulated trustees, the duty to treat different classes of beneficiaries fairly may require balancing the interests of younger members (who will be invested in the superannuation system for some decades) and the interests of older members with shorter investment horizons. Some superannuation funds approach this by implementing a 'life-cycle strategy' for the MySuper product, which has a higher weighting to growth assets for younger age cohorts and a progressively higher weighting to defensive assets for older age cohorts. Most superannuation funds offer choice products that are weighted to lower volatility assets than the MySuper product, and these investment options are typically marketed as aimed at members who prefer a lower risk option.

2.2.22 The appropriateness of APRA-regulated trustees taking into account net returns over the longer term when making investment decisions is supported by their statutory obligations to include ten year investment return targets in the investment strategy for MySuper products, and to publish ten year investment returns for MySuper products. The APRA Heatmap Paper also indicates that APRA proposes to also assess the investment performance MySuper products over seven and ten year timeframes when the data becomes available.

Statutory disclosure requirements applicable to APRA-regulated superannuation trustees

2.2.23 A product disclosure statement (***PDS***) must be given to new or prospective investors in prescribed financial products, including superannuation funds, insurance policies and interests in registered managed investment schemes. The PDS must include any information that might reasonably be expected to have a material influence on the decision of a reasonable person, as a retail client, whether to acquire the product.[73] The PDS for an investment product must include 'the extent to which labour standards or environmental, social or ethical considerations are taken into account in the selection, retention or realisation of investments'[74] (***ESG statement***).

2.2.24 ASIC Regulatory Guide 65 '*Section 1013DA disclosure guidelines*' (issued November 2011) (**ASIC RG 65**) sets out detailed guidelines for ESG statements and, unlike other regulatory guides issued by ASIC, which contain ASIC's interpretation of the law but are not legally binding, the disclosure requirements in ASIC RG 65 are mandatory.[75] However, in 2011, amendments were made to allow superannuation products and simple managed investment schemes to provide their ESG Statements in 'summary form'.[76] Nevertheless, ASIC strongly encourages the use of ASIC RG 65 by entities when they prepare a summary form PDS.[77]

AUSTRALIA

Legal requirements to use investment powers to Invest for Sustainability Impact

2.2.25 There is no *general and explicit* obligation for APRA-regulated trustees to use investment powers to Invest for Sustainability Impact, and this applies to both instrumental or ultimate ends IFSI. Neither are there more specific requirements for APRA-regulated trustees to invest in such a way as to advance a secondary objective (for example, a reduction in greenhouse gases) or that preclude investment in certain industries on the basis of sustainability or to seek to secure wider societal objectives (outside the objective to provide for the retirement of the member) or by reference to any 'public interest'.

2.2.26 However, there is legal academic and practitioner commentary that suggests that proper risk management and consideration of long term returns may import an active duty for APRA-regulated trustees to consider how negative Sustainability Impacts may impact investment performance, on the basis that failure to do so may result in financial losses to the superannuation fund or not meeting the investment objectives.[78] Also, APRA-regulated trustees are required to formulate and give effect to risk management strategies and APRA has stated that it expects regulated entities to actively assess climate change risk and incorporate the assessment into governance frameworks.[79]

2.2.27 APRA commentary also suggests that in order for an APRA-regulated trustee to properly discharge their duties (particularly the best interests duty and the duty of care and diligence), they are required to consider financial risks that may arise from climate change. For example, in APRA's Information Paper *Climate change: Awareness to action* release on 29 March 2019 (**APRA Climate Paper**), APRA's commentary included that it expected APRA-regulated entities to actively assess climate change and incorporate that assessment into their governance frameworks, and that it will be embedding assessment of climate risk into its ongoing supervisory activities.[80]

2.2.28 The requirements in the APRA Climate Paper are further reflected in the McVeigh settlement, where a fund member commenced litigation for the trustee's failure to adequately handle climate change risk. The settlement reflects the initiative trustees should take, discharging their duties whilst actively considering climate change risk. Further, in a media statement, the trustee of the relevant superannuation fund stated that as a result of the case, the superannuation fund would aim to implement strategies to achieve a net zero carbon footprint for the fund by 2050 and enhance its considerations of climate change risks when setting its investment strategies and asset allocation positions.[81]In this regard, the response by the superannuation fund in the McVeigh case is more akin to ultimate ends IFSI.

2.2.29 While APRA-regulated trustees are not required to report on or disclose the Sustainability Impacts of their portfolios, they are required to make certain disclosures about ESG-related matters (see paragraphs 2.2.23 to 2.2.24). Where a PDS states that labour standards or environmental, social or ethical considerations are taken into account, and the APRA-regulated trustee is either then required to invest the portfolio in accordance with the disclosure, or if it subsequently changes the policy, this would need to be notified to Beneficiaries.[82]

Legal freedom to use investment powers to Invest for Sustainability Impact

2.2.30 An APRA-regulated trustee must comply with its statutory duties[83] when using its investment powers. These duties require an APRA-regulated trustee to prioritise financial returns. This means that in general, an APRA-regulated trustee would not be permitted to select stocks for a portfolio by reference to their Sustainability Impact alone but generally would be permitted to select stocks for a portfolio by reference to their Sustainability Impact *in addition to* their contribution to investment return, if the selection offers an appropriate risk-adjusted return (as determined by the trustee) and or is otherwise justifiable as described in paragraph 1.4.7 (ie ultimate ends IFSI).

2.2.31 We note that the conceptual net of IFSI includes undertaking the relevant investment activities *with the intention to increase positive and/or reduce negative Sustainability Impacts*. It is entirely possible that an APRA-regulated trustee could

AUSTRALIA

undertake instrumental IFSI for the sole purpose of providing a financial benefit (ie a source of income) to the member upon retirement.

2.2.32 The SIS Act expressly recognises that for a Choice product, an APRA-regulated trustee may offer a range of investment options, and must develop an investment strategy for each option taking into account prescribed factors such as risk and return having regard to the objectives of the option. This implicitly recognises that an APRA-regulated trustee may offer a range of investment options having different objectives, with corresponding different investment strategies taking into account the risk and return profile of the option determined by the objectives.

2.2.33 This freedom is also supported by APRA commentary, in Prudential Practice Guide SPG 530 *Investment Governance* (November 2013) (**SPG 530**) which states:

> *An [APRA-regulated trustee] may take additional factors into account where there is no conflict with the requirements in the SIS Act, including the requirement to act in the best interests of the beneficiaries. This may result in an [APRA-regulated trustee] offering an 'ethical' investment option to beneficiaries to reflect this approach. An 'ethical' investment option is typically characterised by an added focus on environmental, sustainability, social and governance (ESG) considerations, or integrates such considerations into the formulation of the investment strategy and supporting analysis.*[84]

2.2.34 In all circumstances an APRA-regulated trustee looking to select assets for a portfolio by reference to those assets' Sustainability Impact would be generally limited to Sustainability Impact opportunities that offer an appropriate risk-adjusted return (as determined by the APRA-regulated trustee taking account of all the factors it considered relevant) or where their selection is otherwise justifiable as described in paragraph 1.4.7. (that is, instrumental or ultimate ends IFSI where the investment decision can be justified on purely financial grounds).

2.2.35 Where an APRA-regulated trustee decides that an environment, social and governance or socially responsible investing investment option should be added to the selections available to their members, the APRA-regulated trustee remains responsible for the design of the relevant investment option, and is required to determine the investment objectives and other design features in accordance with their duties.

2.2.36 For a superannuation fund's MySuper product, an APRA-regulated trustee is not permitted to select stocks by reference to their Sustainability Impact *instead of* their contribution to investment return, unless the selection of the particular stock can be justified in accordance with the investment strategy (for example, on the grounds of diversification) taking into account the overall portfolio composition and risk / return objectives. All stocks acquired for the MySuper product must be consistent with meeting the investment objective of the product, but individual stocks will typically have different returns and may be selected for reasons such as diversification and non-correlation (noting that the duties for formulating an investment strategy include consideration of diversification as a separate prescribed factor). For example, if there is an investment case that a company that turns around its ESG credentials has a similar improvement in its share price, then the trustee could invest with an intention to increase positive sustainability impacts for the purpose of achieving financial returns.

2.2.37 Choice products are selected by members, and the APRA-regulated trustee is required to give the member sufficient information about a choice product so that they are fully informed of the investment objectives and strategy and the risk involved. It is arguable in principle that there should be no objection or impediment to a superannuation fund or an investment option that favours Investing for Sustainability Impact being available for selection by a member on a fully informed basis.[85] In that context, the stocks selected for that investment option would meet the Sustainability Impact criteria disclosed. However, the same legal duties apply to all investment options, and ultimately this means that APRA-regulated trustees are required to prioritise financial returns for all investment options. This restricts their capacity to design and offer investment options that have objectives other than financial return. For ESG investment options designed and offered prior to introduction of the requirement that all investment options must promote the financial interests of members[86], there could be some risk that the Sustainability Impact criteria for the investment option

> ANNEXES

> Australia

AUSTRALIA

need to be reassessed to ensure that the new requirement is met. Any material changes to the investment strategy or portfolio composition resulting from this assessment would need to be notified to members.[87] In practice it seems likely that APRA-regulated trustees will wait for the updated APRA guidance in the revised SPG

2.2.38 530 that APRA has announced it intends to provide[88] before undertaking this assessment (see paragraph 2.2.40).

2.2.39 The precedence of statutory duties when an APRA-regulated trustee is using its investment powers is unchanging even if the trustee believes that Beneficiaries share a concern that the portfolio is invested for Sustainability Impact.

2.2.40 As SPG 530 was published before the statutory requirement to promote the financial interests of MySuper members was introduced,[89] there is considerable uncertainty as to whether an investment option where Investing for Sustainability Impact has priority to financial return could be offered.[90] At this stage it is not known whether APRA will consider that the requirement will impose an obligation to reflect Beneficiaries' views on investing for Sustainability Impact. APRA is also currently undertaking a review of its prudential practice standards with a view to responding to the heightened expectations of members in terms of performance outcomes, which has already resulted in the introduction of a new standard on strategic planning and member outcomes (SPS 515).[91] In that context, APRA has announced it may consider enhancements to its standards and guidance 'to provide clarity on the obligations…. to take into account ESG factors when setting their investment strategies.'[92]

2.3 Mutual funds

Types of mutual fund covered

2.3.1 In this Annex, the two common forms of retail investment funds (being an equivalent of mutual funds in this jurisdiction) considered are registered managed investment schemes and Listed Investment Companies (**LICs**).

Registered managed investment schemes

2.3.2 A managed investment scheme is a vehicle through which investors pool funds for a common enterprise and to produce financial benefits or benefits consisting rights or interest in property. Members in a managed investment scheme do not have day-to-day control over the operation of the scheme or its assets. While managed investment schemes can be in various legal forms, generally managed investment schemes embody the basic elements of trusts. Only those managed investment schemes that are constituted as trusts are included within the scope of this report.

2.3.3 Managed investment schemes may be either registered or unregistered. A managed investment scheme must be registered by ASIC if it has more than 20 members or it is promoted by a person who (or whose associate) is in the business of promoting managed investment schemes. The registration system for managed investment schemes is largely justified by reference to the need to protect the interests of 'retail' (as opposed to wholesale) investors.[93]

2.3.4 Registered managed investment schemes must be operated by a 'responsible entity' that manages the scheme in accordance with the functions provided to it by the scheme's constitution and the Corporations Act. A 'responsible entity' for a scheme must be incorporated as a public company and hold an AFS Licence authorising it to operate managed investment schemes.

2.3.5 Registered managed investment schemes structured as trusts may also be listed, allowing for interests in the scheme (units) to be tradeable on the Australian Stock Exchange (**ASX**). Schemes that are listed are subject to the listing and disclosure rules that apply to LICs and the implications of those rules as discussed below in the context of LICs applies to listed schemes.

2.3.6 The key entities are:

- **Asset Owner:** The responsible entity operates the scheme and may hold legal title to the assets of the scheme.
- **Beneficiaries:** The beneficiaries of a scheme are the members (or is the case of schemes that are unit trusts, the unitholders) of the scheme. It is not considered that the meaning of 'beneficiaries' in the context of a managed investment scheme may be taken to include future members.

AUSTRALIA

- **Investment decision-maker:** The investment-decision maker of the scheme may be either the responsible entity or an investment manager engaged by the responsible entity. This investment manager may or may not be a related entity of the responsible entity.

Listed investment companies

2.3.7 LICs are investment funds that are structured as public companies listed on a securities exchange.

2.3.8 In Australia, as in other jurisdictions, LICs are managed by or under the direction of its board of directors and invested in by shareholders. In addition to the rules governing the creation, structure, and governance of public companies in the Corporations Act, LICs must also operate in accordance with the ASX Listing Rules (***Listing Rules***).[94]

2.3.9 The key entities are:

- **Asset Owner**: The LIC owns the underlying assets in its own right.
- **Beneficiaries:** The beneficiaries are the shareholders of the LIC. It is not considered that the meaning of 'beneficiaries' in the context of a LIC may be taken to include future shareholders.
- **Investment decision maker**: The LIC will managed by or under the direction of its board of directors. The LIC's investment activities may be managed either by its board of directors or by one or more external investment manager appointed by its board of directors.

Overview of investment duties and powers – registered managed investment schemes

2.3.10 The primary source of a responsible entity's duties and powers is the Corporations Act. As there is a trust relationship between members of a registered managed investment scheme and the responsible entity,[95] a responsible entity must also comply with the applicable State Trustee Acts and duties imposed by the general law on trustees (which broadly reflect the responsible entity's general duties under the Corporations Act). While the responsible entity's duties under the applicable State Trustee Acts and by the general law on trustees will be subject to or informed by the terms of the constitution of the scheme,[96] the statutory duties of the responsible entity apply notwithstanding the terms of the constitution of the scheme.[97]

2.3.11 The statutory duties imposed on responsible entities under the Corporations Act include the duties to:

- exercise the degree of care and diligence that a reasonable person would exercise if they were in the position of the responsible entity;
- act in the best interests of the members, and if there is a conflict between the members' interests and its own interests, give priority to the members' interests;
- comply with the constitution of the scheme (to the extent that it is consistent with the Corporations Act);
- give priority to the members' interests in the event a conflict between such interests and the responsible entity's own interests; and
- carry out or comply with any other duty, not inconsistent with the Corporations Act, that is conferred on the responsible entity by the scheme's constitution.[98]

2.3.12 A responsible entity is also vested with powers under the constitution of the scheme, being the document that governs the legal relationship and is enforceable between the responsible entity and the members.[99] The Corporations Act prescribes certain content for constitutions of registered managed investment schemes.[100] Relevantly, a scheme's constitution must make provision for '*the powers of the responsible entity in relation to making investments of, or otherwise dealing with, scheme property*'.[101]

2.3.13 Typically, the constitution of the scheme or the product disclosure documents of the scheme provided to members and potential members will set out the investment objectives (including the target financial return), investment strategy and investment guidelines of the scheme. Those objectives, that strategy and those guidelines will likely inform the content of the responsible entities' investment duties and powers.

AUSTRALIA

Overview of investment duties and powers – listed investment schemes

2.3.14 Directors of LICs are subject to the same legal duties as other listed Australian companies, which arise from statutory directors' duties under the Corporations Act, which overlap and codify aspects of the general law fiduciary and other equitable duties. Directors owe those duties to the company as a whole, and not individual shareholders.[102]

2.3.15 Typically, the LIC's investment duties and powers are shaped by:

- statutory duties contained in the Corporations Act as they apply to directors of Australian companies, including:
- the duty to act with a reasonable degree of care and diligence;[103]
- the duty to act in good faith and in the best interests of a shareholders;[104]
- the duty to exercise their powers and discharge their duties for a proper purpose;[105]
- the duty not to improperly use the position of director to gain an advantage for the director or someone else, or cause detriment to the corporation;[106]
- the LIC's constitutional documents (and other governing documents);
- marketing documents given to investors (including prospectuses and other disclosure documents); and
- the Listing Rules (or other relevant market rules).

Registered managed investment schemes

Legal requirements to use investment powers to Invest for Sustainability Impact

2.3.16 We do not consider that responsible entities have a legal obligation, generally, to Invest for Sustainability Impact, and this applies to both instrumental and ultimate ends IFSI. Whether a particular responsible entity of a scheme would have such a duty will depend heavily on the objective purpose of the scheme and its terms (which will be predominantly set out in the constitution and disclosure documents of the scheme).

2.3.17 However, responsible entities may, in order to discharge their duty of care and diligence, be required to have regard Sustainability Impacts that present foreseeable risks of harm to the value of the portfolio of the scheme and members' interests (which in most cases will likely equate to the financial interests of members as members) and consider and take the steps a reasonable responsible entity would take in the circumstances to alleviate these risks. That may, depending on the circumstances (in particular the investment strategy of the scheme) and for example, require a responsible entity to exclude particular or classes of investments that may have negative Sustainability Impact on the value of the portfolio and the interests of members as members (eg exclude investments that are contrary to applicable law) or divest such investments. Whether a responsible entity would in fact have a duty to do so will very much depend on what a reasonable responsible entity would do in the circumstances.

2.3.18 Having regard to the limited and specific investment strategies of registered managed investment schemes, it is difficult to conclude as a general matter that responsible entities could be required to engage in IFSI (whether instrumental or ultimate ends). Whether a responsible entity would be required to engage in IFSI would very much depend on the specific terms of the registered management investment scheme, the particular IFSI being contemplated and other relevant facts and circumstances.

Legal freedom to use investment powers to Invest for Sustainability Impact

2.3.19 Whether or not a responsible entity has the legal freedom to use its investment powers to Invest for Sustainability Impact will depend on the purpose of the scheme and its terms (which will be predominantly set out in the constitution and disclosure documents of the scheme).

2.3.20 Responsible entities will likely be required to act in the best 'financial' interests of members in evaluating investment options and will generally only be permitted to use their investment powers to Invest for Sustainability Impact where that use is consistent with and does not adversely affect the overall financial outcomes for and profile of the scheme (taking into account expected investment return, risk, diversification, liquidity and other characteristics of investments made consistently with the Investing for Sustainability Impact objective). This

AUSTRALIA

corresponds more closely with the concept of instrumental IFSI, which necessary contemplates that a financial objective is being pursued. Where there are opportunities to Invest for Sustainability Impact that are consistent with and do not adversely affect the financial outcomes for and profile of the scheme, the responsible entity may also need to consider any additional due diligence, execution and reporting costs that may be borne by the scheme as result of pursuing and investing in those opportunities and whether they are justifiable taking into account the contribution those opportunities are expected to make to the financial outcomes and profile of the scheme.

Listed investment companies

Legal requirements to use investment powers to Invest for Sustainability Impact

2.3.21 The analysis above at paragraphs 2.3.16 to 2.3.18 with respect to schemes applies broadly to LICs.

2.3.22 Further, we consider that it would be very challenging for a shareholder to establish a director of a LIC has breached its duty of care and diligence by failing to Invest for Sustainability Impact. Under the so-called ‘business judgment rule’, a director will have acted with the degree of care and diligence required by the Corporations Act if the director has acted in good faith for a proper purpose, and rationally believes the act is in the best interests of the company.[107] Notwithstanding that it may be in the interests of the company to engage in IFSI (whether instrumental or ultimate ends), it would be difficult to argue that a director has acted with an improper purpose by failing to prioritise long-term sustainability considerations over the financial interests of current shareholders. This defence militates against a legal requirement on the directors of LICs to Invest for Sustainability Impact.

Legal freedom to use investment powers to Invest for Sustainability Impact

2.3.23 Though the analysis at paragraphs 2.3.18 to 2.3.19 above in relation to schemes applies broadly to LICs, LICs may have a greater legal flexibility to Invest for Sustainability Impact.

2.3.24 The best interest duty may allow the directors of LICs to consider the interests of the company more broadly, including reputational interests.[108] Directors must also be entrepreneurial in their approach (and as such can accept more commercial risks that trustees and may be subject to less scrutiny in their pursuit of the LICs objectives).[109] Certain investments for Sustainability Impact – if made to promote the ‘reputation’ of the LICs, could arguably be permissible.

2.3.25 By merit of LICs being structured as companies, the law governing the conduct of directors has generally afforded directors a greater degree of latitude with respect to risk-taking than it has to trustees[110]. The exact extent to which this entrepreneurial discretion may be used to prioritise Sustainability Impacts is uncertain. Generally, however, the LIC will likely be constrained by the investment strategy statements and fund policies disclosed by the LIC in its formal disclosure documents. Given that LICs are generally formed to generate a financial return, the prioritisation of the selection of investments by reference to their Sustainability Impact over their contribution to investment return may be viewed as an improper purpose and voidable under the doctrine of powers or the statutory duty not to act for improper purposes, unless the selection of those investments by reference to their Sustainability Impact would otherwise directly benefit the LIC. Certainly, if instrumental IFSI, and achieving a financial return through the elimination of systematic risks, were adopted as industry-wide practice, the way that investing for Sustainability Impacts could achieve a long-term, sustainable financial goal would likely receive greater recognition with LICs. In addition, it is conceivable that, if an investment decision could properly be made in accordance with the terms of the LIC and justified based on financial considerations, it would be permitted, notwithstanding the presence of an ultimate ends IFSI motivation.

2.4 Insurance undertakings

Types of insurance undertaking covered

2.4.1 We consider in this report:

- *Life insurance companies* (***Life Insurers***): Life Insurers must be registered under the *Life Insurance Act 1995*(Cth) (***Life Act***). Life insurance policies are either ‘investment-linked’, where the benefits under the policy are determined by the value of the investments supporting

AUSTRALIA

the policy, or risk insurance where the benefit is payable on the happening of prescribed events (death or disability). Life insurers may conduct 'superannuation business', consisting of issuing policies maintained for the purposes of a superannuation or retirement scheme, and 'ordinary business' consisting of non-superannuation policies.

- *General insurance companies* (**General Insurers**): A General Insurer is a company that provides forms of insurance other than life insurance, and to which the *Insurance Act 1992* (Cth) (***Insurance Act***) applies. General insurers issue risk policies only, where the policy holder is entitled to the specified insured amount on the occurrence of the specified event covered under the policy (ie the policy holder's benefit is not determined by investment returns). General insurance broadly includes forms of insurance covering property or covering the insured's liabilities to other persons, such as motor vehicle insurance, home and contents insurance, commercial insurance, professional indemnity insurance, directors and officer's liability insurance and public liability insurance.

2.4.2 Health insurance companies and State and Territory accident insurance bodies are not included here.

2.4.3 The key entities are:

- **Asset Owner:** the Life Insurer or General Insurer.
- **Beneficiaries:** Policyholders. People or other legal entities may also receive a benefit from the policy, for example, for life insurance policies upon the death of the policyholder the nominated beneficiary will receive the benefit, and for Directors & Officers insurance an officer of a company might receive a direct benefit. Shareholders of Life Insurers and General Insurers would also have an economic interest in the management of the assets of the entity.
- **Investment decision maker:** The Life Insurer or General Insurer, or an investment manager appointed by the relevant entity.

Overview of investment duties and powers

2.4.4 Both Life Insurers and General Insurers are regulated by APRA. They are also required to hold an AFS Licence and are subject to the specific statutory duties that apply to AFS Licence holders.[111]

2.4.5 Insurance policies are contracts between the insurer and the policy holder, and therefore the obligation of the insurance company is to meet the terms of the contract (the **policy**). For risk policies, the key contractual obligation is to pay the specified insured amount on the happening of the prescribed insured event. For investment-linked policies, the Life Insurer's contractual obligations in relation to management of the portfolio depend on the terms of the policy as drafted by the Life Insurer and accepted by the policy holder. Insurance companies are not trustees.

2.4.6 An insurance company's shareholders benefit from returns on the insurance company's investments, to the extent that the returns exceed the assets required to meet liabilities to policyholders. Insurance companies are in many cases subsidiaries of financial institutions that are companies listed on the ASX. Therefore returns to the insurance company that are not required to support policy liabilities may ultimately be for the benefit of shareholders of listed companies.

Statutory obligations of Life Insurers

2.4.7 The principal statutory obligations that apply to Life Insurers, in investing the assets of their statutory funds, are set out in the Life Act and *Life Insurance Regulations 1995* (Cth) (**Insurance Regulations**), and in Prudential Standards issued by APRA (which, as noted in paragraph 2.2.5 above, have legal effect as statutory instruments). APRA also publishes Prudential Practice Guides and other commentary and guidance material, which set out APRA's interpretation of statutory obligations and APRA's expectations, as a prudential regulator, for the conduct of Life Insurers.

2.4.8 The principal statutory obligations under the Life Act include:

- Life Insurers are required to maintain statutory funds for their insurance business.[112] The assets of the statutory fund may only be applied: (a) to meet liabilities (including policy liabilities) or expenses incurred for the purposes of the business of the fund; or (b) for the making of investments as permitted; or for the purposes of a permitted distribution.[113]
- In the investment, administration and management of the assets of a statutory fund, a Life Insurer must give priority to the interests of owners and prospective owners of policies referable to the fund.[114]The requirement to give priority

> ANNEXES

> Australia

AUSTRALIA

to the interests of policy holders refers to their interests as policy holders.[115]

- Profits and losses of a statutory fund may only be dealt with in accordance with Divisions 5 and 6 of the Life Act (the object of those Divisions being to ensure that such profits and losses are dealt with in a manner that protects the interests of policy owners and is consistent with prudent management of the fund).[116]

2.4.9 The general rule regarding investment of assets of a statutory fund is that a Life Insurer may invest such assets in any way that is likely to further the business of the fund.[117]

2.4.10 The Life Act does not prescribe substantive powers of investment for shareholders funds, and there are no express duties in relation to the exercise of investment powers for shareholders funds.

2.4.11 Directors of a Life Insurer have a duty to the owners of policies referable to a statutory fund, to use reasonable care, and due diligence in the investment, administration and management of the assets of the fund, so that the Life Insurer gives priority to the interests of owners and prospective owners of policies referable to the fund. In the event of conflict between the interests of owners and prospective owners of policies and the interests of shareholders, a director's duty is to take reasonable care, and use due diligence, to see that the Life Insurer gives priority to the owners and prospective owners of those policies over the interests of shareholders.[118]

Statutory obligations of General Insurers

2.4.12 The principal statutory obligations that apply to General Insurers are set out in the Insurance Act, Insurance Regulations and in Prudential Standards issued by APRA. APRA also publishes Prudential Practice Guides and other commentary and guidance material which set out APRA's interpretation of statutory obligations and APRA's expectations, as a prudential regulator, for the conduct of General Insurers.

2.4.13 General Insurers are required under the Insurance Act to hold assets in Australia (excluding goodwill and any other assets or amounts excluded by Prudential Standards) of a value equal to or greater than the amount of its liabilities in Australia.[119] A General Insurer commits an offence under the Insurance Act where the General Insurer does not hold sufficient assets in Australia. The purpose of this requirement is to ensure that the total value of assets held within the jurisdictional reach of APRA and the Australian courts is sufficient to meet a General Insurer's liabilities in Australia.[120]

2.4.14 Otherwise, the Insurance Act and Insurance Regulations do not prescribe substantive powers of investment for General Insurers, and there are no express duties in relation to the exercise of investment powers.

Risk management requirements for insurance companies

2.4.15 APRA Prudential Standard CPS 220 (Risk Management) applies to Life Insurers and General Insurers. The rules include: 'An APRA-regulated institution must maintain a risk management framework for the institution that enables it to appropriately develop and implement strategies, policies, procedures and controls to manage different types of material risks, and provides the Board with a comprehensive institution-wide view of material risks.'[121]

2.4.16 The risk management framework is required to address a list of risks, including market and investment risk, and liquidity risk, and also risks that, singularly or in combination with different risks, may have a material impact on the institution.

Capital adequacy requirements for insurance companies

2.4.17 A series of Prudential Standards issued by APRA set out detailed and highly prescriptive capital adequacy requirements for Life Insurers and General Insurers.[122]

2.4.18 Complying with the capital base requirements includes calculating the impact of a range of risks, in accordance with prescribed formulas, and these include 'stress-testing' scenarios for categories of assets held in the insurance company. The requirements are aimed at ensuring that insurance companies at all times have sufficient assets to cover their liabilities to policy holders.

General insurance: Legal requirements to use investment powers to Invest for Sustainability Impact

2.4.19 A General Insurer is not required to select investments by reference to their Sustainability Impact, and this applies to both instrumental and ultimate ends IFSI,

AUSTRALIA

either instead of or in addition to their contribution to investment return.

2.4.20 However, general insurance companies are required to formulate and give effect to risk management strategies and APRA has stated that it expects regulated entities to actively assess climate change risk and incorporate the assessment into governance frameworks.[123]

2.4.21 General insurance companies must comply with the capital adequacy requirements set out by APRA in the relevant Prudential Standards.[124] These Prudential Standards include that there must be a strategy for ensuring adequate capital is maintained over time.[125]

2.4.22 As discussed in paragraphs 2.4.12 to 2.4.14 the directors of general insurance companies have a duty to act in the best interests of the company, and so to the extent that would require consideration of sustainability then this may create a legal imperative.

2.4.23 There is no requirement for general insurance companies to consider system-wide sustainability in how a general insurer approaches its investments, or to consider the sustainability aspirations or wider well-being of shareholders a nd policyholders beyond the duties already described.

2.4.24 Reporting under the Modern Slavery Act has commenced in the second half of 2020. As a self-assessment regime the Modern Slavery Act does not prescribe penalties or other liabilities for negative Sustainability Impacts that are identified in the Modern Slavery Act. However, in time, it is anticipated that the reporting requirements will give rise to heightened public expectations that APRA-regulated trustees and insurance companies actively engage with their Investment Managers to reduce modern slavery risks in their portfolios or risk significant reputational damage, potential loss of revenue or share price, and class actions from investors.

2.4.25 Further, APRA expects comprehensive disclosure of climate change risks will progress in the future.[126]

General insurance: Legal freedom to use investment powers to Invest for Sustainability Impact

2.4.26 A General Insurer is permitted to use its investment powers to Invest for Sustainability Impact in addition to contribution to investment return, if the selection of the investments is consistent with the insurance company's duties with respect to shareholders. (See commentary on directors' duties to shareholders and the company at paragraphs 1.3.11 to 1.3.17.)

2.4.27 The investment-related duties of insurance companies make it difficult to select stocks for a portfolio to the extent that the selection is solely for Sustainability Impact reasons, unless the terms of the policy authorise selection on that basis (though we note this is very unlikely to occur). However there should be no difficulty imposed by those obligations in selecting stocks for Sustainability Impact where there is no anticipated adverse effect on financial returns or where the selection is consistent with risk mitigation or other financial considerations (such as diversification or non-correlation).

2.4.28 A General Insurer is not precluded from assessing the views of Beneficiaries on the extent to which they want the insurance company to Invest for Sustainability Impact in managing portfolio assets. The extent to which an insurance company is permitted to reflect Beneficiary views on Investing for Sustainability Impact in the objectives of the portfolio is constrained by their obligations to the policy holders and to the insurance company's own shareholders.

Life insurance: Legal requirements to use investment powers to Invest for Sustainability Impact

2.4.29 A life insurance company is not explicitly required to select investments by reference to their Sustainability Impact, and this applies to both instrumental and ultimate ends IFSI, either instead of or in addition to their contribution to investment return.

2.4.30 However, life insurance companies are required to formulate and give effect to risk management strategies and APRA has stated that it expects regulated entities to actively assess climate change risk and incorporate the assessment into governance frameworks.[127]

2.4.31 As for general insurers, life insurance companies must comply with the capital adequacy requirements set out by APRA in the relevant Prudential Standards,[128] which include that the life company must have a strategy for ensuring adequate capital is maintained over time[129] and the directors have a duty to act in the best interests of the company.

AUSTRALIA

2.4.32 In addition, the Life Act requires that all life insurers maintain statutory funds which hold, among other things, all premiums received and income from the investment of the assets of the statutory fund.[130] In relation to the investment, administration and management of the assets of a statutory fund, the Life Act prioritises the interests of 'owners and prospective owners' of policies.[131] In particular the Life Act requires that where there is conflict between the interests of shareholders and the interests of owners or prospective owners of policies, a director's duty is to take reasonable care, and use diligence, to see that the company gives priority to the interests of owners and prospective owners of policies over the interests of shareholders.[132]

2.4.33 While life insurance companies are not required to report on or disclose the Sustainability Impacts of their portfolios, they are required to make certain disclosures about ESG-related matters (see paragraphs 2.2.23 to 2.2.24). Life Insurers (for investment-linked policies) are required to include statements in the PDS of the product (which are given to new or prospective members) that specify the extent to which labour standards or environmental, social or ethical considerations are taken into account in the selection, retention or realisation of investments.[133] Where a PDS contains a disclosure about labour standards or environmental, social or ethical considerations, and the APRA-regulated trustee or Life Insurer does not implement the investment of the portfolio in accordance with the disclosure, or subsequently changes the policy, this would need to be notified to Beneficiaries.[134]

2.4.34 Moreover, APRA also expects comprehensive disclosure of climate change risks will progress in the future.[135]

Life insurance: Legal freedom to use investment powers to Invest for Sustainability Impact

2.4.35 A life insurance company is permitted to use its investment powers to Invest for Sustainability Impact in addition to contribution to investment return, only if the selection of the investments is consistent with the life insurance companies other duties. For example, the director's duties to shareholders, policy holders and prospective policy holders described above. For investment-linked business of Life Insurers, stock selection must comply with the terms of the policy.

2.4.36 The investment-related duties of insurance companies make it difficult to select stocks for a portfolio to the extent that the selection is solely for Sustainability Impact reasons, unless the terms of the policy authorise selection on that basis. However there should be no difficulty imposed by those obligations in selecting stocks for Sustainability Impact where there is no anticipated adverse effect on financial returns or where the selection is consistent with risk mitigation or other financial considerations (such as diversification or non-correlation).

2.4.37 The position in relation to assessing and responding to the views of Beneficiaries is as for general insurance in paragraph 2.4.28.

2.4.38 For investment-linked policies, a Life Insurer can take account of beneficiary views in constructing policy terms - that is, Life Insurers can design an investment portfolio that includes Investing for Sustainability considerations or even prioritising Sustainability Impact over investment returns, if they were the terms of the policy, as the Life Insurer's obligation is to comply with the terms of the policy as contractual obligations. However, the Life Insurer would be constrained from taking account of beneficiaries' views by the terms of the policy, particularly for portfolios that have multiple policy holders. Where the policy is silent on Investing for Sustainability Impact, the Life Insurer would not necessarily be precluded from taking account of beneficiary views, but equally the Life Insurer would not be able to reflect them in the portfolio in a way that was inconsistent with the policy terms (including the policy's stated objectives and strategies). As the stated objectives and strategies are normally expressed as financial returns, the Life Insurer would not be able to reflect the views of individual beneficiaries where this could adversely impact financial returns.

2.4.39 Similarly an insurance company would not be precluded from taking into account the non-financial impact of an investment decision in which the portfolio is managed (provided that doing so is consistent with the terms of the policy). While the duty to give priority to the interests of policy holders applies in respect of their interests as policy holders only, a Life Insurer is not prohibited from acting in the interests of other parties (including the Life Insurer's shareholders, but also including the policy

AUSTRALIA

holders in other capacities) provided that the interests of policy holders in that capacity are prioritised. Life Insurers are not subject to the sole purpose test or the best interests duty, and they do not have a statutory duty of care and skill in relation to investments (although the Life Insurer would have a duty of care to policy holders under the general law of negligence, and directors of Life Insurers have a duty of care in relation to ensuring that the Life Insurer meets requirements for managing statutory funds). Therefore, there may be some scope to consider the Sustainability Impact in the management of the portfolio, provided that this is consistent with their duties to prioritise the interests of policy holders.

2.4.40 For the superannuation business of Life Insurers, the policy holder is the APRA-regulated trustee. An APRA-regulated trustee can only acquire an investment-linked life insurance policy in accordance with the trustee's own duties in relation to investment, and would not acquire a policy that is not consistent with those duties. Therefore, in designing the investment strategies for investment-linked policies, a Life Insurer would need to take into account the constraints on APRA-regulated trustees (discussed in the commentary on superannuation funds).

AUSTRALIA

3. ASSET OWNERS' USE OF THEIR POSITION TO STEWARD FOR IFSI

3.1 The following section considers the extent to which, and on what basis, each type of Asset Owner is (a) required or (b) permitted or able to use its position to influence enterprises in which it invests by engaging in stewardship activities designed to achieve positive sustainability outcomes and minimise negative sustainability outcomes.

3.1.1 *Cooperation and association:* One consideration for Asset Owners engaging in stewardship activities will be whether engaging in those stewardship activities involves cooperating with other investors in the relevant enterprise. Where that enterprise is a listed company or an unlisted company with more than 50 members, that cooperation may cause the Asset Owner and those other investors to become 'associates' for the purposes of the Corporations Act, which may trigger substantial shareholder and takeover provisions under the Corporations Act.

3.1.2 Under Chapter 6 of the Corporations Act, investors holding more than 5% of a listed companies equities are required to lodge a 'substantial holder notice'. Where a shareholder and their defined 'associates' in aggregate hold more than 20% of a listed company's equities they are barred from acquiring further securities by the takeover prohibition of s 606 of the Corporations Act.

3.1.3 Activities that could result in investors being considered to be associates include:

- investors formulating joint proposals relating to board appointments or a strategic issue;
- investors accepting an inducement to vote;
- investors agreeing on a plan or strategy concerning voting;
- investors limiting their freedom to vote by granting another investor an irrevocable proxy; and
- investors using their cumulative voting power to lodge a notice of meeting for the purpose of putting forward a resolution relating to the entity's affairs or the composition of the board.

Generally, these activities all involve the ingredients of (1) an understanding existing among investors, (2) a course of action relating to control of the listed portfolio constituent's affairs.

The rules contained in Chapter 6 create a risk for investors with significant shareholdings seeking to undertake cooperative stewardship activities.

Where the 'cooperation' is limited to consultative activities such as recommending that another investor vote in a particular manner or exchanging views on a resolution to be voted on at a meeting, the investors involved will unlikely be considered 'associates'. Investors may make representations to the board in relation to forward-looking or long-term strategic matters however they must avoid making anything that could be considered a 'joint proposal'.

3.1.4 Notwithstanding the foregoing, there is an acknowledgment from Australia's financial regulators of the value of certain cooperative stewardship activity. In ASIC's Regulatory Guide 128: Collective Action by Investors (June 2015) ASIC stated that 'we recognise that investors should be allowed to cooperate and coordinate their actions concerning an entity in which they have invested, in the **interests of promoting long-term value for all investors**. At times, 'this type of engagement can be more effective and efficient than individual investor engagement.'[136] In this guidance, ASIC indicated it is less likely to examine collective action that relates to an entity's corporate governance, or issues that can be determined at a general meeting. ASIC cited improved sustainability or corporate social responsibility reporting as conduct that may not attract its scrutiny.[137]

3.1.5 Australian industry associations appear to encourage some form of cooperation between Asset Owners and Investment Managers in relation to stewardship. For instance, the Australian Council for Superannuation Investors (**ACSI**) *Stewardship Code* (2018), to which many Asset Owners are signatories, requires signatories to publicly report on stewardship activities – such as collaborative engagement practices.[138] The Financial Services Council's (**FSC**) *Standard 23: Principles of Internal Governance and Asset Stewardship* requires its Investment Manager members to engage

AUSTRALIA

in stewardship on behalf their clients to ensure that they meet the 'highest standard of governance, as well as ethical and professional practice'. Relevantly, members must disclose their approach to stewardship activities, including their '*approach to considering Environmental, Social and Governance factors (risks and opportunities) and whether these considerations influence investment decision-making and company engagement*'.[139] Despite this industry push on stewardship, such cooperation is limited by the factors discussed at paragraphs 3.1.1 to 3.1.3.

3.2 Pension funds

Legal requirements to steward for IFSI

3.2.1 An APRA-regulated trustee is not required to take action where there is unlikely to be an adverse effect on investment returns. Similarly, they are not required to undertake engagement activities in relation to portfolio constituents designed to achieve positive and/or reduce negative Sustainability Impact (whether for instrumental or ultimate ends investing) instead of or in addition to their contribution to investment return. The APRA-regulated trustee may have an obligation to monitor and manage any adverse effect on investment returns that may arise from a negative Sustainability Impact (and possibly also from failing to achieve a positive Sustainability Impact that is expected for that business) but undertaking engagement activities is not a required response (they may alternatively, for example, divest the portfolio constituent).

Legal freedom to steward for IFSI

3.2.2 Engagement for Sustainability Impact is undertaken in the course of managing a superannuation fund's investment in a corporation, and therefore must also be consistent with the APRA-regulated trustee's duties and other statutory obligations. Anecdotally, APRA-regulated trustees routinely engage with their investee companies:

(a) for the purpose of protecting or improving the value of the superannuation fund's investment in the corporation. Where the trustee forms the view that the value of the investment may be threatened by negative Sustainability Impacts or improved by positive Sustainability Impacts attributed to the business of the corporation (over the short, medium or long term), the stewardship activities may constitute instrumental IFSI aimed at reducing the risk of that threat or promoting those improvements. This is particularly so where improvements will also drive financial returns; or

(b) to support the APRA-regulated trustee's member engagement strategies (aimed at attraction and retention of members to ensure the long term viability of the fund); for example where the corporation's activities may have negative Sustainability Impacts that draw adverse publicity. APRA-regulated trustees position themselves as being 'socially responsible' or 'good corporate citizens' as part of their member attraction and retention strategies (even where such engagement activities are not expected to contribute directly to investment return).[140]

In these cases, it is conceivable that the APRA-regulated trustee could set an ultimate ends IFSI goal that reflects current and potential members' desires to achieve certain sustainability outcomes (provided that the implementation of that goal was otherwise in compliance with the duties of the APRA-regulated trustee).

3.2.3 In reality, the extent to which APRA-regulated trustees undertake this engagement generally depends on the costs and benefits to the superannuation fund of the engagement compared to other options for managing the concern (such as disposing of the portfolio constituent). Factors such as fund size, cost of engagement and likelihood of getting a hearing, and the possibility of acting together with other investors to pursue a common engagement strategy, will be relevant to the cost / benefit analysis. For example, in 2016, Australia's largest superannuation fund, AustralianSuper, instituted a policy of voting against the next director up for re-election in ASX 200 companies with no female directors. In September 2019, it announced that it would vote against the election of the most senior director up for re-appointment if the company has fewer than two women on the board.[141]

3.2.4 An APRA-regulated trustee's statutory duties to comply with the sole purpose test, to exercise powers in the best interests of beneficiaries and to promote the financial interests of beneficiaries make it difficult to undertake engagement activities in relation to portfolio constituents by reference to

AUSTRALIA

their Sustainability Impact separately from any potential investment benefit, as those duties ultimately require an APRA-regulated Trustee to prioritise beneficiaries' financial returns. An APRA-regulated Trustee would generally undertake engagement activities where this was for the purpose of protecting or enhancing the investment; however, member engagement considerations can also be important to the ongoing viability of a superannuation fund.

3.2.5 Academic and practitioner commentary on how the statutory duties and case law are interpreted, in relation to IFSI, is generally supportive of an analysis that the statutory duties and case law do not preclude an APRA regulated trustee from pursuing aspects of IFSI where this is consistent with advancing the financial interests of the members. Some more recent commentary proposes that proper risk management and consideration of long term returns may import an active obligation for APRA regulated trustees to consider how negative Sustainability Impacts may impact investment performance, on the basis that failure to do so may result in financial losses to the fund or not meeting the Investment objectives. Some of this commentary also notes that the duty of care and skill is a higher standard than that required under the law of trusts.[142]

3.3 **Mutual funds**

Registered Managed Investment Schemes

Legal requirements to steward for IFSI

3.3.1 We do not consider that responsible entities are generally subject to a duty to engage for Sustainability Impact, whether instrumental or ultimate ends IFSI.

3.3.2 However, responsible entities may, in order to discharge their duty of care and diligence, be required to have regard Sustainability Impacts that present foreseeable risks of harm to the value of the portfolio of the scheme and members' interests (which in most cases will likely equate to the financial interests of members as members) and consider and take the steps a reasonable responsible entity would take in the circumstances to alleviate these risks. Those steps could conceivably involve engaging in stewardship with respect to investments of the portfolio. Whether a responsible entity would in fact have a duty to do so will very much depend on what a reasonable responsible entity would do in the circumstances.

Legal freedom to steward for IFSI

3.3.3 Where a scheme is established with the objective purpose to generate financial returns, the responsible entity will likely be required to act in the best 'financial' interests of members in engaging in stewardship activities. This is likely to prevent the responsible entity from engaging in stewardship activities in relation to portfolio constituents designed to achieve positive and/or reduce negative Sustainability Impacts instead of their contribution to investment return. The terms of and the disclosures made by the scheme may also limit the ability of the responsible entity to engage for Sustainability Impact. Notwithstanding this, it may be possible for a responsible entity to engage in stewardship activities in relation to portfolio constituents designed to achieve positive and/or reduce negative Sustainability Impacts if those stewardship activities are reasonably expected to contribute positively and directly or indirectly to the growth in value of the applicable portfolio constituent. Where stewardship activities entail minimal expense and effort, it will be easier for the responsible entity to justify these activities.

Listed Investment Companies

Legal requirements to steward for IFSI

3.3.4 The analysis with respect to schemes at paragraphs 3.3.1 to 3.3.3 above applies broadly to directors of LICs. Consequently, we do not consider that LICs are under a general legal duty to engage in activities for Sustainability Impact, whether instrumental or ultimate ends IFSI (outside of considering negative Sustainability Impacts and possible alleviating actions, which may include certain stewardship activities, where Sustainability Impacts may have an adverse effect on the value of the LIC's portfolio).

Legal freedom to steward for IFSI

3.3.5 Though the analysis at paragraph 3.3.3 above in relation to responsible entities applies broadly to LICs, LICs may have

AUSTRALIA

a greater legal flexibility to engage in stewardship activities for Sustainability Impact.

3.3.6 In our view, for the reasons set out at paragraph 2.3.22 relating to the best interest duty and Investing for Sustainability Impact, there may be flexibility within the law for directors of LICs to engage in stewardship for Sustainability Impact. That flexibility will be subject to terms of the constituent and disclosure documents of the LICs and will need to be consistent with the best interests of the LIC (taking into account its likely profit-making objective). We consider that the potential benefit of the stewardship activity for the interests of the LIC, the probability of this benefit arising, and the costs and risk associated with the stewardship will be the core considerations by reference to which directors must justify their decision to engage in stewardship activities.

3.3.7 We also note that under the ASX Corporate Governance Councils Principles and Recommendations, listed entities (including listed registered managed investment schemes) should disclose how they manage or intend to manage social, environmental and governance risks.[143] Though this does not create a legal obligation on the LIC to engage in stewardship activities for Sustainability Impact, it may encourage them to do so.

3.4 Insurance undertakings

General insurance: Legal requirements to steward for IFSI

3.4.1 Investments made by General Insurer are generally to that support risk policies or investments of shareholders' funds. Therefore, the obligations for insurance companies to engage for Sustainability Impact are as for any other company.[144]

General insurance: Legal freedom to steward for IFSI

3.4.2 A General Insurer's investment-related duties would not prevent an insurance company from engaging with portfolio constituents by reference to their Sustainability Impact (separately from any potential investment benefit), provided there was no adverse impact on financial returns.

Life insurance: Legal requirements to steward for IFSI

3.4.3 For investments that support risk policies or investments of shareholders' funds, the obligations for life insurance companies to engage for Sustainability Impact are as for any other company.[145]

3.4.4 Investment-linked policies of Life Insurers are for the purpose of generating financial returns, and the Life Insurer is required to prioritise the interests of policy holders and to comply with the terms of the policy. The effect on engagement activities is that the Life Insurer has no express legal duty to undertake engagement activities in relation to portfolio constituents designed to achieve positive and/or reduce negative Sustainability Impact instead of or in addition to their contribution to investment return. They are not required to take action where there is no adverse effect on investment returns.

Life insurance: Legal freedom to steward for IFSI

3.4.5 Generally, a Life Insurer is permitted to engage with portfolio constituents to achieve positive and/or reduce negative Sustainability Impact *in addition* to their contribution to investment return. There are no relevant duties that would prevent them from undertaking these engagement activities. Engagement activities in relation to investments held in the statutory funds will be subject to the duties described in 2.4.7 to 2.4.11 above. Engagement activities in relation to investments held in shareholder funds will be subject to the general company director's duties described in 3.3.4 to 3.3.5.

3.4.6 A Life Insurer could only seek to use its position as an investor to influence the activities of an issuer, in relation to Sustainability Impact, where the outcome sought was not inconsistent with promoting financial returns from the portfolio (including minimising risks). To this extent, an insurance company's investment-related duties could make it difficult to engage with portfolio constituents by reference to their Sustainability Impact separately from any potential investment benefit and if the cost of doing so negatively impacted risk-adjusted returns.

AUSTRALIA

4. ASSET OWNERS' ENGAGEMENT IN PUBLIC POLICY WORK TO SECURE SUSTAINABILITY IMPACT

4.1 The following section considers the extent to which, and on what basis, each type of Asset Owner is (a) required or (b) permitted or able to use its position to engage in public policy work designed to achieve positive sustainability outcomes and minimise negative sustainability outcomes, for example, where these are relevant to the value of portfolio assets.

4.2 **Pension funds**

4.2.1 An APRA-regulated trustee is not required to engage in policy discussions or lobbying with policy makers in relation to portfolio constituents designed to achieve positive and/or reduce negative Sustainability Impacts.

4.2.2 There is a level of public debate about the extent to which APRA-regulated trustees engaging in policy discussions or lobbying with policy makers, in relation to matters related to Investing for Sustainability Impacts, is consistent with their legal duties – in particular, the sole purpose test and the best interests duty.

4.2.3 An APRA-regulated trustee could legitimately consider that engaging in policy discussions or lobbying with policy makers is consistent with the sole purpose test and the best interests duty, where the engagement:

- is aimed at promoting the superannuation fund's financial returns, including minimising risks.[146] For example, the APRA-regulated trustee's assessment may be that the Government's policy position (or lack of a policy position) is adversely impacting, or is likely to adversely impact, returns of the superannuation fund, or returns of asset sectors that the APRA-regulated trustee invests in (or would invest in). This work may be over the investment time frames, or in some circumstances have a longer view; and / or
- supports the APRA-regulated trustee's member engagement strategies (aimed at attraction and retention of members to ensure the long term viability of the fund), for example, where the lobbying or policy discussion assists the APRA-regulated trustee in positioning themselves as being 'socially responsible' or 'good corporate citizens' as part of their member attraction and retention strategies. This kind of policy engagement could potentially be aligned with ultimate ends IFSI goals discussed in paragraph 3.2.2.

4.2.4 The debate on the issue of engagement was seen in the reporting in relation to the open letter to governments of the world released in June 2019 that was signed by a number of APRA-regulated trustees. This has been subject to some criticism as a political campaign that is not in the members' best interests, and the extent to which active participation in lobbying is consistent with the best interests test has also been the subject of comment.[147]

4.2.5 The current public debate about the appropriateness of APRA-regulated trustees engaging in lobbying and policy discussions in relation to climate change risks has resulted in some uncertainty as to the operation of the sole purpose test and best interests duty in relation to these activities. As a result, APRA-regulated trustees may avoid engagement in policy discussions and lobbying in relation to Sustainability Impact issues, in order to avoid criticism.

4.2.6 As discussed above, APRA-regulated trustees will be prevented from engaging in policy discussions and lobbying of the sort described above to the extent that such engagement and lobbying is not in the best financial interests of members and consistent with the sole purpose test.

4.3 **Mutual funds**

Registered Managed Investment Schemes

4.3.1 We do not consider that there is a duty requiring a responsible entity to engage in public policy work, policy discussions or lobbying in its capacity as a responsible entity.

4.3.2 As with stewardship activities, in order for a responsible entity to engage in public policy work with respect to Sustainability Impact, the particular policy activity will likely need to be justified by reference to financial return to the members of the scheme. Where public policy work seeking to secure sustainability impact may be reasonably expected to contribute positively to the growth in value of portfolio constituents and is not expected to cause a decline in the short-term value of these businesses, this policy discussion and/or lobbying may be open to a responsible entity.

AUSTRALIA

4.3.3 Before commencing public policy work, responsible entities are required, under their duty of care and diligence to consider and evaluate the costs, benefits, potential risks and the likelihood of potential positive and negative outcomes to the members of the scheme.

Listed Investment Companies

4.3.4 The analysis with respect to stewardship activities of LICs, described at 3.3.4 to 3.3.7, largely applies to public policy work of LICs. As such, we do not consider LICs to be subject to a duty to conduct public policy work for Sustainability Impact, and the ability of a LIC to engage in public policy work will be limited by the constituent and disclosure documents of the LIC and by reference to the likely (predominantly, but not exclusively, financial) benefits of that public policy work to the LIC.

4.4 Insurance undertakings

4.4.1 An insurance company is not required to engage in policy discussions or lobbying with policy makers in relation to portfolio constituents designed to achieve positive and/or reduce negative Sustainability Impacts. In practice, it is unusual for insurance companies to engage in policy discussions or lobbying with policy makers. Insurance companies are, in many cases, owned by listed companies (in Australia and overseas) and any policy discussions or lobbying would be in accordance with the group's positioning on the relevant issues.

4.4.2 For investments that support risk policies or investments of shareholders' funds, the considerations for insurance companies in relation to engaging in policy discussions are as for any other company. (See commentary on directors' duties to shareholders and the company generally at paragraphs 1.3.12 to 1.3.17 and specifically in relation to policy engagement at 2.4.8 to 2.4.11.)

4.4.3 Investment-linked policies of Life Insurers are for the purpose of generating financial returns, and the Life Insurer is required to prioritise the interests of policy holders and to comply with the terms of the policy. The effect on participation in policy discussions is that, in principle, a Life Insurer would be permitted to engage, and would not be restricted or prevented from engaging, in policy discussions and lobbying with policy makers, in relation to portfolio constituents designed to achieve positive and/or reduce Sustainability Impacts, provided the outcome sought was not inconsistent with:

- promoting financial returns from the insurance company's investment portfolio (including minimising risks); or
- for Life Insurers in relation to investment-linked policies, the objectives governed by the terms of the policy and any disclosure documents issued to investors.

4.4.4 We note that there may be policy discussions and lobbying engagement of the sort described above that can be justified on that the outcomes sought are likely to contribute positively to the financial interests of the insurance company [beyond financial materiality to its current investment portfolio]. For example, policy discussions and lobbying in relation to carbon reduction and measures to be taken to reduce the pace of climate change may be justifiable on the basis that the expected consequences of climate change (including the possible increased frequency of extreme and destructive weather events) may negatively affect the insurance company's insurance business (through a greater and more unpredictable rate and quantum of claims).

4.4.5 Whether or not public policy work would be considered inconsistent with promoting financial returns of the portfolio if it risked short-term detriment to financial returns for better returns in the long term would largely depend upon the strategy for the particular investment in question. For example, it is possible that an insurer, in compliance with all its statutory obligations and duties could place a portion of its portfolio into an investment with a long term strategy of using public policy engagement to improve returns.

AUSTRALIA

5. ESTABLISHING NEW FUNDS TO INVEST FOR SUSTAINABILITY IMPACT AND AMENDING THE TERMS OF EXISTING ONES

5.1 The following section considers the extent to which it is possible for an Asset Owner to set up a fund, policy or other product with the express objective of IFSI.

5.2 **Pension funds**

5.2.1 An APRA-regulated trustee is permitted to set up a superannuation fund, or an investment option within a superannuation fund, that Invests for Sustainability Impact as well as financial return, in which beneficiaries can choose to invest.

5.2.2 As discussed in paragraphs 2.2.30 to 2.2.32, an APRA regulated trustee's statutory duties remain paramount at all times. It is therefore at best uncertain as to whether a fund or investment option could be offered where IFSI takes priority to financial return.

5.2.3 An APRA-regulated trustee may include considerations of IFSI in formulating investment strategies, where doing so is consistent with generating financial returns (which may be long term returns) and managing risk (see paragraph 2.2.33) and section 9.

5.2.4 Additionally, proper formulation of investment strategies may necessarily require consideration of Sustainability Impact risks (see previous commentary at paragraph 2.2.37).[148]

5.2.5 It is highly unlikely that even if it were possible for a choice product or investment option to be changed to prioritise Investing for Sustainability Impact that this would be done. It is difficult to see how a trustee could determine that it is in the best interests of members to make a decision to change an option that beneficiaries had invested into, knowing that it prioritised financial returns, into an option that instead prioritised Sustainable Impact. To do so would also be an adverse significant event, and require notice to all members.

Duties on those designing, manufacturing and providing pensions

5.2.6 From April 2021 APRA-regulated trustees will be required to comply with new product design and distribution obligations.[149] These obligations include the requirement to make a publicly available 'target market determination' in relation to choice superannuation products that can be acquired by retail clients.

5.2.7 While ASIC is yet to issue final guidance in relation to its interpretation of these obligations, it has stated that it expects issuers and distributors to introduce and maintain effective governance processes across the lifecycle of financial products, such that the target market determination for a product might change over time if data shows that the consumers who are actually buying the product are different to the original target market.[150]

5.2.8 These new requirements will oblige product issuers to gather information about the consumers purchasing their products, which could potentially create an opportunity to get more insight into why consumers have purchased a particular product, and the relevance of Investing for Sustainability Impact in their decision.

5.2.9 As described in paragraph 2.2.23 there are also statutory disclosure obligations with which an APRA-Regulated Trustee is required to comply for any product or investment option.

5.3 **Mutual funds**

Establishing a new retail investment fund for Sustainability Impact investing

5.3.1 Registered managed investment schemes may be set up with an express objective to Invest for Sustainability Impact as well as, or having priority over, a financial return, provided that the scheme is intended to produce financial benefits, or benefits consisting of rights or interests in property. If it is not intended to produce those benefits, the scheme would not satisfy the elements of the definition of 'managed investment scheme' under the Corporations Act.

5.3.2 Listed investment companies can be set up with an express objective to Invest for Sustainability Impact either as well as, or having priority over, a financial return in which investors can choose to invest, or have their benefits determined against.

5.3.3 In all cases, the ability of a fund or other vehicle to Invest for Sustainability Impact either as well as, or having priority over,

AUSTRALIA

financial return would need to be clearly expressed as a purpose of the fund or other vehicle and permitted within the investment strategy and investment guidelines of the scheme in the constitution of the fund (or other vehicle) and the product disclosure statement or other applicable disclosure document of the fund (or other vehicle).

5.3.4 With regard to articulating investing for sustainability impacts effectively as the purpose responsible entities may wish to have their scheme's investment strategy certified by the Responsible Investment Association of Australasia (**RIAA**) under the RIAA's Constitution and Strategy (**RIAA Standards**). This requires that Asset Owners assist in achieving the RIAA's stated belief that 'investment and ownership practices can and should align with society's needs and objectives, such as those set out in the 'UN's Sustainability Development Goals'. The Asset Owner is then required to follow a number of commitments that align with this belief.

5.3.5 Alternatively, a responsible entity may wish to be certified under the RIAA's more rigorous Responsible Investments Certification Program (**RI Certified**). Certification under this program entails subscribing to a detailed program of standards and a code of conduct.

Amending the terms of a retail investment fund to reflect a commitment to Sustainability impact investing

5.3.6 Under the Corporations Act, an amendment of the constituent documents would likely be required to permit a scheme or a LIC to have an express objective to Invest for Sustainability Impact, and this would require the approval of members by special resolution (being a resolution passed with at least 75% of votes cast by members entitled to vote on the resolution).[151]

5.4 **Life insurance products**

5.4.1 Whether or not it is permissible for a Relevant Investor to set up a fund or other vehicle that Invests for Sustainability Impact either as well as, or having priority over, financial return is not applicable to Life Insurers in relation to their risk policies, as policy holders have the right to payment of specified amounts in specified circumstances (ie investment returns do not impact their rights). The question is however relevant to the investment-linked business of Life Insurers. (See commentary on directors' duties to shareholders and the company at paragraphs 1.3.12 to 1.3.17.)

5.4.2 For the superannuation business of Life Insurers, the policy holder is the APRA-regulated trustee. An APRA-regulated trustee can only acquire an investment-linked life insurance policy in accordance with the trustee's own duties in relation to investment, and would not acquire a policy that is not consistent with those duties. Therefore, in designing the investment strategies for investment-linked policies, a Life Insurer would need to take into account the constraints on APRA-regulated trustees (discussed in the commentary on superannuation funds).

5.4.3 For investment-linked non-superannuation policies, the Life Insurer can offer investment portfolios on any basis determined by the Life Insurer. The portfolios supporting these policies could therefore be constructed to include Investing for Sustainability considerations, and the terms of the policies and disclosure documents may be drafted to include Investing for Sustainability Impact objectives. As the Life Insurer's obligation is to comply with the terms of the policy, as contractual obligations, there is no obstacle to designing and offering a portfolio that prioritises Investing for Sustainability Impact over financial returns. Once the policy has been started, it could only be amended to include provisions for IFSI if both parties to the contract agreed to the amendment.

Duties on those designing, manufacturing and providing life insurance

5.4.4 The information on new design and distribution obligations for product issuers in 5.2.6 to 5.2.8 is also relevant for life insurers.

5.4.5 Life Insurers must also ensure that life insurance policies are designed in accordance with the 'Policy design and disclosure' requirements of the Life Insurance Code of Practice. These obligations include that the Life Insurer will define suitable customers for the product, regularly review on sale products to ensure they remain generally suitable for the relevant customers, and re-design on-sale products where necessary.[152]

AUSTRALIA

6. INVESTMENT MANAGERS' DUTIES TO INVEST FOR SUSTAINABILITY IMPACT

6.1 This section considers the extent to which, and in what circumstances, an Investment Manager is (a) required or (b) permitted to Invest for Sustainability Impact on behalf of an Asset Owner or otherwise, in each of the three ways contemplated in sections 2-4.

6.1.1 In this Annex the Investment Managers considered are the Investment Managers who manage funds on behalf of superannuation funds, insurance companies and registered managed investment schemes. We have not considered Investment Managers of LICs as we have only considered internally managed LICs in our analysis.

6.1.2 Australian Investment Managers' investment duties and powers derive from:

(a) the terms of the investment management agreement (or another similar agreement) with the relevant Asset Owner (**IMA**). An IMA entered into between an APRA-regulated trustee of a superannuation fund or an insurance company is required to include certain prescribed content, including:

(i) service levels and performance requirements, form of keeping data, ownership and control of data, reporting requirements (including content and frequency of reporting);

(ii) liability and indemnity and offshoring arrangements;

(iii) an indemnity to the effect that any sub-contracting of the outsourced function will be the responsibility of the service provider (the Investment Manager), including liability for any failure on the part of the sub-contractor; and

(iv) a clause that allows APRA access to documentation and information related to outsourcing arrangement, including the right for APRA to conduct on-site visits to the service provider.

There is no prescribed content for IMAs between Investment Managers and responsible entities and LICs. Some industry templates produced by the FSC and ACSI are widely used as the basis for IMAs for responsible entities and LICs.[153]

(b) certain statutory obligations that apply to all AFS Licence holders;[154]

(c) the duty of care owned to Asset Owners in tort. This duty can be modified and/or excluded in an IMA between an Investment Manager and a managed investment scheme, but not in an IMA between an Investment Manager and an APRA-regulated trustee;[155]

(d) fiduciary duties owed to Asset Owners (which can be modified or contracted out in the IMAs terms);[156] and

(e) the duty to exercise reasonable care and skill to the Asset Owner pursuant to an implied term of the IMA, or by virtue of being a professional.[157]

Legal obligations with respect to Sustainability Impact

Powers of investment and divestment

6.1.3 If the IMA or other such document requires the Investment Manager to engage in IFSI, the Investment Manager will be bound by the relevant terms to pursue a sustainable investment strategy. This must be balanced with the Investment Managers interests in generating financial returns so as to avoid breach of their duties.

6.1.4 If the IMA does not include Sustainability Impacts within its investment objectives, we do not consider that the Investment Manager is under any legal obligation to do so.

6.1.5 If an Asset Owner sought to require its Investment Manager to incorporate IFSI into the Investment Managers investment mandate, the terms of the IMA must be amended to provide for this.

Engagement to achieve Sustainability *Impact*

6.1.6 As above, unless specifically set out in the IMA, we do not consider that there is any duty on an Investment Manager to e ngage with portfolio companies (or any other stakeholders) to achieve Sustainability Impacts.

6.1.7 Notwithstanding that, it is possible that negative Sustainability Impacts may have an adverse effect on the value of the portfolio constituents over the time horizons that apply under the IMA, and to the extent that they do, an Investment Manager may be required, pursuant to its duty of care, to consider what steps a reasonable Investment Manager would take in the circumstances, having regard to the magnitude of the risk and the degree of the probability of its occurrence,

AUSTRALIA

along with the expense, difficulty and inconvenience of taking alleviating action and any other conflicting responsibilities which the Investment Manager may, and take those steps (which may or may not involve stewardship activities).

Public policy work to achieve Sustainability Impact

6.1.8 Again, unless the Investment Managers' mandate includes public policy work to achieve a Sustainability Impact as an objective, we do not consider there to be any legal obligation for an Investment Manager to do so.

6.2 **Legal freedom to Invest for Sustainability Impact**

Powers of investment and divestment

6.2.1 Where an IMA is silent on Investing for Sustainability Impact, given the Investment Manager's duties and the likely financial return objectives under the IMA, Investment Managers are likely to be unable to exercise its investment powers to Invest for Sustainability Impact unless such exercise is otherwise consistent with the IMA and the relevant investment or divestment could be justified on purely financial grounds (which we acknowledge could conceivably encompass instrumental and ultimate ends IFSI).

6.2.2 Investment Managers may be reluctant to exercise their investments powers to Invest for Sustainability Impact as their remuneration is often tied to the value of portfolio being managed and they may also be unwilling to pursue additional objectives without the express approval of the Asset Owner, where that approval could be easily given (with a waiver or amendment of the IMA) or denied.

Engagement to achieve Sustainability Impact

6.2.3 In the absence of express authority under the IMA, an Investment Manager is unlikely to be permitted to engage in stewardship activities in relation to portfolio constituents designed to achieve Sustainability Impacts instead of their contribution to investment return.

6.2.4 It may however be possible for an Investment Manager to engage in stewardship activities in relation to portfolio constituents designed to reduce negative Sustainability Impacts if those stewardship activities are reasonably expected to contribute positively and directly or indirectly to the growth in value of the applicable portfolio constituent.

6.2.5 *Public policy work to achieve Sustainability Impact*

6.2.6 Investment Managers are free to engage in public policy work if funded from its own resources provided it is in the Investment Manager's company's best interest and does not create a conflict between the Investment Manager and its clients.

6.2.7 If an Investment Manager undertakes public policy work on behalf of an Asset Owner, it must do so in accordance with the terms of the IMA and without creating any conflicts of interest with its client. In practice an Investment Manager will likely only undertake such work where it has express authority to do so under the terms of the IMA.

AUSTRALIA

7. LEGAL LIABILITY TO THIRD PARTIES FOR THE NEGATIVE SUSTAINABILITY IMPACT OF ENTERPRISES IN WHICH PORTFOLIOS ARE INVESTED

7.1 This section considers the extent to which, regardless of the legal rules under which it is required to operate and its constitution, an Asset Owner could be legally liable to third parties for the negative Sustainability Impact of enterprises in which it invests, and whether an Investment Manager could also be liable because of its role in assisting the Asset Owner to invest in the relevant enterprise and steward its investment.

7.2 Asset Owners

7.2.1 Asset Owners may face civil liability under the tort of negligence. It is unlikely that Asset Owners will face criminal liability for the negative Sustainability Impacts of the businesses or asset that they fund.

Civil liability

7.2.2 As the law presently stands in Australia, there is no general duty to take steps to mitigate negative Sustainability Impacts.[158] As such, the most relevant cause of action to be brought against an Asset Owner in these circumstances is negligence. Subject to the limited circumstances described in paragraph 7.2.3, it is unlikely that an Asset Owner would owe third parties a duty of care to take reasonable care to refrain from contributing to negative Sustainability Impacts, in circumstances where the Asset Owner owes an inconsistent legal duty to act in the best (and, likely, financial) interests of beneficiaries.[159]

7.2.3 As a consequence of the doctrine of separate legal personality, parent companies in Australia are typically not held liable for the acts of their subsidiary companies. Australian Courts have, however, , on a few limited occasions established liability in the tort of negligence pursuant to a duty of care owed by a controlling parent entity to employees of, and third parties dealing with, subsidiaries.[160] The decisions turned broadly on the questions of whether the parent company exerted a sufficient degree of control or influence over its subsidiary company and whether the harm to the claimant was reasonably foreseeable.[161] This line of cases may be limited to where a parent company exerts control or influence over its subsidiary company and we have not identified any decisions in Australia where the courts have applied the reasoning in this line of cases and extended the duty of care beyond the parent company-subsidiary relationship to institutional or other financial investors (ie Asset Owners in a shareholder or management capacity).

Criminal liability

7.2.4 It is unlikely that an Asset Owner could be held criminally liable for negative Sustainability Impacts of enterprises they have funded. The nature of the relationship between Asset Owners and investee companies make establishing any cause of action highly unlikely (without developments in Australian criminal law).

7.2.5 If Asset Owners were appointed as nominee directors of investee companies, and had managerial responsibility in relation to the causation of a negative Sustainability Impact (eg, destruction of a cultural site, pollution of a national park, breach of environmental laws) criminal liability could possibly arise. However, that liability may attach only to the nominee directors personally, rather than to the Asset Owner who appointed them.

Reputational, regulatory and other risks

7.2.6 We also note that, as in other jurisdictions, NGOs are increasingly making complaints to Australia's National Contact Point (*NCP*) alleging breaches of the OECD's Guidelines. Though complaints have not yet been made against relevant Asset Owners,[162] the Australian NCP is currently considering a matter involving a banks financing of an entity linked to forcible evictions and human rights abuses, and a number of other similar matters have been brought indicating future potential for complaints to be made directly against Relevant Investors.[163]

7.3 Investment Managers

7.3.1 Investment Managers, like Asset Owners, may, in limited circumstances face civil liability for negative Sustainability Impacts under the tort of negligence. It is unlikely that Investment Managers will be held criminally responsible for the negative Sustainability Impacts of assets they have selected for investment.

Civil liability

7.3.2 The analysis concerning civil liability for Asset Owners of 7.2.2 and 7.2.3

AUSTRALIA

applies equally in the case of Investment Managers. Investment Managers may, in limited circumstances, attract liability under the tort of negligence. We note that although this analysis applies equally to Asset Owners and Investment Managers, it is even less likely an Investment Manager would be found to have civil liability to third parties for negative Sustainability Impacts. By virtue of their engagement through the IMA, the Investment Managers are further removed from any conduct which amount to a negative Sustainability Impact. In addition, the indemnification rights of Investment Managers under their IMA may shield Investment Managers from any liability from any such causes of action.

Criminal liability

7.3.3 It is unlikely that an Investment Manager could be held criminally liable for negative Sustainability Impacts of enterprises they have funded. The analysis with respect to the relationship between Asset Owners and investee companies detailed at 7.2.3 applies equally in the case of Investment Managers. Additionally, comments related to the potential criminal liability of Relevant Investor-appointed nominee directors at 7.2.4 also apply. In this case, as in the circumstances detailed above, criminal liability would only attach to the nominee director personally and not the Relevant Investor that appointed them.

AUSTRALIA

8. THE GROWING IMPORTANCE OF TAKING ACCOUNT OF ESG AND SUSTAINABILITY FACTORS WHERE THESE ARE 'FINANCIALLY MATERIAL'

8.1 It has become increasingly important for Relevant Investors to take ESG and sustainability factors into account in managing portfolios because of the way in which they could be material to achieving the financial investment objectives of the Relevant Investor in accordance with their legal duties. The main reasons are summarised below.

8.1.1 In Australia, there has been growing awareness of the importance of taking into account sustainability factors where these are financially material. This is evidenced by a catalyst of developments in Australian policy, law, regulation and industry best practice focusing on ESG and sustainability issues (primarily climate change). Key developments include:

(a) recognition by APRA in its SPG 530 that APRA-regulates trustees may, under their existing duties, offer ethical investment options and/or integrate ESG considerations into the formulation of investment strategy and analysis.[164] Earlier this year APRA indicated it intends to update SPG 530 to '*ensure that the financial risk of climate change is managed effectively*' and urged entities to act prudently to '***assess and mitigate***' climate related risks before its updated guidance is released.[165] APRA also outlined its plans to release a climate change Prudential Practice Guide and to develop a climate change financial risk vulnerability assessment.[166] Further, in 2019, APRA commented that its regulated entities must actively assess climate change risk and incorporate the assessment into governance practices;[167]

(b) enhanced levels of disclosure increasingly encouraged/required by Australian regulators. These disclosures appear in certain entities' risk management frameworks, sustainability reports (or other integrated reporting documents), in a director's operating and financial review, prospectuses and other public investment strategies.[168] ASIC has indicated that it considers that it may be misleading if an entity does not include ESG related disclosures in its operating and financial review or prospectus,[169] and one case was brought by the Environmental Justice Agency alleging the Commonwealth Bank of Australia should have disclosed climate change as a material risk in its annual report (the case was later discontinued).[170] This increased focus on ESG disclosures has in turn has created a changing environment in which investments are made;

(c) an increasing regulatory push on climate change issues, evidenced by the statements and documents released by Australia's financial regulators, APRA,[171] the RBA[172] and ASIC,[173] which called on companies and government to take action on climate change, further creating a changing regulatory environment under which investments are made; and

(d) leading industry associations developing (sometimes mandatory) guidance and standards which includes ESG and sustainability factors. Of particular importance are the standards and guidance developed by the FSC, ACSI and AASB, which provides for ESG related issues in voting of their members,[174] governance,[175] financial reporting and other disclosures,[176] and stewardship.[177]

8.1.2 There is also a growing body of commentary suggesting that beneficiaries may seek to argue that Asset Owners and their Investment Managers have breached their duty to act with care and skill, or their duty to act in the best interest of a company, if they fail to consider financially materially ESG factors.[178] We are not aware of any jurisprudence in Australia that has yet pronounced on this cause of action. With the recent case against REST superannuation settling late last year (see 2.2.27), we will have to wait some time for these laws to update.

8.2 Financial materiality

8.2.1 Because of the growing importance of taking account of ESG and sustainability factors in the investment process where financially material, it is important to understand how the law defines what is 'financially material' and the period by reference to which financial materiality must be measured. Taking account of these factors in order to pursue financial objectives may incidentally have Sustainability Impacts and may also be consistent with Investing for Sustainability Impact.

> ANNEXES

> Australia

AUSTRALIA

8.2.2 The level of significance that is necessary for an ESG factor to be taken into account in seeking to secure financial return in the management of a portfolio, or the 'financial materiality' of ESG factors, is not defined in Australian statute or general law. However, financial materiality is considered in the context of financial statement disclosure obligations. Financial disclosure obligations typically require disclosure of any financial material risks and opportunities.

8.2.3 Under the Corporations Act, disclosure must be made of financially material information that would have an effect on the entity's securities.[179] Pursuant to s 677, information will have a material effect on the price or value of securities if it 'would, or would be likely to, influence persons who commonly invest in securities in deciding whether to acquire or dispose of the … securities.' The same approach is adopted across several industry standards on financial reporting. For example, the Australian Accounting Standards Board (**AASB**) — a Commonwealth entity responsible for developing Australian Accounting Standards defines materiality as 'an entity-specific aspect of relevance based on the nature or magnitude, or both, of the items to which the information relates in the context of an individual entity's financial report.'[180]

8.2.4 Likewise, the ASX Listing Rules — which require ASX listed Asset Owners to continuously disclose financially material information — define material (or 'market sensitive') information as the information that 'a reasonable person would expect to have a material effect on the price or value of the entity's securities'.[181]

8.2.5 Industry is increasingly recognising that environmental, social and governance risks are financially material. Although they are non-binding in nature, the following standards show a developing trend towards recognizing financial materiality of ESG considerations:

The ASX Corporate Governance Principles and Recommendations require listed companies to disclose '*material exposure to environmental or social risks*'.[182] While the Guidance Principles do not define what 'material exposure' is, at least in respect of climate change risks, reference is made to the Financial Stability Board's TCFD, in which entities are '*encourage[d]*' to consider in assessing their respective material exposure to climate change risk.[183]

The ESG Reporting Guide for Australian Companies, issued by the FSC (which represents Investment Managers) and ACSI (which represents Asset Owners), states that:[184] '*ESG risks are material, where a reasonable person would consider the information to have an impact on a company's valuation or the sustainability of its operations. The risk(s) could have an immediate or foreseeable impact on earnings, an impact on a balance sheet, or an impact on the sustainability of its operations*.' It is significant that, for further guidance on materiality, the ESG Reporting Guide makes express reference to the definition of financial materiality provided by the Sustainability Accounting Standards Board (**SASB**). SASB defines financially material issues as '*the issues that are reasonably likely to impact the financial condition or operating performance of a company and therefore are most important to investors*'.[185] Through its 'Materiality Map', SASB has identified several sustainability issues as financially material within a range of industries.[186]

In December 2018, the AASB issued a new practice statement regarding financial materiality of climate-related and other emerging risks.[187] The practice statement underlines a developing industry understanding that climate-related risks can no longer be considered solely from a social corporate responsibility perspective.

8.3 Time period by reference to which 'materiality' is to be assessed

8.3.1 As a general rule, materiality would be assessed with reference to the timeframe that is disclosed to beneficiaries in relation to the particular investment strategy. So, for example, if a strategy was disclosed with a strategy to return 3% over 7 years, then materiality would be assessed by reference to the impact over 7 years.

8.3.2 For pension funds, it is also instructive to look at the statutory obligations in relation to the development of investment strategies and the way in which investment returns are reported, on the assumption that materiality would be assessed with reference to similar timeframes. For example:

(a) APRA-regulated trustees are required to both include 10 year investment target returns in the investment strategy for MySuper products, and to publish the actual 10 year returns for these products (when they are available, noting that most MySuper products commenced in 2014), and

AUSTRALIA

(b) the APRA MySuper Product Heatmap currently reports investment performance for MySuper products over 3 and 5 year periods. This is slated to expand to include longer time horizons (e.g. 7 and 10 years) as time progresses.[188]

8.4 For LICs and registered managed investment schemes, Relevant Investors must measure financial materiality over an appropriate time period which allows them to meet their general duties discussed in this report and the periods disclosed to beneficiaries. However, literature suggests that, as a matter of investment practice, the time period will to some extent depend on the type of investor that the fund will be marketed to and investment in question. For short-term (retail) investors, corporate strategies which sacrifice an immediate profit in order to mitigate long-term ESG risk will be unattractive. Conversely, for the longer term Relevant Investors, slow changes in environmental and social conditions matter more.[189] The specific duration of the fund, in the case of a closed-end fund or the tenure of an Investment Manager will largely be determined at the outset of the fund's creation as opposed to any negotiation between Asset Owners and investors.

CORRS CHAMBERS WESTGARTH

Anton Bobenko, Michael Chaaya, William Chaffey, Kon Mellos, James Whittaker and Phoebe Wynn-Pope

AUSTRALIA

1 *Cowan v Scargill* [1985] Ch 270.

2 *ASIC v Lewski* [2018] HCA 63, [71].

3 *Australian Prudential Regulation Authority v Kelaher* [2019] FCA 1521.

4 Thomas G, *The duty of trustees to act in the 'best interests' of their beneficiaries* (2008) 2 Journal of Equity 177.

5 *Australian Prudential Regulation Authority* (APRA) *v Kelaher* [2019] FCA 1521, [65].

6 Ibid [49].

7 Ibid.

8 Ibid [55].

9 Donald, M Scott and Taylor, Nicholas, Does 'sustainable' investing compromise the obligations owed by superannuation trustees? (2008) 36 Australian Business Law Review 47, 49, citing *Maciejewski v Telstra Super Pty Ltd* [1999] NSWSC 341 [13]; *Telstra Super v Flegeltaub* (2000) 2 VR 276; *Sayseng v Kellogg Superannuation* [2003] NSWSC [63].

10 *Asea Brown Boveri Superannuation Fund No. 1 Pty Ltd v Asea Brown Boveri Pty Ltd and Others* [1999] 1 VR 144: The Court found [at 65]: '... trustees of a superannuation fund owe a duty of loyalty exclusively to the members. It does not follow from that, however, that a trust deed can never be altered to meet the interest of the employer. Trustees are free to negotiate with an employer for a package of amendments that may include benefits to the employer if in the opinion of the trustees that would benefit the members'.

11 Treasury Laws Amendment (Measures for a later sitting) Bill 2020: Best Financial Interests Duty introducing 'best financial interest' and replacing 'best interest of the beneficiaries'.

12 Treasury Laws Amendment (Measures for a later sitting) Bill 2020: Addressing underperformance in superannuation assessing underperforming funds and freezing new beneficiaries if underperformance continues for 2 years.

13 *Slea Pty Ltd v Connective Services Pty Ltd* [2017] VSC 609 [156], citing *Permanent Building Society (in liq) v Wheeler* (1994) 11 WAR 187.

14 *Slea Pty Ltd v Connective Services Pty Ltd* [2017] VSC 609 [156], citing *Reid Murray Holdings Ltd (in liq) v David Murray Holdings Pty Ltd* (1972) 5 SASR 386.

15 *Greenhalgh v Arderne Cinemas Ltd* [1951] Ch 286; applied in *Ngurli Ltd v McCann* (1953) 90 CLR 425, 438 (both in the context of shareholders voting rights). For criticism of the decision's application to the best interest duty, see generally, du Plessis, Jean J, 'Directors' duty to act in the best interests of the corporation: 'Hard cases make bad law' (2019) 34 *Aust Jnl of Corp Law* 3.

16 See, eg, *Russell Kinsela Pty Ltd (in liq) v Kinsela* [1983] 2 NSWLR 452 and Prof Sealy, L S, *Bona Fides and Proper Purposes in Corporate Decisions* (1989) 15 Monash University Law Review 265, 265-6. See, also, du Plessis, above n, 17-19.

17 *Bell Group Ltd (in liq) v Westpac Banking Corp (No 9)* [2008] WASC 239, [4393] per Owen J, as approved in *ASIC v Cassimatis (No 8)* (2016) 336 ALR 209, [516] (though in the context of a directors duty of care, skill and diligence).

18 Parliamentary Joint Committee on Corporations and Financial Services, *Corporate Responsibility: Managing Risk and Creating Value* (June, 2006), [4.6], [4.8] (PJC Report).

19 See generally, Jean J du Plessis 'Directors' duty to act in the best interests of the corporation: 'Hard cases make bad law' (2019) 34 *Australian Journal of Corporate Law* 3, 24-6.

20 *Bell Group Ltd (in liq) v Westpac Banking Corp (No 9)* [2008] WASC 239, [4393].

21 PJC Report [4.6].

22 *See Bell Group Ltd (in liq) v Westpac Banking Corp (No 9)* [2008] WASC 239; *ASIC v Cassimatis (No 8)* (2016) 336 ALR 209; Prof Baxt AO, Bob, 'Future directions for Corporate Law: Where are we now and where do we go from here? The dilemmas of the modern company director' (2011) 25 *Australian Journal of Corporate Law* 213; Jean J du Plessis, 'Directors' duty to act in the best interests of the corporation: "Hard cases make bad law" (2019) 34 *Australian Journal of Corporate Law* 3, 23.

23 *Angas Law Services Pty Ltd (in liq) v Carabelas* [2005] HCA 23 (Angas) [67] (Gummow and Hayne JJ).

24 *ASIC v Cassimatis (No 8)* (2016) 336 ALR 209, As that time of writing, there are no reported decisions in which the courts have enunciated a clear position as Edelman J's in *Cassimatis* specifically in connection with the best interests duty of company directors. Cassimatis appealed this decision before the full Federal Court where the appeal was dismissed. See *Cassimatis v ASIC* (2020) 376 ALR 261.

25 *ASIC v Healey* [2011] FCA 717, [14], though considering community interests as an interest which can be affected by directors decision making broadly and not in the context of the best interest duty.

26 Owen J in *Bell Group Ltd (in liq) v Westpac Banking Corp (No 9)* [2008] WASC 239 [4394] approving of Heydon JD in 'Directors' Duties and the Company's Interests' in Finn P, '*Equity and Commercial Relationships*' (1987).

27 PJC Report, [4.39]; CAMAC, Parliament of Australia, *The Social Responsibility of Corporation*, (Report, 12 December 2006) 111.

28 Kenneth Hayne AC QC, 'Remarks to Business Roundtable on Climate and Sustainability' (Centre for Policy Development, 21 November 2019) https://cpd.org.au/2019/12/full-text-of-kenneth-hayne-ac-qc-remarks-to-cpd-climate-roundtable/.

29 Prof Baxt AO, Bob, 'Future directions for Corporate Law: Where are we now and where do we go from here? The dilemmas of the modern company director' (2011) 25 *Australian Journal of Corporate Law* 213, 225.

30 Gerald Acquaah-Gaisie, 'Toward more effective corporate governance mechanisms' (2005) 18 *Australian Journal of Corporate* Law 1.

31 Bryan Horrigan, 'Teaching and integrating recent developments in corporate law, theory and practice' (2001) *13 Australian Journal of Corporate Law* 182, 23.

32 See 2.2.11, 2.3.11 and 2.3.15.

33 *ASIC v Avestra Asset Management Ltd* [2017] FCA 497, 559-60 (Beach J).

34 Ibid 560.

35 Ibid.

36 *Council of the Shire of Wyong v Shirt* (1980) 146 CLR 40.

37 Ibid.

38 *Tubemakers of Australia Ltd v Fernandez* (1976) 10 ALR 303.

39 *Re Courage Group's Pension Schemes* [1987] 1 WLR 495.

40 *Vatcher v Paul* [1915] AC 372.

41 *Cowan v Scargill* [1985] Ch 270.

42 *Vatcher v Paul* [1915] AC 372.

43 M Scott Donald, Jarrod Ormiston and Kylie Charlton 'The potential for superannuation funds to make investments with a social impact' (2014) 32 *Company and Securities Law Journal* 540.

44 *Whitehouse v Carlton Hotel Pty Ltd* (1987) 162 CLR 285.

45 See, Corporations Act s 181(1)(b).

46 For example, we do not consider the effect of *Military Superannuation and Benefits Act 1991* (Cth) or any other legislation specific to the superannuation and retirement benefits of members of the Australian Defence Force, or any legislation in relation to the Public Sector Superannuation Accumulation Plan.

47 An interdependency relationship is defined in the *Superannuation Industry (Supervision) Regulations 1994* (Cth) at Reg 1.04AAAA as one which, taking into account all the circumstances, one or each of the people provide the other with support and care of a type and quality normally provided in a close personal relationship, rather than by a mere friend or flatmate.

48 *Superannuation Industry (Supervision) Act 1993* (Cth) (SIS Act) s 52(6)(a).

49 *Trusts Act 1973* (Qld), Part 3 (sections 21 — 30C); *Trustee Act 1925* (NSW) sections 14 — 20; *Trustee Act 1958* (Vic) Part I; *Trustees Act 1962* (WA) Part III, *Trustee Act 1936* (SA) Part 1; *Trustee Act 1898* (Tas) Part II; *Trustee Act 1893* (NT) Part I; *Trustee Act 1925* (ACT) Part 2 Division 2.2 Subdivision 2.2.1.

50 See, eg *Trusts Act 1973* (Qld) s 21. The formulation in the NSW, Vic and ACT legislation is: A trustee, unless expressly forbidden by the trust instrument, may invest trust funds in any form of investment, and vary an investment at any time.

51 SIS Act ss 52, 62.

52 Ibid s 62.

53 Ibid s 52(6)(a).

54 Ibid ss 52(6)(a)(i)-(vii).

55 Ibid s 52(2)(b).

56 Ibid s 52(3).

57 Ibid s 52(2)(c).

58 Ibid s 52(2)(d)(i).

59 Ibid s 52(8).

60 Ibid s 52A.

61 Treasury Laws Amendment (Improving Accountability and Member Outcomes in Superannuation Measures No. 1) Act 2019 (Cth).

62 Ibid s 52(12).

63 Ibid s 52(9).

64 Ibid s 52(13).

65 The line of cases is analysed in Self Managed Superannuation Fund Ruling SMSFR 2008/2 issued by the Australian Taxation

AUSTRALIA

Office. SMSFR 2008/2 is being reviewed as a result of the decision in *Aussiegolfa Pty Ltd (as trustee of the Benson Family Superannuation Fund) v Commissioner of Taxation (Cth)* [2018] FCAFC 122.

66 See, eg, *Asea Brown Boveri Superannuation Fund No. 1 Pty Ltd v Asea Brown Boveri Pty Ltd and Others* [1999] 1 VR 144 in which the Court held at [65]: '… trustees of a superannuation fund owe a duty of loyalty exclusively to the members. It does not follow from that, however, that a trust deed can never be altered to meet the interest of the employer. Trustees are free to negotiate with an employer for a package of amendments that may include benefits to the employer if in the opinion of the trustees that would benefit the members'. Also: *Invensys Australia Superannuation Fund Pty Ltd v Austrac Investments Ltd and Others* [2006] VSC 112; *Aussiegolfa Py Ltd (as trustee of the Benson Family Superannuation Fund) v Commissioner of Taxation (Cth)* [2018] FCAFC 122, *Australian Prudential Regulation Authority v Kelaher* [2019] FCA 1521.

67 This perspective is supported by Dominique Hogan-Doran in a presentation to the Law Council of Australia Superannuation Lawyers' Conference in 2019, who emphasised that, despite a literal reading of sole purpose test creating an impression that social impact investing may be off-limits for superannuation funds, the sole purpose test does not 'prohibit positive social outcomes' and that it permits the dual aims of financial return and of a social or environmental return: Dominique Hogan-Doran SC, Current Thinking on the Sole Purpose Test (Speech, Law Council of Australia Superannuation Lawyers' Conference, 2019) 17-18.

68 APRA Prudential Standard SPS 515, *Strategic Planning and Member Outcomes*, [16]-[17].

69 APRA Information Paper *Heatmap – MySuper products* (15 November 2019), 21.

70 See, comments in APRA Media Release dated 15 November 2019, attributed to Helen Rowell APRA Deputy Chair: '*In most cases, this will be a continuation of the supervisory action that APRA has already taken with these entities to address identified areas of poor member outcomes. If trustees don't fix these issues within a timeframe that is acceptable to APRA, we will be requiring them to consider other options, including a merger or exit from the industry in some cases*'.

71 *Corporations Act* s 912A.

72 *Story v National Companies and Securities Commission* (1988) 13 NSWLR 661, 69.

73 Ibid s 1013E.

74 Ibid s 1013D(l).

75 ASIC Regulatory Guide 65 – *Section 1013DA disclosure guidelines* (issued 30 November 2011) (ASIC RG 65) is issued under section 1013DA of the Corporations Act which provides that 'ASIC may develop guidelines that must be complied with where a Product Disclosure Statement makes any claim that labour standards or environmental, social or ethical considerations are taken into account in the selection, retention or realisation of 'investments'.

76 Corporations Regulations sch 10D, reg 7.9.11O, cl 9(c); Corporations Regulations sch 10E, reg 7.9.11W, cl 7(c).

77 See, ASIC RG 65.

78 Hutley and Mack; Barker et al: McAlister, *Are you exposed: Examining the potential liability of superannuation trustee directors for failure to take account of climate change risk* Banking & Finance Law Bulletin October 2015 Pam McAlister.

79 APRA Information Paper – *Climate change: Awareness to action* (29 March 2019) (APRA Information Paper on Climate Change), 17. This information paper also refers to a report by ASIC on climate risk disclosure by Australia's listed companies in 2018. See also, APRA, Understanding and managing the financial risks of climate change (24 February 2020).

80 APRA Climate Paper.

81 Statement from Rest, Media Release, 2 November 2020.

82 Corporations Act s 1017B.

83 Statutory duties include the sole purpose test, the best interests duty, the duty of care and skill, and the duty to promote the financial interests of the members.

84 SPG 530, [34].

85 As of 24 June 2021, the Responsible Investment Association Australasia identifies several Australian super funds that have been certified as applying a responsible or ethical investment strategy (these funds include Australian Catholic Superannuation Retirement Fund, UniSuper, Aware Super, VicSuper, sunsuper, Christian Super, Future Super and Active Super) - https://www.responsiblereturns.com.au/.

86 *Treasury Laws Amendment (Improving Accountability and Member Outcomes in Superannuation Measures No. 1) Act 2019* (Cth) introduced s 52(9) into the SIS Act, requiring APRA-regulated trustees to covenant that the financial interests of beneficiaries are being promoted by the trustee.

87 Corporations Act s 1017B requires notification of material changes to a matters that was disclosed in a Product Disclosure Statement.

88 Letter from APRA to all APRA-regulated entities dated 24 February 2020.

89 Refer to paragraph 2.2.13.

90 SIS Act ss 52(9), 52(11), 52(12), 52(13).

91 SPS 515 is discussed at paragraph 2.2.16.

92 APRA, 'Review of APRA's 2013 prudential framework' Information Paper (30 April 2019) https://www.apra.gov.au/sites/default/files/information_paper_review_of_apras_2013_superannuation_prudential_framework.pdf 37.

93 A managed investment scheme does not have to be registered if all the issues of interests in the scheme that have been made would not have required the giving of a Product Disclosure Statement under Division 2 of Part 7.9 if the scheme had been registered when the issues were made (eg if all the issues of interests in the scheme have been made offered and made to 'wholesale clients' under Chapter 7 of the Corporations Act): s 601ED.

94 See, eg, ASX, *Listing Rules* (at 26 March 2021) rr 1.3.4, 4.10.20, 15.16.

95 The Corporations Act provides that responsible entities hold scheme property on trust for scheme members: s 601FC(2).

96 *Harries v Church Commissioners* [1993] 2 All ER 300, 305 and, for example, *Trustee Act 1958* (Vic) ss 5—6.

97 Corporations Act s 601FC(1)(m); *Wellington Capital Ltd v ASIC* (2014) 254 CLR 288, [11] (French CJ, Crennan, Kiefel and Bell JJ).

98 Corporations Act s 601FC(1).

99 Ibid s 601GB.

100 Ibid s 601GA.

101 Ibid s 601GA(1)(b).

102 *Re Smith & Fawcett Ltd* [1942] Ch 304; *Greenhalgh v Arderne Cinemas Ltd* [1951] Ch 286; *Percival v Wright* [1902] 2 Ch 421.

103 Corporations Act s 180(1).

104 Ibid s 181(1).

105 Ibid s 181(2).

106 Ibid s 182(1).

107 Ibid s 180(2).

108 *Bell Group Ltd (in liq) v Westpac Banking Corp (No 9)* [2008] WASC 239.

109 *EV Daniels and others (formerly practising as Deloitte Haskins & Sells) v Anderson* (1995) 37 NSWLR 438.

110 *Daniels (formerly practising as Deloitte Haskins & Sells) v Anderson* (1995) 37 NSWLR 438, 494.

111 See paragraph 2.2.19.

112 *Life Insurance Act 1995* (Cth) (Life Act) s 31.

113 Ibid s 38(2).

114 Ibid s 32.

115 *ACN 074 971 109 Pty Ltd (as trustee for the Argot Unit Trust) v The National Mutual Life Association of Australasia Ltd (No 2)* [2012] VSCA 241, [108]: 'It is the plain and ordinary meaning of 'interests of owners and prospective owners of policies referable to the fund' in s 32 is their interests as framed by their entitlements under the Policies'.

116 Ibid s 30(f).

117 Ibid s 43(2).

118 Life Act, s 48. APRA Prudential Standard CPS 510 *Governance* (1 July 2019) also imposes requirements for Board composition that has regard to skills. At paragraph 19, the Board must ensure that directors and senior management of the institution collectively have the full range of skills needed for the effective and prudent operation of the institution, and that each director has skills that allow them to make an effective contribution to Board deliberations and processes. This includes the requirement for directors, collectively, to have the necessary skills, knowledge and experience to understand the risks of the institution, including its legal and prudential obligations, and to ensure that the institution is managed in an appropriate way taking into account these risks.

119 *Insurance Act 1973* (Insurance Act) s 28.

120 Insurance (prudential standard) determination No.8 of 2019: *Prudential Standard GPS 120 Assets in Australia*.

121 APRA Prudential Standard CPS 220, *Risk Management* [19].

122 APRA Prudential Standards LPS 110, 112, 114, 115, 117, 118; APRA Prudential Standards GPS 110, 112,114, 115,117,118, 120.

123 APRA Climate Paper.

124 APRA Prudential Standards GPS 110, 112,114, 115,117,118, 120.

AUSTRALIA

125 APRA Prudential Standard GPS 110 [11(b)].

126 APRA Climate Paper 17.

127 APRA Climate Paper.

128 APRA Prudential Standards LPS 110, 112, 114, 115, 117, 118.

129 APRA Prudential Standard LPS 110 Capital Adequacy, [13(b)].

130 Life Act s 36.

131 Ibid s 32(b).

132 Ibid s 48(3).

133 Corporations Act s 1013D(l); Corporations Regulations, reg 7.9.14C; ASIC RG 65.

134 Corporations Act s 1017B.

135 APRA Climate Paper 17.

136 RG 128 at RG 128.2.

137 RG 128 at RG 128.49-50.

138 Australian Council for Superannuation Investors (ACSI) *Stewardship Code* (2018), principle 3 (p 11 discussion).

139 The Financial Services Council's (FSC) *Standard 23: Principles of Internal Governance and Asset Stewardship* (July 2017) [2.3.3].

140 Anecdotally, the hearings conducted by the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry were seen as contributing to severe reputational damage for Australia's major banks, and their subsidiaries that are APRA-regulated trustees, which resulted in significant outflows of member funds from their superannuation funds.

141 Cara Waters, 'Biggest super fund vows to vote against companies with one woman boards', *Sydney Morning Herald* (online), 15 September 2019, https://www.smh.com.au/business/companies/biggest-super-fund-vows-to-vote-against-companies-with-one-woman-boards-20190913-p52qwv.html.

142 Noel Hutley and James Mack, 'Memorandum of Opinion: Market Forces – Superannuation Fund Trustee Duties and Climate Change Risk' (15 June 2017), available at https://www.envirojustice.org.au/sites/default/files/files/20170615%20Superannuation%20Trustee%20Duties%20and%20Climate%20Change%20(Hutley%20%26%20Mack).pdf; Sarah Barker, Mark Baker-Jones, Emilie Baron, Emma Fagan, 'Climate change and the fiduciary duties of pension fund trustees – lessons from the Australian law' (2016) 6(3) *Journal of Sustainable Finance & Investment* 211; Pam McAlister, 'Are you exposed: Examining the potential liability of superannuation trustee directors for failure to take account of climate change risk' (October 2015) *Banking & Finance Law Bulletin*.

143 ASX Corporate Governance Council, *Corporate Governance Principles and Recommendations*, (4th ed, February 2019) Recommendation 7.4.

144 See paragraphs 3.2.4 to 3.2.6 for consideration of the duties of directors of LICs with respect to stewardship.

145 See paragraphs 3.2.4 to 3.2.6 for consideration of the duties of directors of listed investment companies with respect to stewardship.

146 For example, legal commentary on consideration of climate change risks includes analysis of the sole purpose test, best interests duty, and the duty of care and skill, and suggests that trustees have a positive duty to take action to address these risks: see paragraph 2.2.17.

147 Joanna Mather, 'Put members' returns ahead of activism, Samuel tells super funds', *Australian Financial Review* (online), 11 September 2019, https://www.afr.com/companies/financial-services/put-members-returns-ahead-of-activism-samuel-tells-super-funds-20190911-p52q7l.

148 APRA Information Paper, *Climate change: Awareness to action* (20 March 2019).

149 *Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Act 2019* (Cth).

150 ASIC Consultation Paper 325: *Product design and distribution obligations*, [27].

151 See Corporations Act ss 136(2), 601GC(1).

152 Financial Services Council *Life Insurance Code of Practice*, [3.1].

153 Templates have been released by the Financial Services Council (FSC), and the Association of Superannuation Funds of Australia (ASFA).

154 See paragraph 2.2.19.

155 SIS Act s 116.

156 *ASIC v Citigroup Global Markets Australia Pty Ltd (No 4)* [2007] FCA 963.

157 *Astley v Austrust Ltd* (1999) 197 CLR 1.

158 It is worth noting that Australian practitioners keenly await further developments in the United Kingdom following the decision of *Vedanta Resources plc and another v Lungowe and others* [2019] UKSC 20, a jurisdictional decision of the UK Supreme Court which suggests that parent companies that are significantly involved in the affairs of their subsidiaries may owe a duty of care to third parties harmed by the acts of those subsidiaries. The decision (and others in the Commonwealth that may be decided in light of it) also holds some persuasive value for Australian courts, and is in line with a growing focus on human rights by the Australian Parliament and judiciary.

159 See *Sullivan v Moody* (2001) 207 CLR 562, [55] — [62]; *Caltex Refineries (Qld) Pty Ltd v Stavar* (2009) 75 NSWLR 649.

160 See *Barrow v CSR Ltd* (Unreported, 4 August 1988, Supreme Court of Western Australia, Rowland J); *CSR Ltd v Wren* (1997) 44 NSWLR 463 and *CSR v Young* (1998) Aust Tort Reports 81-468.

161 In *CSR Ltd v Wren* (1997) 44 NSWLR 463, a majority of the Supreme Court of New South Wales (on appeal) accepted the trial judge's conceptualisation of the requisite degree of control as being a parent company's exertion of 'dominant, pervasive, constant and controlling' influence such that there is a 'necessary relationship of proximity' so as to give rise to a duty of care: 476.

162 See, National Contact Point, 'View a closed complaint' https://ausncp.gov.au/complaints/view-closed-complaint (accessed 15 July 2020).

163 See, eg, OECD Watch Case Database, *EC and IDI v Australia and New Zealand Banking Group*.

164 SPG 530.

165 APRA, *Understanding and managing the financial risks of climate change* (24 February 2020).

166 Ibid.

167 APRA Information Paper, *Climate change: Awareness to action* (20 March 2019). See also APRA, 'APRA to step up scrutiny of climate risks after releasing survey results' (Media Release, 20 March 2019).

168 See, eg, ASIC RG 228, ASIC RG 227, ASX Principles and Recommendations.

169 Address by ASIC Commissioners Sean Hughes and Cathie Armour, 'ANU Climate Update' (Canberra, Sydney and Adelaide, 7 February 2019, 21 February 2019 and 4 March 2019) where it was stated that ASIC considers it misleading for directors to discuss a company's prospects without referring to business risks, which could include climate change. See ASIC 'ASIC updates Guidance on climate related disclosure' (Media Release 19-208MR, 12 August 2019) where it was stated ASIC will conduct surveillance of climate change related disclosure practices by certain listed companies.

170 EJA Comms, 'Climate Change Risk Disclosure Case Goes before the Federal Court', *Environmental Justice Australia* (Media Release, 8 August 2017) https://www.envirojustice.org.au/climate-change-risk-disclosure-case-goes-before-the-federal-court/.

171 Discussed at paragraph 9.2(a) above.

172 See, eg, Guy Debelle, Reserve Bank of Australia, 'Climate Change and the Economy' (Speech, Public Forum hosted by the Centre for Policy Development, Sydney, 12 March 2019).

173 See our discussion at 9.2(b).

174 See, for example, *FSC, FSC Standard No. 13: Voters Policy, Voting Record and Disclosure* (2013). This is a mandatory standard of which the FSC has formal oversight of.

175 See, for example, *FSC, Standard No.20: Superannuation Governance Policy* (2012). This is a mandatory standard of which the FSC has formal oversight of.

176 FSC and ACSI *ESG Reporting Guide for Australian Companies* (2017). See also, *Climate Related and other emerging risks disclosures: assessing financial statement materiality using AASB Practice Statement 2* (December 2018).

177 FSC, *FSC Standard 23: Principles of Internal Compliance and Asset Stewardship* (2017). This is a mandatory standard of which the FSC has formal oversight of.

178 See Centre for Policy Development, Business Roundtable on Climate and Sustainability, 21 November 2019, Remarks by Kenneth Hayne AC QC https://cpd.org.au/2019/12/full-text-of-kenneth-hayne-ac-qc-remarks-to-cpd-climate-roundtable/; Noel Hutley and Sebastian Hartford-Davis, 'Climate Change and Directors' Duties' (2016), *The Centre for Policy Development and Future Business Council*; see also Noel Hutley and Sebastian Harford-Davis, 'Climate Change and Directors' Duties' (2019), The Centre for Policy Development and Future Business Council, 3 — 7.

179 Corporations Act s 677.

180 AASB Practice Statement, 'Making Materiality Judgments', Statement 2, December 2017, para. 5. The definition appears in AASB standards AASB 1048 *Interpretation of Standards* (para. [QC11]), AASB 101 *Presentation of Financial Statements* [7] and AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors* [5]. AASB accounting standards are available through the following link: https://www.aasb.gov.au/Pronouncements/Current-standards.aspx.

181 ASX Listing Rules, Guidance Note 8, Continuous Disclosure: Listing Rules 3.1 — 3.1B https://www.asx.com.au/documents/rules/gn08_

AUSTRALIA

continuous_disclosure.pdf 7.

182 ASX Principles and Recommendation, Principle 7 (Recognise and manage risk), Recommendation 7.4.

183 Ibid 28.

184 FSC, Guidance Note no. 30, 'ESG Reporting Guide for Australian Companies' (2015), 6.

185 SASB, 'Why is Financial Materiality important?' https://www.sasb.org/standards-overview/materiality-map/.

186 SASB, Materiality Map, https://materiality.sasb.org/.

187 AASB, 'Climate-related and other emerging risks disclosures: assessing financial statement materiality using AASB Practice Statement 2', December 2018. https://www.aasb.gov.au/admin/file/content102/c3/AASB_AUASB_Joint_Bulletin_13122018_final.pdf.

188 APRA Information Paper *Heatmap – MySuper products* November 2019, 12.

189 See generally 'Corporate responsibility: Managing risk and creating value', report by the Parliamentary Joint Committee on Corporations and Financial Services, 21 June 2006, Chapter 5, paras 5.15-5.19.

BRAZIL

1. INTRODUCTION

1.1 This annex considers the laws of the Federative Republic of Brazil as at 31 January 2021. Sections 2 to 4 address the ability of Asset Owners to pursue 'Investing for Sustainability Impact' (**IFSI**) where the relevant portfolio does not have an express Sustainability Impact objective.

1.2 As discussed in the main body of the report, the expression 'Investing for Sustainability Impact' is not a term of art. Rather, the expression is used here as a type of 'conceptual net' to denote any power or freedom on the part of Asset Owners or their Investment Managers to pursue one or more Sustainability Impact objectives whether in order to protect or enhance the financial performance of their investment (instrumental IFSI) or otherwise (ultimate-ends IFSI).

The following key feature of Brazilian law apply to multiple relevant investors:

1.3 ***Social function of ownership and social function of contract***

1.3.1 Under Brazilian law, (a) all assets in Brazil are subject to the 'social function of ownership'[1], and (b) all contracts governed by and construed in accordance with Brazilian law are subject to the 'social function of contract'[2-3] . Such principles suggest that property and contracts shall perform a social role in the Brazilian economic order – which, in turn, is founded on the social values of labour [4] and free enterprise [5].

1.3.2 It is generally understood that the principles of the social function of contract and ownership apply to all entities comprising the Brazilian economy. Thus, a series of duties imposed on the performance of economic activities may be justified by such principles, including the prohibition of price abuse under antitrust law and the liability imposed on companies by reason of misleading propaganda and/or product defects in relation to their consumers [6].

1.3.3 Furthermore, it could be argued that these principles guide all contracts to the fundamental objectives stated in the Federal Constitution, namely human dignity, eradication of poverty, decrease of inequality and an ecologically balanced environment, among others. The social function is a matter of *jus cogens* and therefore cannot be waived contractually [7]. In line with that, the Federal Constitution expressly states that the economic order of Brazil has the purpose of assuring all citizens a dignified existence, observing the principles of, among other things, (a) the social function of ownership and (b) the defence of the environment, including by providing a different treatment according to the environmental impact associated with products made and services rendered.

1.3.4 On this basis, IFSI is consistent with the rationale for the social function of ownership and contract and it could be argued that setting Sustainability Impact objectives for a portfolio would fulfil the social function of owning said assets. Likewise, managing a portfolio pursuing positive Sustainability Impact, irrespective of the objective established in the investment policy, would be a way to fulfil the social function of the management agreement, through which the Investment Manager was engaged [8].

1.3.5 As per the social function of ownership and of contract, one could argue that all Asset Owners have an implicit duty to use best efforts to at least minimise negative Sustainability Impacts, since this would promote social justice and aim for the best balance for the natural environment and wider well-being, as intended by the Federal Constitution [9]. Therefore, as a result of the legal principle of social function of ownership and of contract, it is possible to argue that Relevant Investors may engage in ultimate ends and/or instrumental IFSI, according to the limits set by the legal framework and by the applicable contracts providing the duties and powers of such Relevant Investors.

BRAZIL

1.3.6 It is important to note that the discussion presented herein with regard to an investment decision-maker justifying IFSI if the respective Asset Owner's by-laws are silent on the matter by reference to the social function of ownership and contract has never been tested in a Brazilian court of law. As a result, at this time, the social function supremacy argument should be considered as a framework within which Relevant Investors would be allowed to pursue ultimate-ends and/or instrumental IFSI, but not required to do so. Notwithstanding that, we cannot predict the outcome of a dispute regarding compliance with an investment policy or payment requirements if such obligations are not met because a Relevant Investor pursued Sustainability Impact instead of, or in addition to, financial return, irrespective of the investment policy objectives.

1.4 ***Duties that could arise from regulations***

1.4.1 Duties arising from pension funds, mutual funds or insurance regulations generally applicable to the investment decision-makers of each Asset Owner [10]– as will be discussed in detail in Sections 2 to 4 and 6 below – may be relevant to support construing instrumental IFSI as a legal duty, ie when facing a situation where achieving the relevant Sustainability Impact goal is 'instrumental' in protecting the Asset Owner's financial performance. Hence, if such an investment decision-maker, on the available evidence ought to conclude that one or more sustainability factors poses a material risk to its ability to realise the Asset Owner's financial investment objectives, it will generally have a legal obligation to consider what, if anything, it can do to mitigate that risk, using the means at its disposal (eg investment powers, stewardship, policy engagement or otherwise) and to act accordingly.

BRAZIL

2. ASSET OWNERS' USE OF POWERS OF INVESTMENT AND DIVESTMENT TO INVEST FOR SUSTAINABILITY IMPACT

2.1 The following section considers the extent to which and in what circumstances each type of Asset Owner is (a) legally required or (b) legally permitted or able to use its powers of investment and divestment to pursue IFSI.

2.2 **Pension funds**

Types of pension fund covered

2.2.1 Due to their size and relevance in the Brazilian capital and financial markets, this analysis considers exclusively closed private pension plan entities (*entidades fechadas de previdência complementar* – hereinafter referred to as **Pension Funds**). Open private pension plan entities (*entidades abertas de previdência complementar* – OPPE) are addressed in 2.4 below.

- **Asset Owner:** Pension Funds.
- **Beneficiaries:** current and past contributors – who are or were employees or associates of the Pension Funds' sponsor (as defined in 2.2.5 below) and present or future beneficiaries.
- **Investment decision-maker:** directors, administrators, investment committee members of the Pension Funds or professional Investment Managers authorised by the Securities and Exchange Commission of Brazil (*Comissão de Valores Mobiliários – CVM*) to manage portfolios of pension plans, as the case may be.

2.2.2 Pension Funds are entities organised as civil society organisations or foundations, which under Brazilian law are defined as pools of assets allocated to a certain purpose and organised as a non-profit organisation (with legal personality). Pension Funds have the objective of providing private assistance to their Beneficiaries, which is done by the provision of financial security and the establishment of a mechanism for long-term savings.

2.2.3 To ensure its ultimate and exclusive purpose, which is to pay benefits for the Beneficiaries, a Pension Fund collects the contributions due by the participants and the sponsors (as applicable) and manages these third parties' resources by investing according to specific rules.

2.2.4 Pension Funds may engage, through an investment management agreement, a professional Investment Manager authorised by CVM to manage the portfolios of pension plans with the purpose of paying pensions to retirees of one specific legal entity or of a group of legal entities.

2.2.5 A Pension Fund manages one or more pension plans that may only be accessed by the employees of a company (private or public), as well as career employees of federated units (the federal government, Brazil's states, the federal district, and the municipalities) or the associates of a professional association or union; the company, the federated units, the class association or union, as the case may be, figures as the plan's sponsor. The employee or associate who chooses to participate in a plan pays a monthly contribution [11], which entitles the employee or associate, or a beneficiary indicated thereby, to receive a pension upon retirement.

Overview of investment duties and powers

2.2.6 Pension Funds have the power to establish and operate pension plans, which must observe technical rules with the purpose of assuring transparency, solvency, liquidity and the pension plans' financial, economic and actuarial health.

2.2.7 Pension Funds must have their pension plans' portfolios managed with regard to the actuarial obligations thereof and to the cash flow of payments, in order to achieve a balance between their benefit pay-outs and income rate. When setting the investment policies – including their financial return goals – of the pension plans they manage, Pension Funds must take into account a horizon of at least 60 months, with annual reviews, which are typically based on the plan category, Beneficiaries' life expectancy, interest rates of the assets comprising the portfolio and other factors that could potentially affect the Pension Funds' investments [12].

2.2.8 Pension Funds are not legally required to invest in certain categories of enterprises or jurisdictions. Nonetheless, Pension Funds must comply with legal and regulatory provisions regarding crimes of money laundering or concealment of assets, rights and valuables, as well as laws regarding the combating the financing of terrorist activities [13].

BRAZIL

2.2.9 The regulation applicable to Pension Funds [14] does not determine the maximisation of profit as their sole purpose, but due to their duty to follow the principles of safety and profitability and meet their actuarial obligations, one could argue that Pension Funds would be implicitly obliged to seek profit), even if their primary financial return goals are achieved, since they would not have permission to prioritise certain kinds of investments or seek goals other than the ones provided in the pension plan's investment policies.

2.2.10 Recent episodes of corruption involving Pension Funds in Brazil have induced a shift in Pension Funds' and their Investment Managers' behaviour, whereby they have become much more active in the due diligence pre-, post and during the investment process, not only regarding the assets invested in but also their respective managers. One of the consequences of this activism is the recent increase in litigation and internal investigations (*sindicâncias*) conducted by Pension Funds. These changes have led the Pension Funds' investment decisionmakers to be reluctant to engage in activities or take investment decisions that are not explicitly established in the regulations in force and/or in pension plan's investment policies.

2.2.11 The applicable regulations regarding investment of reserves by Pension Funds (a) determine that such investments must be managed (i) in good faith and diligently with loyalty to the Beneficiaries and the pension plan itself and (ii) in a way that seeks to maintain high ethical standards, which could be an argument for the requirement to invest the Pension Funds portfolio so as to secure the wider well-being of Beneficiaries (eg not investing in certain sectors that may jeopardise society or the environment); and (b) do not specifically address how possible conflicts between different categories of Beneficiaries are to be resolved.

2.2.12 Additionally, the regulations applicable to Pension Funds do not require them to (a) disclose information to the market in general, but only to regulators and their Beneficiaries; or (b) engage in stewardship activities.

Legal requirements to use investment powers to pursue IFSI

2.2.13 Despite the need to observe the social function principle as mentioned in Section 1 above, the rules for Pension Funds' investments fail to encompass objective criteria and measures to achieve Sustainability Impact, which leads to significant uncertainty as to the extent to which Sustainability Impacts are required to be taken into account by the Pension Funds when establishing their investment portfolios in an ultimate-ends IFSI perspective. However, from an instrumental IFSI perspective, the latest regulations establish that Pension Funds should consider aspects related to the economic, environmental, social and governance sustainability of their investments, whenever possible [15], in their risk analysis; see 1.5.1 above as regards instrumental IFSI.

2.2.14 Pension Funds must include, in the investment policies of the pension plans they manage, guidelines for observing ESG principles preferentially segregated for each industry they invest in [16]. On the date hereof, there is no case law regarding what those guidelines should or should not encompass.

Legal freedom to use investment powers to pursue IFSI

2.2.15 Although the current laws and regulations do not create any express obligation for Pension Funds to pursue IFSI, considering (a) the social function of ownership and of contract, and (b) the long-term nature of a Pension Funds' investment schemes, which (i) are closed-end, and, therefore, allow redemptions before the disability, retirement or death of the Beneficiary only in specific circumstances, and (ii) have an indefinite term, and whereas contributions made will typically only need to be repaid many years ahead, the Pension Funds' pension plan could pursue IFSI provided its legal and regulatory obligations are fulfilled [17]. This is based on the argument that (as regards instrumental IFSI) it is thus protecting the portfolio's net value in the long term [18] and (as regards ultimate-ends IFSI) fulfilling the social function of ownership and of contract provided in the Federal Constitution and in the Civil Code.

2.2.16 However, as per Pension Funds' actuarial obligations stated in 2.2.7 above and the need for strict compliance with the provisions of the Pension Funds' rules described in 2.2.9 above, any investments made thereby to pursue Sustainability Impact goals would always be subject to the provisions of the by-laws, applicable regulations and contracts and to their primary pursuit of financial return in order to meet their actuarial and financial duties.

BRAZIL

2.3 **Mutual funds**

Types of mutual fund covered

2.3.1 There are many types of Brazilian investment funds [19], all of which are organised as a special condominium, hence they have no legal personality. Such investment funds issue quotas, which are securities that denote ownership in the condominium and are subscribed for by the fund's investors.

2.3.2 This analysis covers all types of Brazilian investment funds, notwithstanding that certain conclusions hereof may be affected by specific regulation applicable to each type of fund.

- Asset Owner: investment fund.
- Beneficiaries: holders of quotas throughout the fund's term (quotaholders).
- Investment decision-maker: professional Investment Manager authorised by the CVM to manage securities portfolios [20].

Overview of investment duties and powers

2.3.3 The main duties and powers that an investment fund's fiduciary administrator and Investment Manager have consist in: (a) carrying out their activities in good faith, transparency and loyalty in relation to the quotaholders; (b) seeking to meet the quotaholders' investment objectives and avoid practices that may jeopardise the fiduciary relationship maintained towards the quotaholders; (c) complying with the resolutions of the quotaholders' general meeting; (d) complying with and enforcing all the provisions of the fund's by-laws (*regulamento*); and other provisions that are specific to each type of fund, including diversification rules regarding categories of financial assets and issuer concentration limits; and (e) periodically disclosing to all quotaholders and to the CVM certain documents and information related to the fund [21].

2.3.4 The powers specifically attributed to Investment Managers consist, briefly, in analysing and selecting investments and allocating resources of the investment fund in the market. Fiduciary administrators' specific functions consist in, for instance, representing the fund in and out of court, convening quotaholders' general meetings, engaging the fund's service providers and keeping the fund's documents [22]. Typically, fiduciary administrators will engage an Investment Manager or perform themselves activities related to portfolio management if they are authorised by the CVM to do so.

2.3.5 Brazilian investment funds are not legally required to invest or to refrain from investing in certain categories of enterprises [23].

2.3.6 Investment funds' Investment Managers and fiduciary administrators (a) must establish rules, procedures and internal controls to assure the fulfilment of their obligations pursuant to applicable regulation and adopt a code of ethics; and (b) must comply with legal and regulatory provisions regarding crimes of money laundering or concealment of assets, rights and valuables [24]. When prospecting investments these requirements may limit the companies and jurisdictions eligible for investment.

2.3.7 The regulations applicable to investment funds (a) determine that situations of conflict of interest must be taken to the quotaholders' general meeting, but do not specifically address how possible conflicts among quotaholders of different classes are to be resolved; and (b) determine that Investment Managers must act (i) in good faith and diligently and with loyalty to the fund, and (ii) in a way that does not breach their fiduciary duties towards investors, which could be an argument for the requirement to invest the fund's portfolio so as to secure the wider wellbeing of quotaholders and society (eg not investing in certain sectors that may jeopardise society or the environment), always without prejudice to their obligation to seek financial return if no other goal is provided in the by-laws.

Legal requirements to use investment powers to pursue IFSI

2.3.8 Brazilian legislation and regulation provide that investment funds may invest in varied securities, assets and rights, pursuant to the investment policy established in the by laws [25], and some specific laws and rules establish further limitations on those securities, assets and rights. There are no laws or regulations defining what the investment policy's objectives need to be [26].

2.3.9 It should be noted that investment funds do not have investment or divestment powers on their own: these powers are entirely held by the Investment Managers [27]. CVM rules state that it is part of the Investment Manager's duties to comply with the provisions of the investment fund's by-laws. Therefore, if the by-laws of a certain fund provide the need to take Sustainability Impact factors into account when making investment or divestment decisions regarding the investment fund's

ANNEXES

Brazil

BRAZIL

portfolio, the Investment Manager would be contractually required to observe said criteria and could be held liable for not doing so. In other words, these criteria are not legally mandated to be in an investment fund's by-laws, but if they happen to be stated therein, the duties of the Investment Manager oblige it to comply with them (see 1.5.1 on instrumental IFSI).

Legal freedom to use investment powers to pursue IFSI

2.3.10 In spite of the applicability of the social function principle to all economic activities as explained in Section 1 above, it would not be possible for an Investment Manager to pursue Sustainability Impact (subject to this being legally mandated in the investment fund's by-laws) if such a pursuit is isolated from financial return and clearly and in an *ex ante* analysis jeopardises or is contrary to seeking profitability.

2.3.11 Notwithstanding the above, it is arguable that even when the pursuit of Sustainability Impact is not expressly stated in the by-laws of the investment fund, if (a) there is wording related to the pursuit of long-term returns; and (b) a reasonable link could be made between the long-term profitability and likelihood of success of investments and their Sustainability Impact, the Investment Manager could invest in potentially positive Sustainability Impact projects, regardless of potential lower short-term returns and without prejudice to its liability towards the CVM or quotaholders, which could be considered as an instrumental IFSI investment strategy. It should be noted, however, that there is no clear definition for the timeframe in which this assessment should be carried out.

2.3.12 Likewise, if an Investment Manager reasonably concludes that sustainability factors pose a risk to its financial investment objectives, it would be compelled to act accordingly and take appropriate measures, subject to the provisions of the by-laws and the relevant investment management agreement, to mitigate such risk. Such measures include, but are not limited to, the exercise of voting rights, by the Investment Manager on behalf of the fund, in a way to develop sustainability policies and procedures in a fund's investee.

2.3.13 Furthermore, a significant amount of Brazilian investment funds' by-laws determine that the Investment Manager's performance fee shall only be collected and due if the fund's profits reach a certain benchmark [28]. In this sense, if IFSI has a higher chance of causing the fund to obtain less profit in the short term, Investment Managers might tend not to take Sustainability Impact aspects into consideration when selecting investments for the fund's portfolio.

2.3.14 On the other hand, there is a growing environment encouraging the exercise of powers of investment/divestment for promoting positive Sustainability Impact. For example, in January 2020, the Brazilian Association of Financial and Capital Markets Entities (*Associação Brasileira das Entidades dos Mercados Financeiro e de Capitais* – ANBIMA) published the ANBIMA ESG Guide for the Incorporation of ESG factors in investment analysis (ANBIMA ESG Guide), which recommends both methodologies [29] and criteria [30] for adopting ESG factors when investing [31]. These and other industry participants' guidelines might encourage Investment Managers to use their powers to pursue IFSI in order not to miss out on strategies employed by their peers in the industry.

2.3.15 Notwithstanding the provisions above, the flexibility to pursue IFSI is limited by compliance with applicable regulations, notably with the diversification rules regarding categories of financial assets categories and issuer concentration limits, which are established with the purpose of not overexposing the fund to risks associated with a particular issuer or financial asset.

2.4 Insurance undertakings

Types of insurance undertaking covered [32]

2.4.1 Due to their size and relevance in the Brazilian financial and capital markets, this analysis covers exclusively OPPE [33], insurance companies and local reinsurance companies.

- **Asset Owner:** (a) OPPE; (b) insurance company; and (c) local reinsurance company – collectively hereinafter referred to as **Insurance Undertakings**.
- **Beneficiaries:** (a) for OPPE: past and present contributors and present or future beneficiaries ; (b) for insurance companies: (i) the insured parties and those appointed thereby as beneficiaries, and (ii) holders of securities issued by the insurance company, including its shareholders; and (c) for local reinsurance companies, the reinsured parties (insurance companies, other local

BRAZIL

reinsurance companies, Pension Funds and healthcare companies), and holders of securities issued by the reinsurance company, including its shareholders.

- **Investment decision-maker:** executive board, investment committee or financial officer, as applicable.

2.4.2 OPPEs are organised as corporations and professionally manage pension plans opened for anyone to join at any time. Participants are free to transfer their contributions between plans, as well as redeem the amount of their payments according to the rules set forth by the plan.

2.4.3 Insurance companies are also organised as corporations and their main purpose is to sell individual and collective insurance. As a rule, the insurer defines the terms under which financial compensation would be payable to the insured party or to a beneficiary appointed by the insured party upon occurrence of a given event.

2.4.4 Local reinsurance companies are organised as corporations as well. They share part of the risks that are taken by insurance companies, other reinsurance companies, Pension Funds and healthcare companies in exchange of a reinsurance premium paid by the reinsured party to said reinsurance companies. Local reinsurance companies may also share the risks taken with other local reinsurance companies – this operation is usually referred to as 'retrocession'.

2.4.5 In Brazil, Insurance Undertakings are regulated by the same supervision authority: SUSEP [34].

Life insurance companies

2.4.6 Life insurance companies and their officers and directors are subject to the same duties mentioned for Insurance Undertakings in 2.4.12 to 2.4.15 above

2.4.7 However, there are two types of products operated by life insurance companies for which the regulation establishes different investment conditions: (a) life insurance with survival coverage products, and (b) open private pension plans (that can be managed by both OPPEs and life insurance companies).

2.4.8 Life insurances providing survival coverage and open private pension plans have individualised reserves formed by the payment of contributions which are, on their turn, injected into investment funds constituted by the insurance company (since both types of products are marked by the feature of accumulation of reserves, ie capitalisation system).

2.4.9 According to the applicable regulation [35], the resources collected from the insureds and the participants must be allocated to special purpose investment funds (funds-of-one), the sole quota holders of whom are the relevant OPPEs or insurance companies. These special purpose investment funds shall then invest in securities and other assets, pursuant to all rules applicable to these types of Asset Owners, as discussed in 2.3, 3.9, 4.5 and 5.3 herein and pursuant to the applicable regulations enacted by the CMN [36].

General insurance companies

2.4.10 General insurance companies and their officers and directors are subject to the same duties mentioned for Insurance Undertakings in 2.4.12 to 2.4.15 above

2.4.11 The premiums for general insurance products paid by all insureds that purchased the same type of product establish a common set of assets which are used to pay indemnifications in the event of loss.

Overview of investment duties and powers

2.4.12 OPPE have the power to establish and operate pension plans, which must observe technical rules to assure transparency, solvency, liquidity and the pension plan's financial, economic and actuarial health.

2.4.13 All Insurance Undertakings are organised as corporations [37], thus their officers and directors are legally required to fulfil specific fiduciary duties to the corporation, namely: duty of diligence [38]; duty to pursue the company's interest [39]; duty of loyalty to the company [40]; duty not to act in case of conflict of interests [41]; and, if the corporation is publicly held [42], duty to inform [43].

2.4.14 Moreover, Insurance Undertakings must grant access to SUSEP in regard to the composition of all of their portfolios of assets, as well as periodically submit their financial statements to SUSEP [44].

2.4.15 Apart from these legal duties, there is a general regulatory framework [45] applicable to the investment of Insurance Undertakings' reserves which, among other provisions, establishes that

BRAZIL

Insurance Undertakings must (a) follow the principles of safety, profitability, solvency, liquidity, transparency, diversification and adequacy for the nature of their obligations; (b) exercise their activities in good faith and diligently and with loyalty to the company; (c) seek to maintain high ethical standards; (d) adopt practices that permit the fulfilment of their investment policy; and, (e) whenever possible, observe aspects of ESG sustainability in relation to the investments thereof.

2.4.16 Once a year, corporations are required to hold an ordinary shareholders meeting, in which the shareholders will consider a resolution on the corporation's managers' proposal for allocating the last fiscal year's earnings. If the pursued strategy for IFSI involves distributing a smaller portion of the earnings and reinvesting it, the inclusion thereof in the managers' proposal would be legally required [46].

2.4.17 The specific legislation applicable to insurance and local reinsurance companies establishes guidelines for the National Private Insurance Policy (*Política Nacional de Seguros Privados*) [47], which intends to foster the insurance market and to coordinate its objectives with the federal government's investment policy. Pursuant to this notion, one of its objectives is to provide for the necessary operational conditions to integrate the insurance market in the social and economic process of the country, as well as to preserve solvency and liquidity of insurance and local reinsurance companies.

Legal requirements to use investment powers to pursue IFSI

2.4.18 The legal framework that relates to Insurance Undertakings' investments does not provide express requirements for them to pursue IFSI. This renders it uncertain as to the extent to which Sustainability Impact is required to be taken into account by these entities when selecting assets for their investment portfolio, in an ultimate-ends IFSI perspective.

2.4.19 However, from an instrumental IFSI perspective, the applicable regulations require Insurance Undertakings to consider, whenever possible [48], ESG factors in their portfolio allocation [49]. Even though the regulations are vague about the objectives of this requirement and fail to specify the requirements that must be fulfilled in this allocation, the reference to ESG factors could be construed as an attempt to encourage ISFI; see also 1.5.1 above.

2.4.20 Additionally, since Insurance Undertakings are corporations, they are profit-seeking entities [50] and profitability must not be weighted with less importance in decision-making than IFSI.

2.4.21 In this context, the applicable legislation states that the National Private Insurance Policy aims to 'promote the necessary operational conditions to integrate the insurance market in the economic and social progress of the country'. 'Economic and social progress' could be understood as reference to principles stated in the Federal Constitution subjecting all economic relations to considerations of fairness, respect for human dignity and the preservation of the environment, which could be construed as an indirect requirement to consider Sustainability Impact in their portfolio allocation analysis. However, as previously mentioned, there is no direct reference to such requirement in the law.

Legal freedom to use investment powers to pursue IFSI

2.4.22 There is no legal impediment for Insurance Undertakings to pursue IFSI. However, the applicable law lacks specific criteria that should be met by these corporations:

- with the purpose of maintaining balance between their duties – especially those of managing solvency, ie being able to pay policyholders' claims – and investments for Sustainability Impact; and
- with the purpose of maintaining balance between their directors' and officers' duties – especially those of generating value to the shareholders – and investments for Sustainability Impact.

2.4.23 We understand that insurance and reinsurance companies would not have to comply with prudential regulations enacted by the CMN in relation to the portion of their resources that do not constitute their technical reserves or technical provisions, subject to the regulation enacted by CNSP. Nonetheless, we understand that the conclusions stated in 2.4.22(b) still hold valid in relation to the utilisation of these resources to pursue IFSI.

2.4.24 Furthermore, a transaction made without financial goals or in order to pursue goals other than the ones provided in applicable regulation or the by-laws of the Insurance Undertaking could be barred by SUSEP or other regulators if it has the potential to harm the financial, economic and actuarial balance of their technical reserves.

BRAZIL

3. ASSET OWNERS' USE OF THEIR POSITION TO ENGAGE IN STEWARDSHIP ACTIVITIES TO SECURE SUSTAINABILITY IMPACT

3.1 Brazilian Asset Owners do not have a strong history of stewardship activities [51]. In any case, stewardship shall be exercised by those who can exercise effective influence in the managerial decisions of the investee company, which can be done through participation in the capital stock or though positive and negative covenants agreed upon in the context of the subscription for or purchase of the security or asset which the Asset Owner owns.

3.2 In 2016, the Association of Capital Market Investors (*Associação de Investidores no Mercado de Capitais* – AMEC) published a Code of Principles and Duties of Institutional Investors – Stewardship (*Código de Princípios e Deveres dos Investidores Institucionais* – Stewardship – AMEC Stewardship Code), which sets forth seven principles [52] to foster a stewardship culture among institutional investors in Brazil. Adhesion to the AMEC Stewardship Code is seen by the market as a commitment to adopt best practices and therefore an Asset Owner could be interested in adhering thereto in order to improve its image and reputation in the market and seize opportunities that could arise therefrom.

3.3 Asset Owners that adhere to the AMEC Stewardship Code would have a duty to observe its Principle No. 3, which provides a recommendation for institutional investors to integrate ESG factors in their investment process and stewardship activities, evaluating both their impact on risks and returns and their contribution to the sustainable development of the issuers of securities [53]. Moreover, pursuant to its Principle No 1, they would have to state in a written document the stewardship activities to be developed and how the exercise of these activities will progress, as well as how the guidelines chosen for the interaction between institutional investors and the issuers of securities will create value for and protect the Beneficiaries. Visibility of the stewardship programme should be provided to all stakeholders of the Asset Owners, not just to the Beneficiaries.

3.4 Despite potential benefits, collective shareholder engagement may raise legitimate concerns, and uncertainty in this area is still likely to discourage collective engagement in practice:

- **Competition law concerns.** In Brazil, any conduct that has the potential to restrain, distort or in any way harm competition may constitute an antitrust violation, even if such effects are not achieved and regardless of the intention of the wrongdoer. This include explicit or tacit agreements between competitors [54] regarding aspects that could have a competitive effect, such as price-fixing, division of territories, assignment of customers, supply restriction or agreements to exchange competitively sensitive information [55]. In this sense, arrangements designed to achieve Sustainability Impact [56] could have a competitive effect and therefore could raise concerns of a potential antitrust violation. However, it is possible that Asset Owners and Relevant Investors cooperate to maximise the impact of their sustainability activities if potential antitrust risks are neutralised [57]- [58].
- **Other possible activities.** Relevant Investors and Asset Owners may also focus on collaborative actions that do not pose antitrust concerns, especially joint advocacy initiatives with policymakers, stakeholders and the competition authority, such as: joint initiatives to develop standard investment classification or measurement tools (provided there are fair and equal rights to their use); or exchanging best practice insights on IFSI (provided the information is not competitively sensitive).

3.5 These initiatives shall result in more transparency and legal certainty for Relevant Investors and Asset Owners engage in stewardship activities designed to achieve positive sustainability outcomes and minimise negative sustainability outcomes.

3.6 Accordingly, to comply with the obligations undertaken by being a signatory of the AMEC Stewardship Code, institutional investors should: (a) implement a stewardship programme; (b) implement mechanisms to manage conflicts of interest; (c) take ESG factors into account in their investment processes and stewardship activities; (d) monitor the issuers of invested securities; (e) be active and diligent in the exercise of voting rights; (f) establish collective engagement criteria; and (g) be transparent as to their stewardship activities.

3.7 The following section considers the extent to which, and on what basis, each type of Asset Owner is (a) required or (b) permitted or able to use its position to influence the activities of investee enterprises by engaging in stewardship

BRAZIL

activities designed to achieve positive sustainability outcomes and minimise negative sustainability outcomes.

3.8 **Pension funds**

Legal requirements to engage for Sustainability Impact

3.8.1 Although the latest regulations establish that Pension Funds should consider aspects related to the economic, environmental, social and governance sustainability, as well as they shall be diligent in monitoring investments and transparent with their participants, there are no direct and express legal provisions that (a) require Pension Funds to engage in stewardship activities related to Sustainability Impact nor (b) arise from the discovery that an investment is generating negative Sustainability Impact; see 1.5.1 above on instrumental IFSI.

Legal freedom to engage for Sustainability Impact

3.8.2 Although the current laws and regulations do not create any express obligation for Pension Funds to actively engage in stewardship activities to secure Sustainability Impact, they could engage in such activities, provided their legal and regulatory obligations are fulfilled, pursuant to the guidelines set forth in their investment policies [59]. It should be highlighted that, in any case, engaging in stewardship activities would only be permissible to the extent that actuarial obligations of Pension Funds are not put in jeopardy as a consequence thereof [60].

3.8.3 Nonetheless, actively engaging in stewardship activities could result in civil liability for the Pension Funds and/or their investment decisionmakers if they breach their fiduciary duties and cause damage, and, as a consequence, they could be discouraged from doing so, especially if the potential benefits arising from such activities are shared among other stakeholders and the costs are solely borne by the Pension Funds and/or the Investment Manager. Cooperation with other Asset Owners, such as the IPC's initiative – which has the full support of the United Nations' Principles for Responsible Investment – and the Anti-Corruption Action [61] – which is led the Brazilian local network of the United Nations' Global Compact –, is likely to mitigate such an inhibitor, however no duty to collaborate arises from the legislation in force. In this context, adhesion to the AMEC Stewardship Code is seen by the market as a commitment to adopt best practices and therefore a Pension Fund could be interested in adhering thereto in order to improve its image and reputation in the market and seize opportunities that could arise therefrom.

3.8.4 As a consequence, Pension Funds that adhere to AMEC Stewardship Code would have a duty to observe its Principle No. 3, which provides a recommendation for institutional investors to integrate ESG factors in their investment processes and stewardship activities, evaluating both their impact on risks and returns and their contribution to the sustainable development of the issuers of securities [62].

3.9 **Mutual funds**

Legal requirements to engage for Sustainability Impact

3.9.1 Unless otherwise provided in the by-laws of the investment fund or in the by-laws (*estatuto social*) or articles of association (*contrato social*) of the Investment Manager, no direct legal duties (a) require investment funds to engage in stewardship activities related to Sustainability Impact nor (b) arise from the discovery that an investment is generating negative Sustainability Impact.

3.9.2 As an exception to the rule described above, investment funds in the form of FIPs are required by applicable regulation to take part in their investees' decision-making process, with effective influence on their strategic policy and management[63]. However, such duty is not directly connected to the requirement to (a) engage in stewardship activities; or (b) generate positive and/or reduce negative Sustainability Impact to any extent. However, if the lack of engagement were to result in a direct loss for the FIP's investors (quotaholders), the Investment Manager would have a duty to act to prevent such avoidable harm to the quotaholders by actively engaging in stewardship activities, which could potentially be connected to Sustainability Impact (instrumental IFSI, see also 1.5.1 above)

3.9.3 Also, it should be noted that, depending on the type of investment fund and the provisions of the by-laws, any charges or expenses related to engagement in stewardship activities would have to be borne by the Investment Manager and/or fiduciary administrator thereof.

Legal freedom to engage for Sustainability Impact

3.9.4 Investment funds' Investment Managers would generally only be able to actively engage in stewardship activities to secure Sustainability Impact if such powers are provided for in the fund's by-laws (which would be characterised as an ultimate ends IFSI strategy) or granted thereto by the agreement through which it was engaged. That said, an argument could be made that IFSI could be pursued where these documents are silent if (a)

BRAZIL

there is wording related to the pursuit of long term returns; (b) a reasonable link could be made between the long-term profitability and likelihood of success of the stewardship activities to be performed; and (c) the cost of engaging in such activities is perceived to be smaller than the increase in long-term profitability that they would generate, weighted by the likelihood of success [64]. It should be noted, however, that there is no clear definition for the time frame in which this assessment should be carried out.

3.9.5 Additionally, there would be no impediments as to the engagement of an Investment Manager that has a house approach of pursuing sustainability outcomes in its engagement activity, irrespective of the by-laws, although the Investment Manager must not carry out any activity not permitted by the investment policy.

3.9.6 Moreover, investment funds that do not invest the majority portion of their resources in equity securities, such as FIDCs, could engage in stewardship activities. This could be done, for instance, by conditioning the purchase of receivables to the execution of an agreement by means of which the FIDC would be granted the power to influence the assignor's or debtor's activities regarding Sustainability Impact.

3.9.7 Passively managed funds, typically fixed-income investment funds referenced in a specific fixed-income index or ETF would likely face practical difficulties regarding the costs associated with stewardship activities due to the low management fees they usually charge.

3.10 Insurance undertakings

Legal requirements to engage for Sustainability Impact

3.10.1 No direct legal duties (a) require Insurance Undertakings to engage in stewardship activities related to Sustainability Impact nor (b) arise from the discovery that an investment is generating negative Sustainability Impact, unless otherwise provided in the by-laws of the Insurance Undertakings. However, if such activities were to support the financial return goal, there might be circumstances where IFSI is indeed required (see 1.5.1 above on instrumental IFSI).

Legal freedom to engage for Sustainability Impact

3.10.2 Insurance Undertakings are permitted to engage in stewardship activities to secure Sustainability Impact, as long as their actuarial obligations and regulatory duties are not put in jeopardy as a consequence thereof [65].

3.10.3 If Insurance Undertakings are publicly held corporations, mandatory disclosure of environmental data, as described in 2.4.20 above, could nudge their managers towards adopting strategies to pursue IFSI, including engaging to secure Sustainability Impact, in case not doing so could lead them to be less attractive to investors considering their competitors. However, the costs of such engagement could be an inhibitor, since they could outweigh any foreseeable return achieved by the engagement itself.

BRAZIL

4. ASSET OWNERS' ENGAGEMENT IN PUBLIC POLICY WORK TO SECURE SUSTAINABILITY IMPACT

4.1 The following section considers the extent to which, and on what basis, each type of Asset Owner is (a) required or (b) permitted or able to use its position to engage in public policy work designed to achieve positive sustainability outcomes and minimise negative sustainability outcomes, for example, where these are relevant to the value of portfolio assets.

4.2 It is important to note that Brazil lacks a specific regulatory regime for lobbying. Nonetheless, the Brazilian political system is an open field for engagement in public policy work to secure Sustainability Impact, offering several fields in which to engage: lobbying could be engaged with the legislative branch and/or the executive branch (whereas the latter includes not only the heads of office but also ministries, secretaries, regulatory agencies such as the CVM, inter-ministerial or inter-agency working groups), and both branches may be engaged in federal, state and/or municipal levels. Moreover, most parts of the debates at the Brazilian National Congress are open to civil society participation.

4.3 All Asset Owners described in this annex have the legal freedom to cooperate among themselves in policy activities, and although that might be recommendable in order to address systemic sustainability issues that may negatively affect the performance of their investment portfolio, no specific duty to do so arises from the legislation in force (see 1.5.1 on instrumental IFSI).

4.4 **Pension funds**

4.4.1 Funds are not expressly required by law or regulation to engage in policy discussions and/or lobbying with policymakers.

4.4.2 There are no rules preventing engagement in policy discussions and/or lobbying. Therefore, where the by-laws are silent on the matter, Pension Funds could potentially engage in such activities as long as it does not prejudice their compliance with the applicable laws and regulations and their actuarial obligations [66].

4.4.3 It should be noted that in some cases any expenses indirectly related to lobbying would have to be borne exclusively by the Pension Funds, which act as an inhibitor to engaging in such activities, since Pension Funds are non-profit-making entities and only manage third parties' resources.

4.4.4 Nonetheless, a Pension Fund may act together with other investors in an investment fund in which it holds a large enough portion of quotas to engage in policy discussions and/or lobbying through the fund, with the related expense being charged to the fund, its fiduciary administrator or its Investment Manager, pursuant to 4.5.2 below, or it could act through interest groups who would then bear such expenses.

4.4.5 **Mutual funds**

4.4.6 Investment funds are not expressly required by law or regulation to engage in public policy discussions and/or lobbying with policymakers.

4.4.7 There are no rules preventing investment funds from engaging in policy discussions and/or lobbying. Nonetheless, current regulation provides that any expenses not provided for in the by-laws as a charge payable by the fund shall be borne by the fiduciary administrator or the Investment Manager, as applicable, unless otherwise resolved by the quotaholders' general meeting. Hence, expenses related to engagement in policy discussion and/or lobbying would have to be borne exclusively by the fiduciary administrator or the Investment Manager and they might, for this reason, be unwilling to do so.

4.5 **Insurance undertakings**

4.5.1 Insurance Undertakings are not expressly required by law or regulation to engage in policy discussions and/or lobbying with policymakers.

4.5.2 Usually, any expenses related to lobbying would have to be borne by the Insurance Undertaking if this is in accordance with its standard practices and compliance policies.

4.5.3 Nonetheless, these corporations may act together with other investors in an investment fund in which they together have a large enough portion of the issued quotas, or act through professional associations of Insurance Undertakings, to engage in policy discussions and/or lobbying through this fund, with the related expense being charged to the fund, to its fiduciary administrator to its portfolio management or to relevant associations, pursuant to 4.5.2 above [67].

› ANNEXES
› Brazil

BRAZIL

5. ESTABLISHING NEW FUNDS TO INVEST FOR SUSTAINABILITY IMPACT AND AMENDING THE TERMS OF EXISTING ONES

5.1 The following section considers the extent to which it is possible for an Asset Owner to set up a fund, an insurance policy or other product with the express objective of pursuing IFSI.

Private autonomy

5.1.1 The by-laws or other applicable relevant documents [68] of the Asset Owners themselves could provide that (a) only an Investment Manager that seeks or that has provisions in its by-laws or articles of association regarding Sustainability Impact or that has publicly committed to address Sustainability Impact goals may be engaged to manage the portfolio of the Asset Owner; or that (b) the Asset Owner would only engage in transactions with counterparties that observe ESG principles and/or engage in activities aimed at reducing negative and/or increasing positive Sustainability Impacts. The validity of any such provision should be strengthened by the Declaration of Economic Freedom Rights [69], which establishes rules and principles to assure protection for free enterprise and the free exercise of economic activity.

Potential practical difficulties with pursuing IFSI

5.1.2 First of all, it is worth mentioning that investment decision-makers may face the typical practical difficulties associated with IFSI, such as the lack of disclosure requirements regarding the social and economic impact of the portfolios they manage or of investees themselves [70]; for that reason, the investment decisionmakers would probably require the investee to adopt levels of governance related to Sustainability Impact that it has never previously had in order to be eligible for the investment of an Asset Owner's fund that invests for Sustainability Impact.

5.1.3 Additionally, one of the greatest challenges to sustainable investing is to change the general misperception of investors that IFSI does not lead to good financial returns [71]. In this context, academic and industry research have been changing such perception, since their findings show that (a) over the long-term, the risk-return ratio of projects focused on Sustainability Impact is not significantly different from projects without such focus; and (b) Sustainability Impact-focused projects offer potential additional risk protection to their investors [72].

5.1.4 The increasing awareness about this topic is likely to increase investors' desire to pursue IFSI, which, in its turn, positively reinforces the nudge for Asset Owners to adopt strategies focused on Sustainability Impact or that, to some extent, take Sustainability Impact-related issues into account.

5.2 **Pension funds**

Establishing a new pension fund or pension plan and amendment of an existing pension fund or pension plan

5.2.1 It is important to highlight that Pension Funds have a limited scope of activity and are not allowed to engage in any sort of transaction other than manage pension plans. Failure to comply with this requirement subjects the managers of a Pension Fund subject to administrative penalties, according to the applicable rules.

5.2.2 Since the pension plans are structured in a capitalisation system, the investment activities carried out by Pension Plans are understood as an essential activity to ensure its ultimately and exclusive purpose which is to pay benefits for the Beneficiaries.

5.2.3 There are no provisions in Brazilian law that would prevent a Pension Fund from stating in its by-laws or in the by-laws of any of the pension plans operated by it – subject to the PREVIC's approval – that the portfolio should be managed in such a way as to try to achieve the most positive Sustainability Impact possible, although doing so would be unusual. For instance, it is possible for a Pension Fund to include in the investment policies of its pension plans the objective of generating welfare to its Beneficiaries [73]. Notwithstanding this, the investment policies could never prioritise Sustainability Impact over financial return, since Pension Funds have actuarial and financial duties to meet.

5.2.4 Having said that, the content of the by-laws of any pension fund (*estatuto*) and of the by-laws of the pension plans (*regulamento*) managed by it, as well as any amendments to such documents, must be approved by PREVIC to be effective. Subject to PREVIC's approval of the content of the amended and restated by-laws, the competent body within the Pension Fund – generally the deliberative council (analogous to a board of directors) – is able to amend the existing by-laws, with a statement by the legal representative of the Pension Fund ensuring that prior notice of the amendment was given to the participants and sponsors of

BRAZIL

the plan [74]- [75]. When amending by-laws, the Pension Funds must present to PREVIC formal consent from its sponsors.

5.2.5 When establishing their investment policies, Pension Funds must consider the following aspects: (a) diversification rules regarding financial assets categories and issuer concentration limits; (b) reference indexes and actuarial rates; (c) objectives of using derivatives; (d) guidelines for observing ESG principles per industry invested in [76]; and (e) information pertaining to (i) pricing methodology of financial assets in its portfolio, (ii) risk management, (iii) assessment and selection of service providers, (iv) monitoring of the risk-return ratio of the portfolio, (v) limitation of the liability of each individual analysing, assessing, managing and supporting investment decisions, and (vi) mitigation of potential conflicts of interest in the decision-making process [77].

5.2.6 Additionally, Pension Funds' investment policies must be annually reviewed, pursuant to 2.2.7 above.

5.2.7 It is important to note that even though the legal duties and powers of Pension Funds' investment decisionmakers do not permit or allow sufficient flexibility for a Pension Fund to have an objective for a portfolio that would involve IFSI rather than having an investment objective to achieve a particular investment return, there are no impediments regarding the amendment of the Pension Fund's by-laws in order to provide Sustainability Impact as a goal of the Pension Fund, pursuant to 5.2.4 above.

5.2.8 If the Pension Fund has fulfilled its actuarial and financial obligations, its investment decisionmakers could take steps to make the competent governance body of the Pension Fund approve amendments to the by-laws of the relevant pension plan (*regulamento*) so that Sustainability Impact goals are expressly provided as one of the objectives thereof.

Duties on those designing, manufacturing and providing pensions funds

5.2.9 There are no legal requirements to observe Sustainability Impact when organising or amending the by-laws of a Pension Fund.

5.3 Mutual funds

Establishing a new mutual fund

5.3.1 There are no provisions in Brazilian law that would prevent an investment fund from stating in its by-laws that its portfolio should be managed by the Investment Manager in a way to pursue Sustainability Impact as its sole or main objective (ultimate-ends IFSI) [78]. As described in 2.3.3 above, if such provisions are stated in the by-laws, the Investment Manager, in pursuing the fund's investment policy and taking into consideration the best interests of the investors, must comply with them.

5.3.2 It is important to note that the analysis of the actual Sustainability Impact of an investment would necessarily be *ex post*, meaning that compliance with a requirement to allocate a certain amount of assets in projects that yield positive Sustainability Impact could thus be subsequently called into question.

5.3.3 Additionally, it is worth noting that the fiduciary administrator, Investment Manager and any other service provider must comply with all the provisions of current law and regulation, the investment fund's by-laws and perform their activities with transparency, diligence and loyalty towards their clients.

Amending an existing mutual fund

5.3.4 To amend an investment fund's by-laws to establish an IFSI investment policy, a resolution of the quotaholders [79] gathered at a general meeting is required. The general meeting may be convened by the administrator or quotaholders representing at least five per cent of the fund's committed capital. It should be noted that, investment funds with a wide dispersion of ownership may find convening quotaholders' general meetings impractical.

Duties on those designing, manufacturing and providing mutual funds

5.3.5 There are no legal requirements to observe sustainability impact when establishing or amending the by-laws of an investment fund.

5.4 Insurance products

Establishing a new insurance product

5.4.1 Insurance companies must prioritise financial security to the Beneficiaries related to the insurance policy, as described in 2.4 [80], meaning that they shall manage their technical reserves to prevent the risk of becoming insolvent or in any way unable to perform their financial duties. Technical reserves are created with the specific purpose of ensuring the ability of the insurance company to provide

› ANNEXES

› Brazil

BRAZIL

payments or indemnities under the policy.

5.4.2 It should also be noted that Brazilian insurance products are conceived to protect the insurable interests of their insured parties and beneficiaries, thus preventing any provision that is inconsistent with such protection.

5.4.3 However, there are no provisions in Brazilian law that would prevent an insurance company from managing their insurance products reserves' assets to invest with the goal of achieving positive Sustainability Impact to the extent considered likely to reduce risks to reserves in the long term.

5.4.4 Just as Pension funds, insurance companies have a limited scope of activity and are not allowed to engage in any sort of transaction that is not comprised in said scope (ie manage insurance products). Failure to comply with this requirement subjects the company to administrative penalties, according to the insurance and reinsurance regulations.

5.4.5 Since the investment activity may be understood as an essential activity to ensure its ultimately and exclusive purpose which is to pay insurance indemnification for the beneficiaries appointed in the insurance policies, from an instrumental IFSI perspective, it would be possible for insurance companies to invest with the goal of achieving positive Sustainability Impact to the extent considered likely to reduce risks to reserves in the long term.

Amending an existing policy

5.4.6 As previously stated in 5.4.2 above, expect for open pension plan and life insurance with survival coverage, insurance policies only contain provisions regarding insurance coverage and do not provide for the investments made by the insurance company.

Duties on those designing, manufacturing and providing life insurance products

5.4.7 There are no legal requirements to observe Sustainability Impact when establishing or amending the by-laws of an Insurance Undertaking.

ANNEXES

Brazil

BRAZIL

6. INVESTMENT MANAGERS' DUTIES TO INVEST FOR SUSTAINABILITY IMPACT

6.1 This section considers the extent to which, and in what circumstances, an Investment Manager is (a) legally required or (b) legally permitted to pursue IFSI on behalf of an Asset Owner or otherwise, in each of the three ways contemplated in sections 2-4.

6.1.1 Investment Managers need to be duly authorised by the CVM before rendering portfolio management services professionally. The applicable regulation enacted by the CVM mandates that they always act ethically, in good faith and with transparency and loyalty to the Asset Owner, pursuant to the investment objectives of the Asset Owner and those of the Beneficiaries thereof, with the diligence observed by an active and honest person while managing his/her own business. Investment Managers also must avoid practices that may harm the fiduciary relation with the Asset Owner.

6.1.2 Typically, an Investment Manager's investment duties and powers are provided for in: (a) the investment management agreement entered into between itself and the Asset Owner [81]; and (b) the regulations applicable, which are highly dependable on the Asset Owner's regulators [82], as will be further explained in 6.2 and 6.3 below. The investment management agreement, on its turn, typically has provisions regarding: (a) the investment objective(s) based on which the Investment Manager's performance will be assessed (and performance-related compensation earned, if applicable); (b) the types of assets that may compose the portfolio, as well as the minimum and maximum concentration limits per issuer and per asset class [83]; (c) any investment restrictions [84]; (d) any investment strategy specified by the Asset Owner; and (e) indemnity clauses against the Asset Owner or its legal representative.

6.2 Legal obligations with respect to Sustainability Impact

Powers of investment and divestment

Pension funds

6.2.1 Where its mandate is silent regarding Sustainability Impact, the Investment Manager has no general obligation nor is under any duty to pursue IFSI regarding both instrumental IFSI or ultimate-ends IFSI; however, where IFSI serves as a mean to reach a financial return goal, there might be circumstances in which there is an obligation to consider sustainability factors and eventually act accordingly (see 1.5.1 on instrumental IFSI)

Mutual funds

6.2.2 In an investment fund, the Investment Manager holds all powers related to the investment and divestment of assets, as well as exercises at its discretion – unless provided for otherwise in the by-laws – all rights granted by the assets in the fund's portfolio (such as voting rights arising from ownership of a share) [85].

6.2.3 Brazilian legislation in force does not set forth which objectives investment funds must have, nor does it require investment funds to have non-financial goals or to take non-financial objectives into account, nor even to consider positive Sustainability Impact as a by-product of the investments made.

6.2.4 On the other hand, applicable regulation states that it is part of the Investment Manager's duties to comply with the investment fund's by-laws. Therefore, if the by-laws of a certain fund provide for the need to take Sustainability Impact factors into account when making an investment or divestment decision regarding the investment fund's portfolio, the Investment Manager is required to observe said criteria (ultimate ends IFSI) and could be held liable for not doing so.

6.2.5 Moreover, unless otherwise specified in the fund's by-laws, the Investment Manager is not under any duty to (a) ascertain the investors' objectives regarding sustainability objectives, given that the Investment Manager is solely responsible for the portfolio management decisions on behalf of the Asset Owner and cannot be liable for not assessing Beneficiaries' individual views or objectives on Sustainability Impact, or (b) address long-term systemic risks (eg those related to climate change) which, were they to materialise, could damage the long-term financial interests of the quotaholders.

6.2.6 Furthermore, legislation and regulation in force do not require Investment Managers or fiduciary administrators to ascertain their clients' sustainability objectives.

Insurance undertakings

6.2.7 Although unusual, Insurance Undertakings could engage an Investment Manager to manage their assets. Where its mandate is silent regarding Sustainability Impact, the Investment Manager has no obligation nor is under any duty to invest for Sustainability Impact.

> ANNEXES

> Brazil

BRAZIL

Engagement to achieve Sustainability Impact

Pension funds

6.2.8 As mentioned in 6.2.1 above, the Investment Manager would be limited in its engagement activities by the terms of the pension plan's by-laws and by the terms of the investment agreement through which it was engaged.

Mutual funds

6.2.9 Where the by-laws of a certain fund provide for the need to engage in stewardship activities and to take Sustainability Impact factors into account when doing so, the Investment Manager is legally required to observe said criteria and could be held liable for not doing so.

Insurance undertakings

6.2.10 There is no legal or regulatory obligation or requirement for Investment Managers of Insurance Undertakings to pursue IFSI, either by utilising their investment and divestment powers or by engaging in stewardship activities.

Public policy work to achieve Sustainability Impact

6.2.11 Asset Owners are not required to engage in policy discussions and/or lobbying with policymakers to achieve Sustainability Impact.

6.3 Legal freedom to Invest for Sustainability Impact

6.3.1 The Investment Manager's freedom to manage the portfolio of an Asset Owner towards generating positive or minimising negative Sustainability Impact shall always be limited to the terms of the investment management agreement through which it was engaged.

6.3.2 However, even where the investment agreement through which the Investment Manager was engaged and the by-laws of the investment fund or of the Pension Fund's pension plan are silent regarding Sustainability Impact, the Investment Manager would, under certain circumstances and on reasonable grounds, be able to Invest for Sustainability Impact – although with little leeway [86]. Additionally, an Investment Manager could have Sustainability Impact goals provided for in its own by-laws or articles of association [87], which could set objectives for the company or principles which its officers and directors should follow under their tenures. Where those are incompatible with the mandate given by the Asset Owner, the mandate shall prevail.

6.3.3 If an Investment Manager intends to actively engage in stewardship activities, it should prove to the CVM that it maintains appropriate technical and human resources to do so [88].

Powers of investment and divestment

Pension funds

6.3.4 Where the investment agreement through which the Investment Manager was engaged and the by-laws of the investment fund are silent regarding Sustainability Impact, the Investment Manager could pursue IFSI as stated in 2.2.15 above, subject to the provisions of 2.2.16 above; see also 1.5.1 above on instrumental IFSI.

6.3.5 The Investment Manager's decisions should follow the provisions of the Pension Fund's pension plan's by-laws and its actions must be in accordance with the powers granted to it in the investment management agreement.

Mutual funds

6.3.6 The Investment Manager's decisions must follow the provisions of the investment fund's by-laws and its actions must be in accordance with the investment management agreement. This means that Investment Managers could fully use their investment and divestment powers to pursue IFSI if the by-laws set that as a target for the investment fund's investment policy.

6.3.7 Where the investment agreement by which the Investment Manager was engaged and the by-laws of the investment fund are silent regarding Sustainability Impact, the Investment Manager would, under certain circumstances and on reasonable grounds, be able to invest for Sustainability Impact – although with little leeway, as indicated in 2.3.11 above.

6.3.8 Furthermore, it is common for Investment Managers to provide in their code of ethics that the investment funds they manage shall not invest in certain industries, such as tobacco, gambling, arms and ammunitions, atomic energy or industries that depend on supplies or manufacturing processes that heavily generate greenhouse gases or other harmful by-products.

Insurance undertakings

6.3.9 Investment Managers only have the powers granted thereto by the Insurance Undertaking and they may invest their funds in accordance with the regulatory restrictions applicable to the technical reserves and provisions, when the case may be.

BRAZIL

Engagement to achieve Sustainability Impact

6.3.10 Since stewardship activities are less likely to affect the composition of an investment portfolio, it could be argued that there is more flexibility to pursue Sustainability Impact through stewardship activities than through Sustainability Impact investments. However, as stated in 4.5.2 above, it should be noted that for most investment funds, the costs of such engagement would likely have to be borne exclusively by the fiduciary administrator or the Investment Manager, which could act as an inhibitor for engaging in such activities.

6.3.11 ***Public policy work to achieve Sustainability Impact***

6.3.12 Asset Owners are not required by law or regulation to engage in public policy work to achieve Sustainability Impact, although that may be recommendable, as stated in 4.3 [89].

BRAZIL

7. LEGAL LIABILITY TO THIRD PARTIES FOR THE NEGATIVE SUSTAINABILITY IMPACT OF ENTERPRISES IN WHICH PORTFOLIOS ARE INVESTED

7.1 This section considers the extent to which, regardless of the legal rules under which it is required to operate and its constitution, an Asset Owner could be legally liable to third parties for the negative Sustainability Impact of enterprises in which it invests, and whether an Investment Manager could also be liable because of its role in assisting the Asset Owner to invest in the relevant enterprise and steward its investment.

7.1.1 The analyses in 7.2 and 7.3 below do not cover the liability of an Asset Owner or an Investment Manager, respectively, to their Beneficiaries [90] nor the liability of an investee company to an Asset Owner [91].

7.2 **Asset Owners**

Civil liability

7.2.1 Civil liability in Brazil depends, in general, on the establishment of causation – ie one shall only be liable to third parties where a causal relationship can be established between its conduct and the damages incurred by the third party. Furthermore, civil liability is generally subjective [92], which does not prevent an Asset Owner from having strict or subjective contractual liability, if such a contract or an agreement has been entered into between itself and a third party [93].

7.2.2 As a rule, the civil liability of an Asset Owner in relation to its investees is limited to the capital it committed thereto. However, under certain circumstances, an Asset Owner could be called upon to make additional contributions to enable the investees to meet their obligations [94].

7.2.3 As the examples below show, although the possibility of an Asset Owner being held liable for negative Sustainability Impact caused by its investments cannot be fully discarded, the risks of civil liability being imposed in practice may be regarded as remote.

Subjective civil liability

7.2.4 Some precedents in Brazilian case law suggest that the performance of economic activities without due observation of the social function [95] may result in the imposition of liabilities towards the general community, in the case of negative social impacts, such as human rights violations. Considering the collective essence of the damages to the general community, these can be claimed, among others, by the state, the public prosecutor's office, the public defender's office or non-profit organisations through an action claiming liability for moral or material damages to collective or diffuse interests [96], according to Law No. 7,347, of 24 July 1985.

7.2.5 For example, there is a precedent of tort liability holding a company that outsourced part of its production chain liable for collective moral damages, because one of its suppliers kept employees working under conditions analogous to slavery [97]. The passive behaviour of the contracting company was considered '*harmful to the economic and financial order, especially to the fundamentals of (...) the social function of ownership and the reduction of regional and social inequalities*', thus, negligent and unlawful, triggering tort liability. As a rule, cause of action for tort liability requires intent or negligence of the wrongdoer, in which case Brazilian law allows the injured party (or a representative of a class or group of injured parties, such as the public prosecutor's office) to pursue civil liability claims to remedy the harm suffered. There are three cumulative elements required for the establishment of tort liability: (a) the practice of an unlawful conduct (act or omission – in this case, the enterprise's negligent omission); (b) damage to the injured party (in this case, the judge deemed the mentioned working conditions impacted society as a whole); and (c) direct causal link between the unlawful act and the damage (in this case, the causal link was defined due to the supply chain).

7.2.6 Even though underlying general principles of economic activity have not been confronted in relation to the role played by Asset Owners, they could be applied – although this is unlikely – to hold them liable for negative Sustainability Impacts incurred by the enterprises they have funded, if their acts can be deemed unlawful (eg due to an omission in at least not minimising negative Sustainability Impacts of the investees), and other tort liability requirements are verified, as explained above. It would be important to have clearer rules to establish the liabilities of investors in such cases.

Strict civil liability

7.2.7 From a civil perspective, the Brazilian National Environmental Policy (*Política Nacional do Meio Ambiente*) [98] establishes that liability for environmental damages

› ANNEXES

› Brazil

BRAZIL

is strict [99], meaning that the fault of the polluter does not need to be proven, assuming that the chain of causation between the polluting activity performed by the polluter and the environmental damage is verified. For this reason, any individual or company, publicly or privately held, directly or indirectly responsible for any environmental degradation is considered a polluter, and hence is subject to environmental civil liabilities. This means that the environmental damage must be duly addressed by remediation or indemnification. Under this very broad 'indirect polluter' notion, civil liability may be, in theory, extended to any party involved in the activity that was the cause of environmental degradation.

7.2.8 When confronted with the interpretation of the indirect polluter concept, the STJ held [100] that any party that (a) fails to prevent, or acts with indifference to, polluting activities; (b) fails to report such activities to authorities; (c) finances those that carry out such activities; or (d) benefits from such activities, is deemed to be an indirect polluter, thereby being encompassed by the pollution chain of causality and subject to joint and several liability for environmental degradation. In other relevant case law [101], the STJ clarified that the indirect polluter concept encompasses all those who have a duty to prevent an environmental degradation and fail to do so, profiting, even if indirectly, from third party actions that lead to environmental harm. This far-reaching concept could, in theory, comprise all Asset Owners discussed herein, which contribute to companies or projects that result in environmental damages.

7.2.9 Thus, the decisions should be interpreted as indicating the potential inclination of the STJ in relation to the concept of 'indirect polluter'. The earliest decision was rendered in 2007 (published in 2009) and there has not been any concrete case that applied this theory and held an investor liable for environmental damages.

7.2.10 Nonetheless, it is important to mention that the decisions presented hereinabove were not made in relation to the liability of the Asset Owners referred in this annex – most of the related case law consists of judicial discussions involving financial institutions. Moreover, even in such cases there is not a consensus on the limit of liability regarding indirect polluters, given that in other STJ decisions the indirect polluter concept was applied in a more restrictive manner.

Criminal liability

7.2.11 All criminal liability in Brazil is personal and subjective – ie it requires that causation is established between the conduct of the defendant and the crime – and requires proof beyond reasonable doubt. As a general rule, it is only applicable to individuals – the sole exception being environmental crimes, for which legal entities can also be held criminally liable.

7.2.12 Law No. 9,605, of 12 February 1998, which establishes Brazilian environmental crimes and administrative sanctions, imposes criminal and administrative sanctions on individuals and legal entities whose conduct and activities caused environmental damage. In Brazil, individuals (including managers and officers) or legal entities that commit a criminal offence against the environment can be punished with sanctions that range from fines to imprisonment (individuals) or fines to dissolution (legal entities). In this sense, if an Asset Owner commands the legal entity to take an action (or omission) unlawfully causing (or potentially causing) harm to the environment, it or its managers may be criminal liable.

7.2.13 Law No. 9,605, of 12 February 1998, allows for the corporate veil should be lifted as a last resort when necessary to compensate for environmental damage caused by a legal entity, which presents a potential risk for Asset Owners [102].

Administrative liability and other risks

7.2.14 Administrative sanctions could also arise from a breach of the Asset Owners contractual or fiduciary duties, in case the by-laws of the Asset Owner provide that one of its objectives is to mitigate and minimise negative Sustainability Impact and the Investment Manager does not take measures within its capabilities to do so.

7.2.15 Administrative liability is enforced by administrative entities only (independently of the judiciary), mainly by environmental agencies, through the application of the administrative sanctions, such as fines, partial or total suspension of activities, forfeiture or restriction of tax incentives or benefits, and forfeiture or suspension of credit lines made available by official credit establishments, among others, which are automatically enforceable.

7.2.16 Sectorial administrative liability is also applicable, since Pension Funds, investment funds [103] and Insurance Undertakings are supervised entities, respectively, by PREVIC, the CVM and SUSEP. Administrative liability of an Asset Owner or a manager thereof [104] shall only

BRAZIL

arise out of an any act it or they may have performed against the applicable laws and regulations, including breach of contractual obligations set forth in the relevant documents [105].

7.2.17 The sanctions imposed by PREVIC [106], the CVM [107] and SUSEP [108] can range from warnings and fines to the suspension or disqualification of the Asset Owner and/or its managers to perform the activities to which they have been authorised to perform or, in more severe cases, any activities for Pension Funds, Insurance Undertakings and/or other insurance-related entities, financial institutions and public service for a certain period. Administrative sanctions may also include a prohibition to enter into a public sector contract, as applicable.

7.2.18 Additionally, where an Insurance Undertaking is publicly held, the investor relations officer could be held administratively liable before the CVM in case he or she fails to disclose a material act or fact (which, depending on the circumstances, may be related to Sustainability Impact).

7.3 **Investment Managers**

7.3.1 Brazil's investment management industry is relatively incipient when it comes to producing a body of legal precedents created by judicial decisions, although the Brazilian capital market has grown considerably in recent years. Therefore, conflicts tend to be discussed and resolved at the administrative level.

Civil liability

7.3.2 As a rule, Investment Managers cannot be liable based on the poor performance of investments. However, if there has been any (a) commission of a crime or wilful misconduct, (b) breach of the obligations undertaken by the Investment Manager in the by-laws or in any agreement entered into with the Asset Owner, and/or (c) fraudulent performance or performance involving serious breach of the Investment Manager's obligations, it may be liable towards third parties.

7.3.3 Moreover, an Investment Manager could be held liable due to its role in assisting the Asset Owner that caused a negative Sustainability Impact under the abovementioned notion of "indirect polluter", as a party that is indirectly involved in the activity that caused environmental degradation [109]. In this scenario, an Investment Manager could also be liable towards the general community [110].

Criminal liability

7.3.4 As stated in 7.2.11 above, only individuals are subject to criminal liability, except in case of crimes against the environment.

7.3.5 Criminal liability in Brazil is personal and subjective – ie it requires that causation is established between the conduct of the offender and the crime – and requires evidence beyond reasonable doubt. Authorities may press criminal charges against any individual acting either wilfully or negligently (the latter only as expressly provided by law) to commit or conspiring to commit –either directly or indirectly – a criminal offence.

7.3.6 Whenever individuals do not commit the crime themselves but somehow contribute to it, criminal liability can arise from assistance or intellectual or direct participation in a crime, including by not acting to avoid a crime in certain cases. Thus, Investment Managers' officers, directors, representatives, agents, or employees involved with a criminal enterprise may also be subject to criminal prosecution to the extent of their personal contribution to the offense [111].

Administrative liability and other risks

7.3.7 Investment Managers and their officer(s) liable for the activity in question will have administrative liability for all damages and losses imposed on investors and third-parties resulting from their wilful misconduct or fault by means of negligence [112] and arising out of any act they may have performed against the applicable laws and regulations [113] and the by-laws, pursuant to Law No. 6,385, of 7 December 1976, which govern the Brazilian capital markets. Members of investment committees that are responsible for making investment or divestment decisions and for other activities typical of an Investment Manager share the same liability as those.

7.3.8 In addition, in case of settlement of an administrative proceeding, the CVM may require those facing charges to compensate investors for any losses they may have suffered in connection with the violation of CVM regulation by the fiduciary administrator or service provider of an investment fund – including the Investment Manager.

BRAZIL

7.3.9 Furthermore, an Investment Manager will also be subject to penalties imposed by ANBIMA once it adheres to the ANBIMA's self-regulatory rules for any breaches of the provisions stated in said rules of best practices, among which there is a duty to act with loyalty to the client.

7.3.10 In these contexts, an Investment Manager could be held administratively liable only where the by-laws clearly mandated some sort of consideration of Sustainability Impact which was not fulfilled [114].

7.3.11 Also, it should be noted that, aside from traditional litigation risks, there is a current trend of the largest institutional investors engaging in internal investigations regarding their contributions made to investment funds and the management of such investments by the investment fund's Investment Manager. These investigations may result in lawsuits or administrative proceedings involving the CVM and/or the Central Bank of Brazil in case an agreement is not reached between the parties.

BRAZIL

8. THE GROWING IMPORTANCE OF TAKING ACCOUNT OF ESG AND SUSTAINABILITY FACTORS WHERE THESE ARE 'FINANCIALLY MATERIAL'

8.1 It has become increasingly important for Asset Owners and their managers to take ESG and sustainability factors into account in managing portfolios because of the way in which they could be material to achieving the financial investment objectives of the relevant Asset Owner or manager in accordance with their legal duties. The main reasons are summarised below.

8.1.1 Pension Funds, specifically, in addition to observing the social function explained on section 1 above, must consider in their risk assessment, whenever possible, ESG aspects, preferably for each of their investments [115]. Moreover, Pensions Funds should have guidelines in their pension plans' investment policies ESG aspects [116].

8.1.2 Insurance Undertakings, in turn, shall observe ESG aspects, whenever possible, when allocating their funds [117].

8.1.3 Although in an incipient way, as shown in 9.1.4 to 9.1.9 below, civil society has been devoting increasing attention to Sustainability Impact in connection with investment and economic exploitation. The awareness of Sustainability Impact is at an earlier stage in Brazil than in many countries, therefore most initiatives – either governmental, from stakeholders or from civil society – are still limited to incorporating ESG factors in their investment analysis and monitoring rather than actually investing to generate positive Sustainability Impact, either as a goal in itself (ultimate-ends IFSI) or as a means of value protection in the long-term (instrumental IFSI).

8.1.4 Regarding civil society initiatives, the AMEC Stewardship Code has currently amassed 27 signatories in its three years of existence [118], including some of the largest pension funds in Brazil [119], BNDES Participações S.A. [120], three of the country's largest banks [121] and other major national and international Asset Owners. However, according to the ANBIMA ESG guide, in a survey made by ANBIMA before the publication of the guide, 66 per cent of respondents said they have no internal structure assessing the Sustainability Impact of their portfolios and 51 per cent said they have no formalised responsible investment policy; whereas of those who do integrate ESG-based criteria for selecting assets to comprise a portfolio, only a third are using strategies such as active engagement and integrating that analysis in the valuation of the companies they invest in, while most still rely on more basic strategies such as negative or positive screening and best-in-class [122]- [123].

8.1.5 Some stakeholders have also voluntarily been adopting Sustainability Impact-related practices. In this sense, the CEO of Brazilian brokerage firm XP Inc. (NASDAQ: XP) has been publicly vocal in urging companies and Asset Owners to consider ESG matters and actively engage in stewardship activities [124]. Additionally, several Investment Managers with over BRL1.7tn (roughly US$310bn) in assets under management (AuM) have signed the 'Investors for the Climate' (*Investidores pelo Clima* – IPC) commitment, which seeks to engage and persuade professional investors in Brazil to proceed with decarbonising their portfolios, contributing to the achievement of the Brazilian targets in the Paris Agreement, while seeking returns that are better adjusted to the risk [125].

8.1.6 There has been an increase in the availability of market indexes comprised of shares or units, investment funds' quotas and/or debt instruments that are focused on Sustainability Impact, which offers market infrastructure for players desiring an ecosystem structured around Sustainability Impact. In addition to the traditional Corporate Sustainability Index (*Índice de Sustentabilidede Empresarial* – ISE), launched by B3 S.A. – Bolsa, Balcão, Brasil in 2005, CDP Brazil Climate Resilience Index [126] was launched in July 2020 and Brazil ESG Index [127] was launched in September 2020. The monitoring of such indexes has greatly helped industry and academic research, which has been showing support for the adoption of strategies that incorporate Sustainability Impact [128].

8.1.7 A reflection of this is the increase in ESG-related funds and investment products. For instance, XP Inc. recently announced the creation of an ESG board and initiatives to provide the best products, services, content and recommendations focused on ESG. Additionally, XP Inc. has conceived two (2) ESG-focused funds totalling BRL100m (roughly US$18.3m). One fund, called *Trend ESG Global Fundo de Investimento Multimercado*, will be exposed to three foreign exchange-traded funds (ETFs) and a fund-of-funds (FoF) focused on Brazilian companies that have strong ESG practices.

8.1.8 Discussions with the government and regulators have also increased, which is shown, among other things, by initiatives such as ENIMPACTO, the National

BRAZIL

Guidelines on Business and Human Rights, and recent amendments to the National Policy on Climate Change (*Política Nacional sobre Mudança do Clima* – PNMC) [129] and the creation of the National Fund on Climate Change (*Fundo Nacional sobre Mudança do Clima* – FNMC), which receives funds from the Brazilian federal government and the states in connection with royalties arising from petroleum and natural gas economic exploitation, among other funding alternatives. BNDES also includes generating positive Sustainability Impact among the qualification requirements for its tenders and adopts negative screening to filter projects generating negative Sustainability Impact out of its portfolio. CVM has also recently shown interest in regulating 'green' investments [130].

8.1.9 ABVCAP, ANBIMA, FEBRABAN and other stakeholders have committed to constantly follow sustainability, impact investing, ESG and other correlated matters, which shows their growing importance. Moreover, it could be argued that all of the aforementioned reflect a shift in investors' perspective: Sustainability Impact is ceasing to be a cost that only philanthropists and wealthy investors can afford and becoming a necessary and profitable strategy a diligent manager should undertake.

8.1.10 Furthermore, Asset Owners and Investment Managers are also starting to consider the potential liabilities and reputational damage arising from investments that could result in negative sustainability impacts. Even though Relevant Investors have not been consistently and directly considered liable for the negative Sustainability Impacts of their investments in Brazilian case law, there are important judicial discussions regarding liability of financial institutions that could be used, in the future, to argue that such stakeholders are responsible for negative Sustainability Impacts [131].

8.1.11 In this context, recent research with around 30,000 investors domiciled in Brazil [132] has shown that around two-thirds have little to no knowledge about responsible investment, from an ESG standpoint. Despite that, 70 per cent stated that they were interested in ESG-related investment products. The research also showed that the main concerns about responsible investment among Brazilian investors were: (a) fear of a financial return trade off [133]; (b) fear of greenwashing [134]; (c) fear of a higher inherent risk [135]; and (d) lack of knowledge on the matter [136]. In addition to the latter, a new survey carried out by XP Investimentos with several institutional investors pointed to additional struggles faced by the industry, such as unavailable trustworthy data on ESG matters and insistence of specific regulation of the theme [137].

8.1.12 The public sector – most noticeably the CVM – is also presenting regulatory initiatives regarding ESG matters. In this context, two requests for comments (*audiências públicas*) are the most remarkable:

- **Request for Comments No. 08/20.** With notice published in December 2020, the CVM proposed a new regulatory framework to the formation, management and disclosure of information of investment funds. One of the proposals in the draft of the regulation refers to concerns addressing greenwashing and ESG-washing by limiting the use of words such as 'social' and 'environment' in investment funds' names to funds that have been verified by an external independent reviewer, using internationally recognised methodologies, to generate social and/or environmental impact. The proposal only concerns receivables funds, but market participants have shown interest in the rule being expanded to encompass all investment funds.
- **Request for Comments No. 09/20.** With notice published in December 2020, the CVM proposed a new regulatory framework for the disclosure of information by publicly held companies. The draft of the regulation mentions that the CVM perceives increasing interest in and development around sustainability issues, and thus proposes improvements in the content of mandatory disclosure documents by publicly held companies. Some of the proposed changes are: the obligation to disclose social, environmental and climate risk factors which could affect an investment decision; the requirement to indicate which Sustainable Development Goals are relevant to the business of each issuer of securities and the adoption of 'comply or explain' strategy so that issuers who do not publish sustainability reports or performance indicators of ESG matters explain why they do not; as well as many other measurable ESG-related data that could improve the information available to Asset Owners for composing portfolios with Sustainability Impact-related goals.

8.1.13 In addition, we believe that in light of the ongoing COVID-19 pandemic, governments, investors and other stakeholders have been showing increasing interest in Sustainability Impact issues and re-evaluating their existing strategies regarding the matter. For instance: (a)

BRAZIL

more than two dozen financial institutions around the world, managing more than US$3.7tn in total assets, have recently signed and delivered a letter to the Brazilian government expressing their concern at increasing deforestation rates in Brazil, and the possibility they may divest from Latin America's largest economy if Jair Bolsonaro's administration fails to curb deforestation in the Amazon [138]; and (b) in its public bid notice to allocate up to BRL4bn (roughly US$730m) in receivables investment funds as a means to expand access to credit to micro, small and medium-sized enterprises which were deeply affected by the COVID-19 pandemic, BNDES Participações S.A. required all proposals to contain a description of the investment fund's social strategy, ie (i) the portfolio's expected social impact and (ii) the procedures and mechanisms used to measure and monitor the social impact generated by the fund's portfolio.

8.2 Financial materiality

8.2.1 Because of the growing importance of taking account of ESG and sustainability factors in the investment process where financially material, it is important to understand how the law defines what is 'financially material' and the period by reference to which financial materiality must be measured. Taking account of these factors in order to pursue financial objectives may incidentally have Sustainability Impacts and may also be consistent with IFSI. However, beyond that point, any attempt to realise positive Sustainability Impact might need to rely solely upon IFSI (i.e. because it would no longer be driven by the need to generate financial performance).

8.2.2 Brazilian law indirectly refers to accounting rules for defining the concept of "financial materiality", pursuant to which any information that could affect the economic decisions of the recipients of the financial information is material [139]. Therefore, whenever Sustainability Impact-related information can affect an investor's decision to buy, hold or sell securities of a certain Asset Owner or to invest in a pension plan, such information would be deemed material. The ANBIMA ESG Guide supports this concept of financial materiality.

8.3 Period by reference to which 'materiality' is to be assessed

8.3.1 The regulations in force do not establish a clear timeframe in which the financial materiality of the investments comprising a portfolio should be assessed. The judgment of financial materiality may vary depending on the investment term or as provided for in the by-laws. All Asset Owners may state their preferred pre-established criteria in their respective by-laws or leave the assessment of financial materiality to the Investment Manager's discretion, including whether, which and how ESG aspects shall be considered in portfolio allocation, as well as the relevant period for such an assessment. Due to this self-determination, there is no standard market practice for the assessment of materiality.

MATTOS FILHO >

Mattos Filho, Veiga Filho, Marrey Jr e Quiroga Advogados

Flávio Barbosa Lugão, Fernanda Basaglia Teodoro, Tábata Boccanera Guerra de Oliveira, Vitória de Assis Pacheco Morais, Gabriel de Freitas Queiroz, Eduardo Cezar Delgado de Andrade, Anália Cristina Ferreira Brum, Júlio Figueiró Melo, Renata Fonseca Zuccolo Giannella, Juliana Furini de Vasconcellos Puntel, Juliana Gomes Ramalho Monteiro, Luis Eduardo Kussarev Al-Contar, Ary Oswaldo Mattos Filho, Maria Luiza Miranda Geraldi, Vinícius Paula Castro, Lina Pimentel Garcia, Isabela Sartori, Bárbara Gabriel de Vasconcelos Silveira, Marcela Venturini Diorio and Gabriel Zampieri Ferreira Batista

BRAZIL

1 Pursuant to item III of Article 170 of the Federal Constitution.

2 Pursuant to Article 421 of the Civil Code (Law No. 10,406, of 10 January 2002).

3 The social function has roots in the writings of French scholar of public law Léon Duguid, according to whom law's most important role is to be an instrument for promoting social solidarity and ensuring the greater good. Duguid's conception of law was incorporated in several legal systems, including Brazil's, where the social function constitutes a right and a duty. Pursuant to this notion, '*the right of private ownership includes an obligation to use property in ways that contribute to the collective or common good*' and owners are '*obligated to refrain from using their property in ways that harm others*' (ONDETTI, Gabriel. The social function of property, land rights and social welfare in Brazil. Land Use Policy, [*S.l.*], v. 50, s/n, pp. 29-37, Jan. 2016).

4 The social value of labour is a strong axiom in Brazilian law, considering its slavery past. This principle condemns degrading practices towards workers, such as excessively long shifts, no annual leave, withholding wages, discrimination of any kind – including paying lower wages or dismissal based on gender, sexual orientation, ethnicity or colour – as well as forbidding all sorts of child labour or labour in conditions analogous to slavery.

5 Free enterprise is a principle applicable to the Brazilian economic order, as provided by article 170 of the Federal Constitution which advocates for economic freedom, including the freedom of enterprises and individuals to access and compete in the market without excessive state interference and obstacles imposed by other economic agents (ie monopolies, dumping and other practices damaging to the free market), in other words, it is a condemnation of crony capitalism. In 2019, Law No. 13,874 was enacted, which contains the 'Declaration of Economic Freedom Rights', which aims to foster free enterprise through the reaffirmation of this fundamental principle, the modernisation of the regulation applicable to investment funds, companies in general and the exercise of economic activities, among other legislative innovations. Pursuant to the language in said statute, the state shall only intervene in regard to the exercise of economic activities in a subsidiary and exceptional manner.

6 Legal doctrine in Brazil has showed strong support for adopting a theory of the firm that, instead of following the shareholder primacy doctrine, claims that a firm exists to generate welfare for all of its stakeholders (see, for instance, SILVA, Thiago José da. Administradores e Acordo de Acionistas. Limites à Vinculação. V. 7. São Paulo: Quartier Latin, out. 2015. p. 49-71).

7 The Sole Paragraph of Article 2,035 of the Civil Code expressly states that '*no convention will prevail if it contradicts public policy principles, such as those established by this Code to ensure the social function of ownership and contract*'.

8 As stated herein, such fulfilment could potentially be limited by the current laws and regulations and contracts applicable to the Investment Manager.

9 Such argument is strengthened by the Sole Paragraph of Law No. 6,404, of 15 December 1976 (Corporations Law), which states that '*A controlling shareholder shall use its controlling power in order to make the corporation accomplish its purpose and perform its social role, and shall have duties and responsibilities towards the other shareholders of the corporation, those who work for the corporation and the community in which it operates, the rights and interests of which the controlling shareholder must loyally respect and heed.*'

10 For example, the duty to meet the actuarial obligations of a pension fund or an insurance undertaking or the duty of an Investment Manager to act according to the interest of the investment fund the portfolio of which it manages, pursuant to the rules enacted by the applicable regulators.

11 In case of a sponsored fund, the sponsor also pays a monthly contribution on behalf of the employee.

12 As per the National Monetary Council (*Conselho Monetário Nacional* – CMN) Resolution No. 4,661, of 25 May 2018, and the National Complementary Social Security Superintendence (*Superintendência Nacional de Previdência Complementar – PREVIC*) Rule No. 6, of 14 November 2018.

13 In this regard, see Law No. 9,613, of 3 March 1998 (Anti-Money Laundering Law), and Law No. 13,810, of 8 March 2019, which provides for the immediate compliance with sanctions from the United Nations Security Council against individuals or legal entities regarding the unavailability of assets.

14 PREVIC Rule No. 6, of 13 November 2018, CMN Resolution No. 4,661, of 25 May 2018, and Complementary Law No. 109, of 29 May 2001.

15 This is provided for in Paragraph 4 of Article 11 of CMN Resolution No. 4,661, of 25 May 2018. Please note that the expression 'whenever possible' should be understood as an undertaking of means, not of result; however, interpretations of this provision have never been tested in a Brazilian court of law nor has any regulator issued any rule providing further guidelines on how to interpret the meaning of this expression. Nonetheless, an analogy could be traced with a recent ruling from the High Court of Justice (*Superior Tribunal de Justiça* – STJ), the highest Brazilian court competent for interpreting infra-constitutional rules, rendered on 27 August 2019, in which an investor sued the manager of an investment fund for losses incurred in the fund's portfolio. The court however decided that the manager had no obligation to guarantee profitability in the investments made in the securities market but only to use its best efforts to pursue the best profitability possible for the fund's portfolio considering all apt investment opportunities in the terms of the fund's investment policy stated in the by-laws, thus it could only be held liable if proven that the investments made thereby were a result of mismanagement or reckless management (REsp n° 1.724.722-RJ (2014/0124765-9)). In the case of the applicability of this precedent to the interpretation of 'whenever possible' in Paragraph 4 of Article 10 of CMN Resolution No. 4,661, one could argue that the pension fund must use its best efforts to seek information regarding the supply chain of the investments made thereby, including the investments made by the investment funds invested thereby, in order to make sure there is no use of child labour or workers in a situation analogous to slavery, operation without the adequate licensing, harassment in the workplace etc. However, there is a limit to what would be reasonably expected as 'best efforts'. Legal doctrine sheds light on another constitutional principle that could help interpret the wording 'whenever possible', which is the proportionality principle, the application of which would mean ESG factors would be sufficiently incorporated in the pension fund's pension plan's investment policies if they are adequate to achieve the intended purpose, sufficient to accomplish so and proportionate to the restrictions applicable (MENDES, Gilmar Ferreira; BRANCO, Paulo Gustavo Gonet. Curso de Direito Constitucional. 9ª ed. rev. e atual. São Paulo: Saraiva, 2014). Those restrictions would largely depend on the methodologies adopted for selecting assets and/or Investment Managers based on principles related to Sustainability Impact.

16 As per PREVIC Rule No. 6, of 14 November 2018.

17 In other words, transparency, solvency, liquidity and financial, economic and actuarial balance are ensured, as well as the legal requirements of CMN Resolution No. 4,661, of 25 May 2018, and PREVIC Rule No. 6, of 14 November 2018, are met..

18 An inherent ingredient to this argument is that IFSI presents lower risks than traditional investment, which seems to be supported by the current literature. Sources: LEFKOVITZ, Dan. Does Investing Sustainably Mean Sacrificing Return? Morningstar's Sustainability Indexes have posted strong returns; they also score well on volatility, quality, and financial health. Available at: https://www-prd.morningstar.com/content/dam/marketing/shared/pdfs/Research/Does_Investing_Sustainably_Mean_Sacrificing_Returns_March2018.pdf?utm_source=eloqua&utm_medium=email&utm_campaign=&utm_content=17484. Accessed 11 Feb 2020; NUNES, Tânia Cristina Silva et al. Are sustainable companies less risky and more profitable? Revista de Administração, São Paulo, v. 47, n. 3, pp. 422-435, jul./set., 2012.

19 Namely: (a) mutual funds (*fundos de investimento financeiro* – FIFs), which may have a definite or indefinite term, can invest in financial assets of all sorts and may be subdivided into (i) fixed-income; (ii) stocks, (iii) foreign exchange and (iv) multi-strategy; (b) market index funds, which must have an indefinite term, can only have passive management and follow a specified market index (*fundos de investimento em índice de mercado* – FIIMs); (c) real estate funds, which must have a definite term, can invest in financial assets related to the real estate sector, real estate assets and/or shares or units of companies the corporate purpose of which is related to the real estate sector (*fundos de investimento imobiliário* – FIIs); (d) receivables funds, which may have a definite or indefinite term, can purchase most receivables regardless of the performance of the obligation giving rise to such a credit right, from a single or multiple assignors (*fundos de investimento em direitos creditórios* – FIDCs); (e) private equity funds, which must have a definite term, can invest in shares or units of private companies and must effectively influence their management (*fundos de investimento em participações* – FIPs); and (f) rarer types, which are usually vehicles that have a certain tax advantage in order to attract investment to industries or areas the development of which is incentivised by the federal government as a matter of public policy – such industries related to culture and arts, or companies located in the North or Northeast Regions of Brazil or in Jequitinhonha Valley. There are also funds of funds (*fundos de investimento em cotas de fundos de investimento* – FIC-FIs), which may invest in quotas of the aforementioned investment funds, as applicable. For the purposes of this annex, all these types of funds will be treated indiscriminately as mutual funds, unless otherwise stated.

20 Which oftentimes are financial institutions or subsidiaries thereof but may be any type of company organised under any corporate arrangement provided for in Brazilian law – the most common of which are corporations (*sociedades anônimas*) and limited liability companies (*sociedades limitadas*) – or even individuals.

21 Pursuant to CVM Rule No. 555, of 14 December 2014, and, for instance, to CVM Rule No. 558, of 26 March 2015.

22 In spite of the fact that current regulation establishes that the fiduciary administrator shall constitute the investment fund, Brazilian investment funds are typically conceived and have their investment policy established by the Investment Manager.

23 In this context, CVM periodically updates a list of jurisdictions deemed to be strategically handicapped regarding anti-money laundering practices, pursuant to Financial Action Task Force Against Money Laundering and Terrorism Financing – FATF's recommendations.

24 Any opportunity to IFSI would have to be compliant with this regulatory restriction.

25 Note that CVM rules limit which types of securities, assets and rights each type of investment fund may invest in.

26 Including the potential positive or negative Sustainability Impact as a by-product of the investments made.

27 More on them on section "6. Investment managers' duties to Invest for Sustainability Impact" of this document.

BRAZIL

28 Although commonly provided for in the by-laws of illiquid investment funds, the existence of a performance fee is not mandatory for any type of investment fund.

29 Such as negative screening, positive screening, best-in-class, impact investing and corporate engagement.

30 Such as, for fixed-income-based portfolios, credit, ageing list and profitability analyses; while for variable-income-based portfolios, forecasts, valuations and sensibility analyses.

31 The preamble of the ANBIMA ESG Guide states the best practice recommendations made therein were based on the practices witnessed by ANBIMA's Sustainability Consulting Group – a committee thereof – in some of the largest Investment Managers operating in Brazil.

32 From a regulatory perspective, there are no relevant differences between OPPE, general insurance companies and life insurance companies or reinsurance companies, since they are all: (a) companies incorporated as corporations (sociedades anônimaa, also known as 'S.A.'); and (b) supervised by the Brazilian (Re)Insurance Authority (*Superintendência Nacional de Seguros Privados* – SUSEP), whereas their allocation limits are set forth in CMN Resolution No. 4,444, of 13 November 2015. The main difference refers to their license, since SUSEP shall grant specific approvals for them to operate.

33 In Brazil, open private pension plans can be managed both by OPPEs or insurance companies duly authorised by SUSEP.

34 Pursuant to Law-Decree No. 73, of 21 November 1966, and Complementary Law No. 126, of 15 January 2007.

35 CMN Resolution No. 4,444, of 13 November 2015.

36 CMN Resolution No. 4,444, of 13 November 2015, sets forth many rules with which any investment fund that is invested by an Insurance Undertaking must comply.

37 Pursuant to articles 153 to 157 of Law No. 6,404, of 15 December 1976.

38 Pursuant to which officers and directors shall act with the care and diligence as reasonably performed by an active and honest individual dealing with his/her own businesses.

39 Pursuant to which officers and directors shall act according to the law and the by-laws in order to pursue the company's interest. As a result, officers and directors shall not (a) perform any act of generosity to the detriment of the company; (b) borrow money or property from the company or use, for his/her own benefit or for the benefit of a third party or of a company in which he or she has an interest, the company's properties, services or credits, without the relevant corporate prior approval; and (c) by virtue of his/her position, receive any type of direct or indirect, personal advantage from third parties, without authorisation in the by-laws or from the shareholders' general meeting.

40 Pursuant to which officers and directors shall not (a) use any commercial opportunity which may come to his/her knowledge, by virtue of his/her position, for his or her own benefit or that of a third party, regardless of whether it causes any loss to the company; (b) fail to exercise or protect the company's rights or, in seeking to obtain advantages for himself/herself or for a third party, fail to make use of a commercial opportunity which he or she knows to be of interest to the company; and (c) acquire, for resale with profit, property or rights which he or she knows the company needs or which the company intends to acquire. Additionally, officers and directors must maintain secrecy as to any information not disclosed to the public, obtained as a result of their position and which may influence the trading value of the company's securities.

41 Pursuant to which officers and directors are prevented from voting, or interfering with other members' votes, in any resolution in which such director or officer may have an interest that conflicts with the company's interest.

42 Meaning a corporation, shares of which or any other securities issued by which are admitted to trading on a stock exchange market or an over-the-counter market whether organised or not.

43 Pursuant to which officers and directors shall inform the shareholders about certain material information, acts and facts according to the applicable regulation.

44 As per the SUSEP Circular No. 517, of 30 June 2015.

45 CMN Resolution No. 4,444, of 13 November 2015, and Complimentary Law No. 109, of 29 May 2001.

46 Pursuant to Article 192 of Law No. 6,404, of 15 December 1976.

47 The guidelines referred to herein, provided for in Article 5 of Law-Decree No. 73, of 21 November 1966, much like Article 170 of the Federal Constitution referred to mostly in 1 above – which states that the economic order of Brazil is founded in the social values of labour and free enterprise, has the objective to must ensure all a dignifying existence, pursuant to social justice commandments and must observe the principles of national sovereignty, private property, social function of ownership, free competition, consumer protection, environmental protection, decrease in regional and social inequality, full employment and different treatment to small companies incorporated in Brazil – is a programmatic norm and, as such, has little practical effect, limiting itself to enunciate principles and objectives to be pursued. It depends on the establishment of further regulation by law, decree or norms enacted by a specific regulator – in case of the National Private Insurance Policy, this regulator is the National Private Insurances Council (*Conselho Nacional de Seguros Privados* – CNSP) and SUSEP.

48 Please refer to footnote No. 14, as the arguments presented therein would also be applicable to the interpretation of the bounds of the expression 'whenever possible' in relation to Item V of Article 2 of CMN Resolution No. 4,444, of 13 November 2015: '*Article 2. In the deployment of the funds covered by this Resolution, insurance companies, capitalisation companies and OPPEs shall: […] V – observe, whenever possible, aspects related to economic, environmental, social and governance sustainability of their investment'*.

49 Pursuant to CMN Resolution No. 4,444, of 13 November 2015, and CNSP Resolution No. 321, of 15 July 2015.

50 This, however, should not prevent the engagement in charity or non-profit making corporate social responsibility activities.

51 This may be related to the fact that Brazilian companies have traditionally had very concentrated ownership and control has traditionally been exercised by a clearly defined majority shareholder.

52 Those are phrased as commandments that the adherent Asset Owners should follow and they read as: (a) implement and disclosure a stewardship programme; (b) implement and disclosure mechanisms to manage conflicts of interest; (c) take ESG factors into account in their investment processes and stewardship activities; (d) monitor the issuers of securities; (e) be active and diligent in the exercise of voting rights; (f) establish collective engagement criteria; and (g) be transparent as to their stewardship activities. Furthermore, an annual report on the stewardship activities carried out in the previous fiscal year should be published by each Asset Owner who adheres to the AMEC Stewardship Code.

53 Source: ASSOCIATION OF CAPITAL MARKET INVESTORS. AMEC Stewardship Code. [2016]. Available at: https://en.amecbrasil.org.br/stewardship/amec-stewardship-code/. Accessed 18 April 2021.

54 Please note that relevant investors and Asset Owners that do not seem to compete in a given market may be seen as competitors by the Administrative Council for Economic Defense (*Conselho Administrativo de Defesa Econômica* – CADE). In order to identify actual competitors in a specific market, ie those that are capable of constraining each other and preventing them from behaving independently, CADE has to define the relevant product and geographic market in the specific case.

55 Pursuant to Article 36 of Law No. 12,529, of 30 November 2011.

56 In Brazil, there is no specific exemption for any type of arrangement. See, for example, the CADE note on collaboration between competitors to face the COVID-19 outbreak, released on 6 July 2020. In this document, CADE stresses that competition rules and enforcement will not be soften during the period of the pandemic crises and that '*economic agents will continue to be responsible for the evaluation of their strategies and any indications of practices that are harmful to competition may give rise to the opening of investigations by the authority*'.

57 Eg see Merger Case No. 08700.006723/2015-21 (broadcasting networks Record, SBT and Rede TV); Merger Case No. 08700.002792/2016-47 (five of the largest banks in Brazil); Merger Case No. 08012.007477/2011-50 (Brazilian Union of Recycling Electric Appliances and Electronics (*Associação Brasileira de Reciclagem de Eletroeletrônicos e Eletrodomésticos* – ABREE)); and Merger Case No. 08700.005278/2014-00 (*Jogue Limpo* Institute, which provides services of reverse logistics for lubricants). In these cases, companies adopted firewalls and measures to prevent antitrust risks, such as the exchange of competitive sensitive information, and received CADE's green light to engage in collaborative arrangements.

58 Relevant Investors and Asset Owners interested in engaging in stewardship activities to secure Sustainability Impact may establish protocols to make sure that the discussions do not involve the exchange of data/information, and to minimise any risks related to the necessary exchange of information, such as the use of a third-party independent consultant. Depending on the specific facts of a given cooperation, it would also be possible to seek a CADE pronouncement on the collaborative arrangement and the stewardship strategy in other to avoid antitrust risks. If the collaborative arrangement meets the criteria established in Article 88 of the Brazilian Competition Law, and is subject to mandatory antitrust clearance, CADE will decide whether the arrangement may occur. However, if the collaborative arrangement is not subject to mandatory review by CADE, Relevant Investors may still seek CADE's pronouncement by (a) filing a petition to obtain a written and non-binding pronouncement on the agreement or by (b) filing a consultation to obtain a binding pronouncement from CADE's tribunal. The procedure and requirements for submitting a consultation are described in CADE Resolution No. 12, dated 11 March 2015.

59 Please refer to 2.2.13 and 2.2.14 for a discussion on these guidelines.

60 An argument can be made that if the stewardship is likely to preserve value in the long run, then the actuarial obligations are not being jeopardised, unless, for some reason, the pension funds must make large short-term cash payments and do not have sufficient liquidity to meet their obligations.

61 The United Nations' Global Compact has been developing anti-corruption collective actions for the past 10 years and the Brazilian local network has been selected in 2020 for a four-year project called 'Scaling up anti-corruption collective action within Global Compact Local Networks', which is assisted in the implementation of these collective actions by a consulting council comprised of 20 organisations coming from the public sector, the private sector and civil society. The current composition of such a consulting council currently features at least one pension fund.

BRAZIL

62 Source: ASSOCIATION OF CAPITAL MARKET INVESTORS. AMEC Stewardship Code. [2016]. Available at: https://en.amecbrasil.org.br/stewardship/amec-stewardship-code/. Accessed 9 December 2019.

63 As per CVM Rule No. 578, of 30 August 2016.

64 It should be noted that an Investment Manager with a small investment decision-making team may often find the cost of stewardship activities greater than the benefits that could arise therefrom. As all costs of engagement are born directly or indirectly by the Investment Manager – in the second case through a smaller portion of the management fee to which it would be entitled, in case the expenses are directly borne by the fiduciary administrator – the compensation of the Investment Manager could also be related to its willingness to engage in stewardship: where there is a performance fee, there would be a greater incentive to maintain such human and technical resources and develop stewardship activities.

65 An argument can be made that if the stewardship is likely to preserve value in the long run, then the actuarial obligations are not being jeopardised, unless, for some reason, the OPPE must make large short-term cash payments and has no sufficient liquidity.

66 For example, some pension funds have voluntarily participated in the four-year project 'Fiduciary duty in the 21st century', coordinated by United Nations Environment Programme's Finance Initiative and supported by the Generation Foundation, which advocates for the critical importance of incorporating ESG standards into regulatory conceptions of fiduciary duty.

67 The same indirect lobbying strategy could be achieved through a company instead of an investment fund.

68 For example, the investment policy or any other internal policy or organisational document adopted thereby, as well as, where applicable, the investment management agreement, in case of an investment fund.

69 Stated by Law No. 13,874, of 20 September 2019.

70 It should be noted that the CVM has published a request for comments (*audiência pública*) aimed at reforming the regulations applicable to the periodic and eventual disclosure of information by public companies. The proposed regulation on which market participants were asked to comment, among others, provides for many indicators related to ESG aspects and the disclosure of social and environmental risks, as well as those related to climate change.

71 According to a recent poll, one in every four Brazilian investors was afraid of a trade-off between IFSI and financial return (please refer to footnote No. 142 for further details). The discussion in Brazil about ESG and Sustainability Impact has greatly increased since 2020, being the main theme of a number of investor education events held in the past months, thus it is likely that more investors will forgo this mindset and will be more willing to pursue IFSI.

72 Three studies are worth mentioning, all of which found more positive than negative or neutral results regarding how ESG factors affect financial performance. The first one, a meta-analysis from the University of Hamburg and WDS Investment covered around 2,250 studies published since 1970, found that approximately 48 per cent of the analysed studies that found a statistical significant relationship between ESG and corporate financial performance and approximately 62 per cent of the analysed meta-studies point to a positive relationship between ESG and corporate financial performance, while only 10 per cent found a negative relationship and the rest found a neutral relationship (DWS INVESTMENT. Digging deeper into the ESG-corporate-financial-performance-relationship. Frankfurt am Main: DWS Global Research Institute, 13 Set. 2018. Available at: https://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=&ved=2ahUKEwjdm7nupbrxAhWOqpUCHRlDAr0QFjAAegQIAxAD&url=https%3A%2F%2Fdownload.dws.com%2Fdownload%3Felib-assetguid%3D714aed4c2e83471787d1ca0f1b559006&usg=AOvVaw3aFLi7e9_lqrW-oQ0G2cUD. Accessed 28 June 2021). The second one, a meta-analysis from the University of New York's Stern Center for Sustainable Business and Rockefeller Asset Management covered 1,141 peer-reviewed papers and 27 meta-reviews (on their turn based on approximately 1,400 studies) published between 2015 and 2020, found that, when analysed from a long-term perspective, ESG integration provides downside protection – especially in times of a social or economic crisis – sustainability initiatives and low-carbon management drive better financial performance at corporations, and ESG disclosure without an accompanying sustainability strategy does not drive financial performance, among other findings. '*Dividing articles into those focused on corporate financial performance and those focused on investment performance, the researchers found a positive relationship between ESG and financial performance in 58 per cent of the corporate studies focused on operational metrics or stock price with 13 per cent showing neutral impact, 21 per cent mixed results and only 8 per cent showing a negative relationship. For investment studies, typically focused on risk-adjusted attributes, 59 per cent showed similar or better performance relative to conventional investment approaches while only 14 per cent found negative results*' (WHELAN, Tensie et al. ESG and Financial Performance: Uncovering the relationship by aggregating evidence from 1,000 plus studies published between 2015 – 2020. [Nova York (NY)]: Leonard N. Stern School of Business, 10 Feb. 2021. Available at: https://www.stern.nyu.edu/experience-stern/about/departments-centers-initiatives/centers-of-research/center-sustainable-business/career-development/career-resources-job-board. Accessed 28 June 2021). The third is United Nations' Principles for Responsible Investment's own work, which also found a connection between ESG factors and shareholder returns (PRINCIPLES FOR RESPONSIBLE INVESTMENT. Financial performance of ESG integration in US investing. [S.l.]: United Nations' Principles for Responsible Investment, 2018. Available at: https://www.unpri.org/download?ac=4218. Accessed 28 June 2021). Moreover, evidence from the Brazilian market also points to a positive relationship between social performance and financial performance and to a lack of relationship between financial performance and disclosure of social factors unaccompanied by an underlying social responsibility strategy (AEDO PEREIRA, Anderson Felipe et al. Corporate Social Performance and Financial Performance in Brazilian Companies: Analysis of the Influence of Disclosure. Vitória (ES), Brazilian Business Review, v. 17, n. 5, p 540-558, Sep./Oct. 2020. Available at: http://bbronline.com.br/index.php/bbr/article/view/618/927. Accessed 28 June 2021).

73 Although Brazilian law does not provide for a definition of 'welfare', it is generally understood as encompassing striving for a higher level of wellbeing achieved through access to decent healthcare, education, housing, labour conditions and other things. Higher financial payoffs could grant access to these services, but those could also be directly provided by Pension Funds to their pensioners and to the community.

74 When the sponsor is related to the public administration, however, formal consent is required – not just proof of prior notice.

75 Pursuant to Complimentary Law No. 109, of 29 May 2001, and PREVIC's Licensing Department Ordinance No. 324, of 27 April 2020.

76 PREVIC Rule No. 6, of 14 November 2018, sets forth that the investment policies of Pension Funds' pension plans must establish guidelines for Pension Funds to follow in order to consider ESG factors in their investments. These guidelines aim to provide a framework under which ESG must be integrated in the risk analysis of the investment portfolio, considering each specific industry invested in. Since the referenced rule does not contain any specification with regard to these guidelines, they could, in practice, be generally mentioned in the investment policies, as to express that ESG factors should be considered in the investment risk assessment and portfolio allocation.

77 Pursuant to CMN Resolution No. 4,661, of 25 May 2018, and PREVIC Rule No. 6, of 14 November 2018.

78 For instance, (a) JGP ESG Master Fundo de Investimento em Ações, enrolled with the Legal Entity National Registry of the Ministry of Economy (*Cadastro Nacional de Pessoa Jurídica – CNPJ*) under No. 35.400.868/0001-63; (b) Pátria Crédito Estruturado Fundo de Investimento em Direitos Creditórios, enrolled with the CNPJ under No. 28.819.553/0001-90; and (c) Constellation Compounders ESG Fundo de Investimento de Ações, enrolled with the CNPJ under No. 18.872.811/0001-48.

79 Unless a higher quorum is provided for in the by-laws.

80 Therefore, this duty is not owed to the shareholders and other beneficiaries related to securities issued by the Insurance Undertaking.

81 It should be noted that the CVM published notice of a request for comments (*audiência pública*) on 1 December 2020 regarding a new regulation proposal applicable to investment funds. If the enacted regulation piece maintains CVM's initial proposal, the Investment Manager will, jointly with the fiduciary administrator, form the fund through a joint written resolution approving the formation of the fund and stating its by-laws, which shall then be registered with the CVM. In this scenario, there will be no more necessary investment management agreement to be entered into between the fund and the Investment Manager, but rather the powers thereof will be directly stated in the by-laws and in the applicable regulation, without prejudice, in any case, of the execution of ancillary agreements between the Investment Manager and the fund and/or the quotaholders further governing how the portfolio should be managed.

82 Which are: (a) for pension funds, (i) the National Complimentary Social Security Council (*Conselho Nacional de Previdência Complementar* – CNPC) and (ii) PREVIC; (b) for mutual funds, (i) CMN and (ii) the CVM; and (c) for Insurance Undertakings, (i) the CNSP and (ii) SUSEP. A few duties and powers of Pension Funds' and OPPEs' investment decision-makers are also set by Complimentary Law No. 109, of 29 May 2001, and Law No. 6,404, of 15 December 1976, which sets forth the duties and powers applicable to the officers and directors of Insurance Undertakings.

83 In any case, under the terms of the CMN regulation and, in case of mutual funds, the CVM.

84 Eg restrictions on locations, industries, age or size of invested companies; restrictions on the amount of time for which the asset must be held; restrictions on the stake that may be purchased on behalf of the Asset Owner – controlling or minority shareholder – etc.

85 Except in index funds, where these powers may be exercised directly by the quotaholders.

86 It is arguable that even when the pursuit of Sustainability Impact is not expressly stated in the organisational documents of an Asset Owner or on the investment management agreement, if (a) there is wording related to the pursuit of long-term returns; and (b) a reasonable link could be made between the long-term profitability and likelihood of success of investments and their Sustainability Impact, the Investment Manager could invest in potentially positive Sustainability Impact projects, regardless of potential lower short-term returns and without prejudice to its liability towards the CVM. It should be noted, however, that there is no clear definition for the timeframe in which this assessment should be carried out.

BRAZIL

87 Alternatively, this could also be set in a sustainability policy adopted by the Investment Manager. On this topic, it should be highlighted that the largest Investment Managers in Brazil are financial institutions or are controlled by a financial institution and, as such, they are required by CMN Resolution No. 4,327, of 25 April 2014, to establish a social and environmental responsibility policy (*política de responsabilidade socioambiental* – SERP) which is applicable, pursuant to the Central Bank of Brazil's oversight, to all entities that have a financial institution in their prudential conglomerate. The SERP should contain (a) the social and environmental principles and guidelines that these entities have to follow when conducting their business, including deploying capital managed on behalf of third-parties, and (b) how these entities will manage the social and environmental risks to which they and their assets are exposed. Furthermore, the Brazilian Banks Federation (*Federação Brasileira de Bancos* – FEBRABAN), in the capacity of a self-regulatory organisation, has set non-mandatory guidelines regarding for drafting the SERP which require the entities that are subject thereto to consider ESG factors when selecting and monitoring assets to comprise their investment portfolios, since these factors could affect the risk-return ratio associated with the investment.

88 The appropriateness or sufficiency of the human and technical resources adopted by the Investment Manager will be measured against the activities that it sets itself to perform, considering aspects such as nature, size, complexity etc. Ultimately, if the CVM deems that the Investment Manager is not qualified to pursue IFSI, it may bar it from managing a portfolio in order to pursue IFSI, either as an ultimate end or instrumentally.

89 Having said that, a relevant example is the Investors Policy Dialogue on Deforestation – IPDD Initiative, set up in July 2020, to coordinate a public policy dialogue with Brazilian government-related authorities and associations, as well as other stakeholders on halting deforestation. It marks the start of an ongoing process of investor engagement with Brazilian authorities and associations on the systematic and sustainable management of Brazil's forest assets and on ensuring respect for human rights. The IPDD Initiative has had a lot of media attention and counts with the participation of dozens of Investment Managers who hold assets in Brazil.

90 In this case, liability could be civil or administrative. Civil liability. A Pension Fund or its managers and investment decisionmakers in relation to the participants of the pension plan and/or to the sponsor, an investment fund to its quotaholders or the relevant officers and directors to the Insurance Undertaking itself, as well as the Investment Manager to the same persons or to the Asset Owner itself, could be held civilly liable for breach of applicable regulation, especially breach of fiduciary duties, and breach of contractual obligations set forth in the relevant documents – please refer to footnote No. 102 for a list of these documents. Administrative liability. Sanctions could be levied by PREVIC to the managers of a Pension Fund – or the Pension Fund itself, who would then have recourse against the managers – by SUSEP to an Insurance Undertaking's relevant officers and by the CVM to an Investment Manager and its officer liable for the portfolio management activity. Poor performance of investments cannot result in administrative liability, provided that there has not been any practice of a crime, breach of obligations undertaken in the relevant documents and regulation or fraudulent or negligent performance of its functions.

91 In this case, there could be civil contractual liability (eg where the investment in the investee company was made through a sustainability bond).

92 The Sole Paragraph of Article 927 of the Civil Code states that '*there will be an obligation to repair the damage, independent of fault, in the cases specified in the law, or when the activity as normally conducted by the perpetrator of the damage implies, by its nature, risk to the rights of another*'. Brazilian case law has mostly maintained the interpretation that strict liability will only occur in exceptional cases, either by express legal determination or on the occasion of activities that represent a risk inherent to the rights of third parties.

93 For instance, it would not be uncommon in a private equity deal for the Asset Owner to agree to reimburse the opposing party, either on the sell- or buy-side, in case environmental damages or violations of human rights and other liability arising from negative Sustainability Impact prior to the transaction are discovered after the transaction has taken place.

94 Investment funds have no corporate veil as they lack legal personality, as stated in 2.3.1. Thus, any case of civil liability could result in an obligation of the quotaholders to contribute more capital to pay for the indemnity, as their liability when subscribing for quotas of the investment funds is not limited to the contributed capital.

95 For further explanation on the social function concept, refer to Section 1 above.

96 Such an action is called a 'collective action' or 'public civil action' (*ação civil pública*) and the claim must be related to moral or material damages: (a) to the environment; (b) to consumers, pursuant to consumer protection laws; (c) to goods with artistic, aesthetic, touristic or landscape value; (d) to any other collective or diffuse interest; (e) arising from an infraction to the economic order; (f) to the urban order; (g) to the honour and dignity of racial, ethnic or religious groups; or (h) to public and social heritage.

97 2nd Regional Labour Court. Appeal No. 0000108-81.2012.5.02.0081–SP, Judge-Rapporteur Sonia Maria de Barros, judged on 8 October 2017. Under the terms of the decision, '*it is irrelevant that the contracts maintained with the outsourced companies contained clauses with the obligation of not subcontracting sewing workshops in irregular conditions*'.

98 As stated in Law No. 6,938, of 31 August 1981.

99 Any incident or violation of environmental laws may potentially give rise to civil, administrative and criminal liabilities. This section covers only civil liability, ie criminal or administrative liability still may require that causation is established.

100 Brazilian Superior Court of Justice, Especial Appeal No. 650,728, Judge-Rapporteur Justice Herman Benjamin, judged on 23 October 2007, published on 2 December 2009.

101 Brazilian Superior Court of Justice, Repetitive Especial Appeal No. 1.596.081, Judge-Rapporteur Justice Ricardo Villas-Bôas Cueva, judgement rendered on 25 October 2017, published on 22 November 2017. Pursuant to Article 927 of the Code of Civil Procedure (Law No. 13,105, of 16 March 2015), this a binding precedent that must be observed by the courts.

102 Pursuant to Article 4 of Law No. 9,605, of 12 February 1998.

103 An investment fund itself would not be liable before the CVM. However, a fiduciary administrator thereof and its officer(s) liable for the activity of fiduciary administration could be liable if it breaches its duties, including duties related to oversight of the Investment Manager. For a summary of the duties of the fiduciary administrator of an investment fund, please refer to 2.3.3 and 2.3.4.

104 Please refer to footnote No. 100 in relation to investment funds.

105 The relevant documents we refer to are (a) in case of a Pension Fund: (i) the by-laws of the Pension Fund, (ii) the by-laws of the pension plan or its investment policies, or (iii) the investment management agreement through which the Investment Manager was engaged, if applicable, and, (iv) if an Investment Manager was engaged, its by-laws or articles of association or its sustainability policy; (b) in case of an investment fund: (i) the fund's by-laws, (ii) the investment management agreement through which the Investment Manager was engaged or (iii) the Investment Manager's by-laws or articles of association or its sustainability policy; or (c) in case of an Insurance Undertaking: (i) the by-laws of the Insurance Undertaking and/or (ii) the insurance or reinsurance policies; and/or (iii) the pension plan's by-laws of an OPPE and its investment policies.

106 According to Law No. 9,784, of 29 January 1999, Decree No. 4,942, of 30 December 2003.

107 According to Law No. 9,784, of 29 January 1999, Law No. 13,506, of 13 November 2017, and CVM Rule No. 607, of 17 June 2019.

108 According to Law No. 9,784, of 29 January 1999, and CNSP Resolution No. 393, of 30 October 2020.

109 Brazilian law does not admit, however, that anyone be held liable exclusively on the grounds of their position within a company's organogram, as it must be demonstrated that they contributed somehow to the breach of contract or violation of law.

110 Please refer to 7.2.4 to 7.2.10 above for an explanation of the concept of 'indirect polluter' and the claim of damages through a collective action..

111 The general provisions set forth in the caption of Article 13 and in Article 29 of the Penal Code (Law-Decree No. 2,848, of 7 December 1940), ground this statement. Brazilian law does not admit, however, that anyone can be charged with exclusive grounds on their position within an organogram, as it must be demonstrated that they contributed somehow to the offence.

112 Please note that in Brazilian law, 'fault by means of negligence' (*culpa*) includes acts carried out with carelessness (*negligência*), recklessness (*imprudência*) or inaptness (*imperícia*).

113 Liability of Investment Managers and their officers would have to be connected with their duties of executing investment and divestment orders and representing the investment fund in the exercise of any right arising from holding the securities and other assets in the fund's portfolio or with their duties of adequately managing the risks associated with the portfolio, without prejudice to duties connected to the disclosure of information of the Investment Manager itself to the market and to the CVM. Liability could also arise for a failure to verify the suitability of an investment to a quotaholder, in case the Investment Manager directly distributes the quotas of the investment fund to the beneficiaries.

114 This would be an objective violation, thus not require proof of negligence or wilful misconduct in the violation of CVM regulation. Additionally, please note that in Brazilian law, 'negligence' (*culpa*) includes acts carried out with carelessness (*negligência*), recklessness (*imprudência*) or inaptness (*imperícia*).

115 This provision is established by Paragraph 4 of Article 10 of CMN Resolution No. 4,661, of 25 May 2018.

116 Pursuant to Article 23 of PREVIC Rule No. 6, of 14 November 2018.

117 Pursuant to Item V of Article 2 of CMN Resolution No. 4,444, of 13 November 2015.

118 Source: ASSOCIAÇÃO DE INVESTIDORES NO MERCADO DE CAPITAIS. Signatários. Available at: https://www.amecbrasil.org.br/stewardship/signatarios/. Accessed 12 April 2021.

119 Together, the assets under management of all Pension Funds adherent to the AMEC Stewardship Code correspond to more than 44 per cent of all assets under management by Pensions Funds in Brazil ((Source: ASSOCIAÇÃO DE INVESTIDORES NO MERCADO DE CAPITAIS. Stewardship. Signatários. Available at: https://www.amecbrasil.org.br/stewardship/signatarios/. Accessed 12 April 2021; together with ASSOCIAÇÃO BRASILEIRA DAS ENTIDADES FECHADAS DE PREVIDÊNCIA COMPLEMENTAR; INSTITUTO BRASILEIRO DE GEOGRAFIA E ESTATÍSTICA. Consolidado Estatístico. Agosto/19. Available at: https://www.abrapp.org.br/wp-content/uploads/2021/04/Consolidado-Estatistico_12_2020.pdf. Accessed 12 April 2021).

BRAZIL

120 This company is a subsidiary of the Social and Economic Development Bank (*Banco Nacional do Desenvolvimento Econômico e Social – BNDES*).

121 All of which are in Segment 1 of the prudential segmentation implemented by CMN. According to Article 2, First Paragraph, of CMN Resolution No. 4,553, of 30 January 2017, Segment 1 is comprised of banks and state-owned companies that are allowed to perform banking activities the size of which equals 10 per cent or more of the gross domestic product or that have significant international presence, regardless of their size. Source: BANCO CENTRAL DO BRASIL. Segmento 1. [2019]. Available at: https://www.bcb.gov.br/acessoinformacao/legado?url=https:%2F%2Fwww.bcb.gov.br%2Fnor%2Fbasileia%2Fs1.asp%3Fidpai%3Denquadramento. Accessed 19 November 2019.

122 Source: ASSOCIAÇÃO BRASILEIRA DAS ENTIDADES DOS MERCADOS FINANCEIRO E DE CAPITAIS. GUIA ASG. Incorporação dos aspectos ASG nas análises de investimento. [S.l.]: ANBIMA, jan. 2020. Available at: https://www.anbima.com.br/data/files/1A/50/EE/31/BFDEF610CA9C4DF69B2BA2A8/ANBIMA-Guia-ASG-2019.pdf. Accessed 18 February 2020.

123 It is safe to assume that almost all the most relevant Investment Managers acting in the Brazilian investment funds industry are comprised in said research, since around 71 per cent of all Investment Managers are registered with ANBIMA.

124 Source: ADACHI, Vanessa. Guilherme Benchimol, da XP: "Empresa que não for ESG vai acabar". Capital Reset. 26 June 2020. Available at: https://www.capitalreset.com/guilherme-benchimol-da-xp-empresa-que-nao-for-esg-vai-acabar/. Accessed 5 July 2020.

125 Available at: https://www.english.climaesociedade.org/post/sitawi-investors-for-the-climate. Accessed 10 July 2020.

126 Created in March 2020 by the British NGO Carbon Disclosure Project (CDP), this index intends to establish a relationship between the disclosure of environmental data and local companies' financial performance. It began to be disclosed as from 13 July 2020 on Valor Econômico's website. The index initially comprises 34 of the most liquid companies in the Brazilian market that achieved at least a 'C' score in CDP's methodology, which varies from 'A' to 'D'. Despite the short comparison period, ICDPR has outperformed IBOVESPA (the main stock market index in Brazil which tracks the most actively traded stocks) from April to June 2020. This index tends to provide a good metric for the relation between Sustainability Impact data disclosure and financial return and to encourage other relevant investors to engage in Sustainability Impact businesses considering ICPR's financial return.

127 The Brazil ESG Index is a broad-based index that is designed to measure the performance of securities meeting sustainability criteria and weighted by S&P DJI ESG score. The index applies exclusions based on companies' involvement in specific business activities, performance against the principles of United Nations Global Compact, and companies with no S&P DJI ESG score listed in the exchange market operated by B3 S.A. – Bolsa, Balcão, Brasil.

128 In addition to the more recent initiatives, B3 S.A. – Bolsa, Balcão, Brasil's commitment to the ESG theme goes back to 2004, when it was the first stock exchange to adhere to the UN Global Pact and was a founding signatory of the UN Sustainable Stock Exchanges (SSE).

129 Reference is made to the inclusion of Item X into Article 170 of the Federal Constitution, stating the all economic activity in Brazil must be guided by the need to 'promote climate stability, by usage of mitigating measures to pre*vent climate change and adapt to its negative effects*'.

130 'Audiência Pública SDM nº 04/18 – Processo CVM SEI nº 19957.0037762017-67'. Available at: http://www.cvm.gov.br/audiencias_publicas/ap_sdm/2018/sdm0418.html. Accessed 13 July 2020.

131 For example, in recent lawsuits proposed against public and private financial institutions, the public prosecutor's office has argued that banks have neglected social and environmental risks in providing credit to businesses that engaged in slave labour and other human rights violations. Among other requests, courts have been asked to order these financial institutions to include in their contracts clauses that recognise social and environmental obligations, as well as financial consequences for non-compliance by the investees (see Public Civil Actions No. 1000641-81.2019.5.02.0047 and No. 1000639-03.2019.5.02.0083 at São Paulo's Labour Court, proposed against Banco Safra S.A. and Caixa Econômica Federal S.A., respectively).

132 BERTÃO, Naiara. ESG: sobra interesse, mas falta informação, mostra pesquisa da XP. Valor Investe. São Paulo. 14 ago. 2020 Available at: https://valorinveste.globo.com/objetivo/hora-de-investir/noticia/2020/08/14/esg-sobra-interesse-mas-falta-informacao-mostra-pesquisa-da-xp.ghtml. Accessed 16 Aug 2020.

133 A concern shared by 24 per cent of the respondents.

134 A concern shared by 24 per cent of the respondents.

135 A concern shared by 19 per cent of the respondents.

136 A concern shared by 17 per cent of the respondents.

137 Source: SCHINCARIOL, Juliana, Investidor institucional mostra desconhecimento sobre ESG, Valor Econômico, Rio de Janeiro, 14. April 2021. Available at: ttps://valor.globo.com/wall-concurrence/?next=https://valor.globo.com/financas/noticia/2021/04/14/investidor-institucional-mostra-desconhecimento-sobreesg.ghtml?utm_source=valorinveste&utm_medium=referral&utm_campaign=materia. Accessed: 15 April 2021.

138 Available at: https://www.ft.com/content/ad1d7176-ce6c-4a9b-9bbc-cbdb6691084f. Accessed 13 July 2020.

139 According to the Technical General Brazilian Accounting Rule No. 23, twice amended, which internalises the provisions set forth in the Accounting International Standard No. 8 of the International Accounting Standards Board – IASB.

CANADA

1. INTRODUCTION

1.1 For the purposes of this annex, we have considered the laws of Canada as at 31 January 2021. Canada is composed of ten provinces and three territories. Quebec is a civil law jurisdiction. The other provinces/territories are common law jurisdictions, as is Canadian federal law. Unless otherwise stated, the information contained herein applies in general terms to all provinces/territories. Where there are significant distinctions in respect of Quebec, they are addressed separately.

1.1.1 As discussed in the main body of the report, the expression 'Investing for Sustainability Impact' ("**IFSI**") is not a precisely defined legal expression, and it is important to emphasise that the laws of Canada do not reference it in that way. Rather, the expression is used here as a type of '*conceptual net*' to catch any power or freedom on the part of Asset Owners or their Investment Managers to pursue one or more Sustainability Impact objectives of any sort (instead of or in addition to financial return).

1.2 In this annex certain underlying key themes recur:

1.2.1 Generally, Asset Owners and Investment Managers in Canada may only invest for impact where such investments are in conformity with their existing obligations, which in most cases do not allow Sustainability Impact objectives to take precedence over financial considerations. Put another way, we do not think Canadian law currently allows for Asset Owners to Invest for Sustainability Impact over financial objectives, absent specific authorisation within the fund documents or legislation.

1.2.2 The relatively narrow sub-set of Relevant Investors empowered to Invest for Sustainability Impact in priority to achieving stated financial objectives on investments are generally managers of mutual funds where Investing for Sustainability Impact is explicitly authorised by the constating documents (as discussed further below).

1.2.3 In the absence of a specific mandate allowing for, or directing, an Asset Owner to prioritize IFSI alongside financial returns, Relevant Investors face significant hurdles in prioritizing IFSI. The complex legal framework governing the activities of Asset Owners and Relevant Investors is a significant obstacle to IFSI.

1.2.4 Notwithstanding the foregoing, it is well established in Canadian law and practice that Asset Owners may take into account environmental, social, and governance ("*ESG*") factors in their investment decisions where relevant to fund performance. Moreover, ESG factors are increasingly viewed as relevant to fund performance,[1] and the breadth and depth of ESG factors that are considered relevant by Asset Owners has expanded greatly over the past many years to include such things as measurable environmental targets for portfolio construction, for example.[2] In fact, a routine and robust consideration of ESG factors is relatively common among large Canadian institutional Asset Owners.[3] While there have been proposals to further facilitate ESG investing (as described below at 2.2.24) there are currently no proposals to change the law to specifically allow for IFSI. However, where sustainability risks such as climate change are determined to be financially material to the performance of an investment, and IFSI approaches can be effective in helping to achieve an investor's financial goals (i.e. instrumental IFSI), there would likely be a requirement to consider using them and act accordingly, which may be especially relevant in circumstances where there is a longer-term investment horizon.

1.2.5 Asset Owners in Canada are also sensitive to the increase in regulatory disclosure requirements and the need to increase disclosure related to Sustainability Impact. There is a growing recognition that the underlying relationship between finance and the condition of society more broadly requires a more thoughtful approach to ESG factors.[4] Support for the consideration of ESG factors exists both in Canadian securities law and in the principles of Canadian fiduciary law. Consequently, to the extent disclosure requirements impact a Relevant Investor from a reputational standpoint, such requirements may incentivise IFSI so that Relevant Investors can demonstrate that they are thinking about such matters.

CANADA

2. ASSET OWNERS' USE OF POWERS OF INVESTMENT AND DIVESTMENT TO INVEST FOR SUSTAINABILITY IMPACT

2.1 The following section considers the extent to which and in what circumstances, each type of Asset Owner is (a) legally required or (b) legally permitted or able to use its powers of investment and divestment to Invest for Sustainability Impact.

2.2 **Pension Funds**

Types of pension fund covered

2.2.1 In Canada, a pension plan is typically thought of as a plan "organized and administered to provide a periodic payment for life to an employee in retirement."[5] There are two main features to most pension plans, namely that:

- "The plan contains provisions stating how the pension and other benefits are determined, together with the terms and conditions under which the benefits will be payable ("**design rules**"); and
- Financial arrangements are made to provide the funds needed when benefits fall due, usually by building up assets in a trust fund or under an insurance contract ("**funding rules**")."[6]

2.2.2 Pension plans which comply with the design rules applicable to a "registered pension plan" ("**RPP**") may be registered under the *Income Tax Act* (Canada) ("**ITA**").[7]The ITA allows for contributions to be remitted to the pension fund of an RPP on a pre-tax basis, and exempts funds' investment income from taxation.[8] The design rules prescribed by the ITA include the maximum benefits an RPP may provide and certain other rules to which the RPP must adhere in order to retain its tax-advantaged treatment.[9] One such rule is that the RPP's primary purpose must be to provide a pension.[10] Registration is also required under provincial or federal pension standards legislation. Pension standards legislation establishes the minimum standards to which pension plans must comply.

2.2.3 Canadian RPPs fall into one of two broad categories, based on how they are structured: defined benefit ("**DB**") or defined contribution ("**DC**") pension plans.[11]Historically, the majority of RPPs were DB plans, and the majority of Canadian assets under management with respect to pension funds are still held under such plans. However, the past two decades have seen a steady increase in DC plans.[12]

2.2.4 The term "pension fund" is used in this annex to include pension funds, the investments of which are directed by an administrator. Unless specifically stated otherwise, pension funds for which each member may direct the investment of his or her account, including most defined contribution pension plans and other capital accumulation plans, are not included.

2.2.5 The key stakeholders are:

- **Asset Owners**: Canadian pension funds are commonly established as trusts for which either a board or corporate trustee is the trustee and legal owner of the assets, though certain large statutory plans are established as corporations.[13]
- **Beneficiaries:** The beneficiaries of an RPP are the current and former employees and retirees (and their spouses) who are entitled to receive a benefit from the plan.
- **Investment decision maker**: Decision-making authority regarding the investment of plan assets is allocated by statute to the administrator of the plan. The person or body who administers an RPP is generally identified in the plan text and must be one of an enumerated list of persons or bodies identified in the relevant minimum standards legislation.[14] In Quebec and Manitoba, the administrator of an RPP is generally a pension committee.[15] The administrator may delegate investment decisions to an Investment Manager, however, the administrator retains ultimate responsibility for the investment of plan assets and must monitor and evaluate the Investment Manager and investment performance. In many instances, the Asset Owner and investment decision maker are the same entity.

Overview of investment duties and powers

2.2.6 Pension legislation in Canada imposes on plan administrators a "prudent person" standard for the investment of plan assets, which requires an administrator to apply the level of prudence in dealing with pension assets as one would apply in dealing with the property of another.[16] The standard is similar, but not identical, to the standard imposed at common law on trustees to apply the level of prudence in dealing with trust property as one would apply in dealing with his or her own property – commonly referred to as the "ordinary prudence standard".[17] Pension benefits legislation also recognizes that certain tasks related to the administration of the plan and fund may be delegated to an Investment Manager. Under some provincial legislation, delegates become subject to the statutory standard of prudence.[18]

CANADA

2.2.7 While there are a number of cases in which administrators have been sued for failing to adhere to the "prudent person" standard, or in Quebec the "reasonable person in similar situations" standard, there is little discussion of the precise content of either standard[19], and no discussion regarding the difference, if any, between the standard articulated under pension legislation and that of "ordinary prudence".[20] However, it is generally accepted that the standard applicable to a trustee would also apply to the administrator of a pension fund.

2.2.8 The Supreme Court of Canada has described the objective standard applicable to a trustee as that of a man of ordinary prudence in managing his own affairs, and this standard has been applied equally to both professionals and non-professionals. The court has noted, however, that while the standard could be relaxed or modified, "a trustee's primary duty is preservation of the trust assets, and the enlargement of recognized powers does not relieve him of the duty of using ordinary skill and prudence, nor from the application of common sense."[21]

2.2.9 In addition, the relationship between plan administrators and plan members is regarded as a fiduciary relationship at common law.[22] The Supreme Court of Canada in *Hodgkinson v. Simms*[23] recognized three indicia of a fiduciary relationship, namely (1) the ability to exercise some power or discretion; (2) the ability to exercise this power or discretion unilaterally so as to affect the legal or practical interests of beneficiaries; and, (3) a vulnerability to the exercise of this power or discretion.[24]

2.2.10 All of the foregoing indicia characterize the relationship between a pension plan administrator and pension plan beneficiary in the management of a pension fund. The fiduciary duty owed to beneficiaries has also been codified through legislation in all minimum standards regimes across Canada.[25]Although Quebec civil law does not recognize "fiduciary relationships"[26] in the same manner as does Canadian common law, Quebec plan administrators have fiduciary-like obligations to act in good faith, with loyalty and in the best interests of the plan members which are often termed "fiduciary obligations".

2.2.11 Under Quebec law, a pension committee that is the administrator of a pension plan acts as the trustee of the pension fund.[27] In Quebec, trustees are also regulated under the *Civil Code of Quebec* (**"CCQ"**). Pension funds which are established as trusts are considered private trusts under the CCQ, whose object is the erection, maintenance, and preservation of corporeal property or the use of property appropriated to a specific use.[28] Trustees act as the administrators of the property of others charged with "full administration."[29] An administrator charged with full administration must preserve the trust property and make it productive, increase the patrimony, or secure its appropriation where the interest of the beneficiary or the pursuit of the purpose of the trust requires it and, in executing its duties, the administrator must act with prudence and diligence, and finally, the administrator must also act honestly and faithfully in the best interests of the beneficiaries or the object pursued.[30]

2.2.12 Some, though not all, pension statutes expressly require that pension assets be invested "in a manner that a reasonable and prudent person would apply in respect of a portfolio of investments of a pension fund."[31] It is generally accepted that pension assets ought to be invested bearing in mind "the overall reasonable level of risk the plan should undertake as a whole and the appropriate level of diversification of the entire pension fund."[32]

2.2.13 Finally, pension funds are also subject to modest but specific investment rules set out in legislation that limit the way pension fund assets may be invested (**"Pension Investment Rules"**).[33] One key Pension Investment Rule is the requirement to establish and adhere to a statement of investment policies and procedures (**"SIPP"**) for the pension plan which discloses "what the plan will invest in, how it will select, or terminate, an investment manager, how it will measure performance, and what risks are acceptable."[34] Regulatory guidance similarly requires that a SIPP sets out the administrator's investment and risk philosophy, and criteria to select, monitor and replace managers.[35]

2.2.14 The SIPP must also disclose certain information, including the administrator's policies and procedures with respect to categories of investments, diversification, asset mix and expected rate of return, and liquidity, among others.[36] As such, investments and Investment Managers are generally selected so as to maximize financial return within the specific asset mix and risk tolerances articulated in the SIPP.

Legal requirements to use investment powers to Invest for Sustainability Impact

2.2.15 No Canadian jurisdiction currently imposes on any trustee/administrator of a pension plan a duty to Invest for Sustainability Impact.[37] Moreover, and as discussed below,

CANADA

while it is well-established that ESG factors should be considered where relevant, there is no support in any jurisdiction for the ability of a plan administrator to Invest for Sustainability Impact (i.e. to prioritize ESG or sustainability factors ahead of the financial best interests of plan members). In addition, it is unclear whether it is appropriate to consider IFSI on an equal plane with economic factors in the absence of express authority to do so unless the financial materiality of the sustainability risks has been clearly established. Therefore, without commenting on the appropriateness of the Canadian regime, the legislative and common law regime is a significant obstacle to the ability of a plan administrator to Invest for Sustainability Impact.

2.2.16 While there are proposals to further facilitate the consideration of ESG factors, as described below, there are currently no proposals to change the law specifically to allow pension Asset Owners to Invest for Sustainability Impact. However, proposed changes to the ability of foundations and non-profit organizations ("**NPOs**") to engage in certain investment practices (both discussed below at 2.2.24) are illustrative of potential changes and may facilitate the movement toward IFSI for NPO Asset Owners.[38]

2.2.17 Finally, disclosure rules, some of which already exist, can be a very effective means of encouraging Relevant Investors to make investments and engage in stewardship to encourage IFSI. Increasing such requirements would likely increase the reputational incentive for Relevant Investors to demonstrate that they are thinking about IFSI.

2.2.18 Certain specific considerations warrant further discussion.

- *Investing the Portfolio to Prevent Damage to Sectors of Interest*. To the extent Sustainability Impact is relevant to the financial viability and appropriateness of the investment, a plan administrator would be required to consider it. As noted above, the breadth and depth of issues that may reasonably be considered relevant has expanded in recent years to include a robust set of ESG-related factors. The duty to consider such factors, where relevant, is consistent with the prudent person standard.
- *Best Interests of Beneficiaries*. There is no statutory authority for trustees or Investment Managers to consider the broader, non-financial "best interests" of beneficiaries, and at least one Canadian pension statute explicitly requires that plan assets be invested in the members' *financial* best interests.[39] Absent a statutory mandate, Canadian law likely limits the consideration of "best interests" to those that relate to the duties of the administrator – i.e. to provide a pension. This is reflected in the overall approach to preparing the SIPP and the disclosures required thereunder.
- *Sustainability Aspirations of Beneficiaries*. In a DB plan, employees are guaranteed a defined amount of pension on the basis of a fixed formula for assessing benefit entitlements.[40] There is no duty incumbent upon the administrator of a DB pension fund to assess the views of Beneficiaries in executing on such promise. Similarly, no such duty exists for the administrators of administrator-directed DC pension funds, which like DB plans, rely on the administrator of the plan to establish the investment policy and to select and monitor investments.[41] There exists, however, a second form of DC plan which is commonly referred to as a member-directed DC plan. This type of plan is discussed further below at 2.2.29.
- *Seeking Wider Societal Objectives*. There is no requirement for pension funds to set objectives for increasing the positive and/or reducing the negative Sustainability Impact of their portfolios, nor would it be consistent with the legal framework as it currently stands to do so in priority to plan administrator's stated financial objectives. However, as noted above, where wider societal objectives are relevant to the administrator's stated financial objectives, they must be considered.

Further, certain regulatory requirements related to the maintenance of the SIPP may cause the administrator to disclose an objective of achieving a Sustainability Impact. Each year, fund administrators must review and either confirm or amend their SIPP with respect to the assets held by the fund. In Ontario, additional regulations obligate RPPs to ensure the plan assets are always invested in accordance with the SIPP. As a result, the SIPP must be amended prior to the implementation of any change in investment policy. Thus, while not an explicit requirement to disclose the impact on the portfolio, this requirement would likely oblige any fund which has an objective of achieving a Sustainability Impact to report the same in its SIPP, and to amend such disclosure in the case it should no longer pursue such goals. This requirement, however, is entirely reliant on the fund administrator setting a non-financial goal, which will inevitably be prioritized below the financial interests of the fund – i.e. to fund the plan.

CANADA

Legal freedom to use investment powers to Invest for Sustainability Impact

2.2.19 There is no express legal impediment preventing trustees from assessing the views of Beneficiaries with respect to Investing for Sustainability Impact.[42]However, they may be prevented from reflecting those views in the objectives of the portfolio if these objectives are incompatible with or purport to take precedence over applicable statutory objectives (usually found in pension and/or tax legislation) or over the objectives/purposes of the fund in question under its constitutive document.

2.2.20 It is well established that Asset Owners may take into account ESG factors in their investment decisions where relevant to fund performance objectives or where the trust instrument explicitly permits the use of non-financial criteria.[43] Moreover, ESG factors are increasingly viewed as relevant to fund performance, and the breadth and depth of ESG factors that are considered relevant by Asset Owners has expanded greatly over the past many years to include such things as weather events, water scarcity, carbon emissions, diversity and inclusion, health and safety, consumer protection, clarity of board mandates, executive compensation, and board independence.[44] In fact, a routine and robust consideration of ESG factors is relatively common among large Canadian institutional Asset Owners.[45]

2.2.21 Notwithstanding the foregoing, and as noted above, we do not think that the law in Canada has evolved to allow pension Asset Owners to IFSI above fund performance objectives for the following reasons:

- First, as noted above, the legislative framework governing pension plan administrators codifies the common law fiduciary duties of trustees. At common law, trustees must invest assets consistent with the financial best interests of beneficiaries. So too must pension plan administrators and, as noted above, some Canadian pension legislation expressly requires that plan assets be invested in the members' *financial* best interests.[46]
- Second, minimum standards legislation directs the administrator to invest plan assets with a view to ensuring promised pension benefits are paid. Subject to the singular exception at 5.2.1, applicable legislation authorizes no other objective.
- Finally, just as trustees are enabled by the trust deed and the powers contained therein, pension plan administrators are enabled by plan documents which must, according to tax rules, set out that the primary purpose of an RPP "is to provide periodic payments to individuals after retirement and until death in respect of service as employees."[47] Investing plan assets with some other purpose is arguably inconsistent with that requirement. We are therefore of the view that a Relevant Investor pension plan administrator cannot exercise its discretion in a manner that does not relate to the purpose of the fund – that being to provide promised pensions to members. This fiduciary obligation to the beneficiaries of the plan extends to trustees and Investment Managers retained to manage fund investments.[48]

2.2.22 Given the foregoing, we think that specific permission within the pension statutes to consider IFSI on an equal plane or in priority to financial considerations would be required for trustees and Investment Managers to engage in IFSI. No such statutory permission exists, though Manitoba's pension and trust legislation does warrant some discussion.

2.2.23 Interestingly, in Manitoba, the *Trustee Act* (Manitoba) contains a unique provision which states: "Subject to any express provision in the instrument creating the trust, a trustee who uses a non-financial criterion to formulate an investment policy or to make an investment decision does not thereby commit a breach of trust if, in relation to the investment policy or investment decision, the trustee exercises the judgment and care that a person of prudence, discretion and intelligence would exercise in administering the property of others."[49] A similar provision authorizing the use of non-financial criteria in formulating an investment policy is found in the *Pension Benefits Act* (Manitoba).[50] To date, no other Canadian jurisdiction has adopted analogous provisions and neither provision has been tested in court. Given the requirement to consider non-financial factors while still adhering to the standard of prudence, it is not clear whether or not IFSI is permitted for plan administrators and trustees; however, a reasonable case could be made for allowing IFSI to be the deciding factor, all else being equal. Of course, authorization for such an approach would have to be supported by the applicable fund documents.

2.2.24 At this point, it is also potentially instructive to briefly consider the abilities of charities and NPOs to IFSI.[51] Under Canadian law, a charitable organization must have purposes which are exclusively charitable, and these can fall within one or more of (1) the relief of poverty, (2) the advancement of education, (3)

CANADA

the advancement of religion, or (4) certain other purposes that benefit the community, which purposes align substantially with the UN Sustainable Development Goals (“**SDGs**”).[52] Similarly, many NPOs are organized and operated for social welfare or civic improvement (although any purpose that is not that of profit is permissible).[53] As such, charities and NPOs can be important driving forces in the movement towards IFSI.

- In theory, charitable property falls under the exclusive jurisdiction of Canadian provinces. However, the federal government maintains significant control over charities through the ITA.[54] The ITA defines three types of registered charities, namely charitable organizations, public foundations, and private foundations.[55] The ITA and related guidance from the Canada Revenue Agency (“**CRA**”) can “often inhibit the ability of charities [to] participate in revenue generating and capital activity” thereby preventing such organizations from fully participating in forms of IFSI.[56]
- Under the current provisions of the ITA, limitations on charitable expenditures prevent charities from investing in NPOs, co-operatives, social purpose or hybrid businesses, or impact investment funds, where returns risk being below market rate. While investments may be made on market terms subject to prudent investment standards, investments yielding below-market returns may only be made in so-called qualified donees or in non-qualified donees[57] to the extent that the latter are subject to the ongoing control and direction of the charity.[58] These restrictions limit the potential for charities to IFSI.
- In 2017, Bill 154 amending the *Charities Accounting Act* was passed in Ontario in an attempt to grant charities the capacity to IFSI. The amendments provide that directors and trustees of charities may IFSI subject to any restriction contained in their governing documents.[59] Such investments are no longer subject to the prudent investor standard. Instead, directors or trustees IFSI are required to abide by the following: first, before making the investment, they must be satisfied that it is in the best interests of the charity. Second, before making the investment, they must seek advice as needed. Finally, after making the investment, they must review it from time to time and seek advice with respect to such reviews as needed.[60]
- Unfortunately, it is unclear how these provincial regulations interact with the ITA rules outlined above. Given the severe consequences for charities that fail to comply with the investment framework permitted by the ITA, including the loss of assets and the potential stripping of their charitable designation, there is little incentive for charities to act on these amendments to IFSI.[61] One means by which charitable foundations may IFSI is through debt financing to NPOs and social-purpose, for-profit organizations. Many foundations achieve this by investing “through a third-party impact fund or capital program” since direct investments are often considered impossible.[62]
- Much like charities, NPOs fall under shared federal/provincial jurisdiction in Canada.[63] NPOs are prohibited from having any profit earning purposes.[64] However, a 2014 report published by the CRA found that “many in the non-profit sector believe that NPOs must produce a profit for their programs to thrive and for their capital assets to be maintained” and further that “there is a common view that, as long as profits are used to further the organization’s purpose, the source of the funding shouldn’t matter.”[65] Despite its findings, the CRA has issued conflicting guidance, stating on the one hand that an NPO may earn profit where it is incidental to and results from activities which support its stated objectives, and on the other hand that if an NPO intends at any time to earn a profit it shall lose its tax exempt status, regardless of whether the profit was used to support its stated objectives or not.[66] These restrictions limit the growth and potential impact that NPOs may have on the IFSI landscape.

2.2.25 As such, unlike the Manitoba *Trustee Act* and *Pension Benefits Act*, investments under the *Charities Accounting Act* (Ontario) are no longer subject to the prudent investor standard. Nevertheless, such entities are restricted in their investment activities by the ITA. Therefore, although Asset Owners such as pension plans may be empowered to consider IFSI, other regulatory frameworks applicable to the Asset Owner, such as the ITA may circumscribe any such powers (including under the Manitoba *Trustee Act* and *Pension Benefits Act*).

2.2.26 In the absence of specific statutory authority to consider IFSI, Canadian scholarship on the subject has explored the permissibility of considering non-financial criteria in making investment decisions for pension funds, particularly in light of the uncertainty stemming from the 1984 UK decision in *Cowan v. Scargill* which has long been cited in support

CANADA

of the proposition that a "trustee must not select speculative or unduly risky investments … [and] trustees are not to invest on the basis of political or social/economic belief."[67]

2.2.27 We acknowledge that there is an increasing recognition that the concept of the fiduciary is not static and that there is a need to "take a longer term and more systemic view of fiduciary obligations."[68] Considerations such as market integrity, systemic risk, governance risk, and so on, which have a bearing on the longer term viability of funds and therefore upon future generations of beneficiaries, are beginning to become more present in public discourse.[69] Indeed, the ability of funds to continue to provide for beneficiaries is intimately tied to the overall health of the market, as funds hold diversified portfolios which tend to track the market as a whole.[70] Further, it has long been accepted that the consideration of non-financial criteria as risk factors – for example, in the context of ESG factors – is permissible.

2.2.28 However, neither Canadian jurisprudence, nor Canadian legislation outside of Manitoba (and the Ontario *Charities Accounting Act*), has explicitly considered whether a "values-based" approach to investing is equally permissible.[71] Commentators have called into question the authority of *Cowan v. Scargill*, citing a series of cases stemming from both the United States and the United Kingdom which seemingly contradict its conclusions.[72] What may be suggested by these developments is that fiduciary trustees have a duty not necessarily to maximize returns in the short term, but rather to "set investment policy with a reasonable expectation that the portfolio will achieve a reasonable rate of return over the long term that satisfies the individual pension plan's funding requirements while minimizing risk through a portfolio-based investment approach."[73] Yet, given the lack of a clear legislated standard and the lack of direction from Canadian courts, it is likely that pension funds will maintain a more conservative approach to investing which may not extend beyond existing ESG practices.

2.2.29 Finally, it has been suggested that it is possible for certain pension plans (i.e., member-directed plans) to IFSI.[74] Under a member-directed DC plan, the amount of contribution for each of the employer and the employee is specified; however, it is the members who ultimately decide how to invest their own contributions, as well as those of their employer. In the context of such plans, the administrator may opt to provide a selection of funds that are IFSI which members may then choose to invest in. The Canadian Authority of Pension Supervisory Authorities ("**CAPSA**") publishes guidelines with respect to fund administration and it has issued guidance specifically with respect to the selection of investments for members of DC plans. Per the guidelines, administrators must consider "all relevant factors" in selecting investments, including a consideration of the nature of the investment and its risk return profile.[75] Relevance, however, is still related to the primary purpose of the pension plan (i.e. to provide pensions). As such, we think it is in keeping with the administrator's duties to select and offer funds that allow members to build a reasonably diverse portfolio appropriate for retirement savings and to consider the same relevant factors as would a DB plan administrator.

2.3 Mutual funds

Types of mutual fund covered

2.3.1 In this section, we consider mutual funds that are offered to retail investors under a "simplified prospectus", as detailed below, and that are "reporting issuers" in a jurisdiction in Canada to be the most common form of regulated mutual funds in Canada. We exclude other types of investment funds, such as alternative mutual funds[76] and exchange-traded mutual funds (i.e. ETFs),[77] as well as other retail investment funds and quasi-retail funds, such as non-redeemable investment funds (i.e. closed-end funds), flow-through funds, labour sponsored investment funds, scholarship plans, and private mutual/investment funds.

2.3.2 Mutual funds are pooled investment vehicles that issue securities on a continuous basis and are generally redeemable daily by reference to their net asset value ("**NAV**").[78] Mutual funds in Canada are typically structured as trusts and corporations. A mutual fund will often have a specific focus on a type of underlying investment (i.e. equities, bonds), geography (i.e. emerging markets, Europe), some other investment theses (i.e. small cap companies, dividend growth, socially responsible investment, etc.) or some combination of the foregoing (i.e. U.S. small cap companies, Canadian dividend growth, etc.).[79] While mutual funds can be either actively or passively managed, they are generally actively managed in Canada. Some of the more prevalent categories of mutual funds in Canada include equities, bonds, small/large cap business and money market funds.

CANADA

2.3.3 Mutual funds in Canada are regulated at the provincial level by the securities regulatory authority of each province and territory.[80] However, securities regulation is largely harmonized across jurisdictions through rules known as national instruments ("**NIs**") or regulations in Quebec.[81] Mutual funds in Canada are subject to several NIs.[82] In order to sell securities to the public, NI 81-101 (*Mutual Fund Prospectus Disclosure*), requires the investment fund manager ("**IFM**") of a mutual fund to file a simplified prospectus, an annual information form, and "fund facts" for every class or series of the mutual fund (the "**Regulatory Disclosures**"). The IFM must periodically, and not less frequently than annually, review and re-file Regulatory Disclosures and revise them as needed to reflect material changes that are relevant to the disclosures.[83]

2.3.4 Every mutual fund must have an IFM who is registered under applicable Canadian securities laws in the relevant category. The IFM is responsible for the day-to-day management of the mutual fund; however, a mutual fund's investment decisions must be made by a firm that is registered under applicable Canadian securities laws in the category of portfolio manager ("**PM**"). The IFM may also be the mutual fund's PM, but the PM function is sometimes outsourced to an affiliated or third-party firm. Finally, mutual funds may only be distributed to investors that are registered in an applicable category of dealer ("**Registered Dealers**"). Most of Canada's provincial and territorial securities regulators delegate significant aspects of the licensing process of Registered Dealers to self-regulatory organizations, mainly the Mutual Funds Dealers Association ("**MFDA**"), which oversees registered "mutual fund dealers" and the Investment Industry Regulatory Organization ("**IIROC**"), which overseas registered "investment dealers".[84]

2.3.5 The key stakeholders are:

- **Asset Owner:** The mutual fund (in the form of its trustee or body corporate) is the owner of the underlying assets; however, the mutual fund assets must be held separately by a qualified third-party custodian. The custodian must meet certain requirements that are set out under applicable Canadian securities law and is usually a subsidiary of a chartered bank or a trust company.[85] The IFM cannot act as custodian.
- **Beneficiaries:** The beneficiaries of a mutual fund are the beneficial securityholders (also called unitholders) under the fund.
- **Investment decision-maker:** The PM is the investment decision-maker. The IFM, if registered as a PM, may act as a mutual fund's PM or delegate the investment management functions to another PM (whether a third-party or an affiliate). A PM may further delegate all or a portion of the investment decisions in respect of a mutual fund's portfolio to a sub-advisor (such sub-advisor must itself be registered as a PM or exempt from the registration requirements).

Overview of investment duties and powers

2.3.6 An IFM is generally subject to a fiduciary duty at common law and is required to act in the best interests of the mutual fund.[86] As a fiduciary, an IFM must prudently manage the portfolio, including informing themselves and considering all risk management and portfolio techniques.[87] This fiduciary duty, however, does not extend to mutual fund beneficiaries (securityholders); it is the mutual fund itself that owes duties to beneficiaries. The IFMs' investment duties and powers are also shaped by the mutual fund's constating documents drafted when the mutual fund is set up.

2.3.7 Where the IFM has appointed a separate PM, the PM is typically subject to a similar standard to act in the best interest of the mutual fund under the terms of the investment management contract. A PM is also subject to requirements under applicable Canadian securities laws with respect to its dealings with clients (including mutual funds for which it manages investments). We note that although Registered Dealers are not subject to a fiduciary duty with respect to their clients, they still have a duty to act fairly, honestly, and in good faith with clients.[88]

2.3.8 Registered Dealers are subject to "Know Your Client" ("**KYC**") and "Know Your Product" ("**KYP**"), as well as suitability requirements that serve to "ensure that purchases of securities are not incompatible with the client's circumstances, risk tolerance and investment goals."[89] Under these requirements, dealers must engage in a process of due diligence on the proposed investment based on a series of factors including clients' investment needs and objectives, their financial circumstances and their risk profile.[90]

2.3.9 Under NI 81-102 (*Investment Funds*), mutual funds are subject to standard investment restrictions designed to ensure that the mutual funds are diversified, minimize certain risky practices and maintain

> ANNEXES

> Canada

CANADA

sufficient liquidity to meet redemption needs.[91] The principal restrictions include:

- Concentration Restriction: no more than 10% of the NAV of the mutual fund can be in the securities of any one issuer, subject to certain exceptions;
- Control Restriction: no more than 10% of the securities of any single class of an issuer can be held by the mutual fund;
- Asset Prohibitions: no investment in real property, mortgages (other than guaranteed mortgages), commodities (exemptions for certain precious metals), or loan syndications;
- Commodity Restrictions: no more than 10% of the NAV of the mutual fund can be made up of gold, silver, palladium, platinum or other precious metals (exceptions exist for "precious metal funds");
- Illiquid Asset Restrictions: an asset cannot be purchased if it causes "illiquid assets" (as defined in NI 81-102) owned by the mutual fund to exceed 10% of the NAV of the mutual fund; and
- Other restrictions on the composition of underlying fund holdings, use of derivatives and borrowing capabilities.[92]

2.3.10 These restrictions are intended to further the proposition that mutual funds should preserve an investor's right to redeem on demand, while at the same time allowing mutual funds to be offered with more narrow investment objectives than are typically offered by other investment products.[93]

Legal requirements to use investment powers to Invest for Sustainability Impact

2.3.11 We do not consider that IFMs are generally subject to any duty to Invest for Sustainability Impact, although where sustainability risks are financially material, the consideration of IFSI approaches may be appropriate. We further note that to the extent the IFM's fund instrument requires non-financial factors to be considered in making investments, adopting a passive or quantitative strategy may be incompatible with the duty to account for such factors.

2.3.12 IFMs, as discussed above, have a fiduciary duty to act in the best interests of the fund. As their duty is not to securityholders/ Beneficiaries, it follows that there is no legal requirement for IFMs to assess the views of mutual fund Beneficiaries on the extent to which they want their assets managed to achieve an impact. Similarly, the duties and powers of Relevant Investors under Canadian law do not impose any requirement to structure a portfolio by reference to IFSI rather than or in addition to achieving a return on investment.

2.3.13 However, many mutual funds are marketed with reference to specific investment objectives, including IFSI (as discussed below). In such cases the IFM would be expected, and in a general sense, legally required, to invest fund assets in a way that conforms with the representations made to unitholders.

2.3.14 Further, while Registered Dealers are under no general obligation to inquire into clients' views on IFSI, where the fund they are marketing states IFSI as its investment objective (discussed at 2.3.18), it follows that dealers will have to inquire into such views in order to satisfy the KYC requirements and determine whether the investment is suitable for the client. To this extent, interested clients should be able to access appropriate impact vehicles through their Registered Dealers.[94] Indeed, a growing number of bond funds, mutual funds, and ETFs are facilitating – to an extent – the channelling of private capital toward IFSI.[95]

Legal freedom to use investment powers to Invest for Sustainability Impact

2.3.15 Mutual funds may be set up to Invest for Sustainability Impact. While NI 81-102 imposes certain fundamental standard investment restrictions, as discussed above, these investment restrictions in no way prohibit a mutual fund from adopting an investment objective or investment strategy that is geared towards IFSI. For example, Morningstar reported the launch of over 60 such funds in Canada in the past five years, including 11 as of the first quarter of 2020, available to both retail and institutional investors through financial institutions, asset management firms and credit unions.[96] We would expect that any mutual fund IFSI would adopt a "Fundamental Investment Objective" (see below) and tailor its investment strategies in each case as disclosed in the Regulatory Disclosures, such that the mutual fund commits to IFSI. In these circumstances, the approval of the majority of unitholders would be required to alter the specific investment objective of a fund.[97]

2.3.16 Also, while there is no explicit requirement for mutual funds to set objectives for increasing the positive and/or reducing the negative impact of their portfolios, Form 81-101F1 (*Contents of Simplified Prospectus*) imposes specific disclosure requirements in respect of a mutual fund prospectus (which is required to issue and sell units). The mutual fund prospectus, as well as

› ANNEXES

› Canada

CANADA

other Regulatory Disclosures, must be revised to reflect any material changes and must also be updated (renewed) annually for the mutual fund to remain in continuous distribution.[98] Among these disclosure requirements, the fund must disclose its "**Fundamental Investment Objectives**" meaning that it must disclose "the fundamental investment objectives of the mutual fund, including information that describes the fundamental nature of the mutual fund, or the fundamental features of the mutual fund, that distinguish it from other mutual funds." A mutual fund that seeks to Invest for Sustainability Impact (and to market itself to potential investors as doing so) would be required to state such objective as one of its "Fundamental Investment Objectives". As mentioned above, a mutual fund may not change its "Fundamental Investment Objectives" without the prior approval of securityholders.

2.3.17 A mutual fund must also disclose the investment strategies that will be used to achieve the disclosed investment objectives in Regulatory Disclosures. This includes disclosure about "the process by which the mutual fund's portfolio advisor selects securities for the fund's portfolio, including any investment approach, philosophy, practices or techniques used by the portfolio adviser or any particular style of portfolio management that the portfolio advisor intends to follow." Again, while such disclosure does not amount to an explicit requirement to disclose the impact achieved by the mutual fund, it does constitute a requirement for these mutual funds to disclose their investment policies and goals, including IFSI-related goals, if any.

2.3.18 IFMs and PMs that are managing mutual funds marketed as IFSI must consider Sustainability Impact when making all investment decisions, consistent with the Regulatory Disclosures provided to investors. IFMs/PMs that are managing mutual funds that are *not* marketed as IFSI may consider Sustainability Impact where it is financially beneficial or where it is permitted by the constating documents, and may select such investments over traditional investments all other factors being equal. However, to the extent IFMs/PMs of such "non-IFSI funds" were to prioritize Sustainability Impact to the detriment of the financial returns achievable by the mutual fund, such IFMs/PMs could be subject to causes of action from investors and/or enforcement from regulators. Nevertheless, where IFSI investments align with the duties of Relevant Investors, these will be permissible, as long as IFSI objectives are not taking precedence over financial returns.

2.3.19 Ultimately, under certain circumstances IFMs/PMs may Invest for Sustainability Impact where these investments are in conformity with their general obligations toward investors. In the case of certain mutual funds, IFMs/PMs must Invest for Sustainability Impact in conformity with representations made in the mutual fund's Regulatory Disclosures, where this disclosure reflects IFSI as a fundamental investment objective of the mutual fund.

2.4 Insurance undertakings

Types of insurance undertaking covered

2.4.1 Life and health insurance/reinsurance companies/societies and general insurance/reinsurance (in Canada, called property and casualty insurance/reinsurance) companies/societies carrying on business in Canada. These companies/societies may be incorporated/formed under federal Canadian law or provincial Canadian law, or instead outside Canada and carrying on business in Canada on a licensed branch basis.

- **Asset Owner:** Insurer.
- **Beneficiaries:** Policyholder entitled to benefit from the policy and shareholders.
- **Investment decision maker:** Insurer or delegated investment manager.

Overview of investment duties and powers

2.4.2 Insurance companies are prudentially regulated by the Office of the Superintendent of Financial Institutions ("**OSFI**") if incorporated federally or carrying on business in Canada as a branch of a foreign company, or by a provincial Superintendent of Insurance if incorporated provincially.[99] The prudential regulators are responsible for the regulation of the "solvency and financial soundness" of insurance companies incorporated in their jurisdiction (or in the case of OSFI, foreign companies carrying on business in Canada on a branch basis).[100]

2.4.3 Insurance companies are subject to a statutory prudent person standard in relation to the investment of their assets, as well as numerous specific regulatory requirements and guidelines. Notably, however, insurance companies are not fiduciaries for their policyholders in respect of the investment of company assets.

2.4.4 Federally incorporated insurers and foreign branches are subject to certain constraints on investment under the *Insurance Companies Act*[101] (Canada) ("**ICA**") and OSFI Guidelines.

CANADA

Generally, their lending policies and procedures must be such as "a reasonable and prudent person would apply in respect of a portfolio of investments and loans to avoid undue risk of loss and obtain a reasonable return."[102] The provincial regulators impose similar restrictions on provincially incorporated insurers. These restrictions, however, do not impose or give rise to a fiduciary duty of the insurance company toward the insured as relates to the management of their investments.

2.4.5 We also note that insurers have general duties to treat customers fairly and to avoid unfair or deceptive acts or practices in their dealings with the policyholder. Further, unless the terms of the policy documentation are specifically related to IFSI, there are generally no relevant insurance fund obligations or duties that arise because of the terms of the policy documentation that the insurer has entered into with its policyholders.[103]

General insurance: Legal requirements to use investment powers to Invest for Sustainability Impact

2.4.6 There are generally no situations in which it could be suggested that general insurers have a duty to exercise investment powers for IFSI in priority to financial return.

2.4.7 More specifically, there are no legal requirements for insurance companies to assess the views of policyholders on the extent to which they want the company's assets managed to achieve a Sustainability Impact or to set objectives for increasing the positive and/or reducing the negative Sustainability Impact of their portfolios. While insurers must make investments in accordance with a statutory standard of prudence, this does not amount to a fiduciary duty toward policyholders and as such does not impose a duty to take into account the Sustainability Impact of such activities.

2.4.8 *Wider Societal Objectives & Community Development*. We do note, however, that under the ICA, Canadian federal insurers with equity of $1 billion or more must annually publish a Public Accountability Statement ("**PAS**").[104] This statement describes the company's contribution to the Canadian economy and society. The statement must provide detail with respect to, among other things, the goals of the company and its affiliates in the area of "community development" (defined to mean the social, cultural, economic or environmental enrichment of a community), and participation in activities for the purpose of community development, including the making of financial contributions for that purpose.[105] As such, any Sustainability Impacts of the portfolio would presumably be disclosed, but this disclosure requirement in no way requires Investing for Sustainability Impact.

General insurance: Legal freedom to use investment powers to Invest for Sustainability Impact

2.4.9 Even though the applicable legal rules and policy documentation do not result in obligations to Invest for Sustainability Impact, there are circumstances in which they are flexible enough to allow an insurance undertaking to use its investment powers to pursue IFSI.

2.4.10 We note at the outset, however, that while not precluded by law or regulation, it is unlikely that an insurance company would be set up to Invest for Sustainability Impact.[106] As commercial entities in a highly competitive industry answerable to shareholders and regulators, insurance companies are unlikely to prioritize IFSI over financial return.

(a) Insurers are subject to a legislated prudent person standard. The ICA, which regulates federally incorporated insurers and licensed foreign insurers, provides that funds shall be invested in accordance with "investment and lending policies, standards and procedures that a reasonable and prudent person would apply in respect of a portfolio of investments and loans to avoid undue risk of loss and obtain a reasonable return."[107] Similar requirements exist at the provincial level across Canada.[108] This language suggests that insurers are not at liberty to make investments which prioritize Sustainability Impact over and above financial returns, though as above, where an investment can achieve Sustainability Impact and also promise a return on investment consistent with the obligation to invest in view of obtaining a reasonable return, there is nothing to prevent an insurer from making this investment.

(b) Further, directors in Canada do not owe a fiduciary duty to their shareholders, but rather owe such a duty to the corporation itself.[109] Therefore, directors must act honestly and in good faith, with a view to the best interests of the corporation, which, given the competitive nature of the industry, are unlikely to align with an investment strategy which prioritizes IFSI over return on its investment.

2.4.11 The Supreme Court of Canada, on the other hand, has suggested some openness to broadening the fiduciary duty, as it stated in its decision in *BCE Inc. v 1976 Debentureholders* ("**BCE**") that directors are

> ANNEXES

> Canada

CANADA

under a duty to "act in the best interests of the corporation *viewed as a good corporate citizen*" (emphasis added) and it has been argued that such an understanding "furthers the broader social purpose of fiduciary duties by requiring fiduciaries not to undertake unethical actions that would shake public confidence and trust in fiduciaries and the services they provide."[110] Whether this in turn would permit directors to engage in IFSI remains an open question. We note that even if it did, *BCE* would not alone pave the way for insurers to engage in IFSI given the legislative standard of prudence imposed on insurers.

2.4.12 It is also worth noting that in 2019, the federal government passed Bill C-97 which introduced amendments to the CBCA codifying the decision of the Supreme Court of Canada in *BCE*. Per Section 122(1.1), when acting with a view to the best interests of the corporation, directors (and officers) must consider the following non-exhaustive list of factors, which include (1) the interests of shareholders, employees, retirees and pensioners, creditors, consumers and governments; (2) the environment; and (3) the long-term interests of the corporation. Comparable amendments have not been proposed to the statute under which Canadian federal insurance companies are incorporated/regulated.

Life insurance: Legal requirements to use investment powers to Invest for Sustainability Impact

2.4.13 There are generally no situations in which it could be suggested that life insurers have a duty to exercise investment powers for IFSI in priority to financial return. The same commentary/analysis applies as in respect of general insurers (as described above), although investment portfolios of life insurers would typically be oriented more to long-term investment/performance, given the much longer-term nature of life insurance companies' products/obligations.

Life insurance: Legal freedom to use investment powers to Invest for Sustainability Impact

2.4.14 The same commentary/analysis applies as in respect of general insurers (as described above).

CANADA

3. ASSET OWNERS' USE OF THEIR POSITION TO ENGAGE IN STEWARDSHIP ACTIVITIES TO SECURE SUSTAINABILITY IMPACT

3.1 The following section considers the extent to which, and on what basis, each type of Asset Owner is (a) legally required or (b) legally permitted or able to use its position to influence enterprises in which it invests by engaging in stewardship activities designed to achieve positive sustainability outcomes and minimise negative sustainability outcomes.

Overarching Considerations

3.1.1 For pension funds, insurance companies and most mutual funds, it is unlikely that either the prudent person standard, or, where applicable, the fiduciary standard, would require a Relevant Investor to engage in non-financial stewardship activities. Nor are there regulatory obligations that would require such stewardship. Reputational considerations with respect to being perceived as a good economic actor may encourage Relevant Investors to engage in stewardship activities notwithstanding that there is no clear legal duty to do so.[111]

3.1.2 The various disclosure obligations discussed in Section 2 would not give rise to a duty to engage in stewardship, except in the indirect sense that there would be an obligation to make reasonable efforts to obtain accurate information so as to discharge the disclosure obligation. Similarly, there would be no duty to divest, or liability for a failure to divest. Liability is discussed further in Section 7.

3.1.3 Also, strategies can be adopted under existing Canadian law to engage with businesses to promote responsible practices. For example, investors may, under the rules of the CBCA or any of the provincial *Business Corporations Acts*, file shareholder resolutions or vote proxies guided by environmental and social concerns.[112]

3.1.4 A survey of over 100 asset managers/owners in Canada found that among respondents, 55% of organizations had, in 2018, adopted a formal policy on shareholder engagement.[113] Further, 71% of respondents reported publishing formal proxy guidelines with respect to responsible investment practices, and 60% opted to publicly disclose their proxy voting results.[114] These results suggest a robust practice of shareholder engagement among investors and that investees are responsive to this changing landscape.

3.1.5 Finally, while we are not aware of any Sustainability Impact disclosure standards being set within Canada, Asset Owners in Canada are nonetheless sensitive to the increase in regulatory disclosure requirements and the need to increase disclosure related to sustainability and it is likely that several will consider international guidance such as the Global Reporting Initiative ("**GRI**") Sustainability Reporting Guidelines, the International Integrated Reporting Council Integrated Reporting Framework ("**Integrated Reporting Framework**"), and/or the Sustainability Standards Board Standards.[115] In Canada, 119 organizations registered their sustainability reports with the GRI in 2017, a substantial increase from only 47 in 2008. In contrast, very few were found to use the Integrated Reporting Framework.[116]

3.2 Pension funds

Legal requirements to engage for Sustainability Impact

3.2.1 As mentioned, it is unlikely that either the prudent person standard, or the fiduciary standard, would require a Relevant Investor to engage in non-financial stewardship activities unless the rationale for doing so relates to the long-term financial viability of the investment. Nor are there regulatory obligations that would require such stewardship, unless prudence would suggest that doing so would enable or improve the long-term financial viability of the investment.

Legal freedom to engage for Sustainability Impact

3.2.2 Relevant Investors are permitted to encourage investee companies to adopt practices that enhance long-term financial performance and would generally be accorded flexibility to encourage positive Sustainability Impact. There is empirical evidence that companies with good track records on ESG issues tend over the long term to outperform companies in the same industry with poor performance on ESG issues.[117]

3.2.3 The Canada Pension Plan Investment Board (a public sector pension fund, the "**CPPIB**") *Policy on Sustainable Investing* includes the following among its guiding principles: "Responsible corporate behaviour with respect to ESG factors can generally have a positive influence on long term financial performance" and "Employees, customers, suppliers, governments and the community at large have a vested interest in positive corporate conduct and long-term business

CANADA

performance".[118] Similarly, the CPPIB *Proxy Voting Principles and Guidelines* state that proxy voting is a key element in its approach to sustainable investing, and "[as] an owner, we monitor ESG factors and actively engage with companies to promote improved management of ESG, ultimately leading to enhanced long-term outcomes in the companies and assets in which we have a stake."[119] Increasingly, industry associations, such as the Canadian Coalition for Good Governance, are encouraging members to recognize that Sustainability Impacts can be material to a company's long-term value.

3.2.4 The Colleges of Applied Arts and Technology ("**CAAT**") Pension Plan's Responsible Investing Policy provides that the CAAT Plan will vote the proxies attached to its shareholdings thoughtfully and responsibly, and that shareholder proposals dealing with ESG factors will be examined considering the effects of the proposals on shareholder value. According to the CAAT Pension Plan, votes are generally cast in favour of proposals that corporations adopt policies that embrace the International Labour Organization's Conventions, the Ceres Principles on the Environment, and the Organisation for Economic Co-operation and Development Guidelines for Multinational Enterprises.[120]

3.2.5 Conversely, Pension Investment Rules in the regulations under the PBSA limit a pension fund to owning no more than 30% of a company's director voting shares (the "**30% rule**").[121] The same or similar rules apply provincially. It is speculated that the 30% rule was originally intended to ensure that pension funds remained passive investors but is now generally considered incompatible with modern commerce. Nevertheless, the rule remains in place. The 30% rule could theoretically make it difficult for a pension fund to exercise the same degree of influence over an investee company as would be the case if the pension fund were not so constrained.

3.2.6 There are several examples of cooperation among Asset Owners with respect to non-financial stewardship activities through industry groups and the setting of good practice standards. For instance, Investor Leadership Network ("**ILN**") has recently published in Canada a report in collaboration with major institutional investors such as the Alberta Investment Management Corp., the Caisse de dépôt et placements du Québec ("**CDPQ**"), the CPPIB, the Ontario Municipal Employees' Retirement System, the Ontario Teachers' Pension Plan ("**OTPP**"), and the Ontario Public Service Employees Union Pension Trust. The report outlines their experiences and recommendations with respect to the implementation of the goals set forth by the Task Force on Climate-Related Disclosures ("**TCFD**") (which was established by the Financial Stability Board in 2015).

3.2.7 The Responsible Investment Association ("**RIA**") is an industry association devoted to the integration of ESG factors into investment decision-making and the selection and management of investments that provide superior risk-adjusted returns and positive societal impact. RIA is composed of Asset Owners, Investment Managers and Investment Consultants, including pension funds, insurance companies, mutual funds, and individuals. RIA provides educational and networking opportunities, facilitates industry collaboration and also conducts important research and advocacy work in the furtherance of this mandate.

3.2.8 Overall, while the foregoing does not likely represent the majority of Relevant Investors in Canada, it demonstrates that some of its largest investors are taking an active interest in IFSI.

3.3 Mutual funds

Legal requirements to engage for Sustainability Impact

3.3.1 For most mutual funds, it is unlikely that the prudent person standard would require an IFM/PM to engage in non-financial stewardship activities. Nor are there regulatory obligations that would require such stewardship.

3.3.2 In the case of IFSI-oriented mutual funds, though, it is more likely that an IFM/PM of such a fund would, as part of its obligation to act prudently and diligently, have an obligation to monitor its IFSI investments on an ongoing basis to ensure that such investments remain consistent with the purpose of the mutual fund.

Legal freedom to engage for Sustainability Impact

3.3.3 As mentioned, Relevant Investors are permitted to encourage investee companies to adopt practices that enhance long-term financial performance and would generally be accorded flexibility to encourage positive Sustainability Impacts.

3.3.4 IFMs/PMs would also generally have the flexibility to engage in stewardship activities with a view to enhancing the financial performance of investee companies. There is also no legal impediment preventing IFMs from assessing the views of Beneficiaries with respect to IFSI. Depending on the circumstances, stewardship activities may ultimately yield better financial results than simply selling an investment.

CANADA

3.3.5 We note that stewardship activity by a mutual fund is limited by the restriction against exercising or seeking to exercise control of an issuer or generally being actively involved in the management of any issuer in which it invests.[122] Nevertheless, a mutual fund can still actively engage with an issuer in which it invests through proxy voting, including voting against boards that are not operating with a view to Sustainability Impact.[123]

3.4 **Insurance undertakings**

Legal requirements to engage for Sustainability Impact

3.4.1 As mentioned, for insurance companies, it is unlikely that either the prudent person standard, or the fiduciary duty owed to the corporation, would require a Relevant Investor to engage in non-financial stewardship activities. Nor are there regulatory obligations that would require such stewardship. However, circumstances could exist in which sustainability risks are determined to be financially material, in which case consideration of IFSI approaches would be appropriate.

Legal freedom to engage for Sustainability Impact

3.4.2 Insurance companies and their Investment Managers would generally have the flexibility to engage in stewardship activities with a view to enhancing the financial performance of investee companies. Depending on the circumstances, stewardship activities may ultimately yield better financial results than simply selling an investment.

3.4.3 For example, OSFI recently joined the Sustainable Insurance Forum (“**SIF**”) which is a network of insurance supervisors and regulators whose goal is to “strengthen their understanding of and responses to sustainability issues for the business of insurance.” The SIF conducts research on emerging risks and engages in significant knowledge sharing on supervisory practice and policy engagement. Additionally, like the ILN, the SIF, in 2017, issued a joint statement welcoming the recommendations of the TCFD. OSFI is also collaborating with the Bank of Canada on a pilot program to assess financial institutions’ potential risk exposures related to a transition to a lower greenhouse gas economy, and OSFI also contributes to the efforts of the Network of Central Banks and Supervisors for Greening the Financial System (NGFS) to identify and assess data gaps as they relate to financial institution supervision. In January 2021, OSFI released a Discussion Paper on climate risks, for industry review/consultation, particularly by the general insurance (property and casualty insurance) industry. The Paper noted that “Some FRFIs [federally-regulated financial institutions] and FRPPs [federally-regulated pension plans] may already consider climate change within the broader context of environmental sustainability, as an element of environmental, social and governance (ESG) factors. ESG factors are widely discussed, particularly in the investment community, because they can pose financial and reputational risks to investees and their asset holders.”[124]

CANADA

4. ASSET OWNERS' ENGAGEMENT IN PUBLIC POLICY WORK TO SECURE SUSTAINABILITY IMPACT

4.1 The following section considers the extent to which, and on what basis, each type of Asset Owner is (a) legally required or (b) legally permitted or able to use its position to engage in public policy work designed to achieve positive sustainability outcomes and minimise negative sustainability outcomes, for example, where these are relevant to the value of portfolio assets.

Overarching Considerations

4.1.1 There is no requirement for any Asset Owner to engage in public policy work to secure Sustainability Impact.

4.1.2 Relevant Investors may engage in policy discussions and lobbying to the extent these activities are consistent with the best interests of beneficiaries and do not contravene existing duties. Lobbying efforts must also be in compliance with applicable lobbyist registration laws.

4.1.3 Lobbyist registration laws at the federal, provincial and municipal levels generally require registration before contact with public office holders for the purpose of lobbying, subject to limited exceptions.[125] While some flexibility is accorded to "in-house lobbyists" – i.e., officers or employees of an organization who lobby on behalf of their organization – the rules vary widely and can make it difficult to engage in policy discussions.

4.2 Pension funds

Legal requirements to engage for Sustainability Impact

4.2.1 As mentioned, it is unlikely that either the prudent person standard, or the fiduciary standard, would require a Relevant Investor to engage in public policy work to secure Sustainability Impact. Nor are there regulatory obligations that would require such public policy work.

Legal freedom to engage for Sustainability Impact

4.2.2 Subject to the considerations in 4.1.1 and 4.1.2, Relevant Investors are permitted to engage in public policy work. For instance, the CAAT Pension Plan and OTPP, two large Canadian institutional investors are members of the Canadian Coalition for Good Governance ("**CCGG**").[126] The CCGG engages with the boards of Canadian public companies and with Canadian regulators on governance matters that are of interest to its members (among other initiatives, including a voluntary stewardship code).[127] It is of note that OTPP is a member of the Public Policy Committee of the CCGG.[128]

4.2.3 In addition, where legislation or policy creates efficiency in the operations of a pension fund and necessitates a change to minimum standards legislation or regulatory policy, pension fund administrators frequently devote time and resources to pursuing change. We view this activity as in keeping with the administrator's fiduciary duty as it is ultimately in the best financial interest of members for inefficiencies to be eliminated.

4.3 Mutual funds

Legal requirements to engage for Sustainability Impact

4.3.1 For the reasons set out in Section 2, we do not consider that there is any requirement for a mutual fund to use its position to engage in public policy work.

Legal freedom to engage for Sustainability Impact

4.3.2 As mentioned in Section 3.2, there is nothing to prevent mutual funds or IFMs/PMs from lobbying or engaging in policy discussions, so long as these activities do not conflict with existing duties, including any duty to prioritize financial returns.

4.4 Insurance undertakings

Legal requirements to engage for Sustainability Impact

4.4.1 We do not consider that there is any requirement for a general or life insurer to use its position to engage in public policy work.

Legal freedom to engage for Sustainability Impact

4.4.2 As mentioned, however, there is nothing to prevent insurance funds from lobbying or engaging in policy discussions, so long as they do not conflict with existing statutory or regulatory duties of the insurer. Collaborative public policy efforts with insurance funds would also be an option, subject to compliance with applicable competition law requirements.

> ANNEXES

> Canada

CANADA

5. ESTABLISHING NEW FUNDS TO INVEST FOR SUSTAINABILITY IMPACT AND AMENDING THE TERMS OF EXISTING ONES

5.1 The following section considers the extent to which it is possible for an Asset Owner to set up a fund, policy or other product with the express objective of Investing for Sustainability Impact.

5.2 **Pension funds**

Establishing a New Policy

5.2.1 It is possible for statutory pension funds to be established with a requirement to consider or prioritize IFSI. We note, for example, that the CDPQ has a mandate to achieve an optimal return, "while at the same time contributing to Québec's economic development."[129] Community investment is intended to improve the economic and social development of local communities through job creation, developing local enterprise and expertise and providing valuable service to low income or disadvantaged groups.[130] Although CDPQ's mandate does not appear to prioritize IFSI above achieving optimal return, in practice, its investment activities include providing financing as well as business advice to Québec companies at all stages of their development.[131] More recently, CDPQ announced that it is creating a $4 billion envelope to support Québec companies temporarily impacted by COVID-19, the funds of which will be used to address the specific liquidity needs of companies, whether or not in CDPQ's portfolio, that meet certain criteria.[132]

5.2.2 Also, for the reasons articulated above, we think it is not permissible under the current statutory regime for an employer to establish an RPP in which IFSI has priority over, or equal status with, ensuring the plan fund is invested in such a way so as to maximize the likelihood that the pension fund will be sufficient to pay promised benefits within a stated risk tolerance.

Duties on those designing, manufacturing and providing pensions

5.2.3 As mentioned, there is no legal requirement for organizations that provide pensions to design the plan by reference to the needs or views of Beneficiaries. Under the ITA, the primary purpose of a pension plan must be to provide periodic payments to individuals after retirement and until death in respect of service as employees. Accordingly, it can be inferred that the primary purpose of a pension fund, and consideration in any design, ought to be to provide funding that is sufficient to meet the promised pension benefit.

5.3 **Mutual funds**

Establishing a New Policy

5.3.1 As mentioned, mutual funds may be structured to Invest for Sustainability Impact. Aside from standard investment restrictions, such as those discussed at 2.3.9, there are no other legal restrictions or requirements to set up a mutual fund to Invest for Sustainability Impact. Furthermore, it is permissible for a mutual fund to prioritize IFSI over financial returns, provided that such mutual fund has IFSI as its fundamental investment objective.

Duties on those designing, manufacturing and providing mutual funds

5.3.2 There is no legal requirement for IFMs to design a mutual fund by reference to the needs or views of Beneficiaries. As discussed above, IFMs and PMs that are managing mutual funds marketed as IFSI have certain obligations with respect to Regulatory Disclosures that may indirectly engage the views of Beneficiaries. Form 81-101F1, as discussed above at 2.3.16, imposes annual disclosure requirements, including its "Fundamental Investment Objectives". The regulations further require the disclosure of the mutual fund's investment strategies and the process by which IFMs select securities for the mutual fund's portfolio.

5.3.3 While such requirements do not persist throughout the lifetime of the investment, under NI 81-102, the prior approval of unitholders is required in order to effect a change in the fundamental investment objectives of a mutual fund. Therefore, while not a direct assessment of the views of the unitholders with respect to IFSI, unitholders nonetheless maintain a level of control over the objective of the mutual fund and whether, if marketed as a fund with an IFSI objective, it can cease to follow such an investment objective.[133] We briefly note here that mutual funds can adjust their investment strategies without the need to amend their fundamental investment objectives, so long as the adjusted strategy does not conflict.

CANADA

5.4 **Life insurance products**

Establishing a New Policy

5.4.1 There is no legal impediment preventing insurers from assessing the views of Beneficiaries with respect to IFSI. We note that amending existing products to have the express objective of IFSI would likely be so difficult as to be impractical in Canada given how insurance funds are structured.

5.4.2 A number of Canadian life insurers already offer socially responsible investment products structured as "segregated funds".[134] Segregated funds are investment contracts offered by life insurance companies, which, similar to mutual fund products, invest the funds in various asset classes/types as selected by the policyholder. Segregated funds also provide for guaranteed minimum return levels upon withdrawal of the invested amount or upon death of the contractholder. They also provide certain other benefits, including increased creditor protection. New socially responsible investment-oriented segregated funds could readily be established/offered by Canadian life insurers.

Duties on those designing, manufacturing and providing life insurance

5.4.3 The umbrella group of Canadian provincial insurance market conduct regulators, the Canadian Council of Insurance Regulators ("**CCIR**"), has recently published Guidance Respecting the Conduct of Insurance Business and the Fair Treatment of Customers (the "**Guidance**").[135] The Guidance has been adopted by many of the CCIR member regulators. The Guidance is designed to promote the fair treatment of customers, and, among many other expectations, requires that insurers consider the needs and interests of target consumer groups in designing, distributing and administering insurance products. In relation to socially responsible investments, this could include the interests and expectations of investors particularly desiring such types of investments.

› ANNEXES

› Canada

CANADA

6. INVESTMENT MANAGERS' DUTIES TO INVEST FOR SUSTAINABILITY IMPACT

6.1 This section considers the extent to which, and in what circumstances, an Investment Manager is (a) legally required or (b) legally permitted to Invest for Sustainability Impact on behalf of an Asset Owner or otherwise, in each of the three ways contemplated in sections 2-4.

6.2 In many cases, large institutional investors opt to retain Investment Managers to provide expertise and assist in the management of their investment portfolios. Asset Owners will typically enter into contracts which govern the relationship between the Investment Manager and the Asset Owner and thereby create obligations which will bind the Investment Manager.[136] Additionally, an agency relationship will exist where one party – the agent – is empowered by the other party – the principal – to act on behalf of and represent the principal, and such relationships may arise contractually or otherwise.[137] An agency relationship transfers unto the agent the authority of the principal to act on its behalf. The agency relationship creates a number of duties incumbent upon the agent, which include:

- Duty of Obedience: The agent must obey and carry out the instructions of the agent;[138]
- Duty of Personal Performance: Where the execution of the agency involves the exercise of judgment and discretion, the agent cannot delegate their authority;[139]
- Duty to Exercise Care and Skill: An agent must exercise the care and skill in the performance of its duties as necessary for the proper conduct of the business undertaken, and is liable to the principal for negligence;[140]
- Duty of Loyalty:
  - Duty to Act in Good Faith: The agent is in a fiduciary relationship with the principal in the context of the performance of its undertakings on behalf of the principal;[141]
  - Duty to Avoid Conflicts of Interest: An agent cannot put themselves in situations in which their personal interest is in conflict with their duty to the principal.[142]
  - Duty to Make Full Disclosure: Where the agent enters into a contract with the principal, it must make full disclosure of all material circumstances;[143]
  - Duty to Refrain from Making Secret Profits: The agent cannot make a profit out of the agency without the knowledge of the principal.[144]

6.2.1 Finally, the Investment Managers retained by Asset Owners are generally subject to certain registration requirements under Canadian securities legislation.[145] Specifically, as discussed at 2.3.4, Investment Managers – whether they are individuals or firms – will be registered either as PMs (or Restricted Portfolio Managers) or IFMs under NI 31-101. Under NI 31-101, all Investment Managers must satisfy the requirement under the instrument to conduct themselves with integrity, which implies honesty and good faith in the performance of their mandates.[146]

6.3 Legal obligations with respect to Sustainability Impact

Powers of investment and divestment

6.3.1 Practically speaking, it is much more likely that the Sustainability Impact objectives of the Asset Owner and how it wishes to achieve these will be contemplated in the mandate given to the Investment Manager, whether contractually, or simply through instructions given in the context of a principal-agent relationship. Whether bound by contract or by the duty of obedience, though, the Investment Manager must implement the Sustainability Impact objectives if this is required in the mandate given to them by the Asset Owner.

6.3.2 Since there is no legal requirement for Asset Owners (other than Sustainability Impact-oriented mutual funds) to pursue Sustainability Impact objectives, and in some cases it would be prohibited, it follows there is no legal requirement to pursue Sustainability Impact objectives not incorporated into the investment management agreement. It is also very unlikely that the types of Asset Owners under consideration here (pension funds, insurance companies, and mutual funds) would not put in writing the investment objectives they expect an Investment Manager to pursue, particularly given the complexity of the legal framework under which they operate.

Engagement to achieve Sustainability Impact

6.3.3 There is no obligation under Canadian law that requires Investment Managers to enquire about the extent to which Asset Owners have assessed the views of Beneficiaries. As such, unless there is a contractual obligation to engage, Investment Managers are generally under no obligation to engage for Sustainability Impact.

6.3.4 However, there may be circumstances under which Investment Managers are

CANADA

legally required to ensure that Beneficiaries' IFSI views are taken into account in managing a portfolio (if indirectly). For example, where the Regulatory Disclosures for mutual funds describe IFSI as a feature, investors will expect that the funds will be invested in accordance with the Regulatory Disclosures as such feature is likely to inform investors' investment decisions. While this does not amount to directly enquiring into the views of Beneficiaries, it can be argued that the obligation to manage the fund in accordance with the Regulatory Disclosures that informed the Beneficiaries' investment decisions are – in certain circumstances – to an extent a reflection of the views of Beneficiaries. Similarly, the Fundamental Investment Objectives must state that an objective of the fund is to Invest for Sustainability Impact and amending that objective requires the prior approval of securityholders/Beneficiaries. As such, the approval process governing changes to the Fundamental Investment Objectives is also arguably a regulatory process which indirectly solicits input from the Beneficiaries.

6.3.5 As discussed above, Investment Managers, as agents, have a fiduciary duty toward the principal, in this case the Asset Owner. To fulfil this duty, they may be required to keep the Asset Owner informed as to the performance of the investments, which may include reporting on the extent to which Sustainability Impact objectives have been met in managing the portfolio.

6.3.6 Canadian securities regulators have taken steps to increase disclosure in line with the SDGs and the Paris Agreement. While Canadian securities laws do not mandate the practices of ESG or IFSI, reporting issuers must disclose all material information, including any material information with respect to ESG issues.[147] The Canadian Securities Administrators, an umbrella organisation of Canada's provincial and territorial securities regulators ("**CSA**"), further clarified environmental reporting obligations in CSA Staff Notice 51-333 (*Environmental Reporting Guidance*), and has expanded on this guidance with respect to climate-related risk disclosure in CSA Staff Notice 51-358 (*Reporting of Climate Change-related Risks*). Environmental disclosure, where it reaches the materiality threshold, will be required with respect, for example, to environmental risks, trends, and uncertainties, the operational effects of environmental protection requirements, and so on.[148] The Toronto Stock Exchange has issued guidance that while Staff-Notice 51-333 does not make explicit reference to social information, it may be interpreted to also include material social information.[149] Similarly, as of January 1, 2020, pursuant to an amendment to the *Canada Business Corporations Act* ("**CBCA**"), specific governance factors must be disclosed for federally incorporated public issuers, including diversity practices.[150] While privately held businesses are not subject to such disclosure requirements, practical and reputational considerations may in themselves be sufficient to motivate the adoption of ESG or to invest for sustainability impact.

Public policy work to achieve Sustainability Impact

6.3.7 There is generally no duty on an Investment Manager to engage in public policy work unless the contractual mandate with the Asset Owner includes some language to the contrary. Any such efforts would have to be undertaken in compliance with lobbyist registration laws.

6.4 Legal freedom to Invest for Sustainability Impact

Powers of investment and divestment

6.4.1 Generally, an Investment Manager cannot choose investments by reference to Sustainability Impact objectives except where all financially relevant factors are equal, and in such a case, Sustainability Impact considerations could be used as a tiebreaker.

6.4.2 However, as previously noted, Investment Managers are bound by their contractual duties or their duties as agents, and as such will generally be bound to set IFSI objectives where this is required by the Asset Owner under the contract.

Engagement to achieve Sustainability Impact

6.4.3 There is no express legal impediment preventing Investing Managers from engaging in stewardship to achieve Sustainability Impact. However, they may be prevented from doing so if these actions are incompatible with or purport to take precedence over the objectives of the contractual arrangement with the Asset Owner or over the objectives/purposes of the fund in question under its constating document.

Public policy work to achieve Sustainability Impact

6.4.4 As discussed earlier, there is no express legal impediment to an Investment Manager undertaking public policy work to achieve Sustainability Impact, provided it complies with lobbying laws and is not in conflict with the statutory or contractual duties owed to the Asset Owner and fund.

CANADA

7. LEGAL LIABILITY TO THIRD PARTIES FOR THE NEGATIVE SUSTAINABILITY IMPACT OF ENTERPRISES IN WHICH PORTFOLIOS ARE INVESTED

7.1 This section considers the extent to which, regardless of the legal rules under which it is required to operate and its constitution, an Asset Owner could be legally liable to third parties for the negative Sustainability Impact of enterprises in which it invests, and whether an Investment Manager could also be liable because of its role in assisting the Asset Owner to invest in the relevant enterprise and steward its investment.

7.2 **Asset Owners**

Primary Liability & Negative Impacts

7.2.1 The likelihood of primary liability for an Asset Owner in connection with a failure to consider Sustainability Impact or a failure to engage in stewardship activities is very low. Indeed, absent a certain level of control and accompanying conduct, it is difficult to conceive of the circumstances in which such a liability might be fixed on an Asset Owner. One example of such conduct is found in some stewardship activities that could provide for the factual underpinning that would enable a Canadian court to "look through" various legal forms of investment structures, with the result that a Relevant Investor who engaged in stewardship activities could be held liable for actions of the investee company. The ability to "pierce the veil" in such circumstances may act as a deterrent to stewardship.

7.2.2 It is, however, probably fair to say that the main liability risk (broadly construed) of negative Sustainability Impacts is the possible loss in market value of an investment resulting from poor financial performance attributable to a negative Sustainability Impact, including regulatory action, damage to reputation, and litigation risk of the investee company. Thus, as part of the financial analysis at the time of making an investment/loan, and on an ongoing basis as circumstances warrant, an Asset Owner will want to ensure that it has evaluated the level of risk attributable to negative Sustainability Impacts.

7.2.3 Nevertheless, legislative amendments or unambiguous guidance similar to that in the Manitoba pension legislation stating that Asset Owners and Investment Managers who consider IFSI will not thereby be immediately liable for breach of their duty of prudence would be a helpful step in encouraging investors to take Sustainability Impact into account in their investment decisions.

7.2.4 We also think it unlikely that a claimant would be able to establish a duty, let alone a breach of such duty or causative connection recognized in law so as to fix liability for negative Sustainability Impacts on an Asset Owner or Investment Manager that invests in a company that has caused negative Sustainability Impacts. Nor do we think there would be any duty to mitigate negative Sustainability Impacts.

Disclosure Liability

7.2.5 Where a Relevant Investor is required to report on or disclose the Sustainability Impacts of its portfolio, this could create a liability for the Relevant Investor if the Sustainability Impacts are negative (for example, based on arguments that the Relevant Investor has helped to fund activities that have a negative Sustainability Impact).

7.2.6 Such disclosure could create a liability in the sense of damage to the reputation of the Relevant Investor and/or loss of market value of the investment. In the case of a mutual fund marketed as an IFSI fund, it would likely lead to redemptions and loss of market value. However, it is unlikely that a Relevant Investor would incur primary liability for such disclosure in the sense normally used in a legal context – i.e., liability to another person for provable loss or damage caused by a breach of a legal duty (for example, breach of the prudent person standard) or breach of a contractual covenant. We think this to be unlikely because the legal nature of the instruments through which a Relevant Investor is likely to invest would typically insulate such investor from liability and loss beyond that of the amount invested.[151]

7.3 **Investment Managers**

7.3.1 The investment choices made by Investment Managers will be assessed on the basis of the process the Investment Manager engaged in when making the investment, and not on the basis of the financial returns of the portfolio. Therefore, unless the Investment Manager was in breach of any of their duties, it is unlikely that they would incur liability. Practically, though, Investment Managers will seek to achieve strong financial performance as Asset Owners are likely to terminate the employment of Investment Managers who do not meet this standard.

7.3.2 As noted above, we do not think that Asset Owners have a duty to either assess the views of Beneficiaries on IFSI nor to reflect these views in their investments, and

CANADA

further are under no duty to account for the impact these investments may have on beneficiaries. However, should such a duty exist for Asset Owners, we think it would be unlikely that Investment Managers could be found liable to Beneficiaries in the event an Asset Owner breached such a duty. The relationship between Asset Owner and Investment Manager is generally a contractual relationship in which, commercially, it is typical to find provisions limiting the liability of the Investment Manager so as to exclude actions taken by the Asset Owner. Further, Investment Managers, as agents bound by a duty of obedience to follow instructions given to them by the Asset Owner, cannot be found liable under the law of agency for following the instructions given to them by their principal.[152]

7.3.3 Moreover, while an agent is in a *per se* fiduciary relationship with its principal (the Asset Owner), it cannot be said that there is a *per se* fiduciary relationship between the Investment Manager and the persons to whom the Asset Owner owes a fiduciary duty. Notwithstanding the foregoing, KYC requirements may impose an obligation on Investment Managers to have an awareness of statutory prohibitions and requirements applicable to the Asset Owner.

CANADA

8. THE GROWING IMPORTANCE OF TAKING ACCOUNT OF ESG AND SUSTAINABILITY FACTORS WHERE THESE ARE 'FINANCIALLY MATERIAL'

8.1 It has become increasingly important for Asset Owners and their managers to take ESG and sustainability factors into account in managing portfolios because of the way in which they could be material to achieving the financial investment objectives of the relevant Asset Owner or manager in accordance with their legal duties. The main reasons are summarised below.

8.1.1 ESG integration is well established in Canada, representing $1.9 trillion of all assets under management.[153] ESG is both a practical and legal consideration for businesses and investors alike, all of whom are increasingly recognizing the impact of the economy and investing on society.[154] Support for the consideration of ESG factors exists both in Canadian securities law and in the principles of Canadian fiduciary law.

8.1.2 While neither explicitly mandates the inclusion of ESG factors, disclosure requirements for public issuers require disclosure which informs investors as to the issuers' environmental and governance practices.[155] Further practical and reputational considerations are likely to motivate private issuers to integrate ESG factors in their investment decision-making processes. Where ESG factors are known, and are likely to impact the performance or risk of a given investment, the common law supports a fiduciary duty to take these into account.[156] In other words, if negative Sustainability Impacts are *financially* material to the performance of the investment, then Asset Owners would be required to take account of them. For example, an increased regulatory burden for issuers in high carbon-impact industries would likely be a financially material consideration. Moreover, as part of the prudent person standard and, where applicable, the fiduciary duty, and equivalent duties in civil law, Asset Owners would be required to evaluate the level of risk posed by such investments, both to the business of the issuer and the reputational risk to the issuer and Asset Owner.

8.1.3 Where such factors are considered by pension funds, at least in the Province of Ontario, they must be disclosed in the fund's SIPP to meet the requirements of Regulation 909 under the *Pension Benefits Act* (Ontario).[157] Further, the view increasingly being expressed is that pension fiduciaries are "expected to consider questions of future value [and] to assess the impact of their investment decisions on others, including generations to come."[158] The investment process will require "consideration of market integrity, systemic risks, governance risks, advisor risks and the like."[159] This view has been reflected in the rulings of the Supreme Court of Canada, which has held that the duty of loyalty – central to the fiduciary relationship – requires the fiduciary to consider both the pecuniary interests of the beneficiary and their "status as a responsible member of society."[160] The implication is that fiduciaries must avoid practices which are either unethical or which do not accord with prevailing social norms in order to fulfill their duties.[161] As discussed above, the CPPIB has implemented its *Policy on Responsible Investing* which commits it to considering ESG factors in its investment decisions, and to actively engage with investees to spur dialogue with respect to ESG concerns.[162]

8.1.4 Dialogue between investors and the businesses they opt to invest in is another means through which investors may engage in ESG-focused investing. Shareholder engagement encompasses practices which leverage shareholder power to improve corporate ESG practices.[163] While large institutional investors such as the CPPIB can force dialogue with their investees, often directly with management, this may not be open to all investors.[164] However, many strategies are available under the rules of the CBCA or any of the provincial *Business Corporations Acts*, such as filing shareholder resolutions or voting proxies guided by environmental and social concerns.[165]

8.1.5 Screening is another ESG investment strategy which is adopted in Canada. Norms-based screening refers to the alignment of investment policies with stated standards, such as the United Nations Global Compact, while negative screening involves systematically excluding investments in specific industries.[166] Some investors may also opt to invest in businesses which have shown positive ESG performance, regardless of their industry (sometimes known as a "best in class" approach).[167] Screening as a form of investment is a practice which can be more accessible across classes of investors. An increasing availability of mutual funds actively adopting ESG integration and screening methods allows both retail investors and major institutional investors to access more responsible investments.[168]

CANADA

9. THE MEANING OF 'FINANCIALLY MATERIAL'

9.1 Because of the growing importance of taking account of ESG and Sustainability Impact factors into account in the investment process where financially material, it is important to understand how the law defines what is 'financially material' and the period by reference to which financial materiality must be measured. Taking account of these factors in order to pursue financial objectives may incidentally have Sustainability Impacts and may also be consistent with IFSI. However, beyond that point, any attempt to realise positive Sustainability Impact might need to rely solely upon IFSI (i.e. because it would no longer be driven by the need to generate financial performance).

9.2 **Financial materiality**

9.2.1 In Canadian law, financial materiality is normally treated as a question of fact. The provincial *Securities Acts* define "material fact" in relation to the issuance or proposed issuance of securities to mean "a fact that would reasonably be expected to have a significant effect on the market price or value of the securities."[169]

9.2.2 Empirical evidence has established that a good ESG track record contributes to strong long-term financial performance. The line between ESG factors and Sustainability Impact is not well-defined – there is considerable overlap – and therefore the evidence of strong long-term financial performance likely also applies in many cases to positive Sustainability Impacts. The Sustainability Accounting Standards Board, an independent standards board, has published a "Materiality Map" which identifies sustainability issues likely to affect the performance of companies across different industries.[170]

9.3 **Time period by reference to which 'materiality' is to be assessed**

9.3.1 The time period for financial materiality varies depending on the Asset Owner and investment objectives. For example, the CPPIB, a public sector pension fund, has said that its "exceptionally long horizon" requires it to consider risk and potential financial return over "multiple decades".[171] Similarly, as noted above, investment portfolios of life insurers would typically have longer horizons relative to other insurance products, given the much longer-term nature of life insurance companies' products/obligations. By contrast, in the mutual fund context materiality tends to be assessed over a much shorter term.

> ANNEXES

> Canada

Stikeman Elliott

Nicholas Badeen, Stuart S. Carruthers, Christopher D. Lofft, Stewart Sutcliffe and Natasha vandenHoven, with thanks to Sagar Darar and Alexandra Ghelerter

CANADA

1 Morneau Shepell Ltd., *Handbook of Canadian Pension and Benefit Plans* (Toronto: LexisNexis Canada, 2016) at 10 [Pension and Benefit Plan Handbook].

2 See, for example, Ontario Teachers' Pension Plan Board, "2019 Climate Change Report" (July 2020), online (pdf): *Ontario Teachers' Pension Plan* https://www.otpp.com/documents/10179/1021270/2019+Climate+Change+Report/f3eae93f-7531-440e-92ea-91275ec52980 [OTPP Climate Change Report].

3 According to a 2020 survey by the Royal Bank of Canada Global Asset Management, 89% of Canadian institutional investors surveyed integrated ESG principles into their investment approach, and 98% believed that ESG-integrated portfolios perform as well or better than those that do not integrate ESG; RBC Global Asset Management, "Global Adoption – Regional Divide" (2020), online (pdf) at 4: RBC GAM <https://www.rbcgam.com/en/ca/about-us/responsible-investment/our-latest-independent-research> [RBC Responsible Investing Research].

4 Eric Belli-Bivar & Stephen Viscomi, "The ABCs of ESG" (15 August 2019), online: Lexology <https://www.lexology.com/library/detail.aspx?g=b4f010ed-9ca2-4e58-911f-dbb3609d3040>.

5 *Pension and Benefit Plan Handbook*, *supra* note 1 at 10.

6 *Pension and Benefit Plan Handbook*, *supra* note 1 at 9.

7 *Income Tax Act*, RSC 1985, c 1 (5th Supp) [ITA], s 147.1.

8 See ITA s. 149(o).

9 Pension plans that provide benefits in excess of the ITA limits for RPPs are not eligible for the same tax-advantaged treatment.

10 See *Income Tax Regulations*, CRC c 945, s 8502(a) which states that "the primary purpose of the plan is to provide periodic payments to individuals after retirement and until death in respect of service as employees." As discussed further below, an inference could be drawn that the primary purpose of a pension fund ought to be to provide funding sufficient to meet the promised pension benefit.

11 *Pension and Benefit Plan Handbook*, *supra* note 1 at 14. Note that there exist hybrid plans which combine features of DB and DC plans, as well as plans which are not registered. Neither is discussed here.

12 Benefits Canada, "2018 Top 40 Money Managers Report" (November 2018) at 31, online (pdf): Hillsdale Investment Management Inc <https://www.hillsdaleinv.com/uploads/Benefits_Canada_Top_40_Money_Managers.pdf> [2018 Top 40 Money Managers Report]. See also Steven Lamb, "Which pension model is best: DB or DC" (June 2011), online: Benefits Canada <https://www.benefitscanada.com/news/which-pension-model-is-best-db-or-dc/>.

13 See, for example, the OMERS pension plan whereby the OMERS Administration Corporation acts as administrator of the OMERS pension plans and trustee of the pension funds per s. 17(1) of the *Ontario Municipal Employees Retirement System Act, 2006*, SO 2006, c 2.

14 See *Pension Benefits Standards Act, 1985* (Canada), RSC 1985, c 32 (2nd Supp) [PBSA], s. 7(1): the administrator of a pension plan shall be (a) in the case of a multi-employer pension plan established under one or more collective agreements, a board of trustees or other similar body constituted in accordance with the terms of the plan or the collective agreement to manage the affairs of the plan, (b) in the case of a multi-employer plan not described in (a), a pension committee constituted in accordance with the terms of the plan to manage the affairs of the plan, and (c) in the case of a pension plan other than a multi-employer plan, (i) the employer, or (ii) if the plan is established under one or more collective agreements and the terms of the plan or the collective agreement(s) to manage the affairs of the plan provide for the constitution of a board of trustees or similar other body, that body.

15 See *Supplemental Pension Plans Act*, chapter R-15.1 (Quebec), s 147; *The Pension Benefits Act* (Manitoba), CCSM, c P32, s 28.1.

16 See, for example, *Pension Benefits Act* (Ontario), RSO 1990, c P8, s. 22(1).

17 *Fales v. Canada Permanent Trust Co*, [1977] 2 SCR 302 at 315.

18 See for example, *Pension Benefits Act* (Ontario), RSO 1990, c P8, s. 22(8).

19 *R. v. Christophe et al.*, 2009 ONCJ 586, *Langlois c Roy*, 2006 QCCS 297, class action settlement approved, 2010 QCCS 1610; *Gilbert c. Syndicat des chauffeurs de la Société de transport de Laval*, 2010 QCCS 1540; *Syndicat général des professeures et professeurs de l'Université de Montréal c. Gourdeau*, 2009 QCCS 1990, class action settlement approved 2015 QCCS 2496, among others.

20 However, see A. Kaplan and M. Frazer, Pension Law, 2nd ed. (Toronto: Irwin Law, 2013) at 322. The authors speculate that the "standards imposed upon pension plan administrators are higher than those required of trustee as common law because it is assumed that a person of ordinary prudence would be more diligent when dealing with the property of another than they would be in dealing with their own property".

21 Fales v. Canada Permanent Trust Co., [1977] 2 SCR 302 at 315-316.

22 See *Pension and Benefit Plan Handbook*, supra note 1 at 104; while it is only the pension legislation of Alberta and British Columbia that expressly identifies pension plan administrators as fiduciaries, this is how the relationship is viewed in all jurisdictions across Canada (subject to our comments with respect to Quebec), regardless of the type of pension plan.

23 [1994] 3 SCR 377.

24 *Ibid at para 30*; see also *Burke v Hudson's Bay Co*, 2010 SCC 34 at para 39.

25 See for example, *Pension Benefits Act* (Ontario), RSO 1990, c. P8, s. 22(1). In some provinces, the pension legislation addresses the duty of prudence more specifically; see Pension Benefits Standards Act (British Columbia), SBC 2012, c 30, s 60(1), which states "pension plan investments, loans and other pension plan financial decisions must be made … in the best financial interest of plan members, former members and other beneficiaries". See also *Employment Pensions Plans Act* (Alberta), SA 2012, c E-8.1, s 62(2), which states that investments must be made "in a manner that a reasonable and prudent person would apply to the plan's portfolio of investments having regard to the plan's liabilities."

26 The terminology is somewhat confused in Quebec as the term *fiduciaire* translates as both "fiduciary" and "trustee" and pension administrators are often trustees of the pension fund trust.

27 *Act respecting Retraite Québec*, CQLR, chapter R-26.3.

28 CQLR c CCQ-1991 a 1268-1269.

29 *Ibid* at 1278.

30 *Ibid* at 1306 and 1309.

31 PBSA, *supra* note 14 s 8(4.1).

32 *Pension and Benefit Plan Handbook*, *supra* note 1 at 223.

33 See Schedule III to the *Pension Benefits Standards Regulations*, 1985 (Canada), SOR/87-19 [PBSR] which is incorporated into the regulations of several provincial pension statutes.

34 See s. 7.1 of the PBSR which is incorporated into the regulations of several provincial pension statutes. Certain jurisdictions, for example Ontario, also require that the SIPP be filed.

35 Office of the Superintendent of Financial Institutions, "Guideline for the Development of Investment Policies and Procedures for Federally Regulated Pension Plans" (April 2000), online (guideline): OSFI <https://www.osfi-bsif.gc.ca/Eng/pp-rr/ppa-rra/inv-plc/Pages/penivst.aspx>.

36 PBSR, *supra* note 33 s. 7.1(1).

37 See Section 5 which discusses the mandate of the Caisse de dépôt et placement du Québec to invest in "Quebec's economic development".

38 In addition, the Canadian federal government recently proposed draft legislation to establish national net-zero emissions reduction targets for the federal government, which could influence the IFSI approaches of all Asset Owners: Bill C-12, *An Act respecting transparency and accountability in Canada's efforts to achieve net-zero greenhouse gas emissions by the year 2050*, 2nd Session, 43rd Parliament, Canada, 2020 (introduced 19 November 2020).

39 See *Pension Benefits Standards Act* (British Columbia), SBC 2012, c 30, s 60(1) [BC PBSA]. See also *Canada Pension Plan Investment Board Act*, SC 1997, c 40, [CPPIB Act] s. 5(c) which states, in relevant part, that among the objects of the CPPIB is "to invest its assets with a view to achieving a maximum rate of return, without undue risk of loss".

40 *Pension and Benefit Plan Handbook*, *supra* note 1 at 16.

41 Carol M. Dakai et al, *Canadian Employment Benefits and Pension Guide* (Toronto: LexisNexis Canada, 2003) at Commentary S 3418 [Benefits and Pension Guide].

42 Though it is another issue whether it is an appropriate use of pension assets to seek such views.

43 *Benefits and Pensions Guide*, supra note 40 at Commentary S 3416.

44 See *OTPP Climate Change Report*, *supra* note 2.

45 *RBC Responsible Investing Research*, *supra* note 3.

46 BC PBSA, *supra* note 38 s 60(1) and CPPIB Act, s. 5(c).

47 *Income Tax Regulations*, CRC c 945, s 8502(a).

48 *Pension and Benefit Plan Handbook*, note 1 at 223.

49 *The Trustee Act* (Manitoba), CCSM, c T160, s 79.1.

50 *The Pension Benefits Act* (Manitoba), CCSM, c P32, s 28.1(2.2).

51 See *2018 Top 40 Money Managers Report*, supra note 12. Foundations and endowments are responsible for $87,519.4 million of Canadian assets under management, so while they do not compete with the largest institutional investors, they remain an important source of investment in Canada, particularly as relates to investing for impact.

52 Government of Canada, "How to draft purposes for charitable registration", Guidance CG-019 (25 July 2013), online : *Government of Canada* <https://www.canada.ca/en/revenue-agency/services/charities-giving/charities/policies-guidance/guidance-019-draft-

CANADA

purposes-charitable-registration.html>.

53 Government of Canada, "What is the difference between a registered charity and a non -profit organizations?" (last modified 23 June 2016), online : *Government of Canada* <https://www.canada.ca/en/revenue-agency/services/charities-giving/giving-charity-information-donors/about-registered-charities/what-difference-between-a-registered-charity-a-non-profit-organization.html>.

54 Canada's National Advisory Board to the Social Impact Investment Taskforce, "Mobilizing Private Capital for Public Good: Priorities for Canada" (September 2014) at 11, online (pdf): *MaRS Discovery District* < https://www.marsdd.com/wp-content/uploads/2014/09/MaRS-National_Advisory_Board_Report_EN.pdf> [Mobilizing Private Capital 2014].

55 ITA, s. 149.1(1).

56 Susan M Manwaring & Natasha Smith, "Canada Weighs in on Social Impact Investing: Highlights from the Report of the National Advisory Committee" (September 2014), online: *Miller Thomson* < https://www.millerthomson.com/en/publications/communiques-and-updates/social-impact-newsletter-formerly-the/september-2014-social-impact-newsletter-formerly-the/canada-weighs-in-on-social-impact-investing/> [Manwaring & Smith].

57 *Ibid*. See also ITA, ss. 110.1(1)(a), 118.1(1), 149.1(1), 149.1(6.4), 188.1(5) for the definition of "qualified donee".

58 CRA, *Community Economic Development Activities and Charitable Registration*, Guidance CG-014 (9 August 2017) and CRA, Using an Intermediary to Carry Out a Charity's Activities within Canada, Guidance CG-004 (27 November 2020). Such investments fall within the CRA administrative policy with respect to program related investments (PRI).Typically the arrangement is structured so that the non-qualified donee recipient acts as the intermediary of the investor charity; direction and control is exercised through a written agreement, monitoring and supervision of the activity, clear instructions and the intermediary keeping the charity's funds separate from its own.

59 Fasken Martineau DuMoulin LLP, "Changes to Support Social Investing by Charities" (23 November 2017), online: <https://www.fasken.com/en/knowledge/2017/11/charitiesandnot-for-profit-20171123> [Changes to Support Social Investing by Charities].

60 *Ibid*; See also Bill 154, *An Act to Cut Unnecessary Red Tape by Enacting One New Act and Making Various Amendments and Repeals, 2nd Session, 41st Legislature*, Ontario, 2017 (assented to 14 November 2017).

61 *Changes to Support Social Investing by Charities*, *supra* note 59..

62 Karim Harji, Joanna Reynolds, Hilary Best, & Mathu Jeyaloganathan, "State of the Nation Impact Investing in Canada" (2014) at 22, online: *MaRS Discovery District* < https://ccednet-rcdec.ca/sites/ccednet-rcdec.ca/files/impact-investing-canada-2014.pdf> [Impact Investing in Canada].

63 *Mobilizing Private Capital 2014*, *supra* note 54 at 11.

64 ITA, 149.1(1).

65 *Mobilizing Private Capital 2014*, *supra* note 54 at 12.

66 *Ibid* at 12.

67 *Cowan v Scargill*, [1984] 3 WLR 501 (Ch. Div) at 513.

68 Edward J Waitzer & Douglas Sarro, "The Public Fiduciary: Emerging Themes in Canadian Fiduciary Law for Pension Trustees", Canadian Bar Review 91, no. 1 (2012): 163-210 at 165 [Waitzer & Sarro].

69 *Ibid* at 168.

70 Benjamin J. Richardson & Maziar Peihani, "Universal Investors and Socially Responsible Finance: A Critique of a Premature Theory", Banking and Finance Law Review 30, no. 3 (2015): 405-455 at 410 [Richardson & Peihani].

71 Gil Yaron, "Fiduciary Duties, Investment Screening, and Economically Targeted Investing: A Flexible Approach for Changing Times" in Jack Quarter, Isla Carmichael & Sherida Ryan, eds, *Pensions at Work: Socially Responsible Investment of Union-Based Pension Funds* (Toronto: University of Toronto Press, 2008) 70 at 72 [Yaron].

72 John Smith, "Ethical Investment" (Paper delivered at the Pacific Business & Law Institute Conference, February 21, 2001), online: Lawson Lundell LLP <https://www.lawsonlundell.com/media/news/262_EthicalInvestmentPaper.pdf>. *In Board of Trustees of Employee Retirement System of the City of Baltimore v. Mayor and City Councillors of Baltimore 562* A.2d (Court of Appeals of Maryland, 1989), the court ultimately concluded that where the cost of making investments in alignment with non, financial, social considerations was de minimis, such investments would not violate the fiduciary duty, as such investments would best serve the interests of the beneficiaries over the longer term. In *Harries v. Church Commissioners for England* [1993] 2 All E.R. 300, the court determined that an arguably "ethical" investment policy was permissible. See also Yaron, *supra* note 71 at 83-85.

73 Yaron, *supra* note 71 at 91.

74 Randy Bauslaugh & Hendrik Garz, "Pension Fund Investment: Managing Environmental, Social, and Governance (ESG) Factor Integration" (1 May 2019) [Bauslaugh & Garz], online: *McCarthy Tetrault* <https://www.mccarthy.ca/en/insights/articles/pension-fund-investment-managing-environmental-social-and-governance-esg-factor-integration>.

75 Canadian Association of Pension Supervisory Authorities, "Guideline No. 8 Defined Contribution Pension Plans Guideline" (February 2019), online: *CAPSA* <https://www.capsa-acor.org/CAPSAGuidelines> [Guideline No. 8].

76 An "alternative mutual fund" is a relatively new category of mutual fund that was introduced in 2019 that permits exceptions to certain investment restrictions that apply to mutual funds set out in NI 81-102.

77 A growing proportion of Canadian assets under management in the retail funds market can be attributed to ownership of securities of exchange-traded mutual funds ("ETFs"), which are listed on stock exchanges. ETFs generally follow an index, but some are more actively managed; Darin Renton, Jonathan Willson and Malcolm Peck-McQueen, "Retail investment funds in Canada: regulatory overview" (November 2019), online: Practical Law <https://ca.practicallaw.thomsonreuters.com/w-016-0038?transitionType=Default&contextData=(sc.Default)&firstPage=true> [Retail Investment Funds in Canada].

78 *Retail Investment Funds in Canada supra* note 77.

79 Canadian Securities Administrators, "Understanding mutual funds" (2012), online: < https://www.securities-administrators.ca/uploadedFiles/General/pdfs/mutual_funds_brochure.pdf > [Understanding Mutual Funds].

80 Retail Investment Funds in Canada, supra note 77

81 For purposes of this annex, we will simply use the term "NI" for all provinces.

82 Retail Investment Funds in Canada, supra note 77.

83 *Investment Funds*, OSC NI 81-102 [NI 81-102].

84 In Quebec it is the *Chambre de la sécurité financière*.

85 *Understanding Mutual Funds*, *supra* note 79.

86 *Retail Investment Funds in Canada*, *supra* note 77.

87 Margaret Grottenthaler & Philip J Henderson, *Law of Financial Derivatives in Canada* (Toronto: Carswell, 2019) at 7.3 [Grottenthaler & Henderson].

88 Keith Edward MacMaster, "Responsible Investing: Access Denied" (2019) 34 Banking & Finance L Rev 387 at 391 [MacMaster]; *Securities Act* (Ontario), RSO 1990, c. S.5, ss. 25(1), 36(1); *Securities Act* (Nova Scotia), RSNS 1989, c. 418 ss39A; Securities Act (Alberta), RSA 2000, C. S-4, s. 75.2.

89 *Registration Requirements, Exemptions and Registrant Obligations*, OSC NI 31-103 Part 13. Note that the obligations under Part 13 do not apply the fund managers. See also *Retail Investment Funds in Canada*, *supra* note 76.

90 *Ibid*.

91 NI 81-102, *supra* note 83.

92 NI 81-102, *supra* note 83.

93 Grottenthaler & Henderson, *supra* note 87 at 10:77.

94 See also MacMaster, *supra* note 87. Unfortunately, neither the MFDA nor the IIROC maintain any educational requirements with respect to investing for impact, and this lack of education further contributes to the lack of dissemination of impact products.

95 Responsible Investment Canada, "2018 Canadian Impact Investment Trends Report" (February 2019) at 13, online (pdf): *RIA Canada* <https://www.riacanada.ca/content/uploads/2019/02/2018-Canadian-Impact-Investment-Trends-Report-1.pdf> [Impact Investment Report]; See also MacMaster, *supra* note 88 at 393 and 404, where the author points out that the permitted compensation structures for mutual fund sales under NI 81-105 are such that fees are often tied to advisors' commissions. Impact products, such as mutual funds investing for impact, are often actively managed and therefore have higher fees, which in turn impact advisors' commissions, disincentivizing advisors to recommend investments in such products. ETFs, on the other hand, are less expensive than mutual funds and can be structured to achieve impact. However, only IIROC certified investment advisors may advise on alternative products, such as bonds and ETFs. However, there are ten times fewer IIROC certified advisors in Canada than mutual fund dealers, and furthermore, IIROC advisors generally have high minimum thresholds, rendering such investments inaccessible to the majority of retail investors.

96 Ian Tam, "10 Top Sustainable Mutual Funds in Canada" (April 20, 2020), Morningstar, online (article): < https://www.morningstar.ca/ca/news/201554/10-top-sustainable-mutual-funds-in-canada.aspx>.

97 NI 81-102, *supra* note 83 at 5.1(1)(c).

98 NI 81-102, supra note 83 at 2.1(1)(e) and 2.3(1)(a).

99 Insurance Bureau of Canada, "Insurance Regulators", (last modified August 13, 2019), online: IBC <http://www.ibc.ca/on/resources/industry-resources/insurance-regulators> [Insurance Regulators].

CANADA

100 *Ibid*. Note that generally, insurance regulatory laws are fairly uniform and based on principles of common law. However, in Quebec, the laws are structured differently and based on the civil law.

101 SC 1991, c 47.

102 ICA, s 492, 551 and 615(1) and OSFI Guideline B-1 (Prudent Person Approach); Craig Brown et al, *Insurance Law in Canada* (Toronto: Thomson Reuters, 2019) at 2.6 [Brown et al].

103 *Ibid* (Brown et al.) t 10.4(a).

104 ICA, s 489.1(1).

105 *Public Accountability Statements (Banks, Insurance Companies, Trust and Loan Companies) Regulations*, SOR/2002-133, s. 3(1)(c).

106 Note that insurers may only be structured as bodies corporate. An insurance company in Canada cannot be set up as a trust or other form of "fund".

107 ICA, ss 492, 551 and 615(1).

108 For example, in Ontario, under s. 434(1) of the *Insurance Act*, R.S.O. 1990, c. I.8.

109 *BCE Inc v 1976 Debentureholders*, 2008 SCC 69 at para 37.

110 Waitzer & Sarro, *supra* note 68 at 189. See also, *Ibid* at para 65.

111 In its final report, the Expert Panel on Sustainable Finance, which was appointed in 2018 by the Government of Canada, recommended promoting sustainable investment as "business as usual" within Canada's asset management community, and observed that sound environmental stewardship of investments can be a market competitive advantage: Government of Canada, Expert Panel on Sustainable Finance, "Mobilizing Finance for Sustainable Growth" (Final Report, 2019), online: < https://publications.gc.ca/collections/collection_2019/eccc/En4-350-2-2019-eng.pdf>.

112 Royal Bank of Canada, "Financing Social Good: A Primer on Impact Investing in Canada" (June 2014) at 12, online (pdf): *Royal Bank of Canada* <http://www.rbc.com/community-sustainability/_assets-custom/pdf/Financing-Social-Good.pdf> [Financing Social Good]; See also Responsible Investment Association, "2018 Canadian Responsible Investment Trends Report" (October 2018) at 8, 17, online: <https://www.riacanada.ca/research/2018-canadian-ri-trends-report/> [Responsible Investment Report].

113 *Ibid* at 18.

114 Ibid

115 Chartered Professional Accountants Canada, "An Evolving Corporate Reporting Landscape: A Briefing on Sustainability Reporting, Integrated Reporting and Environmental, Social and Governance Reporting" (2015), online: < https://www.cpacanada.ca/en/business-and-accounting-resources/financial-and-non-financial-reporting/sustainability-environmental-and-social-reporting/publications/evolving-corporate-reporting-voluntary-reporting-briefing> at 1.

116 The Conference Board of Canada, "Canada 2030. The Future of Sustainability Reporting" (August 2018), online: <https://www.conferenceboard.ca/focus-areas/sustainability>.

117 Bauslaugh & Garz, *supra* note 74, citing a 2015 study conducted by Harvard Business School and other sources.

118 Canada Pension Plan Investment Board, "Policy on Sustainable Investing" (June 2020) at 3, online (pdf): https://cdn2.cppinvestments.com/wp-content/uploads/2020/10/cpp-investments-policy-on-sustainable-investing-june-19-2020-en.pdf>.

119 Canada Pension Plan Investment Board, "Proxy Voting Principles and Guidelines" (February 2020) at 7, online pdf: < https://cdn3.cppinvestments.com/wp-content/uploads/2020/03/cpp-investments-proxy-voting-principles-guidelines-2020-ENv2.pdf>.

120 The College of Applied Arts & Technology, "Responsible Investing", online: <https://www.caatpension.on.ca/en/investments/responsible-investing>.

121 Section 11(1) PBSR, *supra* note 33.

122 NI 81-102, *supra* note 83 at 2.2(1)(a) and (b); see also, for example, the definition of "non-redeemable fund" in s 1 of the *Ontario Securities Act* (RSO 1990, c S5), which excludes investing for the "purpose of being actively involved in the management of any issuer in which it invests" from the defined activities of a mutual fund.

123 For example, BMO Global Asset Management offers a "Sustainable Portfolio", which promises to utilize its position as owner of the ESG mutual funds "to drive positive change through engagement and proxy voting"; Bank of Montreal, "Responsible Investing", online: https://www.bmogam.com/ca-en/institutional/capabilities/responsible-investing/. Also see TD Canada Trust, "Sustainable Investing", online: https://www.td.com/ca/en/asset-management/resources/sustainable-investing/. Also see filter available at https://www.riacanada.ca/ri-marketplace/investment-options/ for a potential list of Canadian "responsible investment" mutual funds.

124 OSFI, "Navigating Uncertainty in Climate Change" (discussion paper) (11 January 2021) at p. 7, online (pdf): <https://www.osfi-bsif.gc.ca/Eng/Docs/clmt-rsk.pdf>.

125 See for example: *Lobbying Act* (Canada), RSC 1985, c 44 (4th Supp); *Lobbyists Registration Act, 1998* (Ontario), SO 1998, c 27, Sch.; *Toronto Municipal Code*, chapter 140 (Lobbying).

126 The College of Applied Arts & Technology, "Responsible Investing", online: <https://www.caatpension.on.ca/en/investments/responsible-investing>.

127 Canadian Coalition for Good Governance, "Policies", online: <https://ccgg.ca/>.

128 Ontario Teachers' Pension Plan, "Influence", online: <https://www.otpp.com/investments/responsible-investing/influence>.

129 *An Act Respecting The Caisse de dépôt et placement du Québec*, 2004, c 33, s 4.1.

130 *Pension and Benefit Plan Handbook*, *supra* note 1 at 215.

131 Caisse de dépôt et placement du Québec, *Contribution to Québec's Economic Development* (April 2012), online: <https://cdpq.com/sites/default/files/medias/en/nouvelles-medias/documents/ra2012_contribution_quebec_economic_development_en.pdf>.

132 Caisse de dépôt et placement du Québec, "CDPQ joins the collective effort during the COVID-19 Crisis" (March 30, 2020), online (press release): <https://www.cdpq.com/en/news/pressreleases/cdpq-joins-the-collective-effort-during-the-covid-19-crisis>.

133 NI 81-102, *supra* note 83 at 5.1 (c). Unless a greater majority is required by the constating documents of the fund, the laws applicable to the fund, or an applicable agreement, the approval of the unitholders shall be given by a resolution passed by at least a majority of the votes cast at a meeting of the unitholders.

134 For example, RIA Canada lists the London Life Ethics Fund, the Canadian Co-Operative Investment Fund, Desjardin's DFS GIF – Conservative Fund, IA Clarington's Inhance Monthly SRI Fund, and the GWL Socially Responsible Bond, amongst a number of other segregated funds offered in Canada. For more, see: RIA Marketplace, "Investment Products" (2020), online: <https://www.riacanada.ca/ri-marketplace/investment-options/>.

135 *Insurance Regulators*, *supra* note 99.

136 *Canadian Encyclopedic Digest*, 4th ed (Toronto: Thomson Reuters Canada Ltd (Westlaw online), June 2020), [CED Agency] at § 1-2.

137 *Ibid* at § 15-16.

138 *Ibid* at § 124.

139 *Ibid* at § 135.

140 *Ibid* at § 143.

141 *Ibid* at § 150.

142 *Ibid* at § 157.

143 *Ibid* at § 167.

144 *Ibid* at § 174.

145 See for example *Securities Act*, RSO 1990, c S5, s.25; *Securities Act*, RBSC 1996, c 418, s. 34; *Securities Act*, RSA 2000, c S4, s. 75; *Securities Act*, 2001, RSQ, c V-1, s. 148.

146 Ontario Securities Commission, "Initial Requirements", (last modified 2020), online: OSC <https://www.osc.gov.on.ca/en/Dealers_initial-requirements_index.htm#firm-requirements>. See also Portfolio Management Association of Canada, "Canadian Securities Administrators Consultation Paper 33-404 – Proposals To Enhance the Obligations of Advisors, Dealers and Representatives Toward Their Clients", (last modified September 277, 2016), online: *PMCA* < https://pmac.org/wp-content/uploads/2016/09/PMAC-submission-on-CSA-33-404-final-Sept-27.pdf> whereby, additionally, certain industry standards such as the CFA Institute's Code of Ethics and Standards of Professional Conduct binds the members of the CFA Institute to a fiduciary duty towards their clients.

147 Chartered Professional Accountants Canada, "Environmental, Social and Governance (ESG) Issues in Institutional Investor Decision Making" (July 2010) at 16-19, online (pdf): *CPA Canada* < https://www.cpacanada.ca/en/business-and-accounting-resources/financial-and-non-financial-reporting/mdanda-and-other-financial-reporting/publications/institutional-investors-environmental-social-governance-issues>.

148 Toronto Stock Exchange, "A Primer for Environmental & Social Disclosure" (March 2014) at 11-12, online (pdf): *TSX* < https://www.tsx.com/resource/en/73> [Primer for Environmental & Social Disclosure].

149 *Ibid.*

150 *An Act to amend the Canada Business Corporations Act, the Canada Cooperatives Act, the Canada Not-for-profit Corporations Act and the Competition Act*, SC 2018, c. 8, s. 24.

151 We also assume that the factual bases upon which it is theoretically possible to "pierce the veil" are not present.

152 See *Pension and Benefits Act*, RSO 1990, c P8, s 22(8). An exception may exist wherein Investment Managers in Ontario would be bound by the same duty to exercise the care, diligence and skill in the administration and investment of the fund as a person of prudence as the administrator of the fund. This provision is unique to Ontario.

153 Sustainable Insurance Forum, online: <https://www.sustainableinsuranceforum.org/>.

CANADA

154 Eric Belli-Bivar & Stephen Viscomi, "The ABCs of ESG" (15 August 2019), online: *Lexology* < https://www.lexology.com/library/detail.aspx?g=b4f010ed-9ca2-4e58-911f-dbb3609d3040>.

155 Ibid.

156 *Bauslaugh & Garz*, *supra* note 74.

157 RRO 1990, Reg. 909, s 78(3) provides that the pension fund's SIPP "shall include information as to whether environmental, social and governance factors are incorporated into the plan's investment policies and procedures and, if so, how those factors are incorporated"; see also Financial Services Commission of Ontario, *Environmental and Social Governance* (ESG) *Factors*, Investment Guidance Note IGN-004 (January 2016) at 1.

158 Waitzer & Sarro, *supra* note 68 at 168.

159 *Ibid* at 168.

160 *Ibid* at 183-184.

161 *Ibid* at 184, 189.

162 *Ibid* at 191.

163 MacMaster, supra note 88 at 7.

164 *Ibid* at 9.

165 *Ibid* at 8, 17.

166 *Ibid* at 7.

167 *Ibid* at 8.

168 *Ibid* at 10, 29.

169 See for example, *Securities Act* (Ontario), RSO 1990, c S5, s. 1(1).

170 Sustainability Accounting Standards Board, "SASB Materiality Map", online: <https://materiality.sasb.org/>.

171 CPPIB, *2019 Report on Sustainable Investing: Investing Responsibly for CPP Contributors and Beneficiaries* (undated) at p. 3, online: <http://www.cppib.com/documents/2129/CPPIB-2019-Report-on-Sustainable-Investing-Board-EN_6MB_version.pdf>.

CHINA

1. INTRODUCTION

1.1 This annex considers the laws of the People's Republic of China (**China** or the **PRC**, for the purpose of this annex only, excluding Hong Kong, Macau and Taiwan) as at 31 January 2021. Sections 2 to 4 address the ability of Asset Owners to Invest for Sustainability Impact where the relevant portfolio does not have an express sustainability impact objective.[1]

1.2 As discussed in the main body of the report, the expression "*investing for sustainability impact*" (**IFSI**) is not a term of art. Rather, the expression is used here as a "*conceptual net*" to denote any power or freedom on the part of an Asset Owner or its Investment Manager to pursue one or more sustainability impact objectives, whether to protect or enhance the financial performance of their investment (**instrumental IFSI**) or otherwise (**ultimate-ends IFSI**).

Underlying legal relationship

1.3 China is a civil law jurisdiction and has developed various legal concepts of its own. In the asset management industry, one of the fundamental issues is the inconclusive dispute on the nature of the underlying legal nature of various fund schemes, and accordingly, the rights and obligations of Relevant Investors. There are two main views in practice: the fund scheme is either (a) a trust or (b) a so-called "entrustment" contractual arrangement.[2]

1.4 Unless explicitly stipulated as trusts, fund schemes are commonly regarded as contract-based entrustment arrangements. For the purpose of this annex, this issue is relevant only to mutual funds that are public funds. Other funds considered in this annex (eg pension funds or insurance undertakings) are all contract-based arrangements.

General rules and principles

1.5 Under PRC law, general legal duties (eg honesty, good faith, prudence and diligence) or principles (eg the national/public interest, safety, profitability and long-termism) that are applicable to Relevant Investors for asset management and investment may literally or logically be construed to include IFSI considerations. However, in the absence of express statutory or judicial standards,[3] such general duties and obligations are usually too abstract to be regarded as a basis for requiring Relevant Investors to IFSI or for permitting IFSI. Instead, general duties and obligations are more likely to be referred to when a specific provision under PRC law is ambiguous.

1.6 As a result, a legal uncertainty persists under PRC law on whether Relevant Investors have general legal duties or the discretion to IFSI in the absence of express statutory or contractual requirements, and if so, to what extent such a duty could be deemed as being discharged.

China's concept of ecological civilization

1.7 "Ecological civilization" means a new stage in the development of human civilization after the current industrial civilization, a sum of material and spiritual results to be achieved by mankind following the rule of the harmonious development of man, nature and society.[4]

1.8 In November 2012, the 18th national congress of the Chinese Communist Party (**CCP**) for the first time decided to "vigorously promote the establishment of an ecological civilization". In September 2015, the politburo of the CCP[5] passed the Overall Plan for Ecological Civilization System Reform, which establishes the concept of "mountains, rivers, forests, farmlands, lakes and grasslands" as a community of life.[6] The following month, the further establishment of the ecological civilization was written into the five-year plan of the country for the first time and, in March 2018, was written into China's constitution. On 15 March 2021, President Xi stated during the ninth meeting of the Central Committee for Financial and Economic Affairs that achieving net-zero carbon emissions should be incorporated into the ecological civilization plan.

1.9 In the area of investment and financing with respect to ecological civilization, the Guidelines for Establishing the Green Financing System (the *Green Financing System Guidelines*) and the Guidelines for Promoting the Investment and Financing in Response to Climate Change (the *Climate Investment and Financing Guidelines*) were published in August 2016 and October 2020 respectively by the central environmental authority and multiple financial regulators[7] encouraging private investment into areas related to environmental sustainability. There are also a number of official guidelines as "soft law" standards, encouraging private capital to engage in other sustainability impact-related areas, including, for example, the proposal issued by IAMAC for investment by insurance funds,[8] the investment principles for Belt and Road initiatives,[9] and investment guidelines proposed by AMA[10]. However, none of these standards have yet amounted to any express legal grounds for Relevant Investors to be obliged or free to IFSI.

CHINA

2. ASSET OWNERS' USE OF POWERS OF INVESTMENT AND DIVESTMENT TO INVEST FOR SUSTAINABILITY IMPACT

2.1 The following section considers the extent to which, and in what circumstances, each type of Asset Owner is by law required, or permitted or able, to use its powers of investment and divestment to Invest for Sustainability Impact.

2.2 **Pension funds**

Types of pension fund covered

Public schemes

2.2.1 We consider in this section the Basic Pension Fund (**BPF**), the largest sovereign pension scheme in China, and the National Social Security Fund (**NSSF**), a national reserve fund supplements the social security expenditures of a rapidly aging population.

2.2.2 The BPF is a dual-track pension system, under which: (a) an employee shall contribute 8% while the employer shall pay 20% of the employee's total salary to the system; and (b) an unemployed or a self-employed person shall pay a fixed amount as determined by the local government from time to time. The portion of funds contributed by individual employees and part of the funds paid by those who are unemployed or self-employed will be put in their personal accounts, out of which the benefits are paid on a defined-contribution (DC) basis, while the portion paid by the employers and the rest of the funds paid by those who are unemployed or self-employed will be pooled in an account at provincial level, out of which the benefits are paid on a defined-benefit (DB) basis. The benefits are guaranteed by statute. With the population continuing to shift from rural to urban areas, the pressure on the BPF is increasing, as people who used to live in rural areas may be entitled to an increased benefits after they move to an urban area, and the funds in the pooling accounts at provincial level cannot be transferred.

2.2.3 The fund assets of the NSSF are raised through state financial appropriation, state-owned capital re-allocation, investment income and other methods as approved by the State Council.

2.2.4 The key entities are:

- **Asset Owners:** the administering authorities, as sponsors of the BPF and the NSSF, are responsible for fundraising, account management and distribution of benefits by law, and are required to appoint qualified third-party trustees (**trustees**) to manage and operate the fund assets. Although the trustees hold no legal title to the fund assets, they will be deemed the Asset Owners for the purpose of this annex, as they can exercise substantially all investment powers related to the fund assets. For NSSF, the trustee must be the National Council for Social Security Fund (**NCSSF**), an organization specially established for this purpose, as required by the relevant regulations.[11]
- **Beneficiaries:** for the BPF, the unspecified pensioners are entitled to receive all the benefits under the applicable laws and regulations.[12] It is not clear if this covers only existing pensioners or those who will become pensioners in the future as well. We consider the NSSF as having no specific beneficiaries but instead acts for the benefit of the overall social security system. This is because it does not raise funds from individual pensioners, functions as a supplemental funding source for social security expenditures and has other functions beyond paying individual pensioners,
- **Investment decision-makers:** the trustees, or the Investment Manager(s) appointed by the trustees.

Private schemes

2.2.5 We consider in this section occupational pension funds, which are composed of: (a) the Occupational Annuity Fund (**OAF**), which is mandatory for all government and public institution employees; and (b) the Enterprise Annuity Fund (**EAF**), which is optional for enterprise employees. We have excluded contract-based pension schemes operated by insurers (addressed below at Section 2.4) from our consideration.

2.2.6 Under the OAF, an employee contributes 4% while the employer pays 8% of the employee's total salary. Under the EAF, where adopted, an employee shall be auto-enrolled unless they opt out, and contribute up to 8%, and the employee and their employer shall collectively pay up to 12% of the employee's total salary. Unlike the BPF, which is a mixture of DC and DB plans, funds paid by both employers and employees into the OAF and the EAF are put in the employees' personal accounts and paid on either a DB or DC basis.

2.2.7 The key entities are:

- **Asset Owners:** as fund sponsors, both employers and employees are responsible for establishing the fund plan, fundraising and managing accounts by themselves

> ANNEXES

> China

CHINA

or via a third party, and are required to appoint trustees to manage and operate the fund assets. As for public schemes, the trustees will be deemed the Asset Owners for the purpose of this annex.

- **Beneficiaries:** pensioners whose enrolment is conditional on their having the necessary continuous service.
- **Investment decision-makers:** the trustees, or the Investment Manager(s) appointed by the trustees.

Overview of investment duties and powers

Public schemes

2.2.8 Typically, the trustees' investment duties and powers are shaped by:

(a) special laws and regulations[13] regarding the administration of the pension funds, which notably specify or require:

(i) the BPF and the NSSF to achieve "the value preservation and appreciation of fund assets while preserving the integrity and liquidity of the fund assets"[14] without a definitive duration. For the NSSF, the relevant regulations also emphasize consideration of the safety, profitability and long-termism of the investments;[15]

(ii) the establishment of investment strategies and risk control policies;

(iii) investing in accordance with the fund objective and investment strategies referred to above;

(iv) compliance with portfolio diversification requirements;[16]

(v) conducting business with honesty, good faith, prudence and diligence;

(vi) no commingling of fund assets, no unfair treatment of fund assets with assets of other funds under the management or within the same fund,[17] no embezzlement or misappropriation of fund assets, no self-profiting and no guaranteed return or principal;

(b) the terms of the entrustment agreement with the fund sponsors similar to the obligations under laws and regulations, albeit with certain supplements;

(c) contractual[18] and agency[19] duties owed by the trustees to the fund sponsors arising out of the entrustment arrangements, including:

(i) the duty of care as a bona fide manager, or in other words, the duty of prudence and diligence; and

(ii) no delegation and no self-trading (in each case, unless so permitted by the entrusting party).

2.2.9 The standard of the trustees' duties of honesty, good faith, prudence and diligence to the fund sponsors arising out of special laws or the contract-based entrustment arrangements has not been explicitly established under PRC laws. In practice, it is usually understood to be similar to that of the fiduciary duties of loyalty and care of the directors and senior management of a Chinese company (Section 2.2.10) with certain deviations where justified. However, no exact scope for such permitted deviations has been established in practice in respect of achieving a (particular) financial return or IFSI.

2.2.10 The standard for directors' and senior management's fiduciary duty in a PRC company as commonly accepted in practice is set out below:[20]

(a) The duty of honesty and good faith mainly require:

(i) no misappropriation of company assets;

(ii) no deposit of company assets into personal accounts;

(iii) no provision of loans or guarantees to others with company assets;

(iv) no self-trading;

(v) no usurpation of the company's business opportunities or the carrying on of any business competing with the company;

(vi) no commission or fees to be received from a third party for transactions between the company and the third party; and

(vii) no disclosure of the company's secrets.

However, items (iii) to (v) above can be exempted if permitted in the constitutional documents or be authorised by the approval of the shareholders' or board meeting.

(b) The duty of care as a bona fide manager or the duty of prudence and diligence requires the exercise of the professional knowledge, skill and experience of a prudent person under similar circumstances.[21]

We have not seen or found any guideline, past case or discussion on the application of these duties in the context of IFSI.

Private schemes

2.2.11 The objective as well as the duration and any termination events of the EAF will be determined on a case-by-case basis as provided in the fund plan. Fund documents of the EAF should strictly follow the format and content guidelines issued by the human resources and social security department and be filed with the same as a record. According to a template plan provided by the regulatory authorities,[22] the objective of

CHINA

the EAF is to achieve "appropriate profits while preserving the integrity of the fund assets." As the relevant laws and regulations of the OAF are silent on the fund objective, we expect that it will be provided in the fund plans, and that the fund documents will have similar terms as that of the EAF given the governmental or semi-governmental nature of the sponsors of the OAF.[23]

2.2.12 The trustees' investment duties and powers are similar to that of public schemes (Sections 2.2.8(a)(ii) to 2.2.8(c)), being shaped by special laws and regulations regarding the administration of pension funds[24] as well as the terms of the entrustment agreement. In addition, the fund sponsors will separately adopt a fund plan, setting forth the fund objective (Section 2.2.11) and other matters in detail.

Legal requirements to use investment powers to IFSI

2.2.13 We do not generally consider that the trustees are subject to an express duty to IFSI (either instrumental or ultimate-ends IFSI) due to the lack of specific provisions implementing the high-level principles referred to in Sections 1.5 and 1.7-1.9.

2.2.14 However, the beneficiaries of the BPF are the unspecified pensioners (current or future) as a whole, while the NCSSF is required to manage the fund with the goal of long-termism. In each case, the duties of the trustees (ie the duties of honesty and good faith, or more specifically, fair treatment of all fund assets), together with the objectives of the BPF and the NSSF to achieve "value preservation and appreciation of fund assets while preserving the safety and liquidity of the fund assets" and the objective of the EAF to achieve "appropriate profits while preserving the integrity of the fund assets," could be construed as requiring the trustees to secure the interests of the funds for not only current but also future pensioners and to serve the interests of all beneficiaries fairly, not prejudicing the interests of persons to whom benefits will be paid in the future to serve those currently receiving benefits due to the long-term negative sustainability impact at a systemic level. As such, it might be suggested that the trustees have a duty under PRC law to pursue instrumental IFSI if by so doing they could mitigate that negative sustainability impact. However, we do not see any specific precedent or indication in applicable law or regulation for this view, nor is there any specific requirement for the trustees to collaborate with other investors to do so.

Legal freedom to use investment powers to IFSI

2.2.15 We do not consider that there is an over-arching duty under PRC law for the trustees to pursue a particular financial return, which would exclude any possibility of managing the fund to achieve other non-financial goals. Neither the "value preservation and appreciation" for public schemes nor the "appropriate profitability" for private funds should necessarily be construed as requiring the trustees to maximize or achieve a particular financial return without explicit statutory requirements, although literally these terms seem to be more concerned with financial performance. In the absence of any specific requirement, we therefore consider that the applicable legal rules offer some flexibility for a trustee to IFSI (including ultimate-ends IFSI).

2.2.16 However, there are issues that may make the trustees cautious about utilizing the flexibility available to IFSI (particularly the ultimate-ends IFSI that is prioritized over or has a negative impact on the financial performance). For example:

(a) it is not clear to what extent the financial return may be compromised as a result of consideration of sustainability impact in the eyes of the court when assessing if the trustees have discharged their existing duties, and the court may hold the view that the outcome should be at least comparable to that of similar portfolios managed by a prudent third-party professional and not significantly less than could have been achieved without IFSI; and

(b) where the benefits of the BPF are guaranteed by national finances and further supplemented by the NSSF, or DB or mixed plans are adopted, the fund sponsors may in practice exert pressure over the trustees to pursue a short- or medium-term financial return, as they would be responsible for making a further contribution to the pension funds if the funds were to underperform over the short or medium term.

On the other hand, the trustees may face less pressure in adopting instrumental IFSI since instrumental IFSI, by definition, is less likely to compromise the fund's financial return.

2.3 Mutual funds

Types of mutual fund covered

2.3.1 We consider in this annex publicly offered securities investment funds (public funds), a category of large-scale mutual funds offered and managed by licensed public fund management companies (**public fund managers**). Public funds are subject to stringent regulation and supervision in China, and are the most common form of

ANNEXES

China

CHINA

regulated mutual funds. We have excluded asset management schemes offered by other financial institutions, who are licensed to establish and operate their respective asset management schemes under the segregated operation regime, or privately offered by public fund managers.

2.3.2 Public funds can be structured as either contract-based entrustment arrangements or unit trusts according to the provisions of relevant laws and regulations, and the fund agreement between unitholders and public fund managers. The vast majority of public funds are open-ended funds, according to statistics disclosed by AMAC[25] (as defined below). The agreements between fund managers and unitholders provide when and how unitholders can subscribe and redeem their units, so public funds are required to hold sufficient cash or government bonds for redemption purposes.[26]

2.3.3 Closed-ended public funds must last for 10 to 15 years, while open-ended public funds can continue for an indefinite term unless terminated pursuant to the fund documents. The prospectus, which contains the key information in relation to public funds (including the fund objective, investment policies, etc.), together with the fund agreement and other fund documents, must be registered with the regulatory authorities and disclosed to potential investors before a public offering. In case of any material changes[27] thereto, the public funds managers must re-register the fund documents with the regulatory authorities before implementing the changes.

2.3.4 For both trusts and contractual entrustments, unitholders subscribe to fund units by paying the subscription price to public fund managers. The fund assets are registered in the name of the managers (rather than the public funds) but are independent from their own assets and shielded from being seized on the bankruptcy of the public fund managers. During the term of a public fund, the unitholders may, through the unitholders' general meeting, unilaterally amend the "key terms" of the fund agreement and determine other matters relating to the fund,[28] but not directly participate in or interfere with the investment activities of public funds.[29] Procedural rules for the unitholders' general meeting are provided in the fund agreement.

2.3.5 The key entities are:

- **Asset Owners:** public fund managers.
- **Beneficiaries:** for closed-ended funds, current unitholders, and for open-ended funds, the unitholders. The law and practice are silent on whether future unitholders are also Beneficiaries of open-ended funds.
- **Investment decision-makers:** public fund managers. Public fund managers are not licensed to appoint Investment Managers to manage portfolio investments; rather, according to the internal control requirements,[30] they shall establish, improve and strictly comply with their internal Investment decision-making policy and prevent ultra vires decision-making.

Overview of investment duties and powers

2.3.6 A fund scheme for asset management in China by its nature[31] is more like a trust, and the parties thereto are required to comply with the duties and obligations under the trust law.[32] However, as China has long adopted the principle of segregated operation to regulate financial institutions, under which each type of financial institution may carry out only one kind of financial business, it may give rise to regulatory risk when a financial institution that is not a registered trust company claims that the schemes it manages are trusts. The Supreme People's Court of China has also clarified that not all fund schemes (eg public funds schemes) shall constitute a trust scheme under the trust law.[33]

2.3.7 Typically, the public fund managers' investment duties are shaped by:[34]

(a) special laws and regulations[35] regarding the administration and operation of the public funds, which notably specify:

  (i) duties similar to that of pension funds (Section 2.2.8(a)(ii) to (vi)); and

  (ii) no damage of the national/ public interest;

(b) the terms of the fund agreement similar to obligations under the laws and regulations, albeit with supplementary information:

  (i) fund name, objective and investment policies;

  (ii) fund structure (eg trust/entrustment arrangement) and operational mechanism (eg open- or closed-ended);

  (iii) portfolio diversification requirements and investment restrictions; and

  (iv) rules for procedures and other matters at unitholders' general meetings;

(c) contract law and agency duties owed to the unitholders arising out of the entrustment arrangements (Section 2.2.8(c));

(d) trust law[36] duties owed to beneficiaries arising out of trusts, which are independent from the entrustment arrangement (Section 1.3), including:

CHINA

(i) the duty to handle trust affairs in the best interests of the beneficiaries with honesty, good faith, prudence and effectiveness (Section 2.3.8); and

(ii) no self-dealing (unless permitted by the trust documents and at a fair market price), no self-profiting (other than payment required by law) and no possession of trust assets (unless permitted by the trust documents or principals, and at a fair market price).

2.3.8 The standard for the principle of being in the best interests of beneficiaries under trust schemes, as a general principle of the fiduciary duty of loyalty,[37] has not been explicitly established under PRC law. Literally speaking, it requires a substantial inquiry into the merits of the trustees' acts, provided that self-profiting, possession of trust assets and self-dealing are presumed invalid. We have seen cases where the courts have held the trustees liable for breaching the principle of best interests when the trust assets were adversely affected, but there is no conclusive meaning of "best interests" in practice in respect of the duty to achieve a (particular) financial return or IFSI.

2.3.9 The standard of public fund managers' duties of honesty, good faith, prudence and diligence/effectiveness[38] to the unitholders arising out of special laws or the contract-based entrustment arrangements or trusts has not been explicitly established under PRC laws. In practice, it is usually understood to be similar to that of the fiduciary duties of loyalty and care of the directors and senior management of a Chinese company (Section 2.2.10) with certain deviations where justified. However, the exact scope of such permitted deviations has not been established in practice in respect of the duty to achieve a (particular) financial return or IFSI.

Legal requirements to use investment powers to IFSI

2.3.10 We do not generally consider that the public fund managers are subject to an express duty to IFSI (either instrumental or ultimate-ends IFSI) for the similar reasons mentioned in Section 2.2.13.

2.3.11 However, as for pension funds (see above Section 2.2.14), for open-ended public funds, the systemic risk of jeopardizing the interests of potential future beneficiaries for the interests of the current ones may practically require public fund managers to consider long-term negative sustainability impact or instrumental IFSI. As such, the public fund managers arguably also have a duty under PRC law to pursue instrumental IFSI, although we do not see any specific precedent or indication in applicable law or regulation for this view, nor is there any specific requirement for the public fund managers to collaborate with other investors to do so.

Legal freedom to use investment powers to IFSI

2.3.12 We consider that the applicable legal rules offer some flexibility for a public fund manager to IFSI (including ultimate-ends IFSI). However, there are issues that may make public fund managers cautious about utilizing the flexibility available to IFSI (particularly the ultimate-ends IFSI that is prioritized over or has a negative impact on the financial performance). For example:

(a) Due to the lack of a standard for the unitholders' "best interest," it is not clear to what extent IFSI considerations may have compromised financial returns in the eyes of the court when assessing if the public fund managers have discharged their duties.

(b) Financial return is focused on the benchmarks commonly used in rating public fund performance. This may in practice exert pressure on public fund managers not to IFSI if it has a negative impact on financial return. For example, the valuation indicators adopted by the rating system of the Golden Bull Award, also known as The Oscars of China's investment fund industry, focus on (i) a single fund's financial return over the short to medium term (eg three or five years),[39] and (ii) the overall portfolio performance of stock and fixed income assets and the AuM of a public fund manager. In contrast, barely any non-financial indicators as indicated in the goal of the award[40] are considered.

(c) The public funds' stated investment objectives and strategies, which are established prior to the units being made available to the public, determine the factors public funds managers may take into account when making investment decisions. The objectives and policy must be disclosed in the documentation constituting the scheme, which must be true, accurate and complete.[41] If sustainability impact carries substantial weight in investment decision-making, the public fund managers may need to disclose it as part of the objective or policy, and this may make such fund schemes less attractive to profit-driven investors.

On the other hand, the public fund managers may face less pressure in adopting instrumental IFSI since instrumental IFSI, by definition, will serve the financial return objective.

CHINA

2.4 **Insurance undertakings**

Types of insurance undertaking covered

2.4.1 The scope of insurance funds is widely defined under PRC law, consisting of capital funds, capital and surplus reserves, undistributed profits, all kinds of other reserves and other funds of insurers under the relevant regulations.[42] We consider in this annex:

(a) *Life insurance*. The insurer undertakes, in consideration of a specific premium being paid, to pay out a lump sum or fixed regular income on the insured's death or another defined event. The main purpose of this policy is investment. Life insurance policies are divided into three types, according to the profits generated from the investment return from the premium paid by the relevant policyholder to which such policyholder is entitled:[43]

(i) the premium multiplied by a fixed interest rate (compounded annually), where the insurer bears all investment risk;

(ii) the premium multiplied by a guaranteed minimum interest rate (compounded annually) *plus* dividends (if any) generated from the investment return (declared monthly or quarterly), where the insurer and the policyholder share the investment risk; and

(iii) the dividends (if any) generated from the investment return (declared at least once a week), where the investment risk is entirely borne by the policyholder.

(b) *General insurance*. This includes types of insurance policies that are not life insurance, including property, accident and sickness, travel and liability insurance. The insurer's liability is to pay out when a valid claim is made by the relevant policyholder. Any profits of investment activity are retained by the insurer.

We have excluded from consideration "non-life investment insurance" that has the same profit and risk sharing feature as life insurance policies but over a shorter time span (usually one to three years). It has been removed from the market due to risk concerns.

2.4.2 Key terms and conditions of the policyholder documentation (including the actuarial report and other ancillary supportive documents) and any subsequent amendments thereto must be submitted to the regulatory authorities for approval before implementation.[44]

2.4.3 For life insurance policies where the policyholders share or solely bear the investment risk, policyholders will select the notional "units" they wish to "purchase" with their premium from a range of funds made available by the insurance company. Returns payable to the relevant policyholder reflect the performance of the fund held and managed by the insurer in connection with those "units" based on the entrustment arrangements, as all insurance policies are contract-based.[45] Insurers can either make investments themselves or appoint Investment Managers to manage the portfolio.[46]

2.4.4 The key entities are:

- **Asset Owners**: insurers.
- **Beneficiaries**: natural or legal persons who are entitled to benefit under the policy, including policyholders, dependents, employees, etc. For the purpose of this annex, we are also treating the current shareholders[47] of the insurers as "beneficiaries" due to their economic interest in the management of the insurer's assets.
- **Investment decision-makers:** insurers, or Investment Managers appointed by insurers.

Overview of investment duties and powers[48]

2.4.5 Typically, an insurer's investment duties are shaped by:

(a) special laws and regulations[49] regarding the administration and operation of insurance funds, which notably specify that:

(i) the purpose of the investment of insurance funds is to achieve long-termism, value investing and decentralized investment for the insurance industry;[50]

(ii) the funds should establish and implement investment strategies and annual asset allocation plans;

(iii) the funds should comply with portfolio diversification requirements and investment restrictions;

(iv) business should be conducted conducted with honestly, good faith, prudence and safety;

(v) where one or more Investment Managers are appointed, there should be no diversion of insurance profits or illegal transmission of interests, and no request for guaranteed revenue by the Investment Manager(s);

(b) the terms of policyholder documentation similar to obligations under the laws and regulations, albeit with supplementary information:

(i) insurance name, term, premium rates and benefits;

> ANNEXES

> China

CHINA

(ii) financial or business management policies, business plan and estimated impact on solvency;

(c) contract law and agency duties owed to the policyholders arising out of the entrustment arrangements (Section 2.2.8(c)); and

(d) the insurer's directors and senior management's duty of loyalty and care under company law to the shareholders and external creditors (Section 2.2.10).

2.4.6 The standard of insurer's duties of honesty, good faith, prudence and diligence to the policyholders arising out of special laws or the contract-based entrustment arrangements has not been explicitly established under PRC laws. In practice, it is usually understood to be similar to that of the fiduciary duties of loyalty and care of the directors and senior management of a Chinese company (Section 2.2.10) with certain deviations where justified. However, the exact scope of such permitted deviations has not been established in practice in respect of achieving a (particular) financial return or IFSI.

General insurance: legal requirements to use investment powers to IFSI

2.4.7 We do not consider insurers to be under an express general duty to IFSI (either instrumental or ultimate-ends IFSI) for reasons similar to those mentioned in Section 2.2.13.

2.4.8 However, there are special requirements in relation to the investment of insurance funds in certain sectors or areas that have the effect of requiring ultimate-ends IFSI.[51] These supersede insurers' other duties and liabilities under the insurance policies or to shareholders. For example:

- for equity investment, target companies must comply with national industrial policies, and not be big energy consumers or polluters;[52]
- for equity investment in the long-term rental market, target projects must have positive economic and social benefits;[53]
- for investments via collective trusts, target projects or target enterprises must comply with general national and industrial policies;54
- for debt investment, target projects must have a positive social effect and comply with national and local industry, land, environmental protection, energy saving and other policies; and[55]
- for the acquisition of listed companies with other parties, the targets must comply with national industrial policies, not be big energy consumers or polluters, meet the state's energy-saving and environmental protection standards, or not be of low technical standards.[56]

2.4.9 If a general insurer is a listed company, it is required to bear greater general social responsibilities, including the following,[57] without guidance on what this entails:[58]

(a) to actively practice the concept of sustainable development, add the ecological and environmental protection requirements into strategy development and corporate governance processes, actively participate in the construction of ecological civilization, and play an exemplary and leading role in pollution prevention, resource conservation and ecological protection; and

(b) to be socially responsible in terms of community welfare, disaster relief, public welfare, etc., while maintaining sustainable development, improving operating performance and protecting shareholder's interests.

It is also encouraged to support poor counties or villages, support industrial development in poor areas, nurture talent and promote employment. However, it is unclear how these obligations interact with the insurers' other duties and obligations under insurance policies or to shareholders.

General insurance: legal freedom to use investment powers to IFSI

2.4.10 We consider that, in addition to the requirements referred to above, the applicable legal rules offer some flexibility for general insurers to IFSI (including ultimate-ends IFSI), provided that the outcome is at least comparable to that of a similar portfolio managed by a prudent third-party professional and not significantly less than could have been achieved without IFSI.

2.4.11 Listed insurers are encouraged to publish an annual social responsibility report[59] and are subject to the mandatory disclosure of major events related to environmental protection. However, disclosed events are those of the insurers or their consolidated subsidiaries, and the investments made by insurers with insurance funds or the underlying assets do not fall into the scope of disclosure, since they represent minority stakes as a result of the diversification requirements. Therefore, we do not think listed insurers are under pressure to disclose environmental information relating to their sustainability impact.

CHINA

Life insurance: legal requirements to use investment powers to IFSI

2.4.12 We do not consider life insurers to be under an express general duty to IFSI (either instrumental or ultimate-ends IFSI) for the same reasons as general insurance although the exception of the special statutory requirements (Sections 2.4.7 to 2.4.9) also applies to life insurers.

Life insurance: legal freedom to use investment powers to IFSI

2.4.13 Even for life insurance policies where the policyholders share or solely bear the investment risk, we do not consider that there is an over-arching duty under PRC law for the life insurer to pursue a particular financial return which excludes any possibility of managing the fund to achieve any other goals such as ultimate-ends IFSI, due to the lack of statutory duties of insurers (eg loyalty and diligence) explicitly requiring the insurers to do so.

2.4.14 We consider that the applicable legal rules allow some flexibility for life insurers to IFSI (including ultimate-ends IFSI) for the same reasons and to the same extent as general insurers (Sections 2.4.10 and 2.4.11).

CHINA

3. ASSET OWNERS' USE OF THEIR POSITION TO ENGAGE IN STEWARDSHIP ACTIVITIES TO SECURE SUSTAINABILITY IMPACT

3.1 The following section considers the extent to which, and on what basis, each type of Asset Owner is required, or permitted or able, to use its position to influence enterprises in which it invests by engaging in stewardship activities designed to achieve positive sustainability outcomes and minimize negative sustainability outcomes.

Overarching considerations

3.1.1 There is no specific legislation under PRC law on Asset Owners' powers and duties to carry out stewardship or engagement activities (like the stewardship code of the UK, Japan or other jurisdictions). Nor does PRC law impose a duty on Asset Owners to work collaboratively to address systemic (non-portfolio/issuer-specific) risk on the future performance of the target assets or issuer. Furthermore, insurers and public funds managers are generally required to use the rights attached to the instruments in which they have invested[60] to protect beneficiaries' interests, but this does not necessarily require them to engage in stewardship activities. Therefore, in general, Asset Owners' investment duties and powers regarding stewardship will be shaped by the same considerations as set out in the "*Overview of investment duties and powers*" in Section 2.

3.1.2 The costs incurred by stewardship activities are not explicitly allocated by law, so it is unclear who would bear the costs of stewardship activities. Therefore, we see possible disputes between beneficiaries and Asset Owners if any stewardship activities do not generate short-term financial returns to at least offset the costs.

3.1.3 Having regards to investment diversification requirements[61] and with limited implementation of cumulative voting and proxy solicitation, which are available in listed companies and non-listed public companies only, Asset Owners may not be able to hold a stake in the underlying assets that is significant enough to exercise stewardship activities.

3.1.4 A best practice for the stewardship activities of Asset Owners and other institutional investors in respect of listed securities was introduced under PRC law in 2018. It encourages (but does not require) Asset Owners to (a) actively participate in the governance of listed companies by exercising shareholder's rights (eg the right to vote, to information and to make a proposal) and via their delegates (ie directors and supervisors), and (b) publicly announce their objectives and principles of corporate governance, strategies adopted for exercising voting rights, and records and outcome of exercising shareholder's rights.[62]

3.1.5 There is no law or regulation explicitly prohibiting Asset Owners from collaborating with others for stewardship activities, however, there may be material impediments or deterrents to cooperation of this sort, including:

(a) *Competition law*. Collaboration between competitors amounting to price fixing, output or sales restrictions, sharing of markets and customers, joint restrictions on new products or technology, or collective boycotts, will virtually never be permitted.[63] A collaborative arrangement involving the exchange of information or the coordination of commercial activities may also infringe competition law if it eliminates or restricts competition or is considered to facilitate or lead to any of the above-mentioned infringements. Chinese competition law provides an exemption for collaboration arrangements that are intended to realize public interests such as energy efficiency and conservation, environment protection, and the provision of disaster relief and assistance,[64] which may concern joint efforts designed to achieve sustainability impact. Exempt arrangements must also allow consumers a fair share of the resulting benefits, and must not significantly restrict competition in the market.[65] However, as of today, China's competition authority has not yet published any decision granting an exemption for such collaborations. No prior notification or application for exemption to China's competition authority is required. Parties can implement the collaboration arrangements if, based on a self-assessment, they consider that the arrangement is eligible for exemption. If the authority initiates an antitrust investigation, the parties must provide evidence demonstrating actual or intended realization of public interests, consumer benefits as well as no significant adverse impact on competition. In general, collaboration for non-binding and non individualized sustainability targets or exchanging high-level best practice insights are less likely to give rise to competition issues, provided that such collaborative actions do not facilitate

CHINA

or lead to any of the aforementioned infringements and competitively sensitive information must not be exchanged.

(b) *Merger control.* Collaboration between Asset Owners can potentially trigger a merger filing obligation under China's merger control regime. If Asset Owners reach an agreement on how to exercise their voting rights due to their collaboration for sustainability impact, these Asset Owners could be treated as concerted entities acting as one party. Depending on their aggregated voting rights, the matters on which they agree to act in concert and the corporate governance structure prior to and post the collaboration, these Asset Owners acting as one party may be regarded as jointly obtaining control over the invested company from the perspective of Chinese competition law via their collaboration arrangements.[66] Such collaboration will be subject to a merger control filing in China if these Asset Owners meet the filing thresholds, which are based on the parties' global and PRC turnover. Thus a detailed assessment of the notifiability of such collaborations should be made before implementation.

(c) *Reporting requirements.* Collective shareholder action in respect of listed securities may trigger reporting requirements regarding combined shareholdings.[67] In particular, insurers are subject to special disclosure requirements when acquiring listed companies with other parties acting in concert.[68]

(d) *Insider and short-swing trading.* Shareholders acting in concert may become insiders thus subject to relevant obligations/restrictions, including disgorging any profits made from the purchase and sale of securities where both transactions occur within a short time frame.[69]

(e) *Mandatory tender offer.* Collective shareholder action may trigger the requirement to make a mandatory tender offer to acquire listed securities from other shareholders or infringe restrictions in place during certain periods.[70]

3.2 Pension funds

Legal requirements to engage for sustainability impact

3.2.1 For the reasons set out in Section 2.2.13, and subject to the caveats in Section 2.2.14, we do not consider that pension fund trustees are generally subject to an express duty to engage in stewardship activities for sustainability impact.

Legal freedom to engage for sustainability impact

3.2.2 Subject to the general obstacles in Section 3.1 and for the reason set out in Section 2.2.15, in our view there is some flexibility for pension fund trustees to engage in stewardship activities for sustainability impact.

3.3 Mutual funds

Legal requirements to engage for sustainability impact

3.3.1 For the reasons set out in Section 2.3.10 and subject to the caveats in Section 2.3.11, we do not consider that public fund managers are generally subject to an express duty to engage in stewardship activities for sustainability impact.

Legal freedom to engage for sustainability impact

3.3.2 Subject to the general obstacles in Section 3.1 and for the reason set out in Section 2.3.12, in our view there is some flexibility for trustees to engage in stewardship activities for sustainability impact.

3.4 Insurance undertakings

General insurance: legal requirements to engage for sustainability impact

3.4.1 Subject to the general obstacles in Section 3.1 and for the reasons set out in Sections 2.4.7 to 2.4.9, we consider that general insurers are subject to a duty in specific cases to engage in stewardship activities for sustainability impact if the investee later engages in poor sustainability practices (Section 2.4.8) although, from the wording of the legislation, insurers are simply required to avoid investing in companies that fail to meet the standards.

General insurance: legal freedom to engage for sustainability impact

3.4.2 Subject to the general obstacles in Section 3.1 and for the reason set out in Section 2.4.10, in our view, there is some flexibility for trustees to engage in stewardship activities for sustainability impact.

Life insurance: legal requirements to engage for sustainability impact

3.4.3 Subject to the general obstacles in Section 3.1 and for the reasons set out in Section 2.4.12, we consider that life insurers are subject to a duty in specific cases to engage in stewardship activities for sustainability impact if the investee later engages in poor sustainability practices (Section 2.4.8) although from the wording of the legislation, insurers are simply required to avoid investing in companies that fail to meet the standards.

Life insurance: Legal freedom to engage for sustainability impact

3.4.4 For the reason set out in Section 2.4.14, in our view, there is some flexibility for the trustees to engage in stewardship activities for sustainability impact.

CHINA

4. ASSET OWNERS' ENGAGEMENT IN PUBLIC POLICY WORK TO SECURE SUSTAINABILITY IMPACT

4.1 The following section considers the extent to which, and on what basis, each type of Asset Owner is required, or permitted or able, to use its position to engage in public policy work designed to achieve positive sustainability outcomes and minimize negative sustainability outcomes, for example, where these are relevant to the value of portfolio assets.

Overarching considerations

4.1.1 There is no specific legislation under PRC law in respect of Asset Owners' powers and duties to carry out public policy work activities. We are not aware of any duties or powers regarding public policy work activities shaped by other principles and legal rules. Asset Owners engaging in public policy work for sustainability impact should act on their own behalf and be funded from their own resources to avoid being accused of misuse of fund assets as participation in public policy work is in general too remote to be deemed as one of the commonly accepted areas of fund activity in China.

4.2 **Pension funds**

4.2.1 For the reasons set out in Section 4.1.1, we consider that trustees are generally not obliged but have the legal freedom, subject to the considerations mentioned in Section 4.1.1, to engage in public policy work activities for sustainability impact.

4.3 **Mutual funds**

4.3.1 For the reasons set out in Section 4.1.1, we consider that public fund managers are generally not obliged but have the legal freedom, subject to the considerations mentioned in Section 4.1.1, to engage in public policy work activities for sustainability impact.

4.4 **Insurance undertakings**

4.4.1 For the reasons set out in Section 4.1.1, we consider that insurers are generally not obliged but have the legal freedom, subject to the considerations mentioned in Section 4.1.1, to engage in public policy work activities for sustainability impact.

ANNEXES

China

CHINA

5. ESTABLISHING NEW FUNDS TO IFSI AND AMENDING THE TERMS OF EXISTING ONES

5.1 The following section considers the extent to which it is possible for an Asset Owner to set up a fund, policy or other product with the express objective of IFSI (especially ultimate-ends IFSI).

5.2 Pension funds

Public schemes

5.2.1 Public schemes (ie the BPF and the NSSF) are sovereign funds, established and regulated by statutory rules (Section 2.2.1). The trustees have no authority to set up a new fund of this sort or amend the terms of existing ones with the express objective to IFSI (either instrumental or ultimate-ends IFSI). The lawmakers or the government could amend the relevant objective in the relevant laws and regulations to incorporate sustainability impact factors.

Private schemes

5.2.2 Theoretically speaking, we see no legal prohibition on establishing private schemes that incorporate sustainability impact objectives under PRC law as the fund objective can be separately agreed by the parties. Although the trustees are retained by the employers and employees of private funds, directly or through statutory agent in the case of the OAF,[71] to manage the investment and operation of fund assets, the fund documentation is prepared by the employers and employees alone (Section 2.2.7(a)). The trustees thus have no authority to set up a new fund of this sort or amend the terms of existing ones with the express objective to IFSI (either instrumental IFSI or ultimate-ends IFSI).

5.2.3 That said, as private schemes are highly regulated and their fund documentation (including subsequent amendments thereto) should strictly follow the official templates and be filed with the authorities before adoption, the fund objective is likely to be financial only (eg "appropriate profitability" as provided in the official template) (Section 2.2.11). The authorities could challenge private schemes that have IFSI (especially ultimate-ends IFSI) as an express objective, which calls into question the feasibility of setting up a scheme or amending an existing one with such an objective in practice.

Duties on those designing, manufacturing and providing pensions

5.2.4 As the beneficiaries of a private scheme (eg the employees) are responsible for formulating the fund plan, their wish to pursue sustainability impact should be reflected therein, and there is no duty or obligation for the trustees to inquire into the beneficiaries' wishes under PRC law. The express objective of IFSI (including ultimate-ends IFSI) can be defined when a new fund is set up, or on a continuous basis by amending the terms of an existing fund pursuant to the statutory rules.

5.3 Mutual funds

5.3.1 We see no legal prohibition on establishing mutual funds to incorporate sustainability impact as a primary or secondary objective under PRC law. However, as the benchmarks commonly used in rating public fund performance are short- or medium-term financial return and the fund objective should be publicly disclosed before any offering (Section 2.3.12), such funds (particularly those with the objective of ultimate-ends IFSI that is prioritized over or has negative impact on financial performance) may face the challenge that it is not as competitive in the market as funds with less or no focus on sustainability.

5.3.2 For existing public funds, however, as the unitholders may amend the "key terms" of the fund agreement(which we believe should include the fund objective) unilaterally via the unitholders' general meeting throughout the term of the fund agreement (Section 2.3.4), the beneficiaries' wish to pursue sustainability impact is still achievable by law.

Duties on those designing, manufacturing and providing mutual funds

5.3.3 We see no legal duty for public fund managers to design, create or operate mutual funds by reference to the wishes or needs of a "target market" or relevant beneficiaries.

5.4 Life insurance products

5.4.1 We see no legal prohibition on establishing products with investment objectives which seek to IFSI (either instrumental or ultimate-ends IFSI) under PRC law. However, as life insurance products must follow insurance product development guidelines,[72] be approved by the authorities (Section 2.4.2) and meet risk control-associated technical requirements,[73] insurers may face technical challenges in practice in establishing a new product with the express objective of IFSI (especially ultimate-ends IFSI).

5.4.2 The process of amending terms of existing products in order to set the express objective of IFSI (especially ultimate-ends IFSI) may face the same practical challenges

> ANNEXES

> China

CHINA

as new products in respect of product design, operational requirements and approval by the authorities for subsequent changes to policyholder documentation.

Duties on those designing, manufacturing and providing life insurance products

5.4.3 We see no legal duty on insurers to design, create or operate life insurance products by reference to the wishes or needs of a "target market" or relevant beneficiaries.

CHINA

6. INVESTMENT MANAGERS' DUTIES TO IFSI

6.1 This section considers the extent to which, and in what circumstances, an Investment Manager is required or permitted to IFSI on behalf of an Asset Owner or otherwise, in each of the three ways contemplated in Sections 2 to 4.

Powers of investment and divestment

6.1.1 Typically, an Investment Manager's investment duties and powers are shaped by:

(a) specific laws and regulations[74] regarding investment portfolio management, which notably specify:

(i) investing fund assets in accordance with the investment management agreement (**IMA**);

(ii) conducting business with honesty, good faith, prudence and diligence;

(iii) no guaranteed financial return or compensation for losses;

(iv) fair treatment of the fund assets and other assets under management (Section 2.2.8(a)(vi)); and

(v) no commingling of fund assets with its own assets; no seeking of improper benefits for others by taking advantage of the fund assets; and no embezzlement or misappropriation of fund assets;

(b) the terms of the IMA with an Asset Owner, which typically specify:

(i) the objective, scope, term and restrictions of the investment;

(ii) key personnel, conflicts of interest, risk control, information disclosure, divestment, etc.; and

(c) contract law and agency duties owed to Asset Owners arising out of the IMA (Section 2.2.8(c)).

6.1.2 The standard of Investment Managers' duties of honesty, good faith, prudence and diligence to Asset Owners arising out of specific laws or contract-based entrustment arrangements has not been explicitly established under PRC laws. In practice, it is usually understood to be similar to that of the fiduciary duties of loyalty and care of the directors and senior management of a Chinese company (Section 2.2.10) with certain deviations where justified. However, the exact scope of such permitted deviations has not been established in practice in respect of achieving a (particular) financial return or IFSI.

6.2 **Legal obligations with respect to sustainability impact**

Powers of investment and divestment

6.2.1 Where the IMA or relevant laws and regulations (such as specific regulatory requirements on general and life insurers' investment (see above Sections 2.4.8 and 2.4.12)) require IFSI (either instrumental or ultimate-ends IFSI), the Investment Manager must pursue a strategy that complies with such requirements. Investment Managers will want to ensure that the mandate specifies how any sustainability impact objectives should be balanced with financial objectives to minimize complaints and litigation risk.

6.2.2 Where the mandate is silent as to sustainability impact, we do not consider that an Investment Manager would be subject to a duty to IFSI (either instrumental or ultimate-ends IFSI) unless the mandate is subject to the statutory requirements, for example, relating to an insurance fund having the effect of requiring IFSI (Section 2.4.8).

6.2.3 If the Asset Owner wishes to incorporate IFSI (including ultimate-ends IFSI) as an investment objective, the IMA should be amended to incorporate this.

Engagement to achieve sustainability impact

6.2.4 As for powers of investment or divestment, an Investment Manager's duties would follow the terms of its mandate. Where the mandate is silent as to sustainability impact, we do not consider there to be any legal requirement for Investment Managers to engage with portfolio companies to achieve sustainability impact.

Public policy work to achieve sustainability impact

6.2.5 As above, an Investment Manager's duties would follow the terms of its mandate. Where the mandate is silent as to sustainability impact, we do not consider there to be any legal requirement for Investment Managers to engage in public policy work to IFSI (either instrumental or ultimate-ends IFSI).

6.3 **Legal freedom to invest for IFSI**

Powers of investment and divestment

6.3.1 Where the IMA is silent on IFSI (either instrumental or ultimate-ends IFSI), we consider that the applicable legal rules allow some flexibility for Investment Managers to exercise their investment powers for sustainability impact, although they will be reluctant to consider factors additional to financial returns without clear instructions to do so as it may expose them to litigation risk if the practical outcome is reduced financial returns.

6.3.2 Investment Managers are not generally obliged to offer sustainability-focused products to Asset Owners but are free to do so.

CHINA

6.3.3 The Investment Manager and Asset Owner could agree to amend the terms of an existing IMA to IFSI (including ultimate-ends IFSI). There are no limitations on the Investment Manager's ability to do so, but Asset Owners' ability to agree to such changes will be limited by their obligations to their beneficiaries (as discussed above) and so in many cases such an amendment may not be practically possible.

Engagement to achieve sustainability impact

6.3.4 Since stewardship activities are less likely to affect the composition of an investment portfolio, there may be more scope to pursue sustainability impact through stewardship activities, even where the IMA is silent upon the point.

6.3.5 In the absence of instruction on such engagement, the short-term nature of many IMA investment horizons may reduce the flexibility for engagement for sustainability impact if it will reduce financial returns over the relevant time horizon. However, there may exist a tension with the long-term nature of other portfolios (such as for pension funds and life insurance companies), which may increase the flexibility for engagement due to the possibility of sustainability impacts adversely affecting financial performance in the medium to long term (Section 2.2.14).

6.3.6 An Investment Manager is unlikely to engage for sustainability impact where doing so demonstrably costs the portfolio more than it can return as it is unclear under the law which party shall bear the costs.

Public policy work to achieve sustainability impact

6.3.7 An Investment Manager is broadly free to engage in public policy work on its own behalf, funded from its own resources subject to any conflict of interests.

6.3.8 In the absence of instruction on such engagement, the short-term nature of many IMA investment horizons may reduce flexibility for engagement in public policy work to achieve sustainability impact if it reduces financial returns over the relevant time horizon. However, there may exist a tension with the long-term nature of other portfolios (such as for pension funds and life insurance companies), which may increase the flexibility for engagement due to the possibility of sustainability impacts adversely affecting financial performance in the medium to long term (Section 2.2.14).

CHINA

7. LEGAL LIABILITY TO THIRD PARTIES FOR THE NEGATIVE SUSTAINABILITY IMPACT OF ENTERPRISES IN WHICH PORTFOLIOS ARE INVESTED

7.1 This section considers the extent to which, regardless of the legal rules under which it is required to operate and its constitution, an Asset Owner could be legally liable to third parties for the negative sustainability impact of enterprises in which it invests, and whether an Investment Manager could also be liable because of its role in assisting the Asset Owner to invest in the relevant enterprise and steward its investment.

7.2 **Asset Owners**

7.2.1 An Asset Owner would generally not be subject to civil, administrative or criminal liability[75] for the negative sustainability impact of an investee entity/project solely by virtue of its funding of such an entity/project. It would only be subject to criminal liability if it was regarded as acting as a conspirator in committing a crime,[76] which is rare in practice. A conspirator means someone who has jointly committed a crime under a conspiracy, depending on specific circumstances, as a principal offender, an accomplice, a coerced offender or an instigator,[77] but we see no case under PRC law that merely (minority) funding an activity might be assessed criminally.

7.2.2 Where the corporation is held criminally liable, the personnel directly in charge of the criminal offences of the corporation may also face criminal charges.[78] As such, a delegate (eg director) in the investee appointed by an Asset Owner may personally face criminal liability if the delegate takes charge of the investee or otherwise is directly responsible for any negative sustainability impact that amounts to a criminal offence. “Directly responsible” for an offence is commonly interpreted as the employees carrying out the action giving rise to the offence, and “directly in charge” is mainly regarded as the immediate supervisor of the foregoing employees or the direct decision-maker.

7.3 **Investment Managers**

7.3.1 The same considerations as set out in Section 7.2. would apply.

ANNEXES

China

CHINA

8. THE GROWING IMPORTANCE OF TAKING ACCOUNT OF ESG FACTORS WHERE THESE ARE 'FINANCIALLY MATERIAL'

8.1 It has become increasingly important for Asset Owners and their managers to take ESG factors into account when managing portfolios because of the way in which they could impact their investment objectives. The main reasons are summarized below.

8.2 In addition to the official guidelines referred to in Section 1.9, a number of industrial policies promoting the development of sustainability impact-related sectors have been released as well. For example, Made in China 2025, the top-level manufacturing policy issued by the State Council in May 2015, aims to build a sustainable manufacturing sector, which includes developing eco-friendly projects and reducing pollution.

8.3 Commercial enterprises are gradually disclosing more information about their ESG performance. For example, the Measures for the Disclosure of Environmental Information by Enterprises and Public Institutions[79] issued by the Ministry of Environmental Protection in December 2014 mandated that enterprises producing significant pollution shall disclose environmental information, including information related to pollution produced by them. The Shanghai Securities Exchange (**SSE**) encourages listed companies to publish annual social responsibility reports – those listed companies that do so benefit from simplified temporary notice review procedures. SSE also issued the Guidelines of Environmental Information Disclosure by Listed Companies in May 2005, which require, among others, that listed companies should disclose major events related to environmental protection.

8.4 Financial products that are issued to raise money for eco-friendly industries are now subject to more relaxed regulatory requirements. For example, the National Development and Reform Commission issued the Guidelines of Issuance of Green Bonds in December 2015, which has multiple policies that benefit the issuers of sustainable bonds, including providing governmental subsidy and relaxing general bond-issuing regulatory requirements.

CHINA

9. THE MEANING OF "FINANCIALLY MATERIAL"

9.1 Because of the growing importance of taking ESG factors into account in the investment process where financially material, it is important to understand how the law defines what is "financially material" and the period by reference to which financial materiality must be measured. Taking account of sustainability factors that are financially material in order to pursue financial objectives may incidentally have sustainability impacts and may also be consistent with IFSI. However, beyond that point, any attempt to realize a positive sustainability impact might need to rely solely upon IFSI (ie because it would no longer be driven by the need to generate financial returns).

9.2 **Financial materiality**

9.2.1 There is no provision under PRC law or guidance expressly addressing this matter. However, as the notion of "financial materiality" has been commonly referred to in various contexts relating to investment activities, we understand that the need to take into account the sustainability impact when seeking to secure a financial return depends on and is proportionate to the extent to which such a sustainability impact will affect the portfolio in specific cases. For example:

(a) the Administration Measures of Information Disclosure of Listed Companies provide that listed companies shall disclose any information that will have material impacts on investors' investment decision-making; and/or

(b) the Administration Measures of the Material Asset Restructuring of Listed Companies provide detailed ratio standards to ascertain whether a transaction qualifies as a material asset restructuring, as the listed companies generally bear greater social responsibilities (Section 2.4.9).

9.3 **Time period by reference to which "materiality" is to be assessed**

9.3.1 There is no provision under PRC law or guidance on this. Thus, we assume that only the "investment horizon" of the respective beneficiaries is relevant here.

> ANNEXES

> China

Freshfields Bruckhaus Deringer

Amber Liu, Yuxin Shen and Wang Zhe

CHINA

1 If a sustainability objective is expressly stated, there will be a corresponding duty to IFSI in order to achieve this objective.

2 In contrast to the common law concept of trust where the title of the underlying assets is transferred to the trustee, trusts under PRC law fall into the broader scope of contractual relationships, which are however regulated in accordance with trust law instead of contract law. (It is not well established under PRC law whether trusts are regulated by contract law, and further, by the superordinate concept of the contract-based entrustment arrangement.) Trusts also sit at the intersection with the property law – the assets are controlled by the trustee based on the psychological trust between the trustee and the grantor, and the trustee manages the assets in its own name.
The major difference in respect of the duties and obligations owed by an Asset Owner between a trust and a contractual-based entrustment arrangement is the degree of authority for managing the underlying assets. While the Asset Owner of a trust fund has the authority to manage the fund at its discretion based on the trust arrangement, the Asset Owner of a contractual-based entrustment arrangement must act strictly within the terms of the underlying entrustment agreement (although this could grant the Asset Owner authority that is comparable to a trustee's).

3 Except for the judicial interpretations and guiding cases of the Supreme People's Court of China, which constitute part of hard law, precedent cases have no binding effect under PRC law. They may serve as an illustration of the common view in practice of complying with the relevant rules, but they cannot help predicting the outcome of future cases even though there are existing cases addressing the same issue.

4 http://opinion.people.com.cn/n1/2018/1112/c1003-30395901.html

5 The politburo of the CCP is the party's decision-making body. Currently, it is a group of 25 top officials who oversee the CCP. Power within the politburo is further centralized in its standing committee, a smaller group of politburo members.

6 Elements of natural ecology together with the environment (eg mountains and ground, land and sea, upstream and downstream of drainage area) should be taken into consideration and overall protection, systemic maintenance, and comprehensive management should be carried out according to the integrity, systematic workings and internal rules of the ecosystem.

7 The Green Financing System Guidelines promote the establishment of a sustainable financial system in China by bringing more private capital into the "green" economy, developing an ecological civilization, and sending a positive signal on sustainability to the market. The Climate Investment and Financing Guidelines propose several measures to encourage private investment in areas related to climate change, including laying down a regulatory framework, formulating relevant national standards (eg standards for climate-related projects and the disclosure of climate-related information), guiding and supporting local practices, and advancing international cooperation.

8 Insurance Asset Management Association of China (the IAMAC), the self-regulatory body of China's insurance industry, published the Proposal for Green Investment in China's Insurance Asset Management Sector (the Green Insurance Investment Proposal) in June 2018. The Green Insurance Investment Proposal at a high level encourages insurers and Investment Managers of insurance funds to explore various investment instruments, establish industrial standards, enhance investment capabilities, prevent and control risks, and strengthen international cooperation, in each case for sustainable investments with insurance funds.

9 Green Finance Committee of China Society for Finance and Banking (a sub-committee focusing on sustainable finance of a financial academic society under the People's Bank of China) and London Corporation's Green Finance Initiative jointly published the Green Investment Principles for the Belt and Road Initiative (the GIP) in November 2018. The GIP was prepared based on existing responsible investment initiatives as a special version focusing on the countries in the Belt and Road area, and strives to integrate low-carbon and sustainable development principles into Belt and Road construction projects while still meeting the huge demand for infrastructure development along the region.

10 Asset Management Association of China (the AMAC), the association and self-regulatory body of China's investment fund industry, published Green Investment Guidelines (the GIG) in December 2019. "Green investment" refers to the investment strategy with the objective of environmental sustainability. The GIG encourages fund managers, especially those providing investment management services to pension funds, insurance funds and funds for social and public interest to establish a management system for sustainable investment, make sustainable investments and work with target enterprises with a focus on environment-related performance and the disclosure of environment-related information.

11 Article 5 of the Regulation on the National Social Security Fund.

12 Article 4 of the Social Insurance Law.

13 The key laws and regulations are:
(i) BPF: the Social Security Law and relevant implementing provisions, the Measures for the Administration of Investment in Basic Pension Fund and regulatory rules issued by the provincial governments; and
(ii) NSSF: the Regulations on the National Social Security Fund, the Interim Administration Measures of Investment by the National Social Security Fund, and the Interim Provisions on the Administration of Overseas Investment by the National Social Security Fund.

14 Article 4 of the Interim Measures for the Investment Management of National Social Security Funds, Article 1 of the Regulation on the National Social Security Fund, and Article 3 of the Interim Measures for the Investment Management of National Social Security Funds.

15 Paragraph 2 of Article 6 of the Regulation on the National Social Security Fund.

16 The portfolio diversification requirements mainly focus on the categories (eg listed/unlisted stocks, bonds, financial derivatives, etc. of well-developed/emerging markets) and balance (eg a capped amount of fund assets invested in a single category) of the target assets.

17 "No unfair treatment of fund assets with assets of other funds under the management or within the same fund" is the literal translation of the legal provisions, which means the fair treatment of the beneficiaries as represented by their fund assets.

18 Chapter 7 of Part I of the Civil Code.

19 Chapter 23 of Part III of the Civil Code.

20 Articles 147, 148 and 149 of the Company Law.

21 There are discussions on the application of the individual-based test of duty of care, like the "business judgment rule." We have also seen a few cases in which the lower courts in less developed regions of China have followed this approach.

22 http://hrss.hainan.gov.cn/hrss/0900/201811/34621f88276c47f3a7973ce70e5d3745.shtml

23 We are unable to find a template or sample fund plan of the OAF from publicly available sources.

24 The key laws and regulations are:
(i) OAF: the Measures for the Occupational Annuity Funds of State Agencies and Public Institutions, the Interim Measures for the Management of Occupational Annuity Funds and regulatory rules issued by provincial governments; and
(ii) EAF: the Measures for Enterprise Annuity Funds and the Measures for the Management of Enterprise Annuity Funds.

25 http://www.amac.org.cn/researchstatistics/datastatistics/mutualfundindustrydata

26 Article 68 of the Securities Investment Fund Law.

27 These matters include (i) material changes of investment objective, scope, policies or return and risk; (ii) material changes of rules of redemption or subscription, valuation and verification, rate structure, etc., and (iii) other changes that may disqualify the public funds.

28 These matters include (i) to raise extra funds or to extend the term of the fund agreement; (ii) to amend or to terminate the fund agreement, prior to the expiry date; (iii) to replace the public fund manager and the custodian; (iv) to determine the management fees of the public fund manager and the custodian; and (v) other powers and functions as provided in the fund agreement.

29 Articles 47 and 49 of the Securities Investment Fund Law, and Article 40 of the Measures for the Administration of the Operations of Publicly Offered Securities Investment Funds.

30 Article 24 of the Guiding Opinions on Internal Control of Securities Investment Fund Management Companies.

31 According to the Guiding Opinions of the People's Republic Bank of China, the China Banking and Insurance Regulatory Commission, the China Securities Regulatory Commission, and the State Administration of Foreign Exchange on Regulating the Asset Management Business of Financial Institutions (the New Asset Management Provisions) issued and effective on 27 April 2018, the framework and principles regarding systematic vulnerability of the asset management industry shall include, among others, (i) no guaranteed income/principal provided by fund managers to the stakeholders; (ii) fund managers to operate and manage fund assets with the duties of loyalty and diligence; and (iii) no pooled assets or leverage under the schemes.

32 According to the Notice by the Supreme People's Court of Issuing the Minutes of the National Courts' Civil and Commercial Trial Work Conference issued and effective on 8 November 2019, if the asset management business carried out by a financial institution constitutes a trust pursuant to the New Asset Management Provisions, disputes between the parties shall be handled in accordance with the PRC Trust Law and other relevant regulations.

33 2nd Civil Chamber of the Supreme People's Court of China, Understanding and Application of the Notice by the Supreme People's Court of Issuing the Minutes of the National Courts' Civil and Commercial Trial Work Conference, 2019.

34 Under the civil law system, unlike the "absolute" rights (eg human life and health, ownership of property, IP rights, etc.), the infringement of contractual rights or pure economic interests is not remediable under tort law, and the injured can only sue for breach of contract. In practice, however, we see cases where some individual Chinese courts granted remedies to the unitholders of public funds for damages (including loss of expected earnings) due to public fund managers' intentional act or gross negligence given the broadly defined scope of rights and interests in paragraph 2 of Article 2 of the Tort Law. We doubt the grounds for claiming tort in future cases, and do not believe a damages claim is a remedy generally available to the unitholders under PRC law.

35 The key laws and regulations are the Securities Investment Fund Law, the Measures for the Administration of the Operations of Publicly Offered Securities Investment Funds, and the Measures for the Administration of Securities Investment Fund Management Companies.

36 Articles 25 to 30 of the Trust Law.

CHINA

37 Clause 24, Section 2, Chapter 4, Part 2 of the Interpretation of the Trust Law, Law Press China, June 2002, http://www.npc.gov.cn/zgrdw/npc/flsyywd/jingji/2003-11/14/content_324169.htm

38 "Effectiveness" means literally, an efficiency-driven approach to manage the underlying assets.

39 In practice, three years are considered a relatively long duration for mutual fund evaluation in China. Before 2010, most ratings focused on yearly performances. The Interim Measures for the Appraisal of Securities Investment Funds now requires the rating agencies not to evaluate funds and fund managers with a duration of less than three years.

40 The goal is "to draw fund managers' attention to a fund's ability to generate sustainable returns, cultivate and guide investors' understanding of long-term investment, and direct the development of the fund industry toward compliance and health."

41 Paragraph 2 of Article 56 of the Securities Investment Fund Law.

42 Article 3 of the Measures for the Administration of the Utilization of Insurance Funds.

43 The Notice of the China Banking and Insurance Regulatory Commission, the Ministry of Finance, the Ministry of Human Resources and Social Security, and the State Administration of Taxation on Issuing the Guidelines on Developing Individual Tax-Deferred Commercial Pension Products.

44 Article 4 of the Measures for the Administration of Insurance Clauses and Insurance Premium Rates of Personal Insurance Companies, and paragraph 2 of Article 4 of the Measures for the Administration of the Insurance Clauses and Premium Rates of Property Insurance Companies.

45 Article 10 of the Insurance Law.

46 According to the China Insurance Asset Management Development Report 2018 published by the Insurance Asset Management Association of China, around 80% of insurance funds are managed by insurance assets management companies, around 17% by internal investment department of the insurers, and the remainder by other Investment Managers.

47 All insurers (both life insurers and general insurers) are required to be established as limited liability companies under the Company Law pursuant to Article 7 of the Provisions on the Administration of Insurance Companies.

48 Potential restrictions on insurers' powers and duties to use investment powers to IFSI as a result of compliance with industrial and operational requirements (eg SARMRA) is not considered in this annex.

49 The key laws and regulations are the Insurance Law and relevant implementation provisions and judicial interpretations, the Measures for the Administration of the Utilization of Insurance Funds, the Interim Measures for the Administration of Oversea Investment with Insurance Funds, the Interim Administration Measures for the Entrusted Investment of Insurance Funds; the Interim Provisions on the Administration of Insurance Assets Management Companies, and specific regulations regarding investment in various target assets with insurance funds.

50 Articles 4 and 45 of the Measures for the Administration of the Utilization of Insurance Funds.

51 Since 2013, a series of policies related to environmental pollution liability insurance have been issued, and the establishment of a compulsory liability insurance system for environmental pollution in areas with high environmental risks was proposed in the Overall Plan for Ecological Civilization System Reform and the Establishing the Green Financing System. Echoing these policies and the social responsibility of the insurance industry, insurance funds in general shall not invest in enterprises or projects that do not comply with national industrial policies, are big energy consumers or polluters, fail to meet the state's energy-saving and environmental protection standards, or be with low technical standards.

52 Article 12 of the Insurance Funds Equity Investment Measures.

53 Article 1(1) of the Notice of the China Banking and Insurance Regulatory Commission on Matters concerning the Participation of Insurance Funds in the Long-term Rental Market.

54 Article 4 of Notice of the General Office of the China Banking and Insurance Regulatory Commission on Matters concerning the Investment in Collective Trust Funds with Insurance Funds.

55 Article 10 of the Interim Provisions on the Management of Debt Investment Schemes in Infrastructure Facilities.

56 Article 7 of Notice of the China Insurance Regulatory Commission on Matters concerning Further Strengthening the Regulation of Stock Investments with Insurance Funds.

57 Articles 86 and 87 of the Code of Corporate Governance of Listed Companies.

58 The 2018 amendment of the Code of Corporate Governance of Listed Companies imposes greater social responsibilities on listed companies as a result of the adoption of ESG and other concepts advocated in international capital markets.

59 According to Article 5 of the Guidelines on Environmental Information Disclosure of Listed Companies on the Shanghai Stock Exchange, the matters to be disclosed in the annual social responsibility report may be tailored by the listed companies according to specific circumstances but shall include:
(i) activities for promoting sustainable social development (eg protecting employees' health and safety, protecting and supporting local communities, and controlling product quality);
(ii) activities for promoting environmental and ecological sustainability (eg preventing and reducing environmental pollution, protecting water resources and energy, promoting local liveability, and protecting and improving local biodiversity, etc.); and
(iii) activities for promoting sustainable economic development (eg creating value for customers through its products and services, creating better job opportunities, offering better training for workers, and bringing high economic returns to its shareholders, etc.).

The Shenzhen Stock Exchange updated the *Assessment Measure of Information Disclosure for Listed Companies* on 4 September 2020. The updated version includes one sub-article under the social responsibility assessment article: "(to assess) whether the company proactively discloses environmental, social and governance (ESG) information, and whether information disclosed is accurate and complete." This is also included in the assessment table: if a company discloses ESG information accurately it will get one point (out of a total of 100).

60 The Insurance Funds Equity Investment Measures require the Relevant Investors of insurance funds to exercise their legal rights and protect legitimate interests through legal and effective ways. Specifically, where insurers take control of non-insurance financial enterprises or enterprises whose business is connected to insurance, they shall maintain control of the invested enterprises by appointing directors, supervisors, management teams, or other key officers. Further, the Securities Investment Fund Law requires public fund managers to take legal action (which is very broad under Chinese law) for the benefit of the unitholders.

61 The relevant requirements are:

(i) Pension funds: Article 37 of the Notice of the State Council on Issuing the Measures for the Administration of Investment in Basic Pension Insurance Funds, and Articles 28 and 29 of the Interim Measures for the Investment Management of the National Social Security Funds;

(ii) Public funds: Article 32 of the Measures for the Administration of the Operations of Publicly Offered Securities Investment Funds; and

(iii) Insurance funds: Articles 2 to 4 of the Notice of the China Insurance Regulatory Commission on Strengthening and Improving the Proportional Regulation of the Utilization of Insurance Funds.

62 Articles 78 to 80 of the Code of Corporate Governance of Listed Companies.

63 Article 13 of the Anti-Monopoly Law.

64 Article 15 of the Anti-Monopoly Law.

65 Article 15 of the Anti-Monopoly Law.

66 Article 20 of the Anti-Monopoly Law. Such collaborations can be treated as a concentration of undertakings where the Relevant Investors acquire joint control or decisive influence over the invested company by contract. "Control" or "decisive influence" is interpreted broadly in China. Typically, control or decisive influence over a company arises where the shareholder (or shareholders acting in concert), directly or indirectly, owns more than half of the capital or business assets, or has the power (including the de facto ability) to exercise more than half the voting rights, or has the power (including the de facto ability) to appoint more than half the members of the management or supervisory board, or has the right to decide the company's strategic matters or manage the company's business operations. Negative control, ie the ability to block important strategic decisions, is sufficient for control.

67 The Administrative Measures for the Disclosure of Information of Listed Companies, the Measures for the Administration of the Takeover of Listed Companies, listing rules of stock exchanges and relevant implementation rules.

68 Notice of the China Insurance Regulatory Commission on Matters concerning Further Strengthening the Regulation of Stock Investments with Insurance Funds.

69 Articles 36, 44 and 51 of the Securities Law.

70 The Securities Law, the Measures for the Administration of the Takeover of Listed Companies, listing rules of stock exchanges and relevant implementation rules.

71 Under PRC law, government/public institutions and their employees are required to appoint the central OAF management centre established by the government or its local branches as their agent to establish the OAF plan, collect fund assets, manage fund accounts, and supervise the operation and risk control of the OAF, whose role is similar to that of the fiduciary manager. The OAF agent has the exclusive legal duty to appoint a qualified third-party entity (who is deemed to be the trustee of OAF) to manage the assets of the OAF pursuant to the OAF plan.

72 The Measures for the Administration of Insurance Clauses and Premium Rates of Personal Insurance Companies, and the Guidelines on Developing Individual Tax-Deferred Commercial Pension Products.

73 The Notice of the China Insurance Regulatory Commission on Issues concerning the Regulation of Personal Insurance Products with Short and Medium Duration, and the Notice of the China Insurance Regulatory Commission on Issues concerning Strengthening the Administration of Products under the Reform of the Policy on Personal Insurance Premium Rates.

CHINA

74 The key laws and regulations are:

(i) BPF: the Notice of the State Council on Issuing the Measures for the Administration of Investment in Basic Pension Insurance Funds;

(ii) NSSF: the Regulation on the National Social Security Fund, and the Interim Measures for the Investment Management of National Social Security Funds;

(iii) OAF: the Notice of the Ministry of Human Resources and Social Security and the Ministry of Finance on Issuing the Interim Measures for the Management of Occupational Annuity Funds;

(iv) EAF: the Measures for the Management of Enterprise Annuity Funds; and

(v) insurance funds: the Notice of the China Insurance Regulatory Commission on Issuing the Interim Administrative Measures for the Entrusted Investment of Insurance Funds.

75 PRC law allows for the criminal liability of corporations only if expressly provided in the Criminal Law.

76 There are specific crimes related to ESG issues For example, Section 6 of Chapter 6 of the Criminal Law prescribes a series of crimes in respect of the protection of natural resources as a result of violating relevant laws and regulations where the consequences are usually severe.

77 Article 25 of the Criminal Law.

78 Articles 30 and 31 of the Criminal Law. Depending on specific circumstances, criminal sanctions for individuals could be control, detention or fixed-term/lifetime imprisonment plus fines, deprivation of political rights or confiscation of property.

79 http://www.gov.cn/gongbao/content/2015/content_2838171.htm

EUROPEAN UNION

1. INTRODUCTION

1.1 This annex considers the extent to which Investing for Sustainability Impact (IFSI) is required, or may be permitted, under the laws of the EU as at 31 January 2021. However, where sufficiently relevant, we have also included more recent legal developments. The EU is treated as a 'jurisdiction' for the purposes of this report; it is competent to adopt legally binding rules within certain areas of the law, including the matters covered herein.[1] However, as regards legal rules implementing EU law into national law as well as practice, we refer to the annexes relating to the Member States, in particular France and the Netherlands.

1.2 Terms defined in the report glossary apply in this annex.

1.3 This annex covers legislative and non-legislative acts adopted by the bodies of the EU or issued by EU authorities as well as decisions by EU courts. Legislative acts include:

- regulations, which have general application, are binding in their entirety and are directly applicable in all the Member States[2]; and
- directives which are binding, as to the result to be achieved, upon each Member State, but leave the form and method of implementation to their national authorities.[3] Directives have direct effect only in exceptional circumstances.[4]

1.4 These legislative acts may delegate to the European Commission the power to adopt non-legislative acts to supplement or amend specified parts of a regulation or directive.[5] Delegated regulations and delegated directives have the same legal effects as regulations and directives, respectively.

1.5 EU legislation aims to harmonise the rules among the different Member States. However, in practice the system is not perfect. The discretion inherent in the need to implement directives and discretions granted to national authorities under regulations can lead to differential applications and interpretations among the Member States. Only a decision of the European Court of Justice (ECJ) gives rise to a uniform interpretation of EU legislation that is binding in all Member States. However, decisions by the ECJ are limited in number. The application and interpretation of EU legislation may also be guided by interpretations published by EU authorities. This may assist, but does not guarantee, consistent interpretation or application.

1.6 This annex does not explore the implementation or application of EU legislation in particular Member States. To the extent that rules are set out in directives and therefore generally require implementation, we have assumed that these rules have been implemented on a 'copy out' basis.

1.7 Further, the standards set by EU law which we discuss below inevitably do not provide a complete picture. For example, the legal form of an institution for occupational retirement provision (or IORP) or pan-European personal pension product (or PEPP) is not specified in EU law. While the Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (**UCITS Directive**)[6] allows UCITS to be constituted in accordance with contract law (as common funds managed by management companies), trust law (as unit trusts), or statute (as investment companies), the actual legal forms in which a UCITS can be established are governed by Member State law (eg the corporate law or trust law of the relevant Member State). The Directive 2009/138/EC on the taking and pursuit of the business of Insurance and Reinsurance (Solvency II)[7] refers to the permitted forms of insurance undertaking under each Member State's legislation and the Directive 2014/65/EU on markets in financial instruments (MiFID II)[8] generally requires that an investment firm is a legal person constituted under the law of a Member State. Accordingly, the constitution of pension funds, mutual funds authorised for distribution to retail, institutional investors and insurance undertakings (collectively termed Asset Owners) and the relevance of that constitution to investment-related decisions will be a matter of Member State law. Similarly, as regards some forms of pension provision, insurance policies and the arrangements between an Asset Owner and its investment manager, Member State laws of contract will be relevant, and it is also likely that Member State law will include non-contractual tortious obligations that are relevant to many of the relationships between Asset Owners and beneficiaries or between investment managers and Asset Owners (and possibly their own beneficiaries). All these matters are outside the scope of this annex. Therefore, there is very limited discussion of market or good practice in this annex because this tends to apply at Member State level and is only sometimes reported in guidance or opinions published by the ESAs.

EUROPEAN UNION

1.8 The precise circumstances surrounding each Asset Owner or investment manager are critical to its investment-related decisions (ie those concerning investment, holding or disinvestment, stewardship or public policy engagement - the expression is used in this annex as a convenient shorthand to cover all three). This annex seeks to summarise, at the level of EU law and subject to the various limitations described above, the framework of legal and regulatory issues within which those decisions should be made but is no substitute for legal advice in individual circumstances.

EU action plan on sustainable finance

1.9 In recent years, the Commission has communicated a strong political message regarding the importance of sustainability to the EU economy, including the financial sector. The EU Action Plan on Sustainable Finance[9], which was published in March 2018, is a key part of the Commission's sustainability initiatives and the most relevant to this annex. It aims, among other things, to reorient capital flows towards sustainable investment in order to achieve sustainable and inclusive growth and has been the starting point for many initiatives, including actions designed to clarify institutional investors' and investment managers' duties in relation to sustainability considerations.[10] In December 2019, the Commission presented a new growth strategy for the EU that supports the transition of the EU to a 'fair and prosperous society that responds to the challenges posed by climate change and environmental degradation', the so-called European Green Deal[11]. In order to support the EU's ambitions for climate action and its environmental policy underlined by the European Green Deal, the EU consulted on a renewed sustainable finance strategy between April and mid-July 2020,[12] following which the Commission published its comprehensive sustainable finance package on 21 April 2021.[13]

1.10 The following two initiatives which form part of the EU Action Plan on Sustainable Finance represent key legislative trends that drive the EU's approach to sustainable financial markets.

Harmonised rules for assessing environmentally sustainable economic activities

1.11 A cornerstone of the EU Action Plan on Sustainable Finance is the adoption of Regulation (EU) 2020/852 on the establishment of a framework to facilitate sustainable investment (Taxonomy Regulation)[14]. The taxonomy provided by this regulation can be used for a multitude of purposes. As things currently stand, it will be primarily used as a standardised measurement framework to avoid 'greenwashing' and to standardise narrative disclosures to investors. As part of the sustainable finance package published on 21 April 2021, the Commission also unveiled the EU Taxonomy Climate Delegated Act,[15] which supplements the Taxonomy Regulation by defining the technical screening criteria for economic activities that can make a substantial contribution to climate change mitigation and climate change adaptation.

Increased regulatory focus on disclosure frameworks

1.12 Investment managers and Asset Owners are increasingly expected to report on the sustainability aspects of their investment activities beyond their financial materiality to their clients.[16] The same holds true with regard to portfolio companies, who have been subjected to more sophisticated disclosure requirements recently.[17] This trend is likely to continue and will likely see disclosure requirements becoming more and more demanding.[18] This may cause relevant investors to afford sustainability aspects (whether or not financially material) greater weight in their investment activities. As sustainability-related information provided by their portfolio companies will always be important in this context, a broader application of relevant disclosure requirements to portfolio companies should support this development. While disclosure requirements do not in themselves modify the underlying investment managers' or asset owners' duties with regard to the discretionary management of clients' assets, they may create a tension between, if applicable, legal obligations to prioritise financial returns and disclosure requirements that incentivise IFSI to enable relevant investors to make more palatable disclosures.

1.13 In this context, the Regulation (EU) 2019/2088 on sustainability-related disclosures in the financial services sector (SFDR) establishes uniform, cross-sectoral rules for all relevant investors.[19] It applies as of 10 March 2021 and supplements the disclosure requirements laid down in existing EU legislation. It seeks to establish transparency not only regarding the integration of sustainability risks but also regarding the consideration of relevant investor's adverse sustainability impacts, and the provision of sustainability-related information with respect to financial products.[20] The SFDR

EUROPEAN UNION

uses the so-called 'double materiality' perspective which requires the integration of material sustainability factors in portfolios 'with their impact on the financial position and future earning capacity of a portfolio's holdings (ie, the "outside-in" or "financial materiality" perspective)' but also 'the impact of a portfolio on society and the environment (ie, the "inside-out" or "environmental/ social materiality" perspective)."[21]

1.14 To this end, a number of disclosure obligations for relevant investors are established, which relate to the information to be included on websites, in pre-contractual disclosures, in periodic reports and in marketing communications.[22] Additional obligations will apply in respect of financial products that promote environmental or social characteristics or even have sustainable investment[23] as an objective.[24]

1.15 Regarding sustainability risks, defined as 'environmental, social or governance event or condition that, if it occurs, could cause an actual or a potential material negative impact on the value of the investment',[25] Relevant investors will need to provide information through various channels on (a) their policies on the integration of sustainability risks in the investment decision-making process, (b) how their remuneration policies are consistent with the integration of sustainability risks and (c) the manner in which sustainability risks are integrated into investment decisions and the results of the assessment of the likely impacts of sustainability risks on the returns of the financial products made available.[26] For example, the SFDR distinguishes between financial products which have sustainable investment as their objective (Article 9 SFDR) and financial products which merely promote, among other characteristics, environmental or social characteristics, or a combination of those characteristics (Article 8 SFDR).

1.16 In addition, relevant investors will have to provide information on whether they consider principal adverse impacts of their investment decisions on sustainability factors (defined as 'environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters'[27]) on their websites and, by December 2022, at product level in pre-contractual disclosures.[28] Where relevant investors (voluntarily) consider such adverse impacts, they will need to make a statement on their due diligence policies with respect to these impacts.[29] Otherwise, they will need to give clear reasons why these impacts are not currently considered and whether changes are planned for the future.[30] From 30 June 2021, the SFDR obliges certain large relevant investors with more than 500 employees to publish a statement on due diligence policies in place with respect to principal adverse impacts of investment decisions on sustainability factors.[31] While the SFDR explicitly relates only to disclosure, it may well be argued that it also implies an obligation on the part of those required to make the relevant disclosures to consider and assess these potential impacts.

1.17 The SFDR aims to enhance transparency with respect to the integration of sustainability risks and factors in their decision-making process.[32] Moreover, Recital 12 SFDR explicitly sets forth that the 'Regulation *maintains* the requirements for financial market participants and financial advisers to act in the best interest of end investors',[33] implying that it does not materially affect the investment manager's duties *vis-à-vis* its investors. On the other hand, Recital 18 SFDR sets out that financial market participants should integrate in their processes sustainability factors and risks only '[w]here financial market participants, taking due account of their size, the nature and scale of their activities and the types of financial products they make available, consider principal adverse impacts'. This reference to the size of financial market participants as a reason for taking into account principal adverse impacts strongly indicates that large relevant investors must take into account the principal adverse impact of their investment decisions on sustainability factors. This view is further bolstered by several pieces of legislation included in the sustainable finance package published on 21 April 2021 that seek to align the existing legal duties for some relevant investors with the SFDR.[34]

EUROPEAN UNION

1.18 The (first) sustainable finance package which was published by the Commission on 21 April 2021 aims to improve the flow of capital towards sustainable activities across the EU.[35] The measures are designed to enable investors to re-orient investments towards more sustainable technologies and businesses and support the goal to make Europe climate neutral by 2050. The sustainable finance package is comprised of:

- the EU Taxonomy Climate Delegated Act which supplements the Taxonomy Regulation and aims to support sustainable investment by making it clearer which economic activities contribute to meeting the EU's environmental objectives;
- a proposal for a Corporate Sustainability Reporting Directive (or CSRD) which aims to improve the flow of sustainability information by portfolio companies; and
- six amending delegated acts on existing legal duties, investment and insurance advice which aim to ensure that financial firms, eg advisers, asset managers or insurers, include sustainability in their procedures and their investment advice to clients.

1.19 On 6 July 2021, the Commission adopted a further package of measures aimed at improving the financing of the transition to a sustainable economy.[36] This package includes, amongst others, the delegated act supplementing Article 8 of the Taxonomy Regulation.[37] Article 8 of the Taxonomy Regulation obliges certain large undertakings to disclose information on how and to what extent their activities are associated with economic activities that qualify as environmentally sustainable under the Taxonomy Regulation. The delegated act supplementing Article 8 of the Taxonomy Regulation sets out the content, methodology and presentation of information to be disclosed by large financial and non-financial companies and is further specified by several annexes.[38] The delegated act is intended to increase transparency in the market and prevent 'greenwashing'.[39]

EUROPEAN UNION

2. ASSET OWNERS' USE OF POWERS OF INVESTMENT AND DIVESTMENT

2.1 This section considers the extent to which and in what circumstances, each type of Asset Owner is required or permitted to use its powers of investment and divestment to invest for sustainability impact.

2.1.1 Generally, there is legislation outside the scope of the rules we discuss below that is designed to enhance environmental or social sustainability, and which has the effect of limiting the freedom of each of the Asset Owners to use its investment powers. For example, anti-money laundering legislation (which aligns with SDG 16.4) is designed to prevent terrorist and criminal activities since they are inconsistent with social wellbeing[40] and the EU sanctions regimes can be characterised in the same way[41].

2.1.2 To summarise briefly what we explain in more detail in the sections below, an Asset Owner would, if it considered one or more sustainability factors posed a material risk to its ability to meet its financial investment objective over the relevant timeframe, be legally obliged to consider what steps it can take to mitigate that risk. If it identifies reasonable steps it can take to bring about specific sustainability impact goals related to sustainability factors, then we see a duty to act accordingly in the interest of achieving the financial return objective (instrumental IFSI). In addition, Asset Owners may also pursue sustainability investment objectives alongside financial objectives, unless it may affect the financial performance of an investment negatively (ultimate ends IFSI). As noted above, this annex does not address relevant aspects of Member State law which may also impact on the answer to these questions in particular cases, and there are a number of issues in practice that are not the subject matter of this report such as assessing the impact steps of investors actually have on the relevant sustainability goals.[42]

2.2 **Pension funds**

2.2.1 ***Types of pension funds covered***[43]

Institutions for occupational retirement provision

2.2.2 This annex considers institutions for occupational retirement provision (or IORPs) which are, in particular, regulated by Directive (EU) 2016/2341 on the activities and supervision of institutions for occupational retirement provision (IORP II)[44]. IORPs are institutions, irrespective of their legal form, that manage collective retirement schemes for employers, in order to provide benefits for employees and, where permitted by Member State law, to self-employed persons.[45] IORPs in one Member State can manage occupational pension schemes for companies established in another Member State and, as a result, pan-EU companies can have a single pension fund for all their subsidiaries throughout the EU.

Providers of pan-European personal pension product

2.2.3 This annex also considers PEPP providers. These are financial undertakings authorised to manufacture and distribute a pan-European personal pension product (or PEPP). A PEPP is a voluntary personal pension scheme that complements an existing public or occupational pension system, or a national private pension scheme. PEPPs are mainly regulated by the Regulation (EU) 2019/1238 on a pan-European Personal Pension Product (PEPP Regulation)[46], which establishes a legal foundation for a pan-European personal pension market. The PEPP Regulation will start to apply on 22 March 2022.[47]

2.2.4 The main entities/groups of persons involved are:

- **Asset Owner**: for IORPs, the occupational pension fund. For PEPP providers, the personal pension fund.[48]
- **Beneficiaries**: for IORPs, beneficiaries are employees and, where permitted by the relevant Member State (see 2.2.1 above), self-employed persons which are, in each case, in the position of a 'beneficiary' (ie a person receiving retirement benefits) or a 'member"' (ie a person entitled to retirement benefits).[49] Additionally, employers might be considered as a further group of beneficiaries due to their position as contracting party of the employees, which will depend on Member State law. For PEPP providers, consumers who are a PEPP saver (ie a person who has concluded a PEPP contract with a PEPP provider) or a PEPP beneficiary (ie a person receiving PEPP benefits) qualify as beneficiaries.[50]
- **Investment decision-maker**: For IORPs, the occupational pension fund. For PEPP providers, the personal pension fund.

Overview

2.2.5 The investment duties of IORPs and PEPP providers are determined by (i) the respective contractual terms of the relevant pension scheme or PEPP; (ii) EU legislation (as detailed below); and (iii) the national law of the respective Member State (including the constitutional documents and related law applicable to the specific legal form of the IORP or PEPP provider). As noted in section 1 above, we have not covered national laws in this annex.

EUROPEAN UNION

2.2.6 At the EU law level, the main investment-related duties and powers of insurers are primarily set out:

- with respect to IORPs by IORP II; and
- with respect to PEPP providers by the PEPP Regulation.

IORPs

2.2.7 Under EU legislation, certain key investment duties and powers of IORPs are set out, in particular, by IORP II. Broadly, the main legal duties and powers under EU legislation are:

(a) *Prudent person principle and the best (financial) long-term interest of beneficiaries.* IORPs are required to invest in accordance with the PPP.[51] This requires, in particular, that assets are invested in the best long-term interest of beneficiaries as a whole. The primary aim of IORPs is to ensure financial security and good pensions for the beneficiaries in retirement.[52] Therefore, in general, the beneficiaries' 'best long-term interest' is served where the IORP's portfolio achieves risk-adjusted financial return consistent with the IORP's investment goal. In the case of a conflict of interest, IORP II explicitly requires that investment-related decisions must be made in the sole interest of beneficiaries.[53]

Nevertheless, within the PPP, 'Member States shall allow IORPs to take into account the potential long-term impact of investment decisions on environmental, social, and governance factors'.[54] IORP II specifically uses the word 'impact' with respect to ESG factors,[55] which are not necessarily related to any financial return. Consequently, this provision implies that IORPs may consider the long-term effects of investment decisions on sustainability factors in their investment-related decision-making where these effects are financially material as well as where they are not necessarily relevant to the IORP's investment goal.

(b) *Characteristics of the portfolio*. The investment of the assets shall ensure the security, quality, liquidity and profitability of the portfolio as a whole as well as a proper diversification.

(c) *Governance*. Member states must require IORPs to have in place an effective system of governance proportionate to the size, nature and complexity of the activities of the IORP. Such a system shall include consideration of ESG factors related to investment assets in investment decisions.[56]

(d) *Risk management and risk assessment*. IORPs must maintain an effective risk-management system, which shall be proportionate to their size, internal organisation and activities and which shall cover, among other things, the areas of investment, liquidity and concentration risk management as well as ESG risks relating to the investment portfolio and the management thereof.[57] Further, IORPs are required to carry out and document their own-risk assessment.[58] Where ESG factors are considered in investment decisions, IORP II expressly determines that the risk assessment needs to include an assessment of new or emerging risks, including risks related to climate change, use of resources and the environment, social risks and risks related to the depreciation of assets due to regulatory change.[59]

PEPP providers

2.2.8 The PEPP Regulation sets out certain key investment duties and powers of PEPP providers. Broadly, the main legal duties and powers under the PEPP Regulation are as follows.

(a) *Prudent person principle and the best (financial) long-term interest of beneficiaries*. A PEPP provider shall invest its PEPP-related assets in accordance with the PPP.[60] This requires, in particular, an investment in the best long-term interests of beneficiaries as a whole. The PEPP Regulation explicitly specifies that, in the case of a potential conflict of interest, the investment must be made in the sole interest of beneficiaries.

However, as part of the PPP, PEPP providers shall take into account 'risks related to and the potential long-term impact of investment decisions on ESG factors'.[61] Under the PEPP Regulation, 'ESG factors' are defined as 'environmental, social and governance matters such as those referred to in the Paris Agreement, the United Nations Sustainable Development Goals, the United Nations Guiding Principles on Business and Human Rights and the United Nations-supported Principles for Responsible Investment'.[62] Although this definition is rather broad, it clarifies that ESG factors must be taken into account when assessing financial performance.

(b) *Characteristics of the portfolio*. The investment of the assets shall ensure the security, quality, liquidity and profitability of the portfolio as a whole as well as a proper diversification.[63]

(c) *Risk mitigation.* The use of risk-mitigation techniques shall ensure that the investment strategy for the PEPP is designed to build up a stable and adequate individual future retirement income from the PEPP and to ensure a fair treatment of all generations of beneficiaries.[64]

EUROPEAN UNION

Legal requirement to use investment powers to invest for sustainability impact

IORPs

2.2.9 Under IORP II, IORPs are, as a general principle, not explicitly obliged to use investment powers to invest for sustainability impact.

2.2.10 As noted at section 2.2.6(a) above, IORPs must be *allowed* by the Member States to consider the potential long-term impact of investment decisions on ESG factors.[65] This does, however, not strictly oblige them to consider ESG factors[66] or sustainability impact in their investment decisions, nor does it require them to invest for sustainability impact.

2.2.11 However, it cannot be excluded that there may be certain situations in which IORPs are required to consider sustainability factors, and to act accordingly. This would in particular be the case where sustainability factors have an impact on financial return goals and, in these circumstances (instrumental IFSI could be in their chosen response), as briefly described below.

2.2.12 *Financial materiality.* There may be certain situations which give rise to a duty to take account of sustainability impact. This might be the case where IFSI corresponds to the 'best interest' of beneficiaries, ie where sustainability factors are to be considered financially material. Sustainability factors may be financial risks and be therefore financially material regarding the performance of a portfolio. For example, sustainability risks may materialise as market, operational, litigation or reputational risks.[67]

2.2.13 As indicated by several public surveys,[68] the public awareness in respect of sustainability impact is increasing. Moreover, the increased focus on sustainability issues in the legal and regulatory framework, for example the SFDR and EIOPA's opinion on the supervision of the management of environmental, social and governance risks faced by IORPs,[69] might intensify the general necessity for pension funds to have regard to sustainability risks. EIOPA states that the competent authorities should, among other things, 'review whether IORPs have adequately integrated ESG risks in their risk management system'.[70] Moreover, EIOPA points out that taking into account ESG factors 'to reduce the exposure of IORPs toward ESG risks is likely to help IORPs in the pursuit of sustainability goals. Conversely, considering the long-term impact of investment decisions on ESG factors can contribute to mitigating IORPs' exposures to ESG risks.'[71]

2.2.14 Where sustainability risks materialise as financially relevant risks, it can be argued that it is 'prudent' in the traditional sense to take such risks into account as part of the PPP. The question whether certain sustainability risks could be qualified as financially material depends on the time period over which potentially relevant risks are assessed. In relation to the typical time horizon relevant for pension funds, please refer to section 8.3.1 *et seq*.

2.2.15 Furthermore, one might suggest that pension funds, which operate with long-term horizons, might, as part of acting in the beneficiaries' 'best interest', be obliged to secure future financial interests of beneficiaries by taking sustainability risks into account even where they could not be classified as 'financially material' from a current perspective. One might argue that pursuant to the PPP, investments need to be aligned with the 'best *long-term* interests of members and beneficiaries as a whole'.[72] Recital 7 IORP II also indicates that, as a general principle, IORPs should, where relevant, take into account the objective of ensuring the intergenerational balance of occupational pension schemes.[73] The current wording of IORP II, however, leaves substantial doubt whether and, to what extent, risks could be qualified as part of the PPP where they cannot (yet) be considered as 'financially material', especially if such consideration would negatively affect the financial return.

2.2.16 Where long-term risks are systemic, such duty might also be disproportionate considering the practical difficulties an individual investor would face in addressing them: collaboration with other investors may be necessary instead of single actions by individual investors. Collective action is likely to increase a positive sustainability outcome and reduce the costs related to IFSI for individual investors. What the duties of pension funds may require with regard to collective action with other investors, will depend on the circumstances of the individual case. Such collaboration will need to comply with applicable legal requirements such as competition legislation or rules on insider dealing and market abuse (see discussion of collective action in Part B).

2.2.17 Additionally, there might be arguments (discussed briefly below) to interpret the duty to act in the beneficiaries' 'best interest' as a duty to exercise investment powers for sustainability impact as a standalone (ultimate ends

EUROPEAN UNION

IFSI). EU legislation does not, however, generally provide for a duty to invest for sustainability impact.

2.2.18 *Non-financial factors*. It is not made clear in IORPII whether the 'best interest' of beneficiaries is limited to financial interest or can also include non-financial factors. One could argue that the beneficiaries' 'best interest' is able to comprise non-financial aspects such as the well-being or health of beneficiaries. On this basis, one could suggest that pension funds may be obliged to pursue non-financial objectives relevant for beneficiaries also in cases where their (future) financial interests are not affected. However, according to its purpose, the PPP serves as an investment rule for IORPs whose main aim is (from a traditional perspective) to provide their respective beneficiaries with a retirement income. This suggests that the beneficiaries' 'best interest' is primarily met where the investment secures their (future) pension entitlements. For the same reason, it is unclear whether IORPs could, under certain circumstances, be required to seek to ensure wider societal objectives. This indicates that any investment for sustainability impact would need to comply with the limits of the PPP, ie it must not negatively affect the financial return of an investment.

2.2.19 *Beneficiaries' preferences*. Under current EU law, the predominance of the beneficiaries' 'best interest' as a rule for taking investment decisions may not be changed solely by potential sustainability preferences of an IORP's beneficiary. IORP II, however, allows for the consideration of the impact of investment decisions on ESG factors as part of the PPP. Therefore, IORPs may also be entitled, although not obliged, to consider their beneficiaries' views on ESG factors.[74]

PEPP providers

2.2.20 The PEPP Regulation does generally not provide for an obligation of PEPP providers to use their investment powers to invest for sustainability impact. Therefore, the position described for IORPs is similar for PEPP providers (see section 2.2.9 *et seq.*).

2.2.21 This means that, in particular, IFSI in the form of instrumental IFSI – ie where the pursuing of a sustainability objective ultimately serves the financial goal – would be covered by the requirement of the PPP under the PEPP Regulation.

2.2.22 Unlike IORP II, the PEPP Regulation determines that PEPP providers *shall* take account of risks related to and the potential long-term impact of investment decisions on ESG factors.[75] However, the obligation to take account of certain factors primarily constitutes a procedural requirement and does not override the basic financial investment goal of the PEPP. The duty to take account of the potential long-term impact of investment decisions on ESG factors does not therefore generally oblige PEPP providers to pursue(ultimate ends IFSI). Examining this in more detail, under Article 41(1) (b) PEPP Regulation, PEPP providers are required to *take into account* risks related to and the potential long-term impact of investment decisions on ESG factors. In contrast, Article 41(1) (a) PEPP Regulation explicitly requires that assets shall be *invested* in the best long-term interest of beneficiaries. Similarly, Article 41(1) (c) PEPP Regulation sets out that assets shall be *invested* in such a manner as to ensure the security, quality, liquidity and profitability of the portfolio as a whole. Thus, the wording of Article 41(1) PEPP Regulation differentiates between the (procedural) duty to 'take into account' certain factors and the duty to 'invest' in a specific manner. Additionally, according to the wording of Article 41(1) (b) PEPP Regulation, the duty to 'take into account' risks related to ESG factors applies *within* the PPP. This suggests that this duty does not override the obligation of PEPP providers to invest in the 'best interests' of beneficiaries.

2.2.23 Additionally, the PPP does in principle not require PEPP providers to assess the views of beneficiaries on whether they wish to pursue IFSI. PEPP providers are required to specify the 'retirement-related demands and needs' of the prospective beneficiary and to provide a PEPP contract which is consistent with the beneficiary's demands and needs.[76] Moreover, certain PEPP providers are required to assess the suitability of a PEPP for the respective customer, among other things, by obtaining information on that person's investment objectives.[77] Non-financial objectives are not explicitly addressed but could be considered to fall within the the wording of Article 34 PEPP Regulation. Thus, the assessment of the suitability of a PEPP may generally cover sustainability impact as a category as well, and such objectives may thus be pursued in parallel to a financial return objective provided that they do not negatively affect the financial return. However, there is no explicit legal requirement to do so.

> ANNEXES

> European Union

EUROPEAN UNION

Legal freedom to use investment powers to invest for sustainability impact

IORPs

2.2.24 This question only arises where there is not already a duty to invest for sustainability impact, ie where the sustainability factors under consideration are not financially material. We consider that the duties of IORPs pursuant to IORP II are flexible enough to allow for IFSI as long as certain conditions are met; Member State laws, which are not dealt with in this annex, might, however, impose more restrictive conditions..

2.2.25 IORP II explicitly prescribes that IORPs should be allowed to consider the potential long-term impact of investment decisions on ESG factors as part of the PPP.[78]

2.2.26 However, this freedom is subject to the PPP as underlying principle (see section 2.2.6(a) and 2.2.11 *et seq*.). Therefore, the integration of sustainability impact in investment decisions must not conflict with the beneficiaries' 'best long-term interest'; in particular, it should not negatively affect the investment's risk-adjusted financial return and endanger the beneficiaries' (future) pension entitlements. Where a conflict arises between sustainability impact and financial return, the investment would rather need to be made in favour of the (financial) 'best interest' of the beneficiaries.

2.2.27 As long as the PPP is preserved, IORPs should, in principle, be free to use their investment powers[79] to invest for sustainability impact. Pursuant to the Commission, there is a 'growing consensus', that the 'consideration of ESG factors is compatible with fiduciary duties when:

- the ESG factors have a financial material impact on the investment performance or valuation;
- it is reasonable to assume that taking into account ESG factors is supported unanimously by the beneficiaries; and
- ESG factors are a distinctive element when comparing investments with otherwise similar characteristics".[80]

2.2.28 With regard to the first two points, please refer to Section 2.2.10 and Section 2.2.18. The third point listed by the Commission suggests that IFSI should typically be possible under the PPP where it does not negatively affect the financial return but acts as a distinctive element among several equivalent investment options.

2.2.29 Further, IORP II allows in its Article 19(1) (b) for the consideration of the impact of investment decisions on ESG factors as part of the PPP. This implies that IORPs should also be entitled to consider their beneficiaries' views on sustainability factors or risks.[81] Furthermore, the consideration of ESG factors is, pursuant to the wording of Article 19(1) (b) IORP II, part of the application of the PPP and needs therefore to be in line with its limits. In practice it might, however, be difficult to ascertain sufficiently the prevailing views of the beneficiaries and members 'as a whole'.[82] Typically, beneficiaries are likely to have different views on sustainability factors. Additionally, appropriate procedures would need to be established to assess the beneficiaries' preferences.

2.2.30 The obligation to pursue the 'best interest' of beneficiaries does not expressly specify whether IORPs are also obliged to seek the maximum rate of risk-oriented financial return. On the one hand, this might be implied by the requirement to pursue the 'best' interest considering that IORPs primarily aim at ensuring good pensions for their beneficiaries. Moreover, Article 19(1) (c) IORP II (and similarly Article 41(1) (c) PEPP Regulation) requires investments to be made to seek profitability of the portfolio. On the other hand, the obligation to seek profitability does not prescribe a particular level of return which should be achieved. The typical duration of the liabilities of pensions funds implies a general long-term character of their investments.[83] However, some of IORPs investments may also be short term, to match short-term payment obligations.[84] Thus, the principle of maximising financial return requires a balancing of interests of members and beneficiaries fairly to cover short-, middle- and long-term perspectives.

2.2.31 Moreover, IORP II[85] implies that the 'best interest' of the beneficiaries must not be assessed in relation to the individual investment but rather with regard to the 'portfolio as a whole'. This might allow for some freedom in the specific shaping of the investments as long as the 'best' financial return of the portfolio as a whole (taking account of risk) is not negatively affected.

2.2.32 It cannot be excluded that pension funds might, under certain circumstances, be reluctant to make use of their investment freedom in favour of IFSI, for instance, due to legal uncertainties which exist with regard to the interpretation of the beneficiaries' 'best interest' and its interaction with IFSI (see section 2.2.24 *et seq*.). This might, from time to time, be perceived as increased liability risk.

EUROPEAN UNION

2.2.33 Nevertheless, there seems to be some indication that the PPP under IORP II 'has not proven to be a barrier towards sustainable investments'.[86] Moreover, in its advice on potential undue short-term pressure from financial markets on corporates, EIOPA concluded that there 'is no clear evidence of behaviors that could be labelled as undue short-termism' in IORPs, neither is there any 'clear evidence of undue short-term pressures from financial markets' on IORPs.[87]

PEPP providers

2.2.34 Similar to IORPs, the regulation of PEPP providers should, in our view, be flexible enough to invest for sustainability impact as long as certain conditions are met.

2.2.35 Under the PEPP Regulation, PEPP providers shall take into account risks related to and the potential long-term impact of investment decisions on ESG factors within the PPP. This does, however, not oblige a PEPP provider to pursue ultimate ends IFSI but leaves the possibility open to choose such option within the framework of the PPP. Thus, the position of PEPP providers regarding their legal freedom to invest for sustainability impact is, in essence, similar to that of IORPs. Please refer, therefore, to section 2.2.23 *et seq.*

2.3 Mutual funds

Types of mutual funds covered

2.3.1 EU law provides for a framework of provisions applicable to mutual funds (and their managers) which are established and supervised in Member States. Again Member State law may also impact the question addressed below.

2.3.2 This annex only covers undertakings for collective investment in transferable securities (UCITS) which are typically targeted at retail investors.[88]

2.3.3 The UCITS Directive[89] describes UCITS as undertakings for collective investments which solely invest in transferable securities or other liquid financial assets and whose units can be repurchased or redeemed at the unit-holder's request out of the assets it holds.[90]

2.3.4 UCITS can either be constituted in accordance with contract law (as common funds managed by management companies), trust law (as unit trusts) or statute (as investment companies).[91] A UCITS can either appoint an external UCITS management company or, where it has legal personality, be internally managed.[92] However, the regulatory obligations with regard to the management of the UCITS' assets are not affected by the choice of structure.

2.3.5 In this annex, irrespective of the legal form a UCITS may take (contractual, trust or company form), we always consider the UCITS itself (whether or not it has separate legal personality) as the Asset Owner. However, it is legally permitted and common in practice that management companies delegate the portfolio management function to external asset managers. Management companies must monitor and supervise the compliance of investment managers with this regulation in order to remain compliant themselves because delegation does not release them from their responsibilities. For that reason, UCITS management are also considered as investment managers in this annex.

2.3.6 It follows that for UCITS the key parties are:

- **Asset Owner**: UCITS (irrespective of its legal form)[93]
- **Beneficiaries**: the investors who hold shares or units in the UCITS
- **Investment decision-maker**: the UCITS management company or any external Investment Manager to which the portfolio management function has been delegated

2.3.7 It is important to note that the UCITS Directive addresses both UCITS and their management companies and even allows that both roles are combined in one person. It follows that, where this annex refers to UCITS or mutual funds as the holders of powers or as being subject to obligations, such reference shall equally include the management company.

Overview

2.3.8 The management company's duties and powers are governed by the UCITS' constitutional documents, particularly the investment objectives and policies, as well as EU legislation, in particular the UCITS Directive and its supplementing delegated directives and regulations. However, within the UCITS framework, the UCITS Directive does not prescribe many of the UCITS mechanics such as the determination of a specific investment policy or how an investment policy is changed. These aspects of mutual funds are governed by Member State law. Accordingly, this annex does not take into account specific constraints which follow from an existing investment policy the change of which may require investors' (unanimous) consent. In fact, this may pose significant obstacles to the introduction of mutual funds for the purpose of ultimate ends IFSI, but this is not a result of EU legislation.

2.3.9 A UCITS invests its capital for the benefit of its unit-holders. For this reason, a

EUROPEAN UNION

management company is, amongst others, required:

(a) to act honestly and fairly in conducting its business activities in the best interest of the UCITS it manages and the integrity of the market; and

(b) to act with due skill, care and diligence, in the best interests of the UCITS it manages and the integrity of the market.[94]

2.3.10 The duty to act in the 'best interest' is set out in more detail in the UCITS Delegated Directive, including rules on due diligence, inducements and the best execution of orders.[95] The UCITS Delegated Directive specifies, among other things, the organisational requirements, conflicts of interest, conduct of business and risk management rules for management companies.

2.3.11 The UCITS Delegated Directive specifies the 'best interest' rule by requiring, among other things, that the unit-holders of managed UCITS are treated fairly by the management company and that management companies shall refrain from placing the interests of any group of unit-holders above the interests of any other group of unit-holders.[96] Mutual funds are most commonly established for the purpose of generating financial return. The 'best interest' of UCITS is therefore served where the financial return is maximised in line with the investment objectives of the UCITS.[97] In addition, UCITS management companies are required to use fair, correct and transparent pricing models and valuation systems for the UCITS they manage. They are also required to act in such a way as to prevent undue costs being charged to the UCITS and its unit-holders.[98]

2.3.12 When taking investment decisions, UCITS management companies must ensure a high level of diligence in the selection and ongoing monitoring of investments, in the best interests of UCITS.[99] This includes adequate knowledge and understanding of the assets in which the UCITS are invested.[100] To ensure that investment decisions are carried out in compliance with the UCITS' objectives, investment strategy and risk limits, UCITS management companies must establish written policies and procedures on due diligence and implement effective arrangements.[101]

Legal requirement to use investment powers to invest for sustainability impact

2.3.13 EU legislation does currently not provide for rules which require a UCITS to take into account non-financial objectives, such as ultimate ends IFSI as a part of their due diligence process (as a 'procedural rule') or as part of their investment decisions (as a 'substantive rule'). Therefore, UCITS and/or their management companies are not subject to an explicit general duty to invest for sustainability impact as a standalone duty (ultimate ends IFSI).

2.3.14 However, UCITS and/or their management companies will be required to take into account the sustainability impact of investments under specific circumstances when taking investment decisions.

2.3.15 A duty to invest for sustainability impact may arise in individual cases where it is in the 'best interest' of the UCITS to do so, ie an obligation to pursue instrumental IFSI. The Commission noted that 'EU legislation does not constitute a barrier to integrate ESG factors. While ESG factors are not explicitly mentioned in the relevant EU legislation […] existing financial regulation provides scope to incorporate them, given that all factors that have a material impact on financial performance should be considered in the investment and advisory process'.[102] As the 'best interest' is most commonly pursued by maximising financial return, the question whether sustainability impact must be pursued as a parallel objective (ultimate ends IFSI) will need to be answered depending on whether financial return and sustainability impact are aligned, in conflict with each other or compatible.

2.3.16 The impact on financial return and sustainability impact may be aligned, for instance, by investing into a company whose activities have a beneficial effect on the environment that is directly linked to an increased financial return (eg since the 'green' activities are also enhancing the company's competitive position on the market). Likewise, any risks (including those connected to sustainability) which may have a negative impact on the financial return of the UCITS also need to be reflected in the risk management of the UCITS.[103]

2.3.17 Any potential conflict between IFSI and financial return would have to be resolved by an interpretation of the 'best interest' of the UCITS. There are no statutory rules on how to resolve a conflict between maximising financial return and IFSI. Thus, where it is clear that financial return is the UCITS' main objective, such conflict would generally have to be resolved in favour of financial return so that no duty to invest for sustainability impact arises (unless the two are aligned (see 2.3.16.).[104] Typically, if the UCITS is tailored to pursue IFSI, we would expect the investment policy to address the issue of how a conflict (i) between sustainability

EUROPEAN UNION

impact and investment return; and (ii) between different elements of IFSI can be resolved. Even a conflict between different elements of IFSI may occur, for instance, when an investee company's activities may be beneficial for the workforce (and, thus, socially beneficial) but have a negative impact on the environment.

2.3.18 If IFSI neither aligned with or in conflict with financial return, UCITS are currently not obliged to choose the more sustainable investment. According to the Commission, there is a 'growing consensus', that the 'consideration of ESG factors is compatible with fiduciary duties if: the ESG factors have a financial material impact on the investment performance or valuation; it is reasonable to assume that taking into account ESG factors is supported unanimously by the beneficiaries, or ESG factors are a distinctive element when comparing investments with otherwise similar characteristics'.[105] According to the reports that substantiate the 'growing consensus', where ESG factors are the distinctive element, these factors may be taken into account but there is no obligation to do so.[106] In other words, there is no obligation to invest for sustainability impact even in a 'tie-break scenario' although there is a discretion to do so. Note, however this may change (see 2.3.29. below).

2.3.19 In practice, it is unlikely that taking ESG factors into account will be supported unanimously by the beneficiaries, unless such views are set forth the investment policy of the UCITS. Nor is there a requirement to ask for the actual unit-holders' views since determining the 'best interest' of a UCITS does not require an assessment of the actual beneficiaries' views. Accordingly, there is also no requirement to invest for sustainability impact even if the (current) unit-holders' views uniformly support IFSI (unless this is explicitly permitted by the investment policy of the fund).

2.3.20 Acknowledging that the 'best interest' of unit-holders is determined primarily by financial return raises additional questions, such as whether this requires balancing their financial return with the financial return of future unit-holders, which may be negatively affected by a decision in favour of short-term profit at the expense of sustainability impact. The requirement of equal treatment of unit-holders under the UCITS Delegated Directive[107] indicates, however, that it is not permitted (and therefore also not required) to place the interests of future unit-holders over the interests of current unit-holders. For the same reason, it is also neither permitted nor required to take diverging sustainability aspirations of fund investors into account where they are not explicitly mentioned in the investment policy of the fund.

2.3.21 The basic circumstance that the 'best interest' of unit-holders is complied with by securing or maximising financial return in line with the investment policy for them, leaves open the question whether this requires the optimisation of return (in relation to the risk that the UCITS is permitted to take) or the securing of a certain level of financial return beyond which a UCITS may also decide to pursue secondary objectives (such as IFSI) and to sacrifice a certain amount of profit to achieve that secondary objective. In our view, the 'best interest' currently requires optimising financial return, while it leaves the question unanswered over which time period the financial return needs to be achieved. This is crucial since decisions in favour of sustainability impact involves seeking to secure long-term profits at the expense of short-term gains (or the incurring of immediate costs). There is no fixed time period in EU legislation over which the financial return needs to be achieved. Acting in the 'best interest' of unit-holders should require determining the typical investment horizon for the individual UCITS. Since UCITS are open-ended and therefore subject to constantly changing ownership, investment horizons may typically be rather short-term, whereas also long-term strategies may well be pursued making use of the UCITS framework.

2.3.22 The circumstances under which a UCITS may be legally required to seek to secure wider societal objectives (ultimate ends IFSI) are rare. The UCITS Directive requires UCITS to also act in the best interest of the integrity of the market.[108] However, acting in the 'integrity of the market' does not generally justify IFSI. As the UCITS Delegated Directive states, it rather aims to capture 'preventing malpractices that might reasonably be expected to affect the stability and integrity of the market'[109] (eg where a 'fire-sale' may limit losses of the UCITS but would lead to significant price volatility) but rather not to generally balance goals such as pursuing financial return and ultimate ends IFSI.

Upcoming changes in regulation

2.3.23 The Commission has published the final UCITS ESG Delegated Directive that will amend the UCITS Delegated Directive.[110] The main aim of the UCITS ESG Delegated Directive is to ensure consistency between the disclosure requirements of the SFDR, as described in more detail in section 1.13 *et seq*., and organisational

> ANNEXES

> European Union

EUROPEAN UNION

requirements under the UCITS Delegated Directive.[111] The UCITS ESG Delegated Directive establishes rules that prescribe under which circumstances and for what purpose a UCITS must take into account sustainability-related considerations.

2.3.24 Among other things, UCITS management companies will explicitly be required to take into account sustainability risks when complying with the due diligence requirements.[112] Sustainability risks can have a potential impact on financial return[113] and already need to be considered so the potential amendment is only for clarification purposes.[114]

2.3.25 In addition, the UCITS ESG Delegated Directive provides that 'where management companies […], consider principal adverse impacts of investment decisions on sustainability factors as described in […], or as required by […], those management companies […] take into account such principal adverse impacts when complying with the [due diligence] requirements'.[115] Sustainability factors are not necessarily linked to financial return.[116]

2.3.26 The UCITS ESG Delegated Directive does not aim to amend the general principle of 'best interest'. ESMA has explicitly refused to amend the general principle of 'best interest' since ESMA is not persuaded that this would 'provide more benefits compared to making the requested legislative clarifications directly in the due diligence requirements'. This appears generally convincing in relation to sustainability risks. Where 'sustainability risks' have a negative impact on the value of the investment, they already need to be taken into account in order to comply with the principle of 'best interest' for that reason anyway.[117] So no amendment of the 'best interest' principle is needed.

2.3.27 On the other hand, it is for various reasons uncertain whether, and to what extent, the UCITS ESG Delegated Directive will impact the 'best interest' determination of UCITS and establish to a duty to (or at least increase flexibility for) IFSI as standalone objective (ultimate ends IFSI).

2.3.28 Assuming the SFDR requires, at least, UCITS management companies to consider the principal adverse impact of their investment decisions on sustainability factors, it is unclear which purpose is to be pursued based on those considerations.[118] The provision may be interpreted to only require consideration in the due diligence process or also to become a decisive factor for the selection of the investments (which would result in a duty to invest for sustainability impact). Taking into account the relationship with the SFDR, it may be concluded that only a procedural requirement is stipulated, and that the requirement is only designed to require management companies to disclose the principal adverse impact of their investment decisions.[119] On the other hand, sustainability factors are taken into account when complying with the requirements of Article 23(1) to (4) UCITS Delegated Directive, which includes the obligation to ensure a high level of diligence in the selection and ongoing monitoring of investments. This is an indication that they may be intended to influence the investment decision.

2.3.29 Further, assuming that the investment decision is influenced by the principal adverse impact on sustainability factors, and therefore an obligation to invest for sustainability impact will arise, it is uncertain how such obligation interacts with the 'best interest' of the unit-holders, under which circumstances and to which extent the sustainability impact may or must be pursued, even if to do so negatively affects financial return. While such an obligation may, in general, provide UCITS management companies with a justification to invest for sustainability impact, it is far from clear what the boundaries of such duty (and legal flexibility) are. Management companies may therefore be reluctant to incorporate sustainability impact on a broad basis into their investment decision-making processes. However, in a 'tie-break scenario', UCITS would arguably be subject to an obligation to invest for sustainability impact.

Legal freedom to use investment powers to invest for sustainability impact

2.3.30 As set out in section 2.3.11 the 'best interest' of a UCITS is served where a financial return consistent with the investment objectives of the UCITS is achieved so that IFSI may generally be only pursued where it is aligned with their objective, ie to generate financial return (instrumental IFSI). Various other legal provisions may further limit the possibility of UCITS management companies and investment companies to invest for sustainability impact.

2.3.31 For instance, management companies must act in a way as to prevent undue costs being charged to UCITS and its unit-holders.[120] Costs associated with pursuing investment strategies that take the impact of investment decisions on sustainability factors into account may be considered as undue costs if the investment policy does not permit this.

EUROPEAN UNION

2.3.32 Management companies must have adequate knowledge and understanding of the assets in which the UCITS are invested.[121] A lack of relevant knowledge and difficulties in obtaining the relevant data on IFSI sustainability factors will in practice hamper its integration.[122]

2.3.33 Management companies must use fair, correct and transparent pricing models and valuation systems for the UCITS they manage.[123] This requirement is subject to national law and is also subject to national authorities' interpretation. However, to the extent that sustainability impact does not relate to financial risk and return, it seems to be accompanied by enhanced difficulties to comply with the requirement of fair and correct pricing models since there are no clear rules on how this requirement applies to IFSI.

2.3.34 Disclosure obligations – while themselves not requiring IFSI – might 'nudge' mutual funds towards considering ultimate ends IFSI since (potential) beneficiaries may be interested in it.[124]

2.4 Insurance undertakings

Types of insurance undertaking covered

2.4.1 We consider in this analysis:

- life insurance undertakings - these provide assurance, in consideration for the payment of a premium, on death or another defined event by payment of a lump sum or fixed regular income. Life insurance, in principle, also includes annuities on a contractual basis; and
- general insurance undertakings which underwrite policies that are not life insurance, including, among other things, sickness, fire and natural forces, property and liability insurance. The general insurer's liability is to pay on a valid claim by the policyholder. Any profits of investment activity are retained by the insurer.

2.4.2 The key parties are:

- **Asset Owner:** Insurance company
- **Beneficiaries:** Beneficiaries of the insurance undertaking are any natural or legal persons who are entitled to benefit under an insurance contract, including policyholders and insured persons. The shareholders of an insurance company form a further category of an insurer's beneficiaries because of their economic interest in the management of an insurance company's assets.
- **Investment decision-maker**: Insurance company.

Overview

2.4.3 The investment-related duties of insurance undertakings are typically determined by (i) EU legislation, (ii) the national law of the relevant Member State (in particular in relation to directors' duties of care) and (iii) in the case of a life insurer, the terms of the contract concluded with the relevant policyholder which again will be subject to the laws of a Member State.

2.4.4 At the EU law level, the main investment-related duties and powers of insurers are primarily set out by:

- Solvency II;
- Directive (EU) 2016/97[125] (IDD);
- PRIIPs Regulation[126];
- Solvency II Delegated Regulation[127];
- Amendment Solvency II Delegated Regulation;[128] and
- Amendment IDD Delegated Regulation[129]

in conjunction with guidance issued by EIOPA such as the opinion on sustainability within Solvency II[130] and EIOPA's technical advice on the integration of sustainability risks and factors in the delegated acts under Solvency II and IDD.[131]

2.4.5 Generally, the key investment duties of insurers arising out of EU law can be summarised as follows:

(a) *Prudent person principle*. Member States have to ensure that insurance undertakings invest in accordance with the PPP.[132] This means, in particular, that with respect to the whole portfolio of assets, the insurer is required to invest in assets 'whose risks the undertaking concerned can properly identify, measure, monitor, manage, control and report, and appropriately take into account in the assessment of its overall solvency needs'.[133] Further, the PPP requires that all assets of the insurer are invested in such a manner 'as to ensure the security, quality, liquidity and profitability of the portfolio as a whole'.[134] Additionally, as regards assets which are held to cover the technical provisions, these are to be invested 'in the best interest of all policyholders and beneficiaries taking into account any disclosed policy objective'.[135] In particular, the requirement to ensure the 'liquidity' and 'profitability' of the portfolio indicates that the main objective of the PPP under Solvency II is to ensure financial return, which needs to be consistent with the respective policy objective and to have appropriate regard to the risks involved.

In the case of a conflict of interest, Solvency II explicitly provides that the investment has to be made in the best interest of policyholders and insured persons.[136]

EUROPEAN UNION

Moreover, insurers have to observe diversification duties and restrictions on assets which are not admitted to trading on a regulated financial market.[137]

(b) The integration of sustainability risks in the implementation of the PPP has been clarified by the Amendment Solvency II Delegated Regulation, which has been adopted by the Commission on 21 April 2021. The Amendment Solvency II Delegated Regulation provides for the inclusion of a new article on the PPP in the Solvency II Delegated Regulation stating that when 'identifying, measuring, monitoring, managing, controlling, reporting and assessing risks arising from investments, as referred to in the first subparagraph of 132(2) of Directive 2009/138/EC, insurance and reinsurance undertakings shall take into account sustainability risks'. Additionally, it is clarified that for 'the purpose of paragraph 1, insurance and reinsurance undertakings shall take into account the potential long-term impact of their investment strategy and decisions on sustainability factors and, where relevant, that strategy and those decisions of an insurance undertaking shall reflect the sustainability preferences of its customers taken into account in the product approval process as referred to in Article 4 of Commission Delegated Regulation (EU) 2017/2358'.[138]

(c) *Risk management and risk management function*. Based on the Amendment Solvency II Delegated Regulation, insurance undertakings will be required to consider sustainability risks in their risk management. Further, the identification and assessment of sustainability risks will be included in the tasks of insurance undertakings' risk management function.[139] The Amendment Solvency II Delegated Regulation thereby clarifies that sustainability factors may be financially material and need to be considered in line with other relevant risks.

(d) *Actuarial function*. The Amendment Solvency II Delegated Regulation provides that insurance undertakings' actuarial function will have to take into account sustainability risks in its assessment of the uncertainty involved in estimates made in the calculation of technical provisions.[140]

(e) *Calculation of 'best estimate'*. Furthermore, when calculating the 'best estimate', insurers are obliged to take into account expected future developments, including, among other things, social and environmental developments, that will have a material impact on the cash in- and out-flows required to settle the insurance obligations over the lifetime thereof.[141] According to Article 77 Solvency II, the 'best estimate' is relevant for the calculation of the value of technical provisions.

(f) *Insurance distribution*. In case an insurance company also carries out insurance distribution, the insurance undertaking is obliged to act 'honestly, fairly and professionally with the best interests of their customers'.[142] Further, it has to ensure that any contract proposed is consistent with the customer's insurance demands and needs.[143]

Moreover, the Amendment IDD Delegated Regulation adopted by the Commission on 21 April 2021, amends Commission Delegated Regulation (EU) 2017/2359,[144] among other things, by introducing the requirement for insurance undertakings to assess sustainability preferences of their (potential) customers when providing advice on IBIPs.[145] This introduces an additional element into the suitability assessment, so that an insurer selling an IBIP will be required to, among other things, assess the suitability of a product for the customer by obtaining such information as is necessary to determine their personal recommendation to the (potential) customer meets his/her investment objectives, 'including that person's risk tolerance and any sustainability preferences'.[146]

Legal requirement to use investment powers to invest for sustainability impact

General insurer

2.4.6 Under current EU law, non-life insurers are not subject to an explicit general obligation to use investment powers to invest for sustainability impact.

2.4.7 Article 132 Solvency II sets the PPP as the overarching investment rule (see section 2.4.5(a)).[147] The investment principles provided under Solvency II do not specifically address sustainability risks.[148] However, this does not mean that general insurers would not be obliged to take into account sustainability risks in their investment decisions and to act accordingly. This has now been clarified by the adoption of the Amendment Solvency II Delegated Regulation.

2.4.8 *Financial materiality*. Generally, it can be suggested that there is a duty to take account of sustainability risks and to act accordingly in line with the PPP where such risks are relevant to the 'best interest' of beneficiaries (see section 2.4.5(a)). This would be the case for instrumental IFSI as well as ultimate ends IFSI provided that pursuing the sustainability objective has no negative

EUROPEAN UNION

impact on the financial return objective. Sustainability risks will often materialise as financial risks in the traditional sense.[149] For instance, it is generally recognised that climate change-related risks may manifest as transition risks which can be caused by the (regulatory or technological) adjustment process aiming at a low carbon economy; alternatively, they may manifest as physical risks in the shape of extreme weather events or longer-term climate changes such as rising temperatures.[150] Climate change-related risks may also lead to an increase in liability risks, for example where physical risks such as floods or storms cause property losses.[151] Transition, physical or liability risks may, in turn, affect insurers, for example, as market risk, counterparty default or underwriting risks.[152] EIOPA noted therefore that it 'has become clear, over the past years, that sustainability risks and in particular climate-change risks will affect insurance and reinsurance undertakings'.[153] Generally, such risks can become material for insurance companies in two ways:

- They can affect the assets in which an insurer invests (eg in the shape of market risks) and thus materialise as investment risks.[154]
- Sustainability risks may specifically affect the underwriting risk (eg in case of property or natural forces insurance).[155]

2.4.9 In both cases, it may be 'prudent' or due for an insurer to take such risks into account.[156] However, the question whether a sustainability risk is financially material depends on the time period and over which potentially relevant risks are assessed. In relation to the typical time horizon relevant for insurers, please refer to section 8.3.6.

2.4.10 *Amendment Solvency II Delegated Regulation.* By adopting the Amendment Solvency II Delegated Regulation, the Commission clarified[157] that sustainability risks *must* be taken into account in the implementation of the PPP. For this purpose, 'sustainability risks' are defined as environmental, social or governance events or conditions that, if they occur, could cause an actual or potential negative impact on the value of the investment or on the value of the liability.[158]

2.4.11 Insurers will not only need to assess sustainability risks in relation to their investment the investment portfolios but will also be required to take into account the potential long-term impact of their investment decisions on sustainability factors.[159] As pointed out by EIOPA, this requirement to take into account the impact of the investment on sustainability factors 'would not amount to requiring undertakings to make sustainable investments or to invest with impact, or to accept lower risk-adjusted returns',[160] ie it would not establish a duty to pursue ultimate ends IFSI. However, according to EIOPA, this requirement may include 'undertakings' active engagement with investees to achieve sustainable investment outcomes through voting strategies or other investment strategies'.[161]

2.4.12 Furthermore, insurers must reflect in their investment process the sustainability preferences of their customers as taken into account in the product approval process.[162] Thus, the Amendment Solvency II Delegated Regulation opens up a pathway for insurers to pursue sustainability impact goals where such goals are in line with customers' sustainability preferences (ultimate ends IFSI). This requirement applies 'where relevant' and thereby establishes a link between the manufacturing of insurance products and the investment decision process.[163] As pointed out by EIOPA, 'ESG preferences should be reflected in the investments where ESG preferences are expressed as part of product oversight and governance'[164] and also see to section 5.4.9 *et seq.*

2.4.13 *Conflict of interest.* In relation to cases of a potential conflict of interest, Solvency II explicitly sets out that the investment must be made in the best interest of policyholders. Thus, the predominant factor which the investment has to be aligned with is the interest of the beneficiaries to ensure the due fulfilment of their valid claims. Therefore, where a conflict arises between sustainability impact and financial return, the investment would need to be made in favour of the (financial) 'best interest' of the beneficiaries. However, insurers would be allowed to pursue sustainability goals where customers have expressly chosen a sustainability impact goal or where such goals do not negatively affect the financial return of the investment (ultimate ends IFSI).

2.4.14 *Beneficiaries' views*. The PPP does not generally require insurers to assess the views of beneficiaries on whether they wish to pursue IFSI.[165] Similarly, there is generally no obligation to align the investment with the sustainability preferences of beneficiaries.

Life insurance

2.4.15 For the reasons set out in section 2.4.7 *et seq.*, we do not consider that life insurers are subject to a general obligation to use investment powers to invest for sustainability impact although there may be certain situations in which

ANNEXES

European Union

EUROPEAN UNION

such a duty may arise. Life insurers are however generally obliged to consider sustainability risks and to act accordingly where such risks are financially material and therefore in line with the 'best interest' of beneficiaries.

2.4.16 In contrast to general insurers, life insurers typically need to cover a longer time horizon within their investment decisions for their assets held to cover the technical provisions. This may imply that long-term sustainability risks are generally of greater relevance for life insurers than for general insurers. Thus, Article 132(2) subparagraph 3 Solvency II provides that with regard to assets held to cover the technical provisions, insurers are obliged to invest in a manner appropriate to the nature and duration of the insurance liabilities. EIOPA therefore takes the view that for '(longer-term) life business, the long horizon for cash-flows also means that there may be room to consider the impact of climate change in the calculation of the best estimate'.[166] Further, EIOPA has pointed out that where 'undertakings have long-term assets to match long-term liabilities they should consider whether climate change would impact either their ability to hold these assets over that time frame or their expected cash-flows'.[167] In order to effectively address long-term systemic risks, relevant investors would generally need to collaborate with other investors. Collective action is likely to increase a positive sustainability outcome and reduce the costs related to IFSI for individual investors. What the duties of insurers may require regarding collective action with other investors, will depend on the circumstances of the individual case. As a general rule, the greater the impact of certain systemic risks on the financial return, the more likely it is that such obligation to cooperate with other investors to achieve sustainability impact goals might arise (instrumental IFSI).[168]

2.4.17 Under the Amendment IDD Delegated Regulation, insurers will be required to assess sustainability preferences of their (potential) customers when providing advice on IBIPs.

Legal freedom to use investment powers to invest for sustainability impact

General insurer

2.4.18 Under current EU law, general insurers are free to use investment powers to invest for sustainability impact as long as certain conditions are observed where they are not subject to a duty to invest for sustainability impact due to the financial materiality of certain sustainability factors (instrumental IFSI).

2.4.19 As explicitly clarified by the Amendment Solvency II Delegated Regulation, the PPP requires insurers to take into account sustainability risks. This implies that insurers may, in principle, be allowed to invest for sustainability impact on the ultimate ends basis IFSI provided that the investment decision is compatible with the PPP as overarching investment principle (see section 2.4.5(a) and 2.4.7 *et seq.*). The PPP requires, in particular, that the integration of sustainability factors in investment decisions does not conflict with the 'best interest' of policyholders. Such a conflict might arise where an investment decision would affect the insurers profitability and liquidity in a way that could endanger its ability to duly meet its policyholders' valid claims.

2.4.20 Further limits to an insurer's freedom to integrate sustainability factors in its investment policy might arise out of its director's duties. National corporate law may require a company's directors to act with reasonable care and diligence (see, for instance, with respect to the position under Dutch or French law the Dutch and French annexes). Generally, if such duty of care exists under national corporate law, it might allow for the consideration of long-term or sustainability factors which could affect the company as a whole when taking entrepreneurial decisions. However, it will ultimately depend on the specific conditions of the situation (including the purpose of the company) as well as on the law of the relevant Member State whether and to what extent such considerations will be possible. For instance, where a director's duty of care explicitly permits or recommends the inclusion of long-term consequences or sustainability factors, there should be more flexibility to integrate ESG or sustainability factors in the investment process.

2.4.21 As part of the PPP under Solvency II, insurance companies are obliged to invest in a manner as to ensure the liquidity and profitability of the portfolio as a whole. This requirement does, however, not include the prescription of a specific financial return to be achieved. Moreover, the liquidity and profitability of the portfolio need to be balanced with its security. The objective to ensure the security of a portfolio generally requires a proper assessment of the relevant risks involved with an investment, including sustainability risks.

2.4.22 Furthermore, Solvency II implies that the investment objectives 'security',

EUROPEAN UNION

'quality', 'liquidity' and 'profitability' do not refer to the individual investment but to the portfolio as a whole.[169] As is clarified by the explanatory text to Guideline 29 on the System of Governance by EIOPA, undertakings may therefore 'have individual investments that do not fulfil every feature even if they will finally contribute to the security, quality, liquidity and profitability of the portfolio as a whole'.[170] Further, pursuant to this explanatory text, in 'order for these qualitative features to provide a real benchmark against which compliance can be assessed, it needs to be specified to what extent individual investments do not necessarily have to meet all these qualitative features', concluding that assets that do not fulfil every qualitative feature 'must be kept at prudent levels'.[171] This provides some flexibility in the shaping of specific investments.

2.4.23 Regarding the legal framework as applicable prior to the adoption of the Amendment Solvency II Delegated Regulation, EIOPA has come to the conclusion that it 'did not receive any evidence that the current design and calibration of the Solvency II framework provides either an incentive to invest in sustainable assets or a disincentive that hinders investments in sustainable assets'.[172] This suggests that although the PPP as such does not promote IFSI, it allows insurers to pursue sustainability impact goals. The clarifications adopted by the Amendment Solvency II Delegated Regulation may well facilitate the integration of sustainability risks and factors into the framework of the PPP.

Life insurance

2.4.24 For the reasons set out in section 2.4.19 *et seq.*, life insurers are allowed to invest for sustainability impact subject to the terms of the relevant policy and provided that certain conditions are complied with.

2.4.25 Regarding life insurers, the assessment of the 'best interest' of beneficiaries within the PPP might typically be considered more complex than under a general insurance. On the one hand, the 'best interest' of life insurance policyholders requires, in particular, that the future financial return is secured for the duration of the policy. On the other hand, as has been set out by EIOPA, for '(longer-term) life business, the long horizon for cash-flows also means that there may be room to consider the impact of climate change in the calculation of the best estimate'.[173] This may imply that for life insurers, there is more leeway to consider sustainability risks and factors and to integrate these in their investment decisions.

› ANNEXES

› European Union

EUROPEAN UNION

3. ASSET OWNERS' USE OF POWERS OF STEWARDSHIP

3.1 The following section considers the extent to which, and on what basis, each type of Asset Owner is required or permitted to use its position to influence the activities of investee enterprises by engaging in stewardship activities with a view to influencing portfolio company behaviour as part of a strategy to invest for sustainability impact.

Overarching considerations

3.1.1 The main pieces of EU legislation that cover stewardship activities for some, but not all, Asset Owners are the Shareholders' Rights Directive (SRD)[174] which relates to the exercise of certain shareholder rights attaching to voting shares in relation to general meetings of companies whose shares are admitted to trading on a regulated market in the EU and have their registered seat in a Member State[175] and the Shareholders' Rights Directive II (SRD II)[176], which applies to all Asset Owners that are covered by the SRD. The SRD II seeks to strengthen stewardship and to address short-termism and principal-agent problems in the investment chain. In particular, the SRD II can be seen as establishing stewardship duties for 'institutional investors'[177] to the extent that they invest directly or through an asset manager in shares traded on a regulated market, and 'asset managers'[178] to the extent that they invest in such shares on behalf of investors.[179]

3.1.2 The SRD II acknowledges that asset managers play a significant role in the corporate governance and the strategy and long-term performance of portfolio companies.[180] In particular, the SRD II points out that: 'greater involvement of shareholders in corporate governance is one of the levers that can help improve the financial and non-financial performance of companies, including as regards environmental, social and governance factors, in particular as referred to in the Principles for Responsible Investment, supported by the United Nations'.[181] In the EU Action Plan for Sustainable Finance, the Commission underlines that investments for environmental and social objectives require a long-term orientation and that sustainability and long-termism therefore go hand in hand.[182] ESMA found that long-term engagement is increasingly widespread among investors[183] but recommended further monitoring of whether the application of SRD II is effective to encourage long-term engagement.[184]

3.1.3 A recent study prepared for the Commission that assessed the root causes of 'short-termism' in corporate governance further found that short-termism is partially linked to pressure from institutional investors.[185] However, the study also found other causes for short-termism that are outside the scope of this annex such as the definition and interpretation of directors' duties and 'company's interest' and that the long-term interests of stakeholders other than shareholders are not sufficiently taken into account by board members.[186]

3.1.4 Pursuant to the SRD II, an Asset Owner must develop and publicly disclose a policy that describes how it integrates stewardship in its investment strategy or publicly disclose a clear and reasoned explanation why it has chosen not to develop a policy.[187] An stewardship policy contains the following elements:

(a) monitoring of the investee companies on relevant matters, including social and environmental impact and corporate governance;[188]

(b) conducting dialogues with investee companies;

(c) the exercise of voting rights;

(d) cooperation with other shareholders;

(e) communication with relevant stakeholders of the investee companies; and

(f) managing actual and potential conflicts of interests in relation to their stewardship.

Alternatively, an Asset Owner is required to publicly disclose publicly a clear and reasoned explanation why it has chosen not to comply with the requirement to develop and disclose stewardship policy.[189]

3.1.5 However, even if an Asset Owner bound by these requirements decides to exercise its powers of stewardship, these rules are not explicitly designed to deliver sustainability impact as such instead of, or in addition to, their contribution to investment return. They nevertheless leave some leeway for an Asset Owner.[190]

3.1.6 Certain duties and obligations of Asset Owners under EU law could make it more difficult to engage in stewardship activities in relation to portfolio constituents by reference to their sustainability impact as a standalone objective (ultimate ends IFSI) than it is to pursue an instrumental IFSI strategy, although these duties (below) are relevant in all cases.

(a) *Cost*. Engagement in stewardship activities involves cost. An Asset Owner (and its investment manager) would need to be satisfied that incurring that cost is

EUROPEAN UNION

consistent with its duties under EU law. In many cases, stewardship activities for the benefit of sustainability impact will have no (or just minimal) effect on the financial return of the individual investment. For instance, in relation to UCITS, these costs could be considered as 'undue costs' and not be in the 'best interest' of the UCITS, especially where they are in pursuit of an objective other than the UCITS' stated investment objective.

(b) *Competition law*. Co-ordination between investors designed to wield collective 'shareholder' influence over the ESG strategy of a company in which they are invested is likely to fall outside the realm of competition law, assuming no competitively sensitive information is shared between investors. Co-operation between Asset Owners and/or investment managers beyond this is possible, but needs to be structured in a way that complies with competition law since there is no specific exemption to competition law for arrangements designed to address sustainability risks. Collaboration between competitors amounting to price fixing, collective boycotts, or the sharing of markets and customers will virtually never be permitted.[191] A collaborative arrangement involving the exchange of information or the coordination of commercial activities may also infringe competition law if it is anticompetitive in object or effect and is not otherwise exempt. In most competition law regimes, including that of the EU, exempt arrangements must be necessary and proportionate in order to provide an improvement to the production or distribution process, or a promotion of technical or economic progress, while allowing consumers a fair share of the resulting benefits, and still allowing for sufficient residual competition in the market.[192] Parties are required to provide quantitative evidence of such improvements and consumer benefits if they wish to rely on such an exemption.

(c) The Commission recognises the importance of sustainability on current and future domestic and global agendas and has consulted on how competition law can support the EU Green New Deal.[193] However, it has yet to release further guidance and while there is some case law, there are not enough past examples to give certainty around what evidence of sustainability benefits will be enough to justify competitor collaboration in practice. Collaborative arrangements entered into for sustainability impact may not necessarily provide direct improvements and/or consumer benefits that outweigh their anticompetitive harm, or to the extent that they do, these benefits may be difficult to measure and prove in monetary terms.[194] In addition, even encouragement by regulators or government bodies for collaborative action will not necessarily shield from competition law scrutiny,[195] or from private competition actions brought by companies whose businesses are impacted by collaboration between Asset Owners and/or investment managers with a view to improved sustainability outcomes. Additional guidance is required from competition authorities (here, the EC) to explain in more detail their attitude to investor collaboration to address sustainability risks and how sustainability outcomes can be quantified and assessed within the existing horizontal collaboration regime.

(d) Nonetheless, there remain a wide range of collaborative actions that relevant investors may take. These include, for example:

   (i) collaboration towards non-binding and non-individualised sustainability targets (especially where parties are afforded a high level of discretion as to the means by which they attain such an objective);[196]

   (ii) joint initiatives to develop standard investment classification or measurement tools (provided there are fair, non-discriminatory and equal rights to their use);

   (iii) exchanging information and best practice insights on IFSI (provided the information is not competition sensitive);

   (iv) joint initiatives to enable the rise of new markets and services;[197] and

   (v) joint advocacy/dialogue with policymakers and stakeholders. Most recently, competition regulators are also increasingly open to discussing sustainability initiatives and are starting to recognise the need for further and more harmonised guidance. There are a number of consultations ongoing that are expected to clarify and, to some degree, soften, the past enforcement climate and provide a better framework to account for wider societal benefits.[198]

(e) Though operating within the margins of competition authority guidance may not prevent private competition actions being taken against Asset Owners and/or investment managers who act collectively, it does lower the risk of such actions being brought successfully since a court

EUROPEAN UNION

would assess whether the collaboration was in line with competition law and that jurisdiction's relevant guidance.

(f) There may also be other (actual or perceived) circumstances that may make it difficult for an Asset Owner to engage in stewardship activities, such as the rules on insider trading and market manipulation[199], or the legal uncertainty around the question of which level of coordination results in concerted action and, thus, to additional obligations under the rules on notifications on major holdings[200] or the EU legislation covering takeovers for entities traded on regulated markets.[201]

3.2 **Pension funds**

Legal requirement to steward for IFSI

3.2.1 For the reasons set out in section 2.2.9 *et seq*. and section 2.2.19 et seq., neither IORPs nor PEPP providers are subject to a general duty to use stewardship to pursue an invest for sustainability impact.

3.2.2 Although there are disclosure duties in relation to stewardship for IORPs[202](see 3.1.1. above) , these do not include a specific obligation to seek improvement in the investment's sustainability impact of portfolio companies (see section 3.1.5).

3.2.3 Furthermore, there are no explicit indications under sector-specific EU law that pension funds are generally required to cooperate with other investors to mitigate sustainability risks arising out of systemic challenges. Such cooperation may however enhance the effectiveness of an engagement for sustainability impact. What the duties of pension funds may require regarding collective action with other investors will depend on the circumstances of the individual case, in particular on the extent to which the financial return over the relevant time horizon is affected by certain sustainability risks.

Legal freedom to steward for IFSI

3.2.4 For the reasons set out in section 2.2.23 *et seq*. and section 2.2.33 *et seq*., pension funds are free to engage (in ultimate ends IFSI) as long as certain conditions are observed.

3.2.5 Under IORP II and the PEPP Regulation, pension funds are obliged to comply with the PPP (in relation to the PPP, see section 2.2.5(a) and 2.2.11 et seq.). The PPP allows for a certain degree of flexibility in shaping the investment policy. Moreover, since SRD/SRD II explicitly impose certain stewardship activities on IORPs, this indicates that stewardship activities can generally be compliant with the duties of pension funds.

3.2.6 A pension fund's stewardship for sustainability impact should not, however, get in conflict with the beneficiaries' 'best long-term interest'. This requires, in particular, that any stewardship for sustainability impact does not endanger the due fulfilment of the (future) pension entitlements of the beneficiaries.

3.2.7 Moreover, engagement for sustainability impact may involve costs. This might impede stewardship insofar as pension funds would need to ensure that the costs incurred would be compatible with their legal duties. Nevertheless, the 'comply or explain' provisions concerning stewardship activities under the SRD/SRD II (see 3.1.4. above) might, where applicable, encourage IFSI.

3.3 **Mutual funds**

Legal requirement to steward for IFSI

3.3.1 Under EU law, management companies must develop adequate and effective strategies for determining when and how voting rights attached to instruments held in the managed portfolios are to be exercised, to the exclusive benefit of the UCITS concerned.[203]

3.3.2 There is no legal provision in EU law or guidance by EU regulatory authorities that considers this requirement in respect of IFSI or other sustainability matters. The provision does, however, not amount to a legal requirement to steward for sustainability impact. For instance, the Committee of European Securities Regulators (CESR), indicated that the 'exclusive benefit' may also be complied with by not exercising voting rights at all if a passive investment policy is followed.[204] Although it is not entirely clear whether this statement can be applied more generally so that management companies can freely decide to not exercise voting rights at all, it appears that there is some flexibility and therefore no general duty to exercise voting rights to pursue IFSI or engage by other means.[205]

3.3.3 There is, in particular, some legal uncertainty around whether 'exclusive benefit' needs to be interpreted similar to 'best interest' when conducting investment activities, which is primarily by reference to financial return. Pursuing financial return by exercising voting rights may therefore amount to an obligation where financial return and sustainability impact are aligned (as is the case with instrumental IFSI). An argument for a broader understanding of 'exclusive benefit' can be made from the perspective of investment theory. Modern portfolio theory, which has significant impact on investment activities of UCITS in practice and which is concerned with the optimisation of risk and return,

EUROPEAN UNION

applies only to portfolio construction but not to stewardship. On the other hand, there is no reason to assume that a strategy in the 'best interest' of UCITS should not be to their 'exclusive benefit'. Accordingly, the terms should be interpreted in a similar manner.

3.3.4 The financial return of portfolio companies may not only be impacted by factors that apply to individual portfolio companies included in the portfolio but also by sustainability factors that impact across the portfolio (or even the market – egsystematic risks). One may argue that there is a duty to consider engaging and, under specific circumstances, to act accordingly in such cases (and instrumental IFSI is a strategy designed to do this). This can in practice, be carried out by addressing the issues at an individual company level, but also by cooperating with other companies and their shareholders whose activity makes a difference. Over the long-term, this may result in an increased financial return. That approach may, however, face practical difficulties, namely that there will often be only a long-term gain at the expense of a short-term loss, which could be considered an 'undue' cost. UCITS management companies that apply modern portfolio theory strictly may be hesitant to engage in this way since it is a basic tenet of modern portfolio theory that systematic risks cannot be mitigated by investors (bearing in mind, however, that modern portfolio theory does not directly apply to stewardship activities).

Legal freedom to steward for IFSI

3.3.5 This question only arises where there is not already a duty to invest for sustainability impact, ie where the sustainability factors under consideration are not financially material. Against the backdrop that, generally, UCITS management companies must conduct their business activities in the best interests of the UCITS they manage and that undue costs should be prevented, there is arguably limited flexibility to engage for sustainability impact as a separate objective (ie ultimate ends IFSI). Under the current EU framework, UCITS may therefore be reluctant to engage for ultimate ends IFSI.

3.4 Insurance undertakings

Legal requirement to steward for IFSI

General insurance

3.4.1 For the reasons outlined in section 2.4.7 *et seq.*, non-life insurers are not generally subject to a duty to steward for sustainability impact.

Life insurance

3.4.2 As with general insurers, life insurers are not subject to a general duty to use stewardship to invest for sustainability impact for the reasons set out in section 2.4.15 *et seq.* Life insurers may however be required to consider and to act accordingly if sustainability risks have an impact on the financial performance of an investment goal (instrumental IFSI).

3.4.3 Further, similarly to IORPs, life insurers may be subject to the stewardship-related disclosure duties as set out by SRD/SRD II (see section 3.2.2) which may encourage them to consider IFSI strategies.

Legal freedom to steward for IFSI

General insurance

3.4.4 For the reasons set out in section 2.4.18 *et seq.*, general insurers are allowed to steward for sustainability impact on an ultimate ends basis. Provided that certain conditions are observed. General insurers may however be required to consider, and to act accordingly, if sustainability risks have an impact on the financial performance of an investment goal (instrumental IFSI).

3.4.5 Sector-specific EU law does not regulate the stewardship activities of general insurers. However, it does not prohibit them either. This suggests that an investor's engagement activities may in principle be compatible with its investment duties. However, a general insurer's engagement for sustainability impact must not conflict with the applicable internal investment policies or legal duties. Thus, a general insurer would, in particular, need to ensure that its engagement does not negatively affect the investment's financial return and thereby interfere with the beneficiaries' 'best interest'. Further, the costs associated with stewardship activities might impede stewardship insofar as insurers would need to make sure that the costs incurred would be compatible with their legal duties.

EUROPEAN UNION

Life insurance

3.4.6 For the reasons set out in section 2.4.24 *et seq.*, life insurers are allowed to engage for sustainability impact on an ultimate ends basis provided that certain requirements are observed.

3.4.7 Sector-specific EU law does not expressly prohibit life insurers from stewarding for sustainability impact. Additionally, it provides for certain stewardship duties and rights of life insurers under the framework of SRD/SRD II. Although SRD/SRD II does not explicitly set out a life insurer's duty or right to engage specifically for sustainability impact, the named directives aim to promote sustainability impact. This is clarified, for instance, by Recital 14 SRD II, which points out that effective 'and sustainable shareholder engagement is one of the cornerstones of the corporate governance model of listed companies' and 'one of the levers that can help improve the financial and non-financial performance of companies, including as regards environmental, social and governance factors"' This implies that life insurers should in principle be permitted to engage for sustainability impact. However, their engagement must not conflict with their contractual and other duties (see section 3.4.5).

EUROPEAN UNION

4. ASSET OWNERS' PUBLIC POLICY ENGAGEMENT WITH A VIEW TO PURSUING SUSTAINABILITY IMPACT

4.1 The following section considers the extent to which, and on what basis, each type of Asset Owner is required or permitted to use public policy engagement with a view to pursuing IFSI.

4.2 **Pension funds**

4.2.1 Under current EU legislation, there is no express obligation for pension funds to use public policy engagement with a view to pursuing Sustainability Impact. Moreover, EU legislation neither specifically permits, nor prohibit public policy work. Therefore, the legal framework under current EU law appears to provide flexibility for pension funds to engage in public policy work with a view to pursuing sustainability impact.

4.2.2 However, pension funds would need to ascertain that their engagement is compatible with their legal and regulatory duties and does not, in particular, conflict with the 'best interest' of their beneficiaries. Difficulties may arise where such political engagement produces material costs borne by current beneficiaries but does not generate any (measurable) positive financial effects for them.

4.3 **Mutual funds**

4.3.1 Under current EU legislation, there is no explicit obligation for UCITS to use public policy engagement with a view to pursuing sustainability impact.

4.3.2 The management company must carry out its business activities in the 'best interest' of the UCITS, which also includes engagement in public policy work. Public policy engagement may be difficult to reconcile with the 'best interest' of the UCITS and its unit holders, since it may not result in any quantifiable positive effect on the financial return of the UCITS. In particular, if such public policy work is paid by funds of the UCITS, incurred costs may be considered 'undue'[206] where the financed activities do not have a measurable positive effect on financial return. Management companies may improve the position by seeking cooperation with other Asset Owners that reduces costs and increases the likelihood of the success of public policy engagement.

4.3.3 In addition, the management company must not conduct any activities that result in placing the interests of any group of unit-holders above the interests of any other group of unit-holders. Therefore, the management company of the UCITS has to ensure that the pursued success of its public policy work is beneficial to all unit-holders of a UCITS.

4.3.4 As a result, a duty to use public policy work to pursue IFSI will likely not arise and flexibility to do so is limited by the matters described.

4.4 **Insurance undertakings**

4.4.1 In our view, general or life insurers are, under current EU law, not generally required use public policy engagement with a view to pursuing sustainability impact. Sector-specific EU legislation neither expressly permits nor prohibits such engagement. This suggests that insurers are, to some extent, free to use public policy engagement to pursue sustainability impact.

4.4.2 However, insurance undertakings would need to ensure that their public policy engagement complies with their legal or regulatory duties. This requires, in particular, that their activities do not conflict with capital requirements or the 'best interest' of their beneficiaries. Further, the insurer's public policy engagement needs to be consistent with directors' duties, if applicable, under Member State law. Where such public policy engagement carries a material cost borne by current beneficiaries with benefits expected to accrue to other beneficiaries, it might conflict with an insurer's duties.

EUROPEAN UNION

5. ESTABLISHING NEW IFSI FUNDS AND AMENDING THE TERMS OF EXISTING ONES

5.1 The following section considers the extent to which it is possible for an Asset Owner to set up a fund, policy or other product with an express IFSI objective. It does not cover general insurance policies as the terms of these are not generally relevant to the insurer's investment activities.

5.2 **Pension funds**

5.2.1 Current EU law does not explicitly prohibit setting up new pension funds under either IORP or the PEPP Regulation with an express IFSI objective. The same should apply to the introduction of freely selectable options within existing pension funds with an IFSI objective. This is also confirmed by the SFDR, which provides for specific disclosure obligations in relation to financial products that promote environmental or social characteristics or have sustainable investment as their objective.[207] However, in such cases, the pension fund would need to observe general rules, in particular the obligation to provide sufficient and clear information to the beneficiary on the specific risk profile as well as comply, from the date of application, with the disclosure duties set out in the SFDR.

5.2.2 Furthermore, it might theoretically be possible to amend the terms of existing pension schemes to include an IFSI objective. In practice, the permissibility of such amendments will mainly be a matter of Member State law and practice. In addition, member or beneficiary consent may be required (depending on the structure).

5.3 **Mutual funds**

5.3.1 EU legislation does not prohibit or restrict setting up a UCITS with an express IFSI objective, as long as the statutory requirements regarding the investment policy of the UCITS (eg its restriction to certain eligible types of transferable securities) are observed. An IFSI investment objective could be subordinate or equal to, or have priority over, a financial investment objective. However, the Asset Owner needs to comply with general regulations or rules such as to inform the beneficiary on the risk profile. Management companies are also required to use fair, correct and transparent pricing models and valuation systems which may pose difficulties, given that that an assessment of the financial impact of sustainability factors may require broader flexibility than current regulation permits.

5.3.2 Existing UCITS may amend and revise their investment objectives and policy. In order to do so, the competent authority's approval must be obtained.[208] Furthermore, the publication of a renewed prospectus and key investor information document is likely to be required.[209] Depending on the Member States' implementation of the UCITS Directive in national law, the existing unit-holders may need to be involved in approving the amendment.

Duties on those designing, manufacturing and providing mutual funds

5.3.3 Manufacturers of UCITS may be subject to MiFID II product governance requirements.[210] Among other things, a manufacturer must 'identify at a sufficiently granular level the potential target market for each financial instrument and specify the type(s) of client for whose needs, characteristics and objectives the financial instrument is compatible'.[211] The manufacturer must also identify any group of clients for whose needs, characteristics and objectives the financial instrument is not compatible (the 'negative target market').

5.3.4 ESMA establishes five factors that identify the target market: the type of client (eg retail client or professional client); knowledge and experience; financial situation (with a focus on the ability to bear losses); risk tolerance and compatibility of the risk/reward profile of the product with the target market; and the client's objectives and needs.[212] The client's objectives and needs comprise the investment objectives, including the wider financial goals of the client. However, they can be 'fine-tuned' by specifying particular aspects of the investment expectations of targeted clients. As ESMA notes, a product may be designed with 'specific product features to achieve specific investment objectives, such as […] "green investment", "ethical investment", etc as relevant'.[213] Thus, the investment manager may specify the 'target market' by integrating 'green investment' but would not be legally required to determine whether a product qualified as 'green investment'.

5.3.5 According to the amended delegated directive published by the Commission,[214] the requirement for manufacturers to specify the target market by, and the type(s) of client for whose needs, characteristics and objectives the product is compatible with, is extended to include 'sustainability preferences'.[215] Manufacturers will also be required to ensure that the product meets the identified target market's needs in relation to sustainability factors.[216] This means that the manufacturer will need to identify the actual sustainability aspirations of the target market.

EUROPEAN UNION

5.3.6 As part of its focus on governance arrangements, the MiFID II Sustainability Delegated Directive proposes to amend ongoing obligations to review manufactured financial instruments to include the financial instrument's consistency with the sustainability preferences of the target market.[217]

5.3.7 The Commission has highlighted that changes to the definition of the target market should not lead to mis-selling practices (eg by clearly identifying investment objectives and sustainability constraints) but that also in the future a target market for clients without sustainability preferences can be identified.[218] Therefore, 'non-ESG products' which comprise ESG-neutral and ESG-negative products will continue to be manufactured. For non-ESG products the target market will simply lack a reference to ESG.[219]

5.3.8 Investment managers that distribute units in UCITS are subject to similar requirements, eg to ensure that products and services that are intended to be offered or recommended are compatible with the needs and objectives of the identified target market and an ongoing obligation to review this compatibility.[220] The MiFID II Sustainability Delegated Directive proposes to extend also this requirement to sustainability preferences.[221]

5.4 **Life insurance products**

5.4.1 Current EU law does not prohibit life insurers from setting up new types of products that include an express IFSI objective. Therefore, life insurers are generally allowed to create policies specifically including such an objective.

5.4.2 In relation to IBIPs,[222] this is confirmed, for instance, by the SFDR, which provides for specific disclosure obligations in relation to financial products that promote environmental or social characteristics or have sustainable investment as their objective.[223] Further, Article 8 (3) (c) (ii) PRIIPs Regulation expressly addresses PRIIPs which target 'specific environmental or social objectives'.

5.4.3 The life insurer needs, however, to observe general legal requirements, such as the obligation to sufficiently and clearly inform the beneficiary on the specific risk profile, disclosure obligations set out by the SFDR and information requirements prescribed by the PRIIPs Regulation, as applicable.

5.4.4 In relation to IBIPs, the joint committee of the ESAs noted that PRIIPs are increasingly offered with a focus on target-specific social or environmental objectives, and not only purely financial objectives.[224] They therefore chose to set out some certain technical advice on specific requirements for PRIIPs including the following:

- where a PRIIP manufacturer targets environmental or social objectives, these objectives and how they are to be achieved should be specific, and the strategy for achieving the objectives should be appropriate and proportionate to the objectives;
- the PRIIP manufacturer should clearly disclose to retail investors the objectives and how they are to be achieved;
- governance and monitoring measures should be put in place, be proportionate to the objectives and strategy, and be well documented; and
- regular reviews should be undertaken on progress.[225]

5.4.5 The technical advice also provides that 'specific environmental or social objectives should be treated on equal footing with other investment objectives; retail investors should have full confidence that where PRIIPs are sold as targeting environmental or social objectives, this is backed up by appropriate and sufficient substance, as with other investment objectives, in view of the activities of the PRIIP manufacturer, but also in view of supervisory oversight and civil liability'.[226]

5.4.6 Additionally, EU law does not prohibit an insurer from amending an insurance contract to include an express IFSI objective. Generally, this would, however, require the consent of the policyholder depending on the relevant Member State law.

Duties on those designing, manufacturing and providing life insurance

5.4.7 EU law provides for a product oversight and governance system in relation to insurance products. Thus, under IDD, insurance undertakings shall specify, within a product approval process, an identified target market for each insurance product and ensure that all relevant risks to such identified target market are assessed.[227] The Commission Delegated Regulation (EU) 2017/2358[228] further determines that the identification of the target market shall be carried out at a sufficiently granular level, taking into account the characteristics, risk profile, complexity and nature of the insurance product, and that manufacturers may, in particular in regard to IBIPs, identify groups of customers for whose needs, characteristics and objectives the insurance product is generally not compatible (the 'negative target market').[229] Additionally, manufacturers are required to only design and market insurance products that are compatible

EUROPEAN UNION

with the needs, characteristics and objectives of the customers belonging to the target market.[230]

5.4.8 Furthermore, the insurance undertaking shall regularly review the insurance products it offers or markets to assess at least whether the product remains consistent with the needs of the identified target market.[231] Manufacturers that identify during the lifetime of an insurance product any circumstances which are related to the product and may adversely affect the customer of that product shall take appropriate action to mitigate the situation and prevent further occurrences of the detrimental event.[232]

5.4.9 The Amendment IDD Delegated Regulation which has been adopted by the Commission on 21 April 2021 provides, among other things, for an integration of sustainability factors into the product oversight and governance requirements. It requires, in particular, the product approval process to take into account 'the objectives, interests and characteristics of customers, including any sustainability-related objectives'.[233] Moreover, the identification of the respective target market needs to consider 'its sustainability factors'.[234] Manufacturers will be required to assess whether the insurance products remain consistent with, among other things, the 'objectives, including any sustainability-related objectives, of the identified target market'.[235]

5.4.10 Recital 5 of the Amendment IDD Delegated Regulation specifies that manufacturers of insurance products 'should consider sustainability factors in the product approval process of each insurance product and in the other product governance and oversight arrangements for each product that is intended to be distributed to customers seeking insurance products with a sustainability-related profile'.

ANNEXES

European Union

EUROPEAN UNION

6. INVESTMENT MANAGERS' DUTIES TO INVEST FOR SUSTAINABILITY IMPACT

6.1 This section considers the extent to which, and in what circumstances, an investment manager is required or permitted to invest for sustainability impact on behalf of an Asset Owner.

6.1.1 Typically, an investment manager's investment duties and powers are shaped by the terms of its contractual investment management agreement with an Asset Owner (**IMA**) which will be governed by a Member State law and EU legislation. While, on the whole, the IMA cannot override the requirements of EU legislation, it is likely to be the most important element in determining the investment manager's duties and powers.

6.1.2 An investment manager must act honestly, fairly and professionally in accordance with the best interests of its clients.[236] In particular, it 'must understand the financial instruments they offer or recommend, assess the compatibility of the financial instruments with the needs of the clients to whom [they provide] investment services, also taking account of the identified target market of end clients [...] and ensure that financial instruments are offered or recommended only when this is in the interest of the client'.[237]

6.1.3 Investing on behalf of an Asset Owner will generally be the regulated service of portfolio management. When providing portfolio management services, it is the investment manager's obligation to obtain the necessary information, including about investment objectives and risk tolerance, to enable the investment manager to manage the Asset Owner's assets in accordance with that suitability assessment ('suitability test').[238]

6.2 Legal obligations with respect to sustainability impact

Powers of investment and divestment

6.2.1 Suitability is determined by, among other things, considering the investment objectives of the client. In doing so, it would be necessary for the investment manager to rely on information provided by the client.

6.2.2 Should the investment objectives be silent on IFSI, there is currently no duty to proactively ask for the client's objectives regarding sustainability under MiFID II[239], but ESMA considers it a 'good practice' for investment firms to consider non-financial elements and collect information on the client's preferences on ESG factors.[240] However, once the MiFID II Delegated Regulation is amended as provided for in the Commission Delegated Regulation (EU) …/… of 21.4.2021 amending Delegated Regulation (EU) 2017/565 as regards the integration of sustainability factors, risks and preferences into certain organisational requirements and operating conditions for investment firms[241], the suitability assessment pursuant to Article 54 of MiFID II Delegated Regulation will express include a requirement to ask a client or potential client for his or her sustainability preferences. Sustainability preferences are defined as a client's choice as to whether and, if so, to what extent, one or more of three types of financial instruments with different degrees of sustainability-related ambition (which are defined in the MiFID II Delegated Regulation) shall be integrated into his or her investment. The rationale behind this amended suitability assessment is to enable clients to understand those different degrees of sustainability and take informed investment decisions. It appears that there is an expectation that clients who are sufficiently informed about the features of those financial instruments will tend to express a desire for inclusion of sustainable instruments in their investments.

6.2.3 However, the obligation of an investment manager to ask for the sustainability preferences of an Asset Owner does not amount to an obligation for an Asset Owner to have sustainability preferences. Hence, the client can, of course, decide against the inclusion of any financial instrument with sustainability-related ambitions. Nevertheless, it appears that the European legislator has concluded that asking clients for their preferences will in practice encourage a greater shift to sustainability-factor-related strategies such as IFSI than merely allowing investment managers to do so where they consider it appropriate.

Stewardship

6.2.4 Any engagement that is not required by the IMA would need to be in the 'best interest' of the client. Under these circumstances, we do not consider there to be any legal requirement for investment managers to engage with portfolio companies to achieve sustainability impact, except where this relates to instrumental IFSI.

Public policy engagement

6.2.5 There is no requirement in EU legislation for an investment manager to use public policy engagement for IFSI. An investment manager would, therefore, only be required to use public policy engagement to invest for sustainability impact if its mandate expressly or impliedly required it to do so.

EUROPEAN UNION

6.3 **Legal freedom to invest for sustainability impact**

Powers of investment and divestment

6.3.1 The investment manager's freedom to invest for sustainability impact as a standalone objective (ie on an ultimate ends basis) is limited by the IMA. Where the IMA remains silent on IFSI, some level of flexibility also arises from the duties applicable to Asset Owners. This means, where the Asset Owner contemplates to invest for sustainability impact, the investment manager should find an enhanced degree of flexibility.

6.3.2 Generally, investment managers are also permitted to offer sustainability-focused products to Asset Owners where there is no distinct objective for IFSI, provided that the recommended investments fulfil the suitability test.

Stewardship

6.3.3 Assuming that the IMA does not expressly specify what stewardship is permitted, investment managers will be able to engage for sustainability impact as long this is compatible with the duty to act in the client's best interest. Investment managers may be reluctant to engage in activities that reduce the financial return of investments in the portfolio they manage during the relevant investment horizon.

Public policy engagement

6.3.4 In the absence of specific requirements in the IMA, an investment manager benefits from a broad flexibility to use public policy engagement, provided it does not charge the associated costs to the managed portfolio. An investment manager may also not act against the best interests of its clients.

EUROPEAN UNION

7. LEGAL LIABILITY TO THIRD PARTIES FOR THE NEGATIVE SUSTAINABILITY IMPACT OF ENTERPRISES IN WHICH PORTFOLIOS ARE INVESTED

7.1 This section considers the extent to which, regardless of the legal rules under which it is required to operate and its constitution, an Asset Owner could be legally liable to third parties for the negative sustainability impact of a portfolio company and whether an investment manager could also be liable because of its role in assisting the Asset Owner.

7.1.1 This section does not cover potential liability under any national laws, which will be where liability will most likely arise in practice, but only under specific EU law.

7.1.2 The liability of relevant investors to third parties for negative sustainability impact is currently not explicitly contemplated by EU law. The ECJ to date has not directly addressed the legal liability of an Asset Owner to third parties for the negative sustainability impact of portfolio companies. Nor has the ECJ directly addressed the liability of an investment manager to third parties for negative sustainability impact because of its role in assisting the Asset Owner to invest.

Civil and criminal liability

7.1.3 Any direct imposition of civil or criminal liability on Asset Owners and investment managers through EU regulations or directives is unlikely. There is currently no EU-wide approach to such liability. Rather, any such liability would have to be addressed in national legislation.[242]

7.1.4 In fact, it seems unlikely that Asset Owners would be held liable to third parties for the negative sustainability impact of a portfolio company under EU law. Such liability for Asset Owners, generally minority shareholders in a portfolio company, would entail piercing of the corporate veil. Directives neither require nor prohibit piercing of the corporate veil and each Member State is generally free to provide for it in its national legislation. In circumstances where there is no capability to influence the management of a company's affairs (as is generally the case with Asset Owners), such national laws may be foreclosed by EU primary law. In such cases, piercing of the corporate veil may have a deterrent effect on investors and affect their access to the equity market, thus restricting both freedom of establishment (Article 49 TFEU) and the free movement of capital (Article 63 TFEU).[243]

7.1.5 In the EU framework, as illustrated by EU competition law, shareholder liability generally requires the shareholder to exert influence over a company.[244] Thus, a 'pure financial investor' (an investor passively holding shares for profit with no involvement in the company's management), like most Asset Owners or investment managers, would not be liable for the actions of its investee portfolio companies under EU law.[245]

Administrative liability

7.1.6 A comprehensive administrative liability *vis-à-vis* the state to remediate certain damages caused by negative sustainability impacts or pay for such remediation does not exist under European legislation. However, to some extent it may be covered by the Environmental Liability Directive (or ELD). The ELD establishes a framework of strict environmental liability based on the 'polluter-pays' principle, to prevent and remedy environmental damage.[246] The ELD obliges operators of certain activities which have caused environmental damage to, among other things, implement remedial measures and bear the costs for such measures.[247] It does not, however, provide for claims by private parties against such polluters.[248]

7.1.7 An 'operator' is broadly defined as 'any natural or legal, private or public person who operates or controls the occupational activity or, where this is provided for in national legislation, to whom decisive economic power over the technical functioning of such an activity has been delegated, including the holder of a permit or authorisation for such an activity or the person registering or notifying such an activity'.[249] Relevant investors may, depending on the nature of their involvement, be regarded as either controlling an investee company's activity or as having decisive economic power over the technical functioning of such an activity.[250] Also, a minority investor is not *a priori* excluded from being qualified as operator. However, application will depend on the national implementation of the ELD in each Member State.[251]

EUROPEAN UNION

7.2 **Asset Owners**

7.2.1 The following section assesses whether, in addition to the general legal framework, sector-specific legislation for Asset Owners addresses legal liability.

Pension funds

7.2.2 Current sector-specific EU law does not regulate the potential liability of pension funds for negative sustainability impact. This also applies to Article 31 PEPP Regulation, which concerns civil liabilities of PEPP providers in case of a breach of information requirements. However, a liability for negative sustainability impact might arise out of the Member State.

7.2.3 As public awareness of sustainability issues has grown, the legal liability risks of pension funds might increase correspondingly where investment activities lead to negative sustainability impact. This may make it reasonable to consider sustainability impact, including its financial consequences, in investment decisions. The specific extent of such liability risks will, however, depend on the Member State law.

Mutual funds

7.2.4 The UCITS Directive, including accompanying delegated legislation, does not establish nor does it require Member States to establish a liability for mutual funds in respect of the negative sustainability impact of a portfolio company.

7.2.5 Any liability risk that the portfolio company is exposed to as a result of a negative sustainability impact, may, however, be taken into account as 'sustainability risk' or other type of risk that has a potential impact on the financial return of the investee company when taking the investment decision.

Insurance undertakings

7.2.6 Current sector-specific EU law does not explicitly address the potential liability of insurance undertakings for the negative sustainability impact of a portfolio company. This also applies to Article 11 PRIIPs Regulation, which provides for a civil liability of PRIIP manufacturers in the event of a breach of duty concerning the key information document of a PRIIP.[252]

7.2.7 However, a liability might arise under the national law of the respective Member State.

7.3 **Investment managers**

7.3.1 Applicable EU legislation, notably MiFID II, does not provide for any rules under which an investment manager would be liable for breaches of any duty identified in section 2 that an Asset Owner is subject to. In relation to UCITS, on the contrary, the law provides that the liability of the management company is not affected by the delegation of functions by the management company to third parties, including the investment manager.[253]

7.3.2 Since this annex concerns the standards established under EU law only, it does not consider any contractual or tortious obligations between the investment manager and the beneficiaries that would make the investment manager directly liable to beneficiaries. Any such contractual or tortious obligations would be governed by a Member State or third country law and are therefore out of scope of this annex.

EUROPEAN UNION

8. THE MEANING OF 'FINANCIALLY MATERIAL'

8.1 It is important to understand how the law defines what is 'financially material' in relation to the assessment of sustainability factors and the period by reference to which financial materiality must be measured. Taking account of these factors in order to pursue financial objectives may incidentally have sustainability impacts.

8.2 **Financial materiality**

8.2.1 EU legislation has established the concept of 'sustainability risks' to describe how ESG and sustainability factors become 'financially material'. In Article 2(22) SFDR, sustainability risks are defined as an 'environmental, social or governance event or condition that, if it occurs, could cause an actual or a potential material negative impact on the value of the investment'. Besides the use of this term for the specification of disclosure requirements, the concept of 'sustainability risk' is referred to in the legislation which is part of the sustainable finance package published by the Commission on 21 April 2021 in order to determine how financially material ESG and sustainability factors need to be taken into account in taking investment decisions.[254] Thus, for instance, the Amendment Solvency II Delegated Regulation contains a similar definition of 'sustainability risk' as the SFDR.[255]

8.3 **Time period by reference to which 'financial materiality' is to be assessed**

Pension funds

8.3.1 Generally, pension fund investments must seek to achieve financial returns over the long term so they need to consider the 'best long-term interest' of beneficiaries 'as a whole' as part of the PPP. Specifically, for IORPs, this is also recognised by their classification as 'very long-term investors'.[256] Similarly, in regard to PEPPs, the term 'personal pension product' is defined as a product which, among other things, 'provides for long-term capital accumulation'.[257]

8.3.2 Further, Recital 7 IORP II highlights the importance of ensuring the intergenerational balance of occupational pension schemes 'by aiming to have an equitable spread of risks and benefits between generations in occupational retirement provision'. For PEPP providers, Recital 46 of the PEPP Regulation sets out that 'PEPP providers should be able to opt for an asset allocation that suits the precise nature and duration of their liabilities, including those having a long-term horizon'. This indicates that pension funds must also consider shorter-term matters. The generally long-term character of pension funds' investments implies that the financial materiality of sustainability factors should primarily be assessed over the long-term, considering the time period over which their liabilities arise. In addition, pension funds need to consider the interest of any beneficiaries with shorter-term holding periods. Regarding PEPPs, the generic accumulation period varies from 10 to 40 years.[258]

Mutual funds

8.3.3 Absent any specific provisions, the principle of 'best interest' for UCITS and their unit-holders decides upon the time period over which an impact on financial return must be considered. It therefore appears to be in the best interest of unit-holders where the financial return is positively impacted during their investment horizon, which means that ESG and sustainability considerations should be taken into account where they become relevant for the financial return during the investment horizon of a unit-holder of the fund concerned (ie instrumental IFSI).

8.3.4 Usually, the composition of unit-holders in open-ended funds, such as UCITS, is constantly changing. The investment horizon of unit-holders will therefore be defined as rather short-term.

Insurance undertakings

8.3.5 As a general principle, the time period by reference to which non-life insurers should assess the 'financial materiality' of ESG factors should, in our view, differ from the time period relevant for life insurers (in each case, only in relation to their assets covering insurance liabilities). EIOPA stated the view that for '(longer-term) life business, the long horizon for cash-flows also means that there may be room to consider the impact of climate change in the calculation of best estimate'.[259] Similarly, EIOPA noted that where 'undertakings have long-term assets to match long-term liabilities they should consider whether climate change would impact either their liability to hold these assets over that time frame or their expected cash-flows'.[260]

EUROPEAN UNION

8.3.6 In contrast, for traditional non-life insurance business, the insurance cover period typically amounts to 12 months.[261] Pursuant to EIOPA, insurance business 'whose claims' occurrence or settlement periods are short-term might be less affected. These business models allow, in theory, for annual repricing and recalibration. Therefore, the annual validation of assumptions seems fit for purpose for short-term obligations'.[262] However, EIOPA has pointed out that non-life insurance undertakings could also have long-term liabilities and therefore hold assets over the long term.[263]

Investment managers

8.3.7 The time period that investment managers will primarily consider for the determination of financial materiality will depend on the time period applicable under the relevant investment terms.

Markus Benzing, Wessel Heukamp, David Jansen, Daniel Klingenbrunn, Jadwiga Loiko, Bastian Schuster and David Schwintowski

EUROPEAN UNION

1 Article 288(1) of the Treaty on the Functioning of the European Union (TFEU).

2 Article 288(2) TFEU.

3 Article 288(3) TFEU.

4 Case C- 41/74, Yvonne van Duyn v Home office, Judgement of the ECJ of 4 December 1974, para. 12.

5 Articles 290 and 291 TFEU.

6 Directive 2009/65/EC of the European Parliament and the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities, OJ L 302, p. 32.

7 Directive 2009/138/EC of the European Parliament and of the Council on the taking up and pursuit of the business of Insurance and Reinsurance, OJ L 335, p. 1-155.

8 Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU, OJ L 173, p. 349–496.

9 Communication from the Commission to the European Parliament, the European Council the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions, Action Plan: Financing Sustainable Growth, 8 March 2018, COM(2018) 97 final.

10 Action Point 7 of the EU Action Plan on Sustainable Finance.

11 Communication from the Commission to the European Parliament, the European Council the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions, The European Green Deal, 11 December 2019, COM(2019) 640 final.

12 https://ec.europa.eu/info/consultations/finance-2020-sustainable-finance-strategy_en.

13 https://ec.europa.eu/info/publications/210421-sustainable-finance-communication_en.

14 Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088, OJ L 198, 22 June 2020, OJ L 198, 22 June 2020, p. 13–43.

15 Commission Delegated Regulation (EU) of 4 June 2021, supplementing Regulation (EU) 2020/852 of the European Parliament and of the Council by establishing the technical screening criteria for determining the conditions under which an economic activity qualifies as contributing substantially to climate change mitigation or climate change adaptation and for determining whether that economic activity causes no significant harm to any of the other environmental objectives, C (2021) 2800 final (EU Taxonomy Climate Delegated Act).

16 See, for example, the Regulation (EU) 2019/2088 of the European Parliament and the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector, OJ L 317, 9 December 2019, p. 1–16. as amended by the Taxonomy Regulation.

17 See, for example, the Non-Financial Reporting Directive (or NFR Directive, supplemented by the Guidelines on Non-Financial Reporting: methodology for reporting non-financial information (2017/C 215/01), OJ C 215, and the Guidelines on non-financial reporting: Supplement on reporting climate-related information (2019/C 209/01), C/2019/4490. The NFR Directive is now about to be amended by the Corporate Sustainability Reporting Directive (CSRD) a proposal for which the Commission has published as part of the sustainable finance package published on 21 April 2021 (Proposal for a Directive of the European Parliament and of the Council amending Directive 2013/34/EU, Directive 2004/109/EC, Directive 2006/43/EC and Regulation (EU) No 537/2014, as regards corporate sustainability reporting, 21 April 2021, COM(2021) 189 final, 2021/0104 (COD)).

18 See, for example, the 2020 consultation on the RTS conducted by the EBA, EIOPA and ESMA (the ESAs) in the context of the SFDR (https://www.esma.europa.eu/press-news/esma-news/esas-consult-environmental-social-and-governance-disclosure-rules).

19 Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector, OJ L 317, 9 December 2019, p. 1–16. The SFDR applies to 'financial market participants', a term covering, *inter alia*, (1) insurance companies that make available insurance-based investment products, (2) investment firms and credit institutions providing portfolio management, (3) IORPs, (4) manufacturers of pension products, (5) AIFMs, (6) PEPP-providers and (7) UCITS management companies (Article 2(1) SFDR). Certain Asset Owners are also covered in their role as providers of investment or insurance advice, ie as 'financial advisers' (Article 2(11) SFDR).

20 Cf. Article 1 SFDR.

21 European Commission, Consultation on the Renewed Sustainable Finance Strategy, Consultation Document, 8 April 2020, p. 33 (https://ec.europa.eu/info/consultations/finance-2020-sustainable-finance-strategy_en).

22 As regards the details of the content, presentation and methodologies to be applied to certain information to be disclosed, the ESAs have been mandated to develop respective RTS by December 2020 (cf. Article 4(6) and (7), 8(3), 9(5), 10(2), 11(4), 13(2) SFDR) to be subsequently adopted as delegated acts by the Commission. Further to public consultation in April 2020, on 4 February 2021, the ESAs published the 'Final Report on draft Regulatory Technical Standards with regard to the content, methodologies and presentation of disclosures pursuant to Article 2a(3), Article 4(6) and (7), Article 8(3), Article 9(5), Article 10(2) and Article 11(4) of Regulation (EU) 2019/2088 (2 February 2021, JC 2021 03)'.

23 'Sustainable investment' is defined in Article 2(17) SFDR *as 'an investment in an economic activity that contributes to an environmental objective, as measured, for example, by key resource efficiency indicators on the use of energy, renewable energy, raw materials, water and land, on the production of waste, and greenhouse gas emissions, or on its impact on biodiversity and the circular economy, or an investment in an economic activity that contributes to a social objective, in particular an investment that contributes to tackling inequality or that fosters social cohesion, social integration and labour relations, or an investment in human capital or economically or socially disadvantaged communities, provided that such investments do not significantly harm any of those objectives and that the investee companies follow good governance practices, in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance'* [emphasis added]. The (required information on the) principle of 'do no harm' will be specified in further delegated acts, see Article 2a SFDR (as amended by the Taxonomy Regulation).

24 Articles 8 to 10 SFDR.

25 Article 2(22) SFDR.

26 Articles 3, 5 and 6 D SFDR.

27 Article 2(24) SFDR.

28 Articles 4 and 7 SFDR.

29 Article 4(1)(a) SFDR. As regards the content of the statement, see Article 4(2) SFDR as well as the draft template attached as Annex I to the ESAs' draft RTS, p. 49 *et seqq.* (accessible via https://www.esma.europa.eu/sites/default/files/jc_2020_16_-_joint_consultation_paper_on_esg_disclosures.pdf).

30 Article 4(a) and (b) SFDR.

31 Article 4(3) and (4) SFDR.

32 See eg Article 1 SFDR, which sets forth that this Regulation lays down harmonized rules on *'transparency with regard to the integration of sustainability risks and the consideration of adverse sustainability impacts in their processes', and Recital 10 SFDR, which clarifies that this 'Regulation aims to reduce information asymmetries in principal-agent relationships with regard to', inter alia, the integration of sustainability risks 'by requiring financial market participants and financial advisers to make […] disclosures to end investors when they act as agents of those end investors (principals)'*; see, additionally, Recitals 5, 8, 9 and 23 of the SFDR.

33 Emphasis added.

34 Please refer to sections 2.3.26 *et seqq.* and 2.4.10 *et seqq.*

35 European Commission, press release of 21 April 2021, Sustainable Finance and EU Taxonomy: Commission takes further steps to channel money towards sustainable activities (accessible via https://ec.europa.eu/commission/presscorner/detail/en/ip_21_1804).

36 European Commission, press release of 6 July 2021, Commission puts forward new strategy to make the EU's financial system more sustainable and proposes new European Green Bond Standard (accessible via https://ec.europa.eu/commission/presscorner/detail/en/ip_21_3405).

37 Commission Delegated Regulation (EU) …/… of 6 July 2021 supplementing Regulation (EU) 2020/852 of the European Parliament and of the Council by specifying the content and presentation of information to be disclosed by undertakings subject to Articles 19a or 29a of Directive 2013/34/EU concerning environmentally sustainable economic activities, and specifying the methodology to comply with that disclosure obligation, C(2021) 4987 final (Delegated Act supplementing Article 8 of the Taxonomy Regulation).

38 Annexes to the Commission Delegated Regulation supplementing Regulation (EU) 2020/852 of the European Parliament and of the Council by specifying the content and presentation of information to be disclosed by undertakings subject to Articles 19a or 29a of Directive 2013/34/EU concerning environmentally sustainable economic activities, and specifying the methodology to comply with that disclosure obligation, 6 July 2021, C(2021) 4987 final, Annexes 1 to 5.

39 Delegated Act supplementing Article 8 of the Taxonomy Regulation, p. 2.

40 Cf. Article 1(1) of Directive (EU) 2015/849: *'This Directive aims to prevent the use of the Union's financial system for the purposes of money laundering and terrorist financing.' (OJ L 141, 5 June 2015, p. 73). Also see the first preamble to said Directive: 'Flows of illicit money can damage the integrity, stability and reputation of the financial sector, and threaten the internal market of the Union as well as international development. Money laundering, terrorism financing and organised crime remain significant problems which should be addressed at Union level.'*

41 Cf. preamble 4 of Council Decision (CFSP) 2020/1999 of 7 December 2020 concerning restrictive measures against serious human rights violations and abuses, OJ LI 410/13: *'This Decision establishes a framework for targeted restrictive measures to address serious human rights violations and abuses worldwide. In that regard, the Council emphasises the importance of international human rights law and of the interaction between international human rights law and international humanitarian law when considering the application of targeted restrictive measures under this Decision.'*

42 With respect to the scope of the project, please refer to Part B.

EUROPEAN UNION

43 Annuities can additionally be subject to Solvency II when provided by insurance undertakings, see Article 2(1) and(3) (a) (ii) Solvency II; with regard to insurance companies, please refer to section 2.4.

44 Directive (EU) 2016/2341 of the European Parliament and of the Council of 14 December 2016 on the activities and supervision of institutions for occupational retirement provision (IORPs), OJ L 354, 23 December 2016, p. 37–85.

45 See Article 6(1) IORP II.

46 Regulation (EU) 2019/1238 of 20 June 2019 of the European Parliament and of the Council of 20 June 2019 on a pan-European Personal Pension Product (PEPP), OJ L 198, 25 July 2019, p. 1–63.

47 According to Article 74 PEPP Regulation the delegated acts will apply 12 months after publication in the official Journal of the European Union. Following their adoption by the Commission, the respective acts were published on 22 March 2021.

48 As explained above (please refer to section 1.7), the form an IORP or PEPP takes is not specified in EU law. The constitution of Asset Owners and the relevance of that constitution to investment-related decisions will thus be a matter of Member State law.

49 Article 6(5) and (6) IORP II.

50 Article 2(3) and (6) PEPP Regulation.

51 Article 19(1) IORP II.

52 Cf. Recital 25 IORP II.

53 Article 19(1) (a) IORP II.

54 Article 19(1) (b) IORP II. IORP II does not explicitly define the term 'environmental, social and governance factors' so it is not entirely clear what the phrase means although Recital 58 of IORP II refers to the United Nations-supported Principles for Responsible Investment.

55 IORP II is based on the terminology of 'ESG factors' or 'ESG risks'. The meaning of these terms is, in our opinion, equivalent to 'sustainability factors' or 'sustainability risks'.

56 Article 21(1) and (2) IORP II.

57 Article 25(1) and (2) (g) IORP II.

58 Article 28(1) IORP II.

59 Article 28(2) (h) IORP II.

60 Article 41(1) PEPP Regulation.

61 Article 41(1) (b) PEPP Regulation.

62 Article 2(33) PEPP Regulation.

63 Article 41(1) (c) and (f) PEPP Regulation.

64 Article 46(1) PEPP Regulation.

65 Article 19(1) (b) IORP II.

66 Cf. Recital 58 IORP II, which states that IORPs are not precluded from satisfying information requirements by stating that ESG factors *'are not considered in its investments policy'*.

67 EIOPA, Opinion on the supervision of the management of environmental, social and governance risks faced by IORPs, EIOPA-BoS-19-248, 10 July 2019, para. 3.2.

68 For instance, the UK Department for International Development determined in its survey for its 'Investing in a Better World' project that 56 per cent of 6,000 participating individuals would have opted for a fully or partially sustainable pension by having their savings invested in a sustainable investment fund, if given the choice, see UK Department for International Development/Investing in a better world project, *Investing in a better world: Understanding the UK public's demand for opportunities to invest in the Sustainable Development Goals*, 2019, p. 7, 20 (accessible via https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/834207/Investing-in-a-better-wold-full-report.pdf). Moreover, pursuant to a survey conducted by Bauer/Ruod/Smeets among 2,507 members of a Dutch pension fund, 42 per cent of the members supported a more sustainable investment policy even if this could negatively affect their investment return, see Rob Bauer/Tobias Ruod/Paul Smeets *Get Real! Individuals prefer more Sustainable Investments*, 2018, p. 13 *et seq*. (accessible via https://ec.europa.eu/jrc/sites/jrcsh/files/paper_tobias_ruof.pdf).

69 EIOPA, Opinion on the supervision of the management of environmental, social and governance risks faced by IORPs, EIOPA-BoS-19-248, 10 July 2019.

70 EIOPA, Opinion on the supervision of the management of environmental, social and governance risks faced by IORPs, EIOPA-BoS-19-248, 10 July 2019, para. 3.9.

71 EIOPA, Opinion on the supervision of the management of environmental, social and governance risks faced by IORPs, EIOPA-BoS-19-248, 10 July 2019, para. 2.7.

72 Emphasis added. In relation to PEPP providers, see Article 41(1) (a) PEPP Regulation which lays down the necessity to take account of the 'best long-term interests of PEPP savers as a whole'.

73 Cf. Recital 49 PEPP Regulation, pursuant to which PEPP providers *'are encouraged to allocate a sufficient part of their asset portfolio to sustainable investments in the real economy with long-term economic benefits, in particular to infrastructure projects and corporates'*.

74 Cf. EIOPA, Opinion on the use of governance and risk assessment documents in the supervision of IORPs, EIOPA-BoS-19-245, 10 July 2019, Annex 1 para. 6.5 to 6.7.

75 See section 2.2.9.

76 Article 34(1) PEPP Regulation.

77 Article 34(4) PEPP Regulation.

78 See Article 19(1) (b) IORP II.

79 Cf. Recital 48 IORP II, and similarly, for PEPP providers, Recital 48 PEPP Regulation.

80 European Commission, Commission Staff Working Document Impact Assessment for a Proposal for a Regulation of the European Parliament and of the Council on the establishment of a framework to facilitate sustainable investment and Proposal for a Regulation of the European Parliament and of the Council on disclosures relating to sustainable investments and sustainability risks and amending Directive (EU) 2016/2341 and Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) 2016/1011 on low carbon benchmarks and positive carbon impact benchmarks, 24 May 2018, SWD(2018) 264 final (Impact Assessment), para. 2.1.2.

81 Cf. EIOPA, Opinion on the use of governance and risk assessment documents in the supervision of IORPs, EIOPA-BoS-19-245, 10 July 2019, Annex 1 para. 6.5 to 6.7.

82 Cf. Pensions Europe, Position Paper on the Commission's Legislative Package on Sustainable Finance, 26 November 2018, p. 9 (accessible via https://www.pensioneurope.eu/system/files/Sustainable%20Finance%20Package%20position%20paper%20final.pdf).

83 Cf. Recital 45 IORP II *('IORPs are very long-term investors. […] Furthermore, in order to protect adequately the rights of members and beneficiaries, IORPs should be able to opt for an asset allocation that suits the precise nature and duration of their liabilities.')*.

84 Cf. Recital 45 IORP II *('[…] in order to protect adequately the rights of members and beneficiaries, IORPs should be able to opt for an asset allocation that suits the precise nature and duration of their liabilities.')*.

85 See eg Article 19(1) (c) and (f) IORP II; in relation to the PEPP Regulation, see Article 41(1) (c) and (f) PEPP Regulation.

86 PensionsEurope, Position Paper on the Commission's Legislative Package on Sustainable Finance, 26 November 2018, p. 7 (accessible via https://www.pensioneurope.eu/system/files/Sustainable%20Finance%20Package%20position%20paper.pdf); cf. European Commission, Impact Assessment, para. 2.1.2.

87 EIOPA, Potential undue short-term pressure from financial markets on corporates: Investigation on European insurance and occupational pension sectors, Search for evidence, Year-end 2018, EIOPA-BOS-19-537, 18 December 2019, para. 171 and 172.

88 This Annex does not cover alternative investment funds because, at the end of 2019, only 16% of the net asset value of these investment vehicles was held by retail investors - ESMA, ESMA Annual Statistical Report: EU Alternative Investment Funds 2020, ESMA50-165-1032, 10 July 2020, p. 6.

89 The UCITS Directive was amended multiple times, most recently by Directive (EU) 2019/2162 of the European Parliament and of the Council of 27 November 2019 on the issue of covered bonds and covered bond public supervision, OJ L 32, 18 December 2019, p. 29. The UCITS Directive has been implemented by the laws of the members states and supplemented by several Delegated Regulations and Delegated Directives.

90 Article 1(3) UCITS Directive.

91 Article 1(3) UCITS Directive.

92 This follows from Article 5 (2) sentence 2 of the UCITS Directive; see also Article 50a UCITS Directive which clearly expresses these two options.

93 Depending on the Member State laws, for instance, the management company, the unit-holder (as a community of fractional owners) or the trustee may qualify as legal owner of the assets.

94 Article 14(1)(a) and (b) UCITS Directive.

95 Articles 22 to 29 UCITS Delegated Directive.

96 Article 22(1) UCITS Delegated Directive.

97 A similar interpretation for alternative investment funds (AIFs) is indicated by Recital 12 of Directive 2011/61/EU on Alternative Investment Fund Managers, generally describing the interests of investors of an AIF as the *'investors' interests in their specific capacity as investors of the AIF, and not their individual interests'*.

98 Article 22(4) UCITS Delegated Directive.

99 Article 23(1) UCITS Delegated Directive.

100 Article 23(2) UCITS Delegated Directive.

101 Article 23(3) UCITS Delegated Directive.

102 European Commission, Impact Assessment, p. 17.

103 Article 51(1) UCITS Regulation in conjunction with Article 38 *et seq.* UCITS Delegated Directive as it will be amended by Commission Delegated Regulation (EU) …/… of 21 April 2021 amending Directive 2010/43/EU as regards the sustainability risks and sustainability factors to be taken into account for Undertakings for Collective Investment in Transferable Securities (UCITS) (C(2021) 2617 final).

104 Cf. European Commission, Impact Assessment, p. 39: *'Some entities, in fact, do not analyse these factors, […] because they confuse ESG integration with ethical investing, which implies accepting lower risk-adjusted returns, which would not be in the best interest of their clients/beneficiaries'* (emphasis added).

EUROPEAN UNION

105 European Commission, Impact Assessment, para. 2.1.2.

106 Cf. 2005 Freshfields Report, p. 13; European Commission, DG Environment, Resource Efficiency and Fiduciary Duties of Investors, Final Report, ENV.F1/ETU/2014/0002, Rec. 2.2.; OECD, Investment governance and the integration of environmental, social and governance factors, 2017, p. 50.

107 Article 22(1) UCITS Delegated Directive.

108 Article 14(1)(a) and (b) UCITS Directive.

109 Article 22(2) UCITS Delegated Directive.

110 European Commission Delegated Directive (EU) …/… of 21 April 2021 amending Directive 2010/43/EU as regards the sustainability risks and sustainability factors to be taken into account for Undertakings for Collective Investment in Transferable Securities (UCITS), Ref. C (2021) 2617 final (UCITS ESG Delegated Directive). The final draft was published on 21 April 2021 as part of the EU Sustainable Finance Package.

111 Cf. Recital 3 and 6 UCITS ESG Delegated Directive.

112 Article 23(5) UCITS Delegated Directive, as amended by Article 1(7) UCITS ESG Delegated Directive.

113 For a definition, see section 1.15.

114 ESMA, Consultation Paper on integrating sustainability risks and factors in the UCITS Directive and AIFMD, ESMA34-45-569, 19 December 2018, para. 13.

115 Article 23(6) UCITS Delegated Directive, as amended by Article 1(7) UCITS ESG Delegated Directive.

116 For a definition, see section 1.16.

117 There may, however, be differences in details. The Commission states that sustainability risks would need to be assessed 'mainly over the long term' and this may indicate that such risks need to be assessed beyond the typical investment horizon of individual investors. In addition, assessing sustainability risks may be considered a 'broader concept' since the risks to the performance of the portfolio are not necessarily linked to the activities of individual portfolio companies. European Commission, Impact Assessment, p. 44 *et seq*.

118 See section 1.16.

119 In this regard, Recital 12 SFDR states that the SFDR *'maintains the requirements for financial market participants […] to act in the best interest of end investors, including but not limited to, the requirement of conducting adequate due diligence prior to making investments'*.

120 Article 22(4) UCITS Delegated Directive.

121 Article 23(2) UCITS Delegated Directive.

122 It may be noted that pursuant to Article 5(5) UCITS Delegated Directive, as amended by Article 1(3) UCITS ESG Delegated Directive, it is proposed to oblige management companies to have the necessary resources and expertise for the effective integration of sustainability risks.

123 Article 22(3) UCITS Delegated Directive.

124 See section 1.16 *et seq*.

125 Directive (EU) 2016/97 of the European Parliament and of the Council of 20 January 2016 on insurance distribution (recast), OJ L 26, 2 February 2016, p. 19 (IDD).

126 Regulation (EU) No 1286/2014 of the European Parliament and the Council of 26 November 2014 on key information documents for packaged retail and insurance-based investment products, OJ L 352, 9 December 2014, p. 1–23 (PRIIPS Regulation).

127 Commission Delegated Regulation (EU) 2015/35 of 10 October 2014 supplementing Directive 2009/138/EC of the European Parliament and of the Council on the taking up and pursuit of the business of Insurance and Reinsurance, OJ L 12, 17 January 2015, p. 1–797 (Solvency II Delegated Regulation).

128 Commission Delegated Regulation amending Delegated Regulation (EU) 2015/35 as regards the integration of sustainability risks in the governance of insurance and reinsurance undertakings, C(2021) 2628 final, 21 April 2021 (Amendment Solvency II Delegated Regulation).

129 Commission Delegated Regulation amending Delegated Regulations (EU) 2017/2358 and (EU) 2017/2359 as regards the integration of sustainability factors, risks and preferences into the product oversight and governance requirements for insurance undertakings and insurance distributors and into the rules on conduct of business and investment advice for insurance-based investment products, C(2021) 2614 final, 21 April 2021 (Amendment IDD Delegated Regulation).

130 EIOPA-BoS-19/241, 30 September 2019.

131 EIOPA-BoS-19/172, 20 April 2019.

132 Article 132(1) Solvency II.

133 Article 132(2) subparagraph 1 Solvency II.

134 Article 132(2) subparagraph 2 Solvency II.

135 Article 132(2) subparagraph 3 Solvency II.

136 Article 132(2) subparagraph 4 Solvency II.

137 Article 132(4) subparagraphs 3 and 4 Solvency II (*'Assets shall be properly diversified in such a way as to avoid excessive reliance on any particular asset, issuer or group of undertakings, or geographical area and excessive accumulation of risk in the portfolio as a whole. Investments in assets issued by the same issuer, or by issuers belonging to the same group, shall not expose the insurance undertakings to excessive risk concentration'*').

138 Article 1(6) Amendment Solvency II Delegated Regulation.

139 Article 1(2) and (3) Amendment Solvency II Delegated Regulation.

140 Article 1(4) Amendment Solvency II Delegated Regulation.

141 Article 29 Solvency II Delegated Regulation.

142 Article 17(1) IDD.

143 Article 20(1) subparagraph 2 IDD.

144 Commission Delegated Regulation (EU) 2017/2359 of 21 September 2017 supplementing Directive (EU) 2016/97 with regard to information requirements and conduct of business rules applicable to the distribution of insurance-based investment products.

145 Amendment IDD Delegated Regulation, p. 6.

146 Article 2(3) (a) Amendment IDD Delegated Regulation.

147 EIOPA, EIOPA's technical advice on the integration of sustainability risks and factors in the delegated acts under Solvency II and IDD, EIOPA BoS-19/172, 30 April 2019, p. 20.

148 EIOPA, opinion on sustainability within Solvency II, EIOPA-BoS-19/241, 30 September 2019 (EIOPA, Sustainability within Solvency II), p. 11.

149 EIOPA, Sustainability within Solvency II, p. 5.

150 EIOPA, Sustainability within Solvency II, p. 5.

151 EIOPA, Sustainability within Solvency II, p. 5.

152 EIOPA, Sustainability within Solvency II, p. 5.

153 EIOPA, EIOPA's technical advice on the integration of sustainability risks and factors in the delegated acts under Solvency II and IDD, EIOPA BoS-19/172, 30 April 2019, para. 101.

154 EIOPA, Sustainability within Solvency II, p. 5; EIOPA, EIOPA's technical advice on the integration of sustainability risks and factors in the delegated acts under Solvency II and IDD, EIOPA BoS-19/172, 30 April 2019, p. 21. Cf. EIOPA, Guidelines on system of governance, EIOPA-BoS-14/253, 2014, Guideline 29, p. 13 *et seq.*: The '*undertaking should regularly review and monitor the security, quality, liquidity and profitability of the portfolio as a whole by considering at least: […] (d) the characteristics of the assets including: […] (iv) sustainability*'.

155 EIOPA, Sustainability within Solvency II, p. 5; EIOPA, EIOPA's technical advice on the integration of sustainability risks and factors in the delegated acts under Solvency II and IDD, EIOPA BoS-19/172, 30 April 2019, p. 23 *et seq.*

156 EIOPA, Sustainability within Solvency II, p. 5, 12 *et seq.*; EIOPA, EIOPA's technical advice on the integration of sustainability risks and factors in the delegated acts under Solvency II and IDD, EIOPA BoS-19/172, 30 April 2019, p. 24.

157 Cf. Amendment Solvency II Delegated Regulation, p. 1.

158 Article 1(1) Amendment Solvency II Delegated Regulation.

159 EIOPA, EIOPA's technical advice on the integration of sustainability risks and factors in the delegated acts under Solvency II and IDD, EIOPA BoS-19/172, 30 April 2019, para. 112.

160 EIOPA, EIOPA's technical advice on the integration of sustainability risks and factors in the delegated acts under Solvency II and IDD, EIOPA BoS-19/172, 30 April 2019, para. 115.

161 EIOPA, EIOPA's technical advice on the integration of sustainability risks and factors in the delegated acts under Solvency II and IDD, EIOPA BoS-19/172, 30 April 2019, para. 112.

162 Recital (6) Amendment Solvency II Delegated Regulation.

163 EIOPA, EIOPA's technical advice on the integration of sustainability risks and factors in the delegated acts under Solvency II and IDD, EIOPA BoS-19/172, 30 April 2019, para. 116.

164 EIOPA, EIOPA's technical advice on the integration of sustainability risks and factors in the delegated acts under Solvency II and IDD, EIOPA BoS-19/172, 30 April 2019, para. 119.

165 Cf. EIOPA, EIOPA's technical advice on the integration of sustainability risks and factors in the delegated acts under Solvency II and IDD, EIOPA BoS-19/172, 30 April 2019, p. 11.

166 EIOPA, Sustainability within Solvency II, p. 5, 12.

167 EIOPA, Sustainability within Solvency II, p. 5, 13. In its 'Discussion Paper on Non-Life Underwriting and Pricing in Light of Climate Change' (EIOPA-BoS-20/669, 10 December 2020, p. 14), EIOPA has argued that the investment landscape relevant for non-life undertakings would be influenced by climate change thereby implying that investments of (typically shorter-term) non-life insurance business may also be subject to climate change-related risks.

168 See discussion of collective action in Part B.

169 EIOPA, Final Report on Public Consultation No. 14/017 on Guidelines on system of governance, EIOPA-BoS-14/254, 28 January 2015, explanatory text to Guideline 29, para. 2.142.

170 EIOPA, Final Report on Public Consultation No. 14/017 on Guidelines on system of governance, EIOPA-BoS-14/254, 28 January 2015, explanatory text to Guideline 29, para. 2.142.

171 EIOPA, Final Report on Public Consultation No. 14/017 on Guidelines on system of governance, EIOPA-BoS-14/254, 28 January 2015, explanatory text to Guideline 29, para. 2.143.

172 EIOPA, Sustainability within Solvency II, p. 5, 14.

173 EIOPA, Sustainability within Solvency II, p. 5, 12.

EUROPEAN UNION

174 Directive 2007/36/EC of the European Parliament and of the Council of 11 July 2007 on the exercise of certain rights of shareholders in listed companies, OJ L 184, 14 July 2007, p. 17–24; Member States may exempt, among others, UCITS from the application of the SRD (Article 1(3) (a) SRD). However, please note that Member States cannot exempt UCITS from the stewardship obligations set out in Chapter Ib SRD.

175 Article 1(1) SRD.

176 Directive (EU) 2017/828 of the European Parliament and of the Council of 17 May 2017 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement, OJ L 132, 20 May 2017, p. 1–25.

177 Institutional investors comprise life assurance undertakings and reinsurance undertakings that carry out activities covering life-insurance obligations and pension funds (Article 2(e) SRD).

178 Asset managers comprise UCITS and investment firms providing portfolio management services (Article 2(f) SRD).

179 Article 1(6) SRD.

180 Recital 15 SRD II.

181 Recital 14 SRD II.

182 European Commission, Action Plan, para. 1.3.

183 ESMA, Report on undue short-term pressure on corporations, ESMA30-22-762, 18 December 2019, para. 191.

184 ESMA, Report on undue short-term pressure on corporations, ESMA30-22-762, 18 December 2019, para. 202.

185 Directorate-General for Justice and Consumers (European Commission), EY, Study on directors' duties and sustainable corporate governance, Final Report, July 2020, para. 3.2.2. Short termism is assessed by a comparison of the amount of net corporate funds used for pay-outs to shareholders compared to the amount used for the creation of value for the firm (such as infrastructure, workers training, research & developments and investments into sustainability but not how pay-outs are reinvested) (para. 3.1.1.1.).

186 Directorate-General for Justice and Consumers (European Commission), EY, Study on directors' duties and sustainable corporate governance, Final Report, July 2020, para. 3.2.

187 Article 3g(1) SRD.

188 Relevant matters also comprise strategy, financial and non-financial performance, risk and capital structure.

189 Article 3g(1) SRD.

190 While the SRD II clearly aims at improving companies' sustainability impact ('*greater involvement of shareholders in corporate governance is one of the levers that can help improve the financial and non-financial performance of companies, including as regards environmental, social and governance factors, in particular as referred to in the Principles for Responsible Investment, supported by the United Nations. In addition, greater involvement of all stakeholders, in particular employees, in corporate governance is an important factor in ensuring a more long-term approach by listed companies that needs to be encouraged and taken into consideration.*' (Recital 14 SRD II)), it does not provide for specific obligations to pursue that aim actively.

191 See, for example, Consumer Detergents (Case COMP/39579), Commission Decision of 13 April 2011, C(2011) 2528 final, para. 53.

192 Article 101(3) TFEU.

193 See https://ec.europa.eu/competition/information/green_deal/index_en.html.

194 See for example, the Dutch competition authority's 2015 decision that the sustainability benefits produced by the 'Chicken of Tomorrow' animal welfare standards initiative did not outweigh its anti-competitive costs and was therefore irreconcilable with Dutch and EU competition law ('ACM's analysis of the sustainability arrangements concerning the "Chicken of Tomorrow"', ACM/DM/2014/206028, 26 January 2015). See also, the Dutch competition authority's decision that the industry association Energie Nederland's plans to close down five coal power plants was irreconcilable with Dutch and EU competition law ('Analysis by the Netherlands Authority for Consumers and Markets of the planned agreement on closing down coal power plants from the 1980s as part of the Social and Economic Council of the Netherlands' SER Energieakkoord', 26 September 2013). Conversely, see CECD (Case IV.F.1/36.718) Commission Decision 2000/475/EC [2000] OJ L187/47 where the European Commission held an agreement to discontinue less energy-efficient washing machines did not infringe EU competition law as it provided greater collective environmental benefits (as quantified in monetary terms) than the increase in costs.

195 See Joined Cases C-395 and 379/95P, Commission and France v. Ladbroke Racing [1997] ECR I-6265, para. 33 and 34). See also EU Commission decision in Case AT.39258 – Airfreight, where encouragement of coordination on fuel surcharges among airlines by a civil aviation regulator was not accepted as a defence.

196 See Commission Notice 2001/C 3/02, Guidelines on the applicability of Article 81 of the EC Treaty to horizontal cooperation agreements, OJ C 003, p. 2, para. 185. Note, however, that the subsequent iteration of these guidelines no longer separately addresses environmental agreements (Guidelines on the applicability of Article 101 of the Treaty on the Functioning of the European Union to horizontal cooperation agreements, OJ C 11, p. 1, para. 18).

197 See, for example, DSD (Case COMP/34493), Commission Decision 2001/837/EC [2001] OJ L319/1, para. 114.

198 The most progressive (draft) guidelines to date addressing the interplay of competition law and collaborations for sustainability are by the Dutch competition regulator: https://www.acm.nl/sites/default/files/documents/2020-07/sustainability-agreements%5B1%5D.pdf. The EU Commission is currently looking into the same issues as part of the review of the two Horizontal Block Exemption Regulations and the Horizontal Co-operation Guidelines. Further guidance by other major authorities, such as the US Department of Justice or the CMA, would contribute significantly to the debate. The latter notes in its annual report for 2021: '*We are continuing to develop capability to ensure that when delivering our statutory functions, we act in a way which supports the transition to a low carbon economy*' and '*we will communicate better to ensure that businesses engaged in sustainability initiatives know how to comply with competition and consumer law and do not unnecessarily shy away from those initiatives on the basis of unfounded fears of being in breach of the law.*'

199 MAR.

200 Transparency Directive.

201 Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids, OJ L 142, 30 April 2004, p. 12.

202 Cf. Article 2(e) (ii) SRD.

203 Article 21(1) UCITS Delegated Directive.

204 CESR, CESR's technical advice to the European Commission on the level 2 measures related to the UCITS management company passport, CESR/09-963, 28 October 2009, para. 71.

205 Indeed, it is possible to envisage circumstances where abstention is chosen as a way of expressing Asset Owner displeasure with a proposed shareholder resolution for IFSI related reasons.

206 Article 22(4) UCITS Delegated Directive.

207 See Articles 8 *et seq*. SFDR.

208 Article 5(6) UCITS Directive.

209 Articles 72 and 82 UCITS Directive.

210 Article 16(3) and 24(2) MiFID II; Articles 9 and 10 MiFID II Delegated Directive. UCITS management companies are not required to observe the MiFID II product governance obligations where they do not provide investment non-core services. On the other hand, an investment manager that collaborates with a UCITS management company in setting up a fund may qualify as co-manufacturer of the UCITS, as indicated by ESMA (ESMA, Guidelines on MiFID II product governance requirements, Final Report, ESMA35-43-620, 2 June 2017, para. 60).

211 Article 9(9) subparagraph 1 MiFID II Delegated Directive.

212 ESMA, Guidelines on MiFID II product governance requirements, Final Report, ESMA35-43-620, 2 June 2017, para. 18.

213 ESMA, Guidelines on MiFID II product governance requirements, Final Report, ESMA35-43-620, 2 June 2017, para. 18.

214 Commission Delegated Directive (EU) …/… of 21 April 2021 amending Delegated Directive (EU) 2017/593 as regards the integration of sustainability factors into the product governance obligations - C(2021) 2612 final (MiFID II Sustainability Delegated Directive).

215 Article 9(9) MiFID II Delegated Directive, as amended by Article 1(2) (a) MiFID II Sustainability Delegated Directive.

216 Article 9(11) (b) MiFID II Delegated Directive, as amended by Article 1(2) (b) MiFID II Sustainability Delegated Directive.

217 Article 9(14) MiFID II Delegated Directive, as amended by Article 1(2) (c) MiFID II Sustainability Delegated Directive.

218 Draft MiFID II Sustainability Delegated Directive, Explanatory Memorandum, section 2.

219 ESMA, Consultation Paper on integrating sustainability risks and factors in MiFID II, ESMA35-43-1210, 19 December 2018, para. 10.

220 Article 10(2) and (5) MiFID II Delegated Directive.

221 Article 10(2) and (5) MiFID II Delegated Directive, as amended by Article 1(3) MiFID II Sustainability Delegated Directive.

222 Cf. Article 2(12) (c) SFDR.

223 See Articles 8 *et seq*. SFDR.

224 Joint Committee of the European Supervisory Authorities, Joint technical advice on the procedures used to establish whether a PRIIP targets specific environmental or social objectives pursuant to Article 8 (4) of Regulation (EU) No 1286/2014 on key information documents (KID) for packaged retail and insurance-based investment products (PRIIPs), JC 2017 43, 28 July 2017 (Joint Committee of the ESAs, Joint Technical Advice), p. 5.

225 Joint Committee of the ESAs, Joint Technical Advice, p. 9 *et seq*.

226 Joint Committee of the ESAs, Joint Technical Advice, p. 8.

227 Article 25(1) subparagraph 3 IDD.

228 Commission Delegated Regulation (EU) 2017/2358 of 21 September 2017 supplementing Directive (EU) 2016/97 of the European Parliament and of the Council with regard to product oversight and governance requirements for insurance undertakings and insurance distributors (Commission Delegated Regulation (EU) 2017/2358).

229 Article 5(1) and (2) Commission Delegated Regulation (EU) 2017/2358.

230 Article 5 (3) Commission Delegated Regulation (EU) 2017/2358.

231 Article 25(1) subparagraph 4 IDD. Additionally, cf. Article 7 Commission Delegated Regulation (EU) 2017/2358.

EUROPEAN UNION

232 Article 7(3) Commission Delegated Regulation (EU) 2017/2358; cf. EIOPA, Preparatory Guidelines on product oversight and governance arrangements by insurance undertakings and insurance distributors, EIOPA-BoS-16-071, 18 March 2016, Guideline 9.

233 Article 1(1) Amendment IDD Delegated Regulation.

234 Article 1(2) Amendment IDD Delegated Regulation (with respect to Article 5(1) Commission Delegated Regulation (EU) 2017/2358).

235 Article 1(3) Amendment IDD Delegated Regulation.

236 Article 24(1) MiFID II.

237 Article 24(1) subparagraph 2 MiFID II.

238 Article 25(2) MiFID II.

239 The 'suitability test' is described in Article 54 MiFID II Delegated Regulation.

240 ESMA, Guidelines on certain aspects of the MiFID II suitability requirements, ESMA35-43-1163, 6 November 2018, para. 28. As noted above, we consider that ESG factors are equivalent to/encompass sustainability factors.

241 Commission Delegated Regulation (EU) …/… of 21 April 2021 amending Delegated Regulation (EU) 2017/565 as regards the integration of sustainability factors, risks and preferences into certain organisational requirements and operating conditions for investment firms, - C(2021) 2616 final (MIFID II Delegated Regulation).

242 By way of example, Directive 2008/99/EC of the European Parliament and of the Council of 19 November 2008 on the protection of the environment through criminal law only sets a minimum standard of environmental protection. Although the directive itself makes no reference to the criminal liability of relevant investors, and seems unlikely on its face to create such a liability, Member States have a degree of discretion in implementing any such criminal sanction into the national criminal law system, including rules on inciting, aiding and abetting. Any extension of liability to relevant investors therefore depends on implementation under national law.

243 See Case C-81/09, Idryma Typou AE v Ypourgos Typou kai Meson Mazikis Enimerosis, Judgment of the Court (Second Chamber) of 21 October 2010.

244 See Case T-419/14, The Goldman Sachs Group, Inc v European Commission, Judgment by the General Court of the European Union of 12 July 2018.

245 See Case T-419/14, The Goldman Sachs Group, Inc v European Commission, Judgment by the General Court of the European Union of 12 July 2018.

246 Article 1 ELD. The polluter-pays principle is part of EU primary law, see article 191(2) TFEU: '*Union policy on the environment […] shall be based on the precautionary principle and on the principles that preventive action should be taken, that environmental damage should as a priority be rectified at source and that the polluter should pay*'.

247 Articles 6 to 9 ELD.

248 Article 3(3) ELD.

249 Article 2(6) ELD.

250 On the possibility of a broad interpretation of the term 'operator' see the 'Study on Environmental Liability of Companies', May 2020, commissioned by the European Parliament's Policy Department for Citizens' Rights and Constitutional Affairs, p. 31 *et seq.*; UNEP Inquiry Working Paper 16/07, Lenders and Investors Environmental Liability – How Much is Too Much, April 2016, p. 6, 22; Bergkamp, The Environmental Liability Directive and Liability of Parent Companies for Damage Caused by Their Subsidiaries, European Company Law 13, no. 5 (2016), p. 184 *et seq.*

251 For France and the Netherlands, please refer to the Dutch and French annexes.

252 Cf. Joint Committee of the ESAs, joint technical advice, p. 10 *et seq.*

253 Article 13(2) UCITS Directive.

254 See sections 2.3.24 *et seq.* and 2.4.5(b) *et seq.*

255 In Article 1(1) Amendment Solvency II Delegated Regulation, 'sustainability risk' is defined as '*an environmental, social or governance event or condition that, if it occurs, could cause an actual or a potential negative impact on the value of the investment or on the value of the liability*'.

256 Recital 45 and 48 IORP II.

257 Article 2(1) (b) PEPP Regulation.

258 Cf. Commission Delegated Regulation (EU) 2021/473 of 18 December 2020 supplementing Regulation (EU) 2019/1238 of the European Parliament and of the Council with regard to regulatory technical standards specifying the requirements on information documents, on the costs and fees included in the cost cap and on risk-mitigation techniques for the pan-European Personal Pension Product, OJ L/99, 22 March 2021, p. 1 (PEPP Regulatory Technical Standards), Article 4(3), Annex 1 No. 21(d); EIOPA, pan-European Personal Pension Product (PEPP): Regulatory and Implementing Technical Standards as well as Advice on Delegated Acts – Impact Assessment, EIOPA-20-504, 14 August 2020, p. 5, 8; additionally, cf. Article 15(2) PEPP Regulatory Technical Standards setting out that when using life-cycling as risk-mitigation technique, PEPP providers shall design the life-cycling in such a way as to ensure that the PEPP savers furthest away from the expected end of the accumulation phase invest in long-term investments whereas for the PEPP savers closest to the expected end of the accumulation phase, the PEPP provider shall ensure that the investments are, *inter alia*, predominantly liquid.

259 EIOPA, Sustainability within Solvency II, para. 4.10.

260 EIOPA, Sustainability within Solvency II, para. 4.15. Additionally, EIOPA points out that '*the medium to long-term impacts of climate change cannot fully be captured in the Solvency II capital requirements*' which are calibrated on the basis of a one-year time horizon; however, EIOPA does not consider that the time horizon relevant for capital requirements should be changed, but is rather of the opinion that additional tools should be introduced to capture impacts of climate change; see EIOPA, Sustainability within Solvency II, para. 4.41 *et seq.*

261 EIOPA, Sustainability within Solvency II, para. 1.11.

262 EIOPA, Sustainability within Solvency II, para. 4.9.

263 EIOPA, EIOPA's technical advice on the integration of sustainability risks and factors in the delegated acts under Solvency II and IDD, EIOPA BoS-19/172, 30 April 2019, para. 28.

FRANCE

1. INTRODUCTION

1.1 For the purposes of this annex, we have considered the legal and regulatory framework applicable in France as at 31 January 2021.

1.1.1 As discussed in the main body of the report, the expression 'Investing for Sustainability Impact' (IFSI) is not a precisely defined legal expression, and it is important to emphasise that the law in France does not reference it in that way. Rather, the expression is used here as a type of 'conceptual net' to catch any legal duty or discretion on the part of asset owners or their investment managers to pursue one or more sustainability impact objectives of any sort, whether in order to protect or enhance the financial performance of their investment (instrumental IFSI) or otherwise (ultimate ends IFSI).

FRANCE

2. ASSET OWNERS' USE OF POWERS OF INVESTMENT AND DIVESTMENT TO INVEST FOR SUSTAINABILITY IMPACT

2.1 The following section considers the extent to which and in what circumstances, each type of Asset Owner is (a) legally required or (b) legally permitted or able to use its powers of investment and divestment to IFSI.

2.2 **Pension funds**

Types of pension fund covered

General pension plans

2.2.1 The French pension system is primarily a public system relying on old-age insurance plans that are mandatory and financed on a pay-as-you-go basis. The system, which varies across industries, features mandatory plans covering all workers: basic pension plans (*régimes de base*) and complementary pension plans (*régimes complémentaires obligatoires*).

2.2.2 There are approximately 20 basic pension plans, which can be split into three categories:

- general old-age insurance plans covering private sector employees (*salariés*) and self-employed workers, including the general old-age pensions regime (*régime général*) and the agricultural employees old-age pensions regime (*régime des salariés agricoles*); these pension plans cover approximately 70 per cent of French workers[1];
- basic plans for independent workers (*travailleurs indépendants*), covering various categories of independent workers (eg lawyers, doctors, pharmacists, craftspeople, architects, professional accountants etc); these pension plans cover approximately 13 per cent of French workers[1];
- ad hoc plans (régimes spéciaux), which primarily cover public sector employees (fonctionnaires) as well as employees of public-sector companies and specific activities such as miners, railroad workers, sailors etc); these pension plans cover approximately 17 per cent of French workers[1].

2.2.3 Complementary pension plans come in addition to basic pension plans and are split into two main categories:

- complementary pension plans for private sector employees, including in particular the AGIRC-ARRCO plan,[2] which primarily applies to private sector and agricultural employees covered by the general old-age pensions regime or the agricultural employees old-age pensions regime; and
- complementary standard plans for independent workers, including in particular the 10 sections of the *Caisse nationale d'assurance vieillesse des professions libérales* (CnavPL), which applies to professionals (*professions libérales*), the complementary plan covering farmers (*exploitants agricoles*), as well as the specific complementary pension plans applicable to lawyers and self-employed workers.

There are no separate complementary pension plans for public sector employees and other workers covered by *ad hoc* plans (*régimes spéciaux*), as the relevant basic pension plans include both basic and complementary elements. However, specific categories of public sector employees are covered by additional pension plans (*retraite additionnelle*).

2.2.4 The above pension plans are managed by 35 different pension plan operators (*organismes de retraites*). Some of these operators manage basic and complementary plans; some others manage either a basic plan or a complementary plan. This annex focuses only on two prominent French pension institutions:

- *Fonds de réserve pour les retraites* (FRR), which is in charge of investing with a view to creating reserves for the French basic pension system; and
- the AGIRC-ARRCO federation, which is in charge of operating one of the main complementary pension plans.

2.2.5 FRR is a public administrative institution (*établissement public à caractère administratif*) created by law n°2001-624 dated 17 July 2001[3]. Its mission is to invest monies entrusted to it by the public authorities with the aim of financing the basic pension system[4]. FRR is governed by an executive board and a supervisory board. Members of the supervisory board include members of parliament, employees' and employers' representatives, representatives of the French administration and individuals with recognised credentials in fields that are relevant to FRR's business. The supervisory board is notably responsible for defining, upon the proposal of the executive board, the FRR's general strategic assets allocation, in accordance with the objective and timeframe for use of the FRR's resources. The executive board is responsible for the operation of the FRR. It implements the FRR's investment policy guidelines and ensures compliance with them and reports regularly to the supervisory board on the operation of the FRR, in particular providing information on the way in

FRANCE

which investment policy guidelines take into account ESG considerations.

2.2.6 FRR does not directly manage its portfolio but rather regularly appoints investment managers through calls for tenders. Investment managers are required to comply with the FRR's investment policy guidelines when managing the FRR's assets. FRR was the first French institutional investor to have officially launched in June 2005 a call for tenders to invest about €600m in an ESG-conscious manner[5].

2.2.7 The AGIRC-ARRCO acronym designates both the complementary pension plan for private sector employees covered by the general old-age pensions regime[6], and the national federation (*Fédération AGIRC-ARRCO*) that oversees it. Pension institutions (*institutions de retraite complémentaire*) underlying the AGIRC-ARRCO federation are private, non-profit entities established by collective agreement with the aim of implementing the AGIRC-ARRCO plan, under the supervision and coordination of the AGIRC-ARRCO federation. The federation and pension institution members (the AGIRC-ARRCO Pension Institutions) must operate the AGIRC-ARRCO pension plan within a framework, which is agreed through a collective bargaining process between employers' and employees' representatives. The latest version of this framework agreement is dated 17 November 2017 (the AGIRC-ARRCO framework agreement)[7].

2.2.8 The AGIRC-ARRCO federation and AGIRC-ARRCO Pension Institutions are responsible for the management of the assets of the AGIRC-ARRCO plan. They must do so in accordance with the AGIRC-ARRCO framework agreement as well as the articles of association and regulation (*statuts et règlement*) of the AGIRC-ARRCO federation and the financial guidelines (*règlement financier* – AGIRC-ARRCO financial guidelines) that are adopted from time to time by the board of the AGIRC-ARRCO federation. The AGIRC-ARRCO federation and AGIRC-ARRCO Pension Institutions can manage the assets of the plan either directly or through investment managers, which must contractually agree to comply with the AGIRC-ARRCO financial guidelines[8].

Occupational pension plans

2.2.9 The French pension system also consists of the *retraite professionnelle supplémentaire* system, which is based on occupational pension plans (*plans d'épargne retraite*). The French occupational pension plans framework, which used to cover a large number of different products each governed by specific eligibility requirements, tax regimes and operating rules, was streamlined in 2019 by the PACTE law[9]. Under the current regime, all occupational pension plans (*plans d'épargne retraite* – PER) are governed by a harmonised regime set forth in articles L. 224-1 *et seq.* of the French Monetary and Financial Code (*Code monétaire et financier* – FMFC), which covers the following three types of PER plans:

- 'collective' PER (*plan d'épargne retraite d'entreprise collectif* – PERcol), which are employer-sponsored plans, in which employees participate on a voluntary basis[10];
- 'mandatory' PER (*plan d'épargne retraite d'entreprise obligatoire* – PERcat), which are employer-sponsored plans, in which all employees (or certain defined categories of employees) are required to participate[11]; and
- 'individual' PER (*plan d'épargne retraite individual* – PERin), which are voluntary individual plans[12].

2.2.10 Individual PER plans (PERin) can take the form of either an insurance product or a securities account where the relevant assets are recorded. PERin taking the form of a securities account are operated by the entity that maintains the account (either a credit institution or investment firm). PERin taking the form of an insurance product are operated by an insurance undertaking or a supplementary professional pension fund (*fonds de retraite professionnel supplémentaire* – FRPS[13]). Collective PER plans (PERcol and PERcat) are operated by insurance undertakings or FRPS[14]. The individual (in the case of PERin) or the operator of the PER plan (PER Operator) may delegate the investment management of the PER plan to investment manager(s).

2.2.11 FRPS were created in 2017 by Ordinance 2017-484[15] and are the only French entities that are institutions for occupational retirement provision *(IORPs) within the meaning of Directive (EU) 2016/2341* (IORP II)[16]. As of 1 May 2020, there were five FRPS in France[17] as most occupational pension plans remain operated by insurance undertakings or investment managers.

2.2.12 In principle, a PER plan is managed by the PER Operator (or investment manager(s) appointed by the PER Operator or, for PERin taking the form of a securities account, the saver). However, the relevant employee or saver may opt to make their own investment decisions within the PER plan.

2.2.13 The main entities/groups of persons involved are:

- **Asset Owner**: for basic and complementary pension plans, the relevant pension plan.

FRANCE

For PER plans, the saver for PERin taking the form of a securities account or the PER Operator for PER plans taking the form of an insurance product.

- **Beneficiaries**: for basic and complementary pension plans, the relevant individuals and, arguably the French nation at large (since the purposes of those plans is to manage the French pension resources to ensure their long-term financial sustainability). For PER plans, the relevant individuals. For collective PER plans (PERcol and PERcat), employers might be considered as a further group of Beneficiaries due to their position as sponsor of the plans.
- **Investment decision-maker**: For basic and complementary pension plans, the plan operator or investment manager(s) appointed by the operator. For PER plans, the PER Operator or investment manager(s) appointed by the PER Operator or, in the case of PERin taking the form of a securities account, relevant savers or investment managers appointed by them. Where the relevant individual has opted to make their own investment decisions, such individual.

Overview of investment duties and powers

AGIRC-ARRCO

2.2.14 The AGIRC-ARRCO plan is 'contractual' (*conventionnel*) in nature, inasmuch as it is a product of a collective bargaining agreement between employees' and employers' representatives. Therefore, the French statutory and regulatory provisions applicable to the plan, the AGIRC-ARRCO federation and the AGIRC-ARRCO Pension Institutions do not include specific provisions regarding investment duties and powers of the AGIRC-ARRCO federation and AGIRC-ARRCO Pension Institutions (which are responsible for the management of the plan's assets).

2.2.15 Unlike the basic pension plans, which can receive additional payments from the French state or certain employers to cover any shortfall in financial resources, the AGIRC-ARRCO plan is required to be self-sustainable (ie it can neither receive any such payments nor incur debt). The plan's primary aim is therefore to ensure that it holds sufficient financial reserves to be able to meet future payment obligations to Beneficiaries. In this respect, the preamble of the AGIRC-ARRCO framework agreement and the regulation of the AGIRC-ARRCO federation provides that the plan's financial reserves must be 'managed in a socially responsible manner *while complying with* the expected profitability, security, liquidity and performance needs'[18].

2.2.16 On that basis, Title II of the AGIRC-ARRCO financial guidelines lists the types of assets in which the plan can make investments, and sets forth investment rules and limits to manage the plan's risk exposure[19]. The plan's assets must also be invested in accordance with the asset liability management policy, risk limits and asset allocation policy approved by the board of the AGIRC-ARRCO federation. The AGIRC-ARRCO Pension Institutions must define their asset allocation and more generally investment policy on the basis of such principles[20].

2.2.17 The AGIRC-ARRCO financial guidelines also state that, in light of the principles applicable to the financial management of the plan as set forth in the preamble of the AGIRC-ARRCO framework agreement, the AGIRC-ARRCO Pension Institutions and federation 'must make investments taking account of environmental, social and quality of governance criteria'[21]. ESG criteria are further embedded in the contractual arrangements underlying the AGIRC-ARRCO plan and the federation's and Pension Institutions' investment guidelines. Indeed, both the preamble of the AGIRC-ARRCO framework agreement and the regulation of the AGIRC-ARRCO federation state that 'environmental, social and good governance impacts must be taken into account in the framework of the plan's investment policy'.

FRR

2.2.18 FRR does not directly manage its portfolio since its assets are managed by investment managers it appoints from time to time (which are required to comply with the FRR's investment policy guidelines when managing the FRR's assets). Therefore, the French statutory and regulatory provisions applicable to the FRR do not include specific provisions regarding investment duties and powers of the FRR. However, the investment managers that are appointed to manage the FRR's assets must comply with the FRR's statutory and regulatory regime, which can generally be described as follows.

- **Prudent management**. Under article L. 135-6 of the French Social Security Code (*Code de la sécurité sociale* – SSC), FRR's main purpose is to 'manage the sums entrusted to it with a view to building financial reserves aimed at contributing to the financial sustainability of the pension system'. On that basis, the FRR investment policy guidelines must be consistent with 'the principles of prudence and risk spreading, taking account of the defined timeframe for utilisation of the Fund's resources'[22]. This means that the principal

FRANCE

objective of the FRR's investment strategy is to manage its assets in a manner that will ensure that it can meet the payment obligations set down by French law[23] and, then, to seek the best possible return on its investments.

- **Characteristics of the portfolio**. To ensure that the FRR's investments are appropriately prudent, its assets must be invested in accordance with investment rules and limits that are set forth by the French government[24]. In addition, the FRR's investment policy is based on principles regarding the investment horizon and diversification of its portfolio, as well as a robust risk-management framework.

PER (Plan épargne Retraite)

2.2.19 PER plans are investment plans rather than legal entities. Therefore, PER plans are not subject to any investment duties or powers, which rather bind the PER Operators. However, PER plans are subject to investment rules and limits, which PER Operators (or their delegate investment managers) must comply with when operating a PER plan.

2.2.20 Firstly, under French law, the purpose of a PER plan is to invest the plan's assets to provide the Beneficiary, upon their retirement, with a personal annuities entitlement or right to receive a lump sum to cover their pension needs[25]. To achieve this purpose, PER plans must be invested in a limited list of assets that offer sufficient financial protection[26]. Unless the Beneficiary has opted to make their own investment decisions, PER plans must be managed to minimise over time the financial risk associated with the plan's assets (ie as the Beneficiary nears retirement, the PER Operator is required to invest in progressively less risky assets). The primary aim of a PER plan is therefore to ensure financial security and good pensions for the Beneficiaries in retirement. Therefore, in general, the Beneficiaries' interest is served where the investment achieves financial return consistent with the respective investment objectives.

2.2.21 The PER plans regime requires that Beneficiaries be offered the possibility to select at least one alternative asset allocation, including notably, for PERcol and PERcat[27], an allocation allowing them to invest in social impact funds (*fonds solidaires*) that invest in specific social impact companies (*entreprises solidaires d'utilité sociale*), as defined under article L. 3332-17-1 of the French Labour Code (*Code du travail*)[28]. Social impact companies do *not* directly include companies meeting ESG or sustainability criteria[29]. In any event, any such alternative asset allocation must remain such that it allows the PER plan to procure appropriate retirement benefits.

PER Operators – FRPS

2.2.22 Typically, the investment duties of FRPS are determined by (i) the contractual terms of the relevant PER plan and underlying insurance product (which must be consistent with the PER plan's rules mentioned in sections 2.2.20 and 2.2.21), and (ii) the French-law regime applicable to FRPS.

2.2.23 The main legal duties and powers under the French FRPS regime can generally be described as follows.

(a) **Prudent person principle**. FRPS must invest in accordance with the 'prudent person' principle (PPP)[30]. This requires, in particular, that assets be invested in the best long-term interest of Beneficiaries as a whole[31].

(b) **Governance**. FRPS must have in place an effective system of governance, which provides for sound and prudent management of their activities and is proportionate to the size, nature and complexity of the activities of the FRPS[32]. Such a system shall include consideration of ESG factors related to investment assets in investment decisions[33].

(c) **Risk management and risk assessment**. FRPS must maintain an effective risk-management system, which is proportionate to their size and internal organisation, as well as to the size, nature, scale and complexity of their activities and which shall cover, among other things, the areas of investment, liquidity and concentration risk management as well as ESG risks relating to the investment portfolio and the management thereof and ESG-related risks facing Beneficiaries[34]. Further, FRPS must carry out and document their own-risk assessment[35]. Where ESG factors are considered in investment decisions, article R. 385-16-1 of the French Insurance Code (*Code des assurances*) expressly requires that the risk assessment needs to include an assessment of new or emerging risks, including risks related to climate change, use of resources and the ESG risks and risks related to the depreciation of assets due to regulatory change.

(d) **Reporting requirements**. FRPS are required to include in their annual report and keep available to Beneficiaries information on how they incorporate ESG criteria into their investment policy, the type of ESG criteria taken into account and how they exercise voting rights attaching to investments taking account of their ESG choices[36]. Reporting requirements cover ESG-related

FRANCE

information on (i) how FRPS integrate ESG criteria in their investment policy (Investor ESG Information), and (ii) the FRPS's investments (Investment ESG Information)[37].

Investment ESG Information includes in particular extended climate change-related reporting items, namely (i) an assessment of the FRPS's portfolio's exposure to climate change-related risks, including both physical risks (physical impact of climate change) and transition risks (impact of the transition to a low-carbon economy); and (ii) an assessment of the FRPS's contribution to meeting the international and national low-carbon goals, including the tentative low-carbon targets set by the FRPS itself and the actions taken to achieve these targets[38].

Where they invest, either directly or through investment managers, in shares listed on a regulated market, FRPS must also make available on their website how the main elements of their investment policy are consistent with the profile and duration of their liabilities, in particular long-term liabilities, and how they contribute to the medium-to-long-term performance of their assets[39]. The information disclosed must be updated at least annually and following any substantial change[40].

Legal requirements to use investment powers to pursue IFSI

AGIRC-ARRCO

2.2.24 The French statutory and regulatory regime applicable to the AGIRC-ARRCO plan does generally not provide for a general obligation of the AGIRC-ARRCO federation or Pension Institutions to use their investment powers to pursue IFSI. Even though the regulation of the AGIRC-ARRCO federation states that the plan's financial reserves must be 'managed in a socially responsible manner', it also immediately qualifies this statement by adding that the plan's reserves must be so managed '*while complying with* the expected profitability, security, liquidity and performance needs' and that 'environmental, social and good governance impacts must be taken into account in the framework of the plan's investment policy'[41]. The drafting of the regulation of the AGIRC-ARRCO federation suggests that the requirement to manage reserves in a socially responsible manner. However, the primary aim of the plans remains which is to generate sufficient financial return. This is however not inconsistent with instrumental IFSI, inasmuch as if ESG factors are determined to pose a risk to the achievement of the investment return in the long term and that IFSI is appropriate to mitigate that risk, IFSI would then be required under the regulation of the AGIRC-ARRCO federation.

FRR

2.2.25 Under French law, the FRR is, as a general principle, not expressly obliged to use investment powers to pursue IFSI. The only reference to sustainable investment in the statutory and regulatory regime applicable to the FRR is that the executive board (*directoire*) of the FRR must regularly report to its supervisory board (*conseil de surveillance*) on how the FRR's investment policy guidelines have taken into account ESG considerations. This creates a 'procedural' obligation to maintain investment guidelines that take account of ESG considerations, but does not create any requirement that the FRR's assets should be invested for sustainability impact. However, the requirements that FRR be managed in a prudent way (see section 2.2.18(a)) suggest that instrumental IFSI is required where the FRR determines that ESG factors jeopardise its ability to meet the payment obligations set down by French law[42] and seek the best possible return on its investments

2.2.26 The FRR is also in a unique situation among the institutions within the French pension system. Under French law, the FRR investment policy guidelines must be consistent with 'the principles of prudence and risk spreading, *taking account of the defined timeframe for utilisation of the Fund's resources*'[43]. Facing a defined investment horizon and pay-outs expectations rather than a general, undefined 'long-term' financial return goal, the FRR has had more leeway to consider IFSI than other investors within the French pension system. Actually, although the FRR is under no explicit statutory or regulatory requirement to pursue IFSI, it has long taken the stance to voluntarily take account of ESG criteria in its investment decisions, as further discussed in sections 2.2.32 *et seq.*[44]

PER operators – FRPS

2.2.27 Under French law, FRPS are, as a general principle, not expressly obliged to use investment powers to pursue IFSI. Consistent with the primary aim of PER plans, which is to ensure financial security and good pensions for the Beneficiaries in retirement, the Beneficiaries' interest is served where the investment achieves financial return consistent with that objective. There might be certain situations giving rise to a duty to invest with a view to sustainability impact, in particular where ESG or sustainability factors are to be considered *financially*

FRANCE

material and IFSI is perceived as mitigating their impact. Indeed, ESG risks may trigger, or transform into, financial risks and be therefore financially material regarding the performance of a portfolio. In this case, it might be 'prudent' in the traditional sense to take such risks into account as part of the PPP.

2.2.28 It is unclear under French law whether the 'best interest' of PER plan Beneficiaries should be limited to financial factors or could also include non-financial factors. It could theoretically be argued that the Beneficiaries' 'best interest' may comprise non-financial aspects such as the wellbeing or health of Beneficiaries. On this basis, one could suggest that FRPS might be obliged to consider sustainability impact for Beneficiaries even in cases where their (future) financial interests are not affected. However, PEP plans first and foremost remain 'investment plans', the purpose of which is to cover part of the Beneficiaries' financial needs in retirement. This may suggest that the Beneficiaries' 'best interest' should primarily be regarded as met where the investment secures their (future) financial entitlements. For the same reason, it is unclear whether FRPS could, under certain circumstances, be required to seek to ensure wider societal objectives. On the contrary, PER plans must be managed to minimise over time the financial risk associated with the plan's assets (ie as the Beneficiary nears retirement, the PER Operator is required to invest in progressively less risky assets). This shows that the need to ensure financial security and seek financial return should take precedence over non-financial factors when managing a PER plan.

Legal freedom to use investment powers to pursue IFSI

AGIRC-ARRCO

2.2.29 Both the preamble of the AGIRC-ARRCO framework agreement and the regulation of the AGIRC-ARRCO federation state that the plan's reserves must be managed 'in a socially responsible manner' and that 'environmental, social and good governance impacts must be taken into account in the framework of the plan's investment policy'. The contractual framework that governs the AGIRC-ARRCO plan therefore explicitly gives the federation the possibility to reflect ESG criteria in the plan's investment policy and, more generally, gives the federation and Pension Institutions flexibility for IFSI. These general principles actually go beyond the mere procedural requirement to 'take ESG criteria into account' by explicitly stating that the plan's reserves *must* be managed 'in a socially responsible manner'[45]. Even though this explicit requirement remains subject to the plan's financial sustainability (as further discussed below), it does create a requirement that gives the AGIRC-ARRCO federation and Pension Institutions more leeway, in our view, to pursue IFSI. In September 2019, the AGIRC-ARRCO federation signed the UN-sponsored Principles for Responsible Investment (UNPRI).

2.2.30 This freedom is subject to the overarching requirement that investing the plan's assets must meet its expected profitability, security, liquidity and performance needs. That being said, this obligation to seek profitability and financial performance does not comprise the prescription of a particular level of return to be achieved. The typical duration of the plan's liabilities also implies a long-term nature of its investments. Consistent with the nature of the plan as a pay-as-you-go pension system, which relies on interprofessional and *intergenerational* solidarity[46], the principle of meeting the expected financial return of the AGIRC-ARRCO plan should, at least, require a long-term, rather than a short-to-medium-term perspective. As sustainability risks are more likely to materialise in the long-term, this arguably provides AGIRC-ARRCO Pension Institutions with additional grounds to take account of sustainability criteria.

2.2.31 Moreover, unlike many pension institutions in other countries, the AGIRC-ARRCO federation and Pension Institutions do not have any specific direct duties to individuals that are Beneficiaries of the plan. They therefore are not required to assess whether their investment decisions conflict with the Beneficiaries' interest, but rather only make sure that *overall*, the integration of sustainability impact in investment decisions is not inconsistent with meeting the plan's portfolio's financial return and does not endanger the plan's financial sustainability. This removes any possible perceived increased liability risk associated with investment decisions that could be construed as not being made in the 'best' interest of Beneficiaries. There is also in our view clearer potential alignment between IFSI and a plan that has to foster long-term 'interprofessional and intergenerational solidarity', rather than a plan that has to assess its investment decisions directly in light of specific Beneficiaries' best interest. This might allow for some freedom in the specific shaping of the plan's investments, including seeking to ensure wider societal

FRANCE

objectives that are beneficial to society on an intergenerational basis, and permit a degree of ultimate ends IFSI as long as it is not inconsistent with the expected long-term financial return of the portfolio as a whole.

FRR

2.2.32 The statutory and regulatory rules applicable to the FRR are flexible enough to allow for IFSI, and FRR has long taken advantage of this flexibility to encourage or even require that investment managers take account of ESG criteria when managing its portfolio.

2.2.33 As for the AGIRC-ARRCO federation and Pension Institutions, the FRR does not have any specific direct duties to individual Beneficiaries (see section 2.2.31). The investment managers that manage its assets therefore do not have to assess such Beneficiaries' best interest when making investment decisions. They rather have to ensure that their investment decisions are made in the best long-term interest of the *FRR* itself, and in accordance with the investment management agreements they have entered with the FRR (which reflect the FRR's investment policy). In 2003, the FRR supervisory board emphasised that the FRR's 'investment policy should be consistent with respecting certain collective values that encourage balanced economic, social and environmental development […]'. This typifies the peculiarity of the FRR as compared to those institutional investors that have explicit duties to the individual Beneficiaries. On the contrary, the investment managers that manage the FRR's portfolio are only required to take into account the FRR's interest, as defined in its investment policy guidelines[47] and responsible investment strategy. In this respect, the FRR considers that as a public investor and 'vector for intergenerational solidarity'[48], it must factor ESG principles in the investment management of its assets. In other words, the FRR's interest encompasses factors that are not exclusively financial criteria.

2.2.34 On this basis, the supervisory board and executive board of the FRR have early on adopted a three-pronged strategy to promote ESG investment and best practice corporate governance:

- an active policy of proxy voting at shareholders' meetings of companies in which the FRR invests;
- the broadening of stock research and picking criteria to include ESG considerations by investment managers selected to manage the FRR's portfolio; and
- launching a number of dedicated ESG mandates, with the aim of gaining a better grasp of the ESG-inclusive analysis that can be implemented and the value added by ESG criteria[49].

Since April 2006, the FRR has also committed to applying the UN-sponsored Principles for Responsible Investment (UNPRI).

2.2.35 According to the FRR, its main mission is 'to optimise returns on the funds entrusted to it, on behalf of the community, in as secure an environment as possible'[50]. Because ESG factors can have an impact on company valuations and therefore on the returns of the FRR's portfolio, the FRR has noted that failure to integrate these factors into its decision-making process could be detrimental to achieving its objective[51]. In addition, the FRR has also stated that it must take account of non-financial factors because 'investment yields do not depend solely on the impact of companies' financial and non-financial strategies, but also on the externalities they generate for their industry or the economy as a whole.'[52] FRR draws the conclusion therefrom that, as 'a universal public investor, active in pensions, *whose role it is to protect its investments over the long term*', it must 'analyse the environmental and social externalities of corporate strategies and their effects on the community'. In other words, the fundamental rationale underlying the FRR's Responsible Investment Strategy is that it should take account of systemic risk and non-financial factors.

2.2.36 The framework within which the FRR operates not only fosters taking account of ESG criteria when making investment decisions, but also allows for IFSI. In its 2013-2017 Responsible Investment Strategy, the FRR expressly stated that, as part of 'a new approach for the FRR', it 'shall also help to finance companies the corporate mission of which is to preserve the environment or are beneficial to society'[53]. FRR has also implemented an exclusion policy regarding companies involved in the development, production, maintenance, use, distribution, stockpiling, transport or trade of banned weapons or their key components and the tobacco industry[54]. Finally, the FRR has implemented an ambitious policy aimed at reducing its portfolio's CO2 emissions through low carbon management[55]. In 2018, the FRR decided to further exclude companies whose thermal coal mining or coal-fired electricity, heat or steam generation business exceeds 10 per cent of their revenue, unless they use a carbon capture and storage process or the investment manager invests on behalf of

FRANCE

the FRR with the aim of supporting the relevant company transitioning to a new production model. The call for tenders launched by the FRR in 2015, entitled 'Optimized Equity index strategy with an ESG approach' aimed at awarding mandates to Investment Managers, which require that they factor in all types of ESG-related matters (including those relating to decarbonising assets), as well as the FRR's exclusion policy. These steps taken by the FRR show that it is generally allowed to invest for sustainability impact and also engage in ultimate ends IFSI.

2.2.37 The flexible framework applicable to the FRR does not mean that it is free to unlimitedly prioritise sustainability goals over financial goals.. Its investment managers are still required to deliver expected financial performance. In 2009, the FRR announced that it had terminated an ESG mandate because of its 'poor relative financial performance'[56]. Nonetheless, in our view, the FRR has more flexibility than most institutional investors to balance non-financial factors and financial ones. First because, as discussed above, (i) it has no direct duty, as a matter of statutory or regulatory requirement, to individual Beneficiaries, and (ii) its stated main mission encompasses not only the pension system's financing but also a mandate to manage the funds entrusted to it 'on behalf of the community, [and] in as secure an environment as possible'[57]. In addition, French law sets out a defined timeframe for the pay-outs of the FRR's assets[58]. Its primary financial objective is therefore to be in a position to deliver the required pay-outs, but not, strictly speaking, to achieve the best possible financial performance for its portfolio. This might provide the FRR with more leeway to take into account ESG criteria and engage in ultimate ends IFSI, even in cases where it could potentially affect to some extent the financial performance of certain of its investments. Faced with this constraint, the latest version of the FRR's Responsible Investment Strategy, covering the period from 2019 through 2023, states that the FRR 'might give further thought to the valuation of non-financial performance and on how the utility of its investments' impact should be added to their financial performance'[59].

PER Operators – FRPS

2.2.38 We consider that the duties of FRPS are, in our view, flexible enough to allow for IFSI, subject to the PPP as an underlying principle (see section 2.2.23(a)). Therefore, the integration of sustainability impact in investment decisions must not conflict with the Beneficiaries' 'best interest'. In particular, it should not negatively affect the investment's financial return and security and endanger the Beneficiaries' (future) financial entitlements. Where a conflict arises between sustainability impact and financial return, the investment would rather need to be made in favour of the (financial) 'best interest' of the Beneficiaries. In our view, this does not amount to an obligation to seek either the maximum rate of financial return or a particular level of return (subject to any contractual undertaking to Beneficiaries). However, as the relevant Beneficiaries near retirement, PER plans' outlook converts from a long-term perspective to a medium- or even short-term perspective, which decreases any ability to invest for sustainability impact if it does not align with an expected appropriate level of financial return.

2.2.39 Unlike the AGIRC-ARRCO federation and Pension Institutions and the FRR, FRPS have direct duties to PER plan' Beneficiaries. In our view, this might result in FPRS being reluctant to make use of their investment freedom to pursue IFSI, due to legal uncertainties which exist with regard to the characterisation of the Beneficiaries' 'best interest' and its interaction with IFSI. This might, from time to time, be perceived as increased liability risk. Similarly, there is generally no explicit obligation for FRPS to align investments with the sustainability preferences of Beneficiaries. However, French law applicable to FRPS expressly allows them to take account of Beneficiaries' preferences inasmuch as Beneficiaries must be offered the possibility to select at least one alternative asset allocation, including notably, for PERcol and PERcat, an allocation allowing them to invest in social impact funds (*fonds solidaires*) that invest in specific social impact companies (*entreprises solidaires d'utilité sociale*)[60]. Social impact companies do not directly include companies meeting ESG or sustainability criteria[61] but this regime alleviates any perceived liability risk for FRPS.

2.2.40 Finally, the French ESG reporting regime[62] encourages FRPS to incorporate ESG criteria into their investment policy and assess how they manage and vote their portfolio taking account of their ESG choices. The ESG reporting regime provides institutional investors with broad flexibility in choosing the best way to fulfil the objectives, based on a 'comply or explain' approach. It does not impose any specific method, giving leeway to find the reporting methodology best suiting the investment portfolio. However, investors must provide

FRANCE

information and justification on the methodology used and are encouraged to draw from current best practices. Introducing such detailed reporting requirements, which apply to most French institutional investors, has certainly proven to be a catalyst for such investors to actually take account of ESG criteria in their investment decisions. Even though the reporting regime does not create any statutory or regulatory obligation to IFSI, it has underscored that French law clearly encourages French institutional investors to invest in an ESG-conscious manner, including, as the case may be, IFSI. Similarly, since FRPS must make public how the main elements of their investment policy regarding shares are consistent with the profile and duration of their liabilities, in particular long-term liabilities, and how they contribute to the medium-to-long-term performance of their assets [63], FRPS should factor those constraints into their relevant investment policy.

2.3 **Mutual funds**

Types of mutual fund covered

2.3.1 A mutual fund is a scheme that pools and invests money from investors that are intended to be retail investors. Consistent with the applicable EU regulatory framework, there are two main types of French mutual funds authorised by the French regulator *Autorité des marchés financiers* (AMF):

- French mutual funds that comply with the directive on undertakings for collective investments in transferable securities (Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS)[64], which are referred to as *Organismes de Placement Collectif en Valeurs Mobilières* (OPCVMs).
- French mutual funds that are established as alternative investment funds, within the meaning of the Alternative Investment Fund Managers Directive (Directive 2011/61/EU on Alternative Investment Fund Managers (AIFM)[65], which are referred to as *Fonds d'Investissement Alternatifs* (FIAs).

2.3.2 The most common form of AMF-authorised mutual fund is one that complies with the UCITS Directive. On the other hand, FIAs can assume a variety of different forms, each governed by a specific set of rules under French legislation[66]. Most FIAs invest in a broad range of assets going beyond the asset types covered by this annex and are typically targeted at professional investors. Because of that, this annex considers only UCITS-compliant mutual funds, ie OPCVMs

2.3.3 In France, OPCVMs can either be constituted as (i) investment companies with variable capital, known as *sociétés d'investissement à capital variable* (SICAVs) or (ii) contractual funds, known as *fonds communs de placement* (FCPs). In both cases, OPCVMs must be open-ended investment schemes, meaning that investors can freely redeem their investment in the fund[67].

2.3.4 FCPs are entities without legal personality and are the most common form of OPCVM in France. An FCP is defined by French law as a co-ownership of financial instruments and deposits[68]. An FCP must be operated by a management company[69], which is authorised by the AMF to provide fund management services. An FCP must be operated in accordance with its bylaws (*règlement*) and its prospectus. Investors in the FCP are contractual co-owners who purchase units (*parts*) in the FCP and are referred to as unit-holders (*porteurs de parts*).

2.3.5 SICAVs are companies with legal personality, which must be established as French companies limited by shares (either as a *société anonyme* or as a *société par actions simplifiée*)[70]. Although SICAVs may be self-managed, the majority[71] delegate their operation and the administration of their assets to a management company[72], which is authorised by the AMF to provide fund management services. A SICAV must be operated in accordance with its articles of association (*statuts*) and its prospectus. Investors in the SICAV purchase shares (*actions*) in the SICAV and are referred to as shareholders (*actionnaires*).

2.3.6 Regardless of the way an OPCVM is constituted, its assets must be entrusted to a depositary (*dépositaire*) for safe-keeping. This function is legally separated, which means that a company is prohibited from acting as a depositary and as management company or investment company at the same time[73]. That is because, in addition to being responsible for the safekeeping of the property of the fund, the depositary has certain oversight functions in relation to the activities of the management company[74]. When carrying out its functions, the depositary must act independently and solely in the interest of the fund's investors[75]. However, depositaries are not involved in the actual taking of investment decisions, including those comprising IFSI, and are not the owners of the fund's assets. Depositaries are therefore not covered in this annex.

2.3.7 In this annex, OPCVMs constituted as FCPs are considered as Asset Owners, acting through their management company. For

FRANCE

SICAVs we consider the SICAVs, acting through their management company, if applicable, as the relevant Asset Owner. However, it is legally permitted and common in practice, that management companies delegate investment management to asset managers. These asset managers will be considered as investment managers in this annex. However, a delegation will not release the delegating entity from its obligations. Thus, management companies (and self-managed SICAVs, if applicable) must monitor and supervise the compliance of investment managers with applicable French regulation in order to remain compliant themselves.

2.3.8 For OPCVMs constituted as FCPs, the key parties are:

- **Asset Owner**: FCP (including the management company).
- **Investment Manager**: asset manager (if the investment management is delegated).
- **Beneficiary**: unit-holder.

2.3.9 For OPCVMs constituted as SICAVs, the key parties are:

- **Asset Owner**: SICAV, ie the investment company (including the management company).
- **Investment Manager**: asset manager (if the investment management is delegated).
- **Beneficiary**: shareholder.

Overview of investment duties and powers

2.3.10 The management company's duties and powers are shaped by the OPCVM constitutional documents and prospectus, particularly the investment objectives and policies, which are determined by the manufacturer when the OPCVM is set up, as well as the relevant provisions of the FMFC[76] and General Regulation of the AMF (*Règlement général de l'AMF* – GRAMF) [77].

2.3.11 An OPCVM must be operated, and its assets managed, for the benefit of its Beneficiaries. For this reason, a management company is, among other things, required:

- to act honestly, fairly, professionally and independently and solely in the interests of the OPCVM and its Beneficiaries and the integrity of the market[78]; and
- to act with due skill, care and diligence, in the best interests of the OPCVM it manages and the integrity of the market[79].

2.3.12 Article 321-101 GRAMF specifies the 'best interest' rule by requiring, among other things, that the Beneficiaries be treated fairly by the management company and that management companies must refrain from placing the interests of any group of Beneficiaries above the interests of any other group of Beneficiaries. OPCVMs are established for the general purpose of generating financial return. Traditionally, it is therefore considered that the 'best interest' of OPCVMs is served where the financial return is maximised in line with the investment objectives of the relevant OPCVM. In addition, management companies are required to use fair, correct and transparent pricing models and valuation systems for the OPCVM they manage, and must act in such a way as to prevent undue costs being charged to the OPCVM and its Beneficiaries [80].

2.3.13 AMF rules and guidance[81] have acknowledged since 2007 the possibility to use non-financial criteria in the process of selecting financial instruments for investment by French funds[82]. In addition, other AMF guidance has long provided for disclosure requirements associated with socially responsible funds (referred to as '*fonds ISR*').

- Where non-financial criteria are used in the process of selecting financial instruments for investment by OPCVMs, such criteria must be briefly described in the fund's key investor information document (KIID)[83].
- The legal documentation of a socially responsible fund (ie its prospectus and constitutive documents) should (i) include an investment objective that reflects the non-financial aspects of the fund's investment management; (ii) state which socially responsible investment method(s) are implemented for the fund; and (iii) include information regarding the selection and management methods implemented for the fund[84].
- Funds that communicate in respect of their objectives in terms of ESG impact should (i) use clear, precise and substantiated and measurable objectives; and (ii) monitor over time how these objectives are achieved[85].

2.3.14 Finally, article 77 (29) of the PACTE law[86] passed in spring 2019 defined a new specific mission for the AMF, making it responsible for ensuring the quality of information provided by Investment Managers on their investment strategy and their management of risks related to the effects of climate change[87]. On this basis, on 11 March 2020, the AMF consolidated and expanded its guidance on disclosure requirements for socially responsible funds through the publication of Position-Recommendation 2020-03 – Information to be provided by collective investment schemes incorporating non-financial approaches (AMF ESG disclosure guidelines)[88]. The AMF ESG disclosure

FRANCE

guidelines detail a series of AMF policy positions and recommendations for investor disclosures by French funds as well as foreign funds, which are authorised or registered for marketing in France and incorporate non-financial objectives (eg SRI, ESG integration, responsible, sustainable, green, ethical, social, impact, low carbon).

2.3.15 In terms of reporting requirements, French management companies are subject to the same French ESG reporting regime as FRPS (see section 2.2.23(d)). They are required to report to the Beneficiaries of in each OPCVM they manage how they incorporate ESG criteria into their investment policy, the type of ESG criteria taken into account and how they exercise voting rights attaching to investments taking account of their ESG choices[89]. Investor ESG Information[90] must be provided by all French management companies on their website. Investment ESG information[91] must be provided in respect of each fund French management companies manage, the AuM of which exceeds €500m. It must be provided on the management company's website and in each fund's annual report[92].

(a) Investor ESG Information covers the following items:

- general approach to incorporating ESG criteria into investment and, where applicable, risk management policies;
- content, frequency and means used to inform Beneficiaries;
- list of funds for which ESG criteria are taken into account and the proportion, as a percentage, of the assets of these funds compared to the total AuM of the management company;
- adherence of the management company and/or the funds to charters, codes, initiatives and labels relating to the incorporation of ESG criteria; and
- where applicable, a description of ESG risks, the business's exposure to these risks and the internal procedures used to identify and manage them.

(b) Investment ESG Information covers the following items:

- description of the type of ESG criteria taken into account;
- information used for the analysis conducted on ESG criteria;
- methodology and results of this analysis; and
- description of the way in which the results of the analysis are integrated into the investment policy of the relevant funds: (i) changes made to the portfolios, and (ii) engagement strategy with issuers.

(c) Investment ESG Information also includes extended climate change-related reporting items, as further outlined in section 2.2.23(d).

Legal requirements to use investment powers to pursue IFSI

2.3.16 French law currently does not provide for explicit rules on whether non-financial objectives, such as IFSI, must be taken into account as a part of management companies' due diligence process (as a 'procedural rule') or as part of the decisions to make investments (as a 'substantive rule'). Therefore, OPCVMs and/or their management companies are not subject to any explicit general duty to pursue IFSI.

2.3.17 The main rule that applies to fund management activities is that funds (including OPCVMs) must be managed in the best interest of the relevant fund and its Beneficiaries [93]. There is no definition in French law or AMF's guidance of what the concept of 'best interest' is meant to cover. Such 'best interest' is traditionally understood as primarily a duty to pursue financial return. This traditional view of the purpose of collective investment schemes is supported by the definition of alternative investment funds under the AIFMD. In its guidelines on key concepts of the AIFMD, the European Securities and Markets Authority (ESMA) notes that one of the key characteristics of an alternative investment fund is that it 'pools together capital raised from its investors for the purpose of investment with a view to generating a pooled return for those investors'[94], with 'pooled return' being defined as 'the return generated by the pooled risk arising from acquiring, holding or selling investment assets – including the activities to optimise or increase the value of these assets […]'[95]. If the sustainability impact (or risk associated with the lack thereof) of a given investment decision posed a risk to financial return, a management company should, in our view, invest for sustainability impact if that may be capable of mitigating the risk (which would mean that the decision is in the 'financial' best interest of the Beneficiaries). Conversely, a management company could not in our view make investments that it knows are unlikely to be financially sound (in light notably of the relevant fund's investment horizon), even if they are justified by a positive sustainability impact (subject to the terms of the documentation of the relevant OPCVM (see section 2.3.22).

2.3.18 Notwithstanding the above, French law does not support a purely financial

FRANCE

understanding of 'best interest', which is also used to assess management companies' action in other contexts, such as for instance conflicts of interest circumstances. In circumstances where a potential conflict between IFSI and financial return would arise, we believe a management company would have some leeway to make an informed decision that does not necessarily aim at only maximising financial return. However, the management company would have no obligation to pursue IFSI, as it could decide to prioritise financial return over other considerations (subject always to the terms of the documentation of the relevant OPCVM).

2.3.19 Some French rules applicable to fund management activities may arguably hinder IFSI, inasmuch as some management companies might consider that they limit their ability to make investment decisions taking account of their sustainability impact:

(a) OPCVMs are open-ended funds and therefore subject to constantly changing ownership. Their investment horizons will consequently be rather short-term. As the benefits of IFSI typically arise on a longer-term timeframe (notwithstanding however possible short-term implications), management companies might consider that IFSI does not align with the liquidity profile and associated target investors of OPCVMs.

(b) Beneficiaries of an OPCVM must be treated fairly by the management company, which must also refrain from placing the interests of any group of Beneficiaries above the interests of any other group of Beneficiaries[96]. A management company might consider that it therefore cannot favour the interests of future Beneficiaries (which may be negatively affected by a decision in favour of short-term profit at the expense of sustainability impact) over the interests of current Beneficiaries (which would benefit from short-term financial return). For the same reason, it is neither permitted nor required to take diverging sustainability aspirations of an OPCVM's Beneficiaries into account, where they are not explicitly mentioned in the investment policy of the OPCVM.

(c) OPCVMs must be managed so as to prevent undue costs being charged to the OPCVM and its Beneficiaries [97]. Costs associated with pursuing investment strategies that take the impact of the investment on sustainability into account may be considered as undue costs, if the OPCVM's investment policy does not include such target.

2.3.20 Disclosure obligations under the ESG reporting regime[98] – while themselves not requiring the pursuit of IFSI – might 'nudge' OPCVMs towards the same, since (potential) Beneficiaries may be interested in IFSI[99].

Legal freedom to use investment powers to pursue IFSI

2.3.21 As noted in section 2.3.13, the AMF expressly allows management companies of OPCVMs to use non-financial criteria in the process of selecting financial instruments for investment by French funds[100]. This is an indication that, from the regulator's perspective, management companies may assess the views of Beneficiaries on their investment preferences and take them into account when managing an OPCVM's portfolio. Similarly, article 321-120 GRAMF provides that an OPCVM's prospectus may allow the sharing of the OPCVM's financial returns with associations serving the public interest, through the OPCVM making donations to such associations[101]. Again, this shows that French funds law does not prevent an OPCVM from taking account of the views of Beneficiaries not only on their investment preferences but also, more broadly, on how they wish that the OPCVM's financial return be used. This also suggests that the best interest of Beneficiaries does not necessarily have to be fulfilled through such Beneficiaries benefiting from the fund's financial return.

2.3.22 There is therefore no reason why Investment Managers would not be entitled to take account of the views of OPCVMs' Beneficiaries on IFSI. It is then for Beneficiaries to find and select OPCVMs that reflect their expectations on IFSI. In this respect, the relationship between an OPCVM and its management company, on the one hand, and its Beneficiaries, on the other hand, is primarily contractual in nature. The terms of this relationship are set forth in the OPCVM's prospectus and constitutive documents. As long as this documentation is clear that an OPCVM may (or will) pursue IFSI, neither French law nor the AMF's guidance prevent Investment Managers from investing in such a way on behalf of an OPCVM. In its guidance on OPCVMs that use non-financial criteria[102] or that can share financial returns with associations[103], the AMF outlines several conditions that Investment Managers must meet when managing any such OPCVMs, none of which relates to the 'best interest' rule or duties to treat Beneficiaries fairly or prevent undue costs (see sections 2.3.11 and 2.3.12).

2.3.23 In our view, this also allows Investment Managers to engage in ultimate ends

FRANCE

IFSI, provided this is clearly disclosed to Beneficiaries in the OPCVM's documentation, although this raises additional issues relating to the ability of Investment Managers to combine this type of strategy with their traditional duties *vis-à-vis* Beneficiaries. In this respect, the AMF has noted that impact investing strategies (or investment strategies with a tangible objective) raise various implementation issues, such as:

- the ability of the Investment Manager to formalise criteria allowing the selection of investee companies that actually meet Beneficiaries' views and expectations;
- the ability of the Investment Manager to report on whether the strategy delivers the expected outcome (especially where the fund's objective or impact strategy is a long-term one); and
- the fact that there may be too few investee companies that meet the stated objective or fall within the chose impact strategy to allow the Investment Manager to offer a financially suitable fund for Beneficiaries that are prepared to take only moderate financial risks[104].
- The AMF suggests that this type of strategy may be more suitable for institutional Beneficiaries with sufficient financial footing to invest in these strategies without jeopardising the overall liquidity and diversification of their portfolio[105].

2.3.24 Clear information seems to be the way the AMF considers that Investment Managers can balance the need to manage OPCVMs in compliance with French funds law requirements (such as the duty to act in the best interest of the OPCVM and its Beneficiaries) and the ability to take account of Beneficiaries' preferences on how a given OPCVM should invest (including for sustainability impact). This is the philosophy underpinning the AMF ESG disclosure guidelines that were released by the AMF in March 2020[106]:

- According to the AMF, current developments on ESG investment management in the asset management industry take place in a moving framework in which various approaches, with differing degrees of ambition, may be put forward to Beneficiaries, which themselves have different expectations and needs.
- On that basis, the AMF considers that information provided to Beneficiaries must be accurate, clear and not misleading so that Beneficiaries have a good understanding of the ESG approach implemented by funds they may invest in and to manage 'green-washing' risks. The AMF therefore considers that information provided to Beneficiaries must be proportionate to how the relevant fund actually takes account of non-financial criteria. In particular, only those funds that adopt an approach that corresponds to a significant commitment should be allowed to present their use of non-financial criteria as a key element of their communication or reflect it in their name.
- Accordingly, funds that wish to present their use of non-financial criteria as a key element of their communication or reflect it in their name must comply with minimum standards, as defined in the AMF ESG disclosure guidelines. In particular, funds must include in their legal documentation measurable objectives associated with their taking account of non-financial criteria. These measurable objectives must be significant to ensure a real distinction between the different approaches found on the market. For example, as regards 'best-in-class' approaches, funds must use quantitative thresholds derived from the French SRI label (see section 2.3.29) as a benchmark to assess whether their commitment is significant. For 'selectivity' approaches, funds must commit to a minimum reduction of 20 per cent of issuers with the lowest ESG rating in their investment universe. For other approaches, management companies must be in position to show to the AMF how the chosen commitment is significant.

In other words, the AMF ESG disclosure guidelines are aimed at ensuring that Beneficiaries (in particular retail Beneficiaries) are provided with information that allow them to assess whether investing in a particular fund matches their expectations and needs in terms of ESG investing.

2.3.25 Notwithstanding the preceding paragraphs, should an Investment Manager consider it necessary to pursue IFSI in order to avoid a risk to an OPCVM's expected financial returns, it would, in our view, also be entitled to do so, irrespective of whether the documentation of the OPCVM discloses that it may invest for sustainability impact.

2.3.26 When managing French OPCVMs, Investment Managers have legal freedom to use investment powers to take ESG considerations into account, provided the documentation of the relevant OPCVM is clear about its objectives and the investment policy that is to be implemented. Strictly speaking, they should equally be able to pursue IFSI, although this probably remains hindered by the traditional perspective that the

FRANCE

purpose of an investment fund is to yield financial return for its Beneficiaries (unless the documentation of the OPCVM allows the Investment Manager to pursue IFSI).

2.3.27 This issue also arises under French corporate law, where article 1833 of the French Civil Code (*Code civil*) provides that companies must have a lawful corporate purpose and be constituted in the common interest of their shareholders. This is conventionally understood as requiring that a company's objective is to be profitable. This perspective was significantly altered by the PACTE law[107] passed in spring 2019, which notably introduced the following changes.

(a) Article 1833 Civil Code now states that companies must be managed in their own 'corporate interests' (as opposed to those of their shareholders) 'by taking into consideration the "social and environmental issues" related to their operation'[108].

(b) Article 1835 Civil Code has been amended to allow companies to specify in their articles of association a '*raison d'être*', which the law defines as being 'made up of the principles with which the company is endowed and for the observance of which it intends to allocate resources in carrying out its business' [109].

(c) More importantly, French companies are now allowed to adopt a new 'status', referred to as that of 'mission-based company' (*société à mission*)[110]. Where a company chooses this status, its articles of association must not only state a *raison d'être*, but also define 'one or several social or environmental objectives that the company purports to pursue in carrying out its business'[111].

2.3.28 The rules outlined in sub-paragraphs (a) and (b) above do not fundamentally change the nature and objectives of French companies but are meant to give them the possibility to go beyond the objective of being profitable. The creation of the mission-based company status goes a step further, as it allows companies to be established to further social or environmental objectives. Creating a similar status for funds (ie allowing funds to be created with a *purpose* stated to be other than yielding financial return for Beneficiaries [112]) could be the step necessary to unlock their potential for IFSI (and undoubtedly allow Investment Managers to engage in ultimate ends IFSI on behalf of French funds). This would go beyond the current rules applicable to French funds, under which funds already have enough flexibility to IFSI (provided their documentation is clear about it)[113]. Funds could be established with the purpose of pursuing 'one or several social or environmental objectives' through their investments.

2.3.29 The ability of Investment Managers to use investment powers to IFSI on behalf of an OPCVM is also reflected by France's two public labelling regimes for funds, which were both launched in 2016: the SRI label[114], driven by the Ministry of Finance, and the Greenfin label[115], driven by the Ministry of Ecological and Inclusive Transition. The SRI label[116] requires the systematic and measurable integration of ESG criteria into investment decisions. It is granted to funds[117] that meet criteria grouped into six topics: (a) the fund's general (financial and non-financial) objectives (which must be clearly defined and described to Beneficiaries and taken into account in the fund's investment policy); (b) the ESG criteria analysis and rating methodology used by the companies in which the fund invests; (c) the inclusion of ESG criteria during the portfolio's development and existence; (d) the ESG engagement policy with the companies in which the fund invests (voting and dialogue); (e) fund management transparency; and (f) measurement of the positive impacts of ESG management on the development of a sustainable economy.

2.3.30 The Greenfin label[118] is also based on financial management transparency and environmental impact indicators. However, it is different in nature in that the investment scope is limited to funds that genuinely finance activities with measurable environmental benefits. The label aims at combining green share and exclusions: it is linked to a taxonomy of sustainable activities in which labelled funds must invest a specific percentage of their portfolio. Labelled funds must also exclude fossil and nuclear energies from their investments.

2.3.31 A *Banque de France* study noted that there were in 2019 379 SRI and Greenfin labelled funds with €148bn in AuM, representing almost 7 per cent of the French collective investment management market[119]. In 2020, these numbers had increased to 508 SRI labelled funds (with €204bn AuM)[120] and 50 Greenfin labelled funds (with €15bn AuM)[121]. The existence of these two labels and the growing number of funds they have labelled reflects a more established integration by Investment Managers of ESG criteria into investment decisions, and also an increased use of their investment powers to IFSI.

FRANCE

2.4 **Insurance undertakings**

Types of insurance undertaking covered

2.4.1 We consider in this analysis (i) life insurance undertakings and (ii) general/non-life insurance undertakings:

- life insurance (*assurance vie*) undertakings provide assurance, in consideration for the payment of a premium, on death or another defined event by payment of a lump sum or fixed regular income. Life insurance may also include annuities on a contractual basis. In practice, life insurance products are primarily used in France as savings products; and
- general/non-life insurance (*assurance non-vie*) comprises types of policy which are not life insurance, and which include, among other things, sickness, fire and natural forces, property and liability insurance. The general insurer provides, in consideration for the prior payment of a premium, assurance on the specific risk covered by the insurance by paying out in case a valid claim of the policyholder occurs.

2.4.2 French insurance undertakings may be established in a number of different forms, as listed in Annex III to Directive 2009/138/EC[122] (Solvency II): company limited by shares (*société anonyme*); mutual insurance company (*société d'assurance mutuelle*); provident institution registered under the SSC (*institution de prévoyance régie par le code de la sécurité sociale*); provident institution registered under the French Rural Code (*institution de prévoyance régie par le code rural*); and friendly society registered under the French Mutuality Code (*mutuelle régie par le code de la mutualité*). We formally consider in this annex only those undertakings governed by the Insurance Code, *viz*. companies limited by shares and mutual insurance companies (Insurance Companies) since most of the rules that are relevant to IFSI are common to all types of insurance undertakings and are set forth in the Insurance Code.

2.4.3 Solvency II applies to most French insurance undertakings[123]. However, smaller undertakings, which mainly consist of mutual undertakings (*mutuelles*), fall outside the scope of the directive. This annex considers only Solvency II Insurance Companies, which, given both their number and balance sheet size, manage the chief part of French insurance undertakings' assets[124].

2.4.4 The landscape for life insurance policies (which comprise life insurance contracts (*contrats d'assurance vie*) and capitalisation contracts (*contrats de capitalisation*)) in France can be divided into two products: '*fonds en euros*' contracts (ie with-profits policies with a minimum guaranteed return) and unit-linked contracts (*contrats en unités de compte*)[125]. In a *fonds en euros* contract, investment decisions are left to the Insurance Company. However, the invested capital, as well as any interest and year-end bonus added to it, are guaranteed by the Insurance Company. In contrast, in a unit-linked contract, even though the Insurance Company remains owner of the underlying assets (ie 'units'), the investment risk associated therewith is fully borne by the policyholder. In return, the policyholder can determine the underlying assets in which premiums are invested (such underlying assets typically are collective investment schemes, including in particular OPCVMs)[126].

2.4.5 In each case, the key parties are:

- **Asset Owner**: Insurance Company.
- **Beneficiaries**: Beneficiaries of the insurance undertaking are any natural or legal persons who are entitled to benefit under an insurance contract, including policyholders. Besides, the shareholders of an insurance company are typically considered to form a further category of an insurer's Beneficiaries because of their economic interest in the management of an insurance company's assets.
- **Investment decision-maker**: Insurance Company or Investment Manager appointed by Insurance Company.

Overview of investment duties and powers

2.4.6 The investment duties of Insurance Companies are typically determined by the terms of the contract concluded with the relevant policyholder (for life insurance) and French law (including EU legislation directly applicable in member states).

2.4.7 In France, the main investment duties and powers of insurers are primarily set out by:

- the statutory and regulatory provisions of the Insurance Code; and
- Regulation (EU) 2015/35 on the taking up and pursuit of the business of Insurance and Reinsurance[127].

In addition, France complies with guidance of the European Insurance and Occupational Authority (EIOPA), such as the opinion on sustainability within Solvency II[128] and EIOPA's technical advice on the integration of sustainability risks and factors in the delegated acts under Solvency II and IDD[129].

2.4.8 Generally, the key investment duties of insurers arising out of French law are the following.

(a) *Prudent person principle*. Solvency II Insurance Companies must invest their assets in accordance with the 'prudent

FRANCE

person' principle (PPP) set forth in Article L. 353-1 Insurance Code and detailed in Articles R. 353-1 *et seq*. Insurance Code. This means, in particular, that with respect to the whole portfolio of assets, Solvency II Insurance Companies are required to invest in assets 'whose risks they can properly identify, measure, monitor, manage, control and report, and appropriately take into account in the assessment of their overall solvency needs'[130]. Further, the PPP requires that all assets of Solvency II Insurance Companies are invested in such a manner 'as to ensure the security, quality, liquidity and profitability of the portfolio as a whole', and that the relevant assets be located so as to ensure their availability[131]. This requirement indicates that the main objective of the PPP under the Insurance Code is to ensure financial return consistent with the respective investment objectives and having appropriate regard to the risks involved. This is also confirmed by the requirement that assets held to cover technical provisions be invested 'in the best interest of all policyholders and beneficiaries taking into account any disclosed policy objective'[132]. The 'best interest' of Beneficiaries is typically met if the generated financial return allows the Insurance Company to meet in due course its financial obligations to the Beneficiaries under the relevant policies.

Should a conflict of interest arise, Solvency II Insurance Companies are expressly required to invest in the best interest of policyholders and Beneficiaries[133].

(b) *Investment rules*. Generally, Insurance Companies are not required to invest in particular categories of asset (although they have to comply with diversification duties and restrictions on assets which are not admitted to trading on a regulated financial market[134]). However, as regards life insurance unit-linked contracts, the underlying assets of such contracts must be chosen among eligible assets, as listed in article R. 131-1 Insurance Code.

(c) *Duties under corporate law*. As noted in section 2.3.27, Article 1833 Civil Code was amended in 2019 by the PACTE law to state that companies must be managed in their own 'corporate interests' (as opposed to those of their shareholders) and 'by taking into consideration the "social and environmental issues" related to their operation'[135]. The PACTE law also amended French corporate law to provide that directors of French companies' corporate and management boards must take into account 'social and environmental issues' when determining the orientation of the company's business and supervising how it is carried out[136]. Therefore, French corporate law now explicitly provides for a duty of directors to consider 'social and environmental issues' when operating the company. This duty does not necessarily entail an obligation to actively pursue IFSI though, since directors need to balance various factors without any predetermination of the outcome when deciding which action to take. In particular, it would require the proper consideration of both long-term (sustainability) interests and the interests of present shareholders. In addition, French corporate law provides that the remuneration policy of certain listed companies must contribute, among other things, to the company's long-term interests and sustainability[137]. Their remuneration policy must also set out how the pay and employment conditions of employees of the company were taken into account when establishing the remuneration policy[138]; where the policy is revised, it must describe and explain how it takes into account the votes and views of shareholders on the policy[139]. These obligations suggest that the consideration of a company's long-term interests might be justified in certain cases.

(d) *Beneficiaries' views*. In 2018, the *Fédération française de l'assurance* (FFA)[140] formalised in its Corporate Social Responsibility (CSR) Charter[141] its members' undertaking to include, in the unit-linked policies they manufacture, at least one underlying asset with an ethical investment, charitable or climate label, including in particular the EETC (Energy and Environment Transition for Climate) label or the SRI (Socially Responsible Investment) label. This voluntary undertaking was converted into a statutory requirement by the PACTE law[142] passed in spring 2019. Under article L. 131-1-2 Insurance Code, as amended by the PACTE law, unit-linked contracts manufactured by Insurance Companies must, since 1 January 2020, include at least one underlying asset that either comprises a minimum percentage of securities issued by companies oriented towards social welfare (*entreprises solidaires d'utilité sociale*) or has been awarded a state-recognised label relating to either ecological or energy transition financing or socially responsible investment. As from 1 January 2022, unit-linked contracts will have to include at least one underlying asset for each of the three above categories and Insurance Companies will be required to inform their clients of the percentage of underlying assets within each contract meeting these conditions,

ANNEXES

France

FRANCE

before they decide to invest. The aim of this provision of the PACTE law is to better inform clients of the possibility to invest in ESG underlying assets and direct investments into such underlying assets.

(e) *Insurance distribution*. Where an Insurance Company also carries out insurance distribution, it must act 'honestly, fairly and professionally with the best interests of [its clients].'[143] Further, it has to ensure that any contract proposed is consistent with the client's insurance demands and needs[144]. Where an Insurance Company recommends life insurance contracts, it must ensure that the recommended contract(s) or option(s) are the most suitable for the relevant client and that they are, in particular, in accordance with that client's risk tolerance and ability to bear losses[145].

(f) *Reporting requirements*. Life Insurance Companies are subject to the same reporting requirements regarding their investment strategy as FRPS (as to which, see section 2.2.23(d)).

General insurance: legal requirements to use investment powers to pursue IFSI

2.4.9 Under current French law, non-life Insurance Companies are, in our view, not generally obliged to use investment powers to invest for sustainability impact.

2.4.10 There is no explicit duty of insurers to pursue IFSI. Article L. 353-1 Insurance Code rather establishes the PPP as the overarching investment rule applicable to Insurance Companies (see section 2.4.8(a)). Consequently, the investment principles provided under the Insurance Code do not specifically address ESG or sustainability risks, nor do they expressly require an Insurance Company to take such risks into account.

2.4.11 In respect of non-life insurance, when considering its investment decisions, an Insurance Company must primarily ensure that its investments are appropriate to enable it (i) to pay any amount due to policyholders (or other beneficiaries) under the policies it has underwritten; and (ii) remain compliant with the solvency and other prudential requirements applicable to it. Arguably, as long as an Insurance Company is able to pay the claims under the policies it has underwritten, it will have invested in the 'best interest' of policyholders (or other beneficiaries of the policies). Therefore, in general, where a conflict arises between sustainability impact and financial return, the investment would need to be made in favour of the Insurance Company's duty to be financially able to meet its contractual undertakings (under its policies) to the Beneficiaries.

2.4.12 Nonetheless, there may be circumstances where ESG and sustainability risks may materialise as financial risks that an Insurance Company would have to take into account when investing[146]. This would be the case where the Insurance Company determines that ESG risks may materially affect either (i) the assets in which it invests (eg in the shape of market risks)[147]; or (ii) the underwriting risk (eg in case of property or natural forces insurance)[148]. In both cases, it might be 'prudent' for an Insurance Company to take such risks into account, inasmuch as they would be financially material. However, the question whether certain ESG risks can be viewed as financially material depends on the time period which underlies the investment process and over which potentially relevant risks are assessed.

2.4.13 As regards Beneficiaries' views, neither the PPP nor any other statutory or regulatory obligations of non-life Insurance Companies require them to assess the views of Beneficiaries on whether they wish to pursue IFSI. Similarly, there is generally no explicit obligation to align the investment with the sustainability preferences of Beneficiaries.

2.4.14 Under French corporate law[149], large French companies[150] must establish mechanisms to prevent human rights violations and environmental impacts throughout their chain of production. In this respect, in-scope companies must draw up, implement and publish a 'vigilance plan'. The plan must include 'reasonable vigilance measures to identify risks and prevent serious harm to human rights and fundamental freedoms, health and safety of persons and environment'[151] and cover the activities of the relevant company, its direct or indirect subsidiaries, and subcontractors and suppliers with which an established business relationship is maintained.

2.4.15 The vigilance plan must include (a) a mapping that identifies, analyses and ranks risks; (b) procedures to regularly assess, in accordance with the risk mapping, the situation of subsidiaries, subcontractors or suppliers with whom the company maintains an established commercial relationship; (c) appropriate action to mitigate risks or prevent serious violations; (d) an alert mechanism that collects reporting of existing or actual risks, developed in working partnership with the trade union representatives of the company concerned, and (e) a monitoring scheme to follow up on the measures implemented and an assessment

FRANCE

of their efficiency. In-scope companies are expected to make their vigilance plans, and regular reports on the implementation of the plan, public as part of their annual reports[152]. Finally, failure on the part of an in-scope company to comply with the above obligations within three months from receiving a formal notice, may result in the competent jurisdiction issuing an order for the company to comply or face financial penalties. In addition, a company that would fail to comply with these obligations could be held liable and obliged to compensate for the harm that due diligence would have helped to avoid[153].

2.4.16 Although this corporate duty of vigilance does not expressly cover 'investment' activities, it is meant to apply to all activities of in-scope companies. Therefore, any French in-scope companies, the business of which is to engage in investment activities, must cover such activities in their vigilance plan. In this respect, Insurance Companies should include their investment activities in their vigilance plan and take reasonable measures to 'identify risks and prevent serious harm to [the environment]'[154]. This may in certain circumstances result in a legal requirement to use investment powers to pursue IFSI.

General insurance: legal freedom to use investment powers to invest for sustainability impact

2.4.17 Under French law, non-life Insurance Companies are, in our view, free to use investment powers to pursue IFSI as long as it does not jeopardise their ability to comply with prudential requirements and meet their contractual undertakings.

2.4.18 This ability has arguably been strengthened following the changes to French corporate law brought about by the PACTE law (as to which, see section 2.3.27). As corporate entities, Insurance Companies must be managed not only in their own 'corporate interests' but also 'by taking into consideration the "social and environmental issues" related to their operation'[155]. Following the PACTE law, their directors must take into account 'social and environmental issues' when determining the orientation of the company's business and supervising how it is carried out[156].

Life insurance: legal requirements to use investment powers to invest for sustainability impact

2.4.19 For the reasons set out in sections 2.4.10 *et seq*., we do not consider that life Insurance Companies are subject to a general obligation to use investment powers to pursue IFSI (except where the implementation of their corporate vigilance plan would require them to do so (see section 2.4.16).

However, in contrast to non-life Insurance Companies, life Insurance Companies typically have longer time liabilities, which they need to cover over a corresponding longer investment horizon. This might imply that long-term sustainability risks are generally of greater relevance for life Insurance Companies than for non-life ones. In this respect, EIOPA therefore takes the view that for '(longer-term) life business, the long horizon for cash-flows also means that there may be room to consider the impact of climate change in the calculation of the best estimate.'[157] Further, EIOPA has pointed out that where 'undertakings have long-term assets to match long-term liabilities they should consider whether climate change would impact either their ability to hold these assets over that time frame or their expected cash-flows'[158]. Similarly, under the Insurance Code, life Insurance Companies are required in certain circumstances[159] to publicly disclose how the main elements of their investment policy regarding shares are consistent with the profile and duration of their liabilities, in particular long-term liabilities, and how they contribute to the medium-to-long-term performance of their assets[160]. This reflects the expectation that life Insurance Companies factor those constraints into their relevant investment policy.

2.4.20 Insurance Companies that provide advice on life insurance products are required to assess the suitability of a product for the relevant client, based notably on information on the client's investment objectives and financial situation[161]. Where the Insurance Company makes recommendations on life insurance products, it must ensure that the recommended product is suitable and 'in accordance with [the client's] risk tolerance and ability to bear losses'[162]. Although the relevant provisions are sufficiently broad to cover non-financial objectives, such objectives are not expressly mentioned. On the contrary, references to 'investment objectives', 'financial situation', 'risk tolerance' and 'ability to bear losses' suggest that the main criteria that must be taken into account are financial ones.

2.4.21 However, unit-linked contracts must, since 1 January 2020, include at least one underlying asset that either comprises a minimum percentage of securities issued by companies oriented towards social welfare (*entreprises solidaires d'utilité sociale*) or has been awarded a state-recognised label relating to ecological or energy transition financing or socially responsible investment[163]. This new requirement is

FRANCE

aimed at better informing clients of the possibility to invest in ESG underlying assets by making sure that policies include sustainable investments within the range of underlying assets that policyholders can pick from. This indirectly requires life Insurance Companies to take into account Beneficiaries' views on ESG investing (assuming such Beneficiaries elect to invest in the relevant underlying assets). The repercussion of this requirement should be that, where an Insurance Company assesses the suitability of a product for a client, it should ask for information on that client's investment ESG views, so as to be able to suggest investing in an ESG underlying asset if that would meet the client's expressed needs and objectives.

Life insurance: legal freedom to use investment powers to invest for sustainability impact

2.4.22 Under French law, life Insurance Companies are, in our view, free to use investment powers to pursue IFSI as long as (i) it does not jeopardise their ability to comply with prudential requirements and meet their contractual undertakings, and (ii) it is consistent with the objectives and needs of the relevant policyholders.

2.4.23 Assessing the 'best interest' of Beneficiaries under the PPP might typically be considered more complex than in relation to non-life insurance products. On the one hand, the 'best interest' of life insurance policyholders requires in particular securing contractual pay-outs in respect of longer-term policies. In addition, in respect of unit-linked contracts, the policyholders' expectation is generally that the relevant underlying assets, the investment risk of which they bear, will increase in value over time. Also, as has been set out by EIOPA, for '(longer-term) life business, the long horizon for cash-flows also means that there may be room to consider the impact of climate change in the calculation of the best estimate.'[164] This might imply that life Insurance Companies have some leeway to integrate sustainability risks in their investment decisions.

2.4.24 For unit-linked contracts, Insurance Companies must now include at least one ESG underlying asset among the underlying assets that policyholders may select (see section 2.4.21). Nothing prevents Insurance Companies that manufacture unit-linked contracts from including more ESG underlying assets for policyholders to pick from and thereby directing their investments to such assets. These ESG underlying assets can include funds that pursue IFSI.

2.4.25 Finally, disclosure obligations under the French ESG reporting regime apply to life Insurance Companies, which must report each year information on how they incorporate ESG criteria into their investment policy, the type of ESG criteria taken into account and how they exercise voting rights attaching to investments taking account of their ESG choices[165]. This implies that life Insurance Companies are, in principle, allowed to take ESG or sustainability factors into account provided that their investment decisions remain consistent with the PPP as the overarching investment principle (please refer to section 2.4.8(a)) and do not jeopardise their ability to meet their (long-term) contractual obligations to policyholders.

FRANCE

3. ASSET OWNERS' USE OF THEIR POSITION TO ENGAGE IN STEWARDSHIP ACTIVITIES TO SECURE SUSTAINABILITY IMPACT

3.1 The following section considers the extent to which, and on what basis, each type of Asset Owner is (a) legally required or (b) legally permitted or able to use its position to influence enterprises in which it invests by engaging in stewardship activities designed to achieve positive sustainability outcomes and minimise negative sustainability outcomes.

Overarching considerations

3.1.1 French management companies have been required since 2011 to report to Beneficiaries of their funds (including in particular OPCVMs) how they exercise voting rights in investee companies to take account of the ESG choices defined in their investment policy[166]. This requirement was extended to most French Asset Owners in 2016, as part of the creation of the French ESG reporting regime (as to which, see section 2.3.15).

3.1.2 In the context of the transposition into French law of Directive (EU) 2017/828[167] as regards the encouragement of long-term shareholder engagement (**Shareholders' Rights Directive II or SRD II**), the PACTE law introduced new requirements aimed at strengthening stewardship and addressing short-termism and principal-agent problems in the investment chain[168]. As further discussed below, these new requirements, which apply on a 'comply or explain' basis, do not impose upon the relevant Asset Owners any explicit duty to engage with investee companies to achieve positive or reduce negative sustainability impact. In other words, Asset Owners have no specific obligation to actively pursue that aim. These requirements have however resulted in an increase in Asset Owners' engagement with investee companies and Investment Managers investing on their behalf[169].

3.1.3 Where the relevant investee company is subject to the French corporate 'duty of vigilance' (as to which, see sections 2.4.14 to 2.4.16), Asset Owners should also consider whether such company complies with its obligations thereunder. Indeed, these obligations include a requirement to implement a corporate vigilance plan (including, in particular, to avoid undue environmental harm), failing which the investee company may face financial penalties and civil liability. Asset Owners are therefore prompted to use their position to influence relevant investee companies to avoid adverse financial consequences for their investments.

3.2 Pension funds

Legal requirements to engage for sustainability impact

3.2.1 For the reasons set out in sections 2.2.24 through 2.2.28, AGIRC-ARRCO, the FRR and FRPS do not have any express duty under French law to engage for sustainability impact (although there might be certain situations giving rise to a duty to take account of sustainability impact, in particular where ESG or sustainability factors are to be considered *financially material* and IFSI is perceived as mitigating their impact[170]).

3.2.2 FRPS are subject to the same general engagement requirements as Investment Managers (as outlined in sections 3.3.1 *et seq.*), where they invest, either directly or through Investment Managers, in shares listed on a regulated market[171]. In respect of such investments, FRPS must:

(a) develop and publicly disclose an engagement policy that describes how they integrate shareholder engagement in their investment strategy[172];

(b) publicly report, each year, on how they implemented their engagement policy[173];

(c) publicly report, where Investment Managers implement on their behalf their engagement policy (including through exercising voting rights), the place where such Investment Managers disclose the required voting information[174];

(d) require Investment Managers, with which they enter into investment management agreements or in whose funds they invest, to provide them with information on how their investment strategy and the way it is implemented comply with the relevant contractual arrangements entered into with the FRPS and contribute to the medium-to-long-term performance of the relevant assets[175]; and

(e) publicly disclose, when they invest through Investment Managers, how the agreement they enter into with the relevant Investment Manager incentivises it to engage with investee companies to improve their medium-to-long-term performance[176].

3.2.3 As with the obligations applicable to Investment Managers, the above requirements generally apply on a 'comply or explain' basis[177]. They do not include any specific obligation for the relevant FRPS to actively aim for an improvement of its investments' sustainability impact.

> ANNEXES

> France

FRANCE

Legal freedom to engage for sustainability impact

3.2.4 The rules applicable to AGIRC-ARRCO, the FRR and FRPS do not prevent them from engaging for sustainability impact.

3.2.5 Both the AGIRC-ARRCO Pension Institutions and FRR have voluntarily committed to implement an active engagement approach. The AGIRC-ARRCO's ESG Charter[178] lists, amongst its ESG principles, that AGIRC-ARRCO shall 'engage as shareholder and integrate ESG issues into its engagement policies and procedures' and 'demand, as much as possible, that investee companies be transparent in respect of ESG issues'[179]. The FRR has drawn up proxy voting guidelines[180] that apply to the Investment Managers that manage its assets. These guidelines, which call for the FRR's long-term perspective as an investor[181] to be taken into account, specifically state that any resolution submitted 'on topics of a social, ethical or environmental nature' must be assessed in light of the UN Global Compact principles and the FRR's own socially responsible investment guidelines[182].

3.3 Mutual funds

Legal requirements to engage for sustainability impact

3.3.1 Pursuant to article L. 533-22 FMFC, Investment Managers (ie fund management companies and asset managers authorised under MiFID II[183]) must develop and publicly disclose an engagement policy that describes how they integrate shareholder engagement in their investment strategy. Pursuant to article R. 533-16 FMFC, the engagement policy must include the following items:

- monitoring of investee companies on relevant matters, including social and environmental impact and corporate governance[184];
- conducting dialogues with investee companies;
- the exercise of voting rights and any other rights attaching to shares held in investee companies;
- cooperation with other shareholders;
- communication with relevant stakeholders of the investee companies; and
- managing actual and potential conflicts of interests in relation to their engagement.

In addition, Investment Managers must publicly report, each year, on how they implemented their engagement policy[185]. The report must notably include a general description of how they have exercised voting rights and an explanation of their votes in respect of the most significant decisions[186].

3.3.2 Investment Managers which do not comply with their obligations to develop, disclose and/or report on the implementation of their engagement policy must publicly disclose a clear and reasoned explanation why they have chosen not to comply with the relevant requirement ('comply or explain' approach)[187]. Any third-party may bring a claim to the competent French court to have it require the Investment Manager to comply with its obligations and impose financial penalties pending compliance[188].

3.3.3 However, article R. 533-16 FMFC expressly states that Investment Managers must, when implementing their engagement policy, exercise voting rights for the exclusive benefit of the Beneficiaries of the funds that hold the relevant shares. As with the concept of 'best interest' (see section 2.3.17), Beneficiaries' 'exclusive benefit' in the context of fund management is traditionally associated with the aim of generating financial return. The word 'exclusive' is quite restrictive, inasmuch as it formally covers only (*exclusively*) the interest of current Beneficiaries in the relevant OPCVM. It arguably excludes any interest that is not strictly linked to being an investor in the relevant OPCVM, such as general social or environmental interests (which benefit not only the OPCVM's Beneficiaries, but also non-investors). Retaining the reference to the Beneficiaries' 'exclusive interest' may therefore be conducive to prioritising financial return over other considerations, or at least voting for sustainability impact only where this goal is clearly aligned with an appropriate financial performance (subject however to the documentation of the OPCVM expressly contemplating engaging for sustainability impact (see section 3.3.6)).

Legal freedom to engage for sustainability impact

3.3.4 From a strict theoretical perspective, management companies of OPCVM may consider that they have limited leeway to engage for sustainability impact, unless this has a positive impact on financial return. Management companies may also be reluctant to charge the costs of engagement activities for sustainability impact to the OPCVM they manage. However, neither French law nor AMF's guidance prevent management companies from engaging for sustainability impact with investee companies.

3.3.5 On the contrary, French management companies have been subject to reporting requirements in respect of their engagement policy since 2011.

FRANCE

Even though these requirements, which expressly cover ESG topics, are 'procedural' rather than 'substantive' in nature, their existence shows in our view that engaging for sustainability impact cannot be regarded as inconsistent with the traditional management companies' duties to OPCVMs and their Beneficiaries. France Invest[189] drew up in 2008 a charter covering engagement principles for its members that are private equity Investment Managers. The charter notably includes principles for engaging with investee companies for sustainability impact[190].

3.3.6 As noted in section 2.3.22, the relationship between an OPCVM and its management company, on the one hand, and its Beneficiaries, on the other hand, is primarily contractual in nature. Clearly disclosing in the OPCVM's prospectus that, in respect of the OPCVM's investments, the management company may engage for sustainability impact removes the tension between any such engagement and the traditional duties of management companies to Beneficiaries. Where an investor knowingly invests in an OPCVM that expressly contemplates engagement for sustainability impact, such investor's best (or exclusive) interest necessarily encompasses the same. In the AMF ESG disclosure guidelines[191], the AMF acknowledges the possibility for the documentation of an investment fund to refer to an engagement policy, and recommends providing Beneficiaries with further information on how it is effectively implemented[192].

3.4 Insurance undertakings

General insurance: legal requirements to engage for sustainability impact

3.4.1 Non-life insurers are, in our view, not generally subject to a duty to engage for sustainability impact (although they may be under a duty to have regard to sustainability risks in certain circumstances, as outlined in section 2.4.12).

General insurance: legal freedom to engage for sustainability impact

3.4.2 French law does not specifically regulate stewardship activities of non-life Insurance Companies but does not prohibit such engagement either. Because non-life Insurance Companies face, in relation to some of the risks they insure against, the adverse impact of climate change, they can, in our view, legitimately engage in stewardship activities with a view to minimising such impact on their potential payment obligations. In this respect, we would argue that such an engagement is consistent with a non-life Insurance Company's duties to its Beneficiaries.

Life insurance: legal requirements to engage for sustainability impact

3.4.3 Life Insurance Companies are subject to the same general engagement requirements as Investment Managers (as outlined in sections 3.3.1 *et seq.*), where they invest, either directly or through Investment Managers, in shares listed on a regulated market[193]. In respect of such investments, life Insurance Companies must:

- develop and publicly disclose an engagement policy that describes how they integrate shareholder engagement in their investment strategy[194];
- publicly report, each year, on how they implemented their engagement policy[195];
- publicly report, where Investment Managers implement on their behalf their engagement policy (including through exercising voting rights), the place where such Investment Managers disclose the required voting information[196];
- require Investment Managers, with which they enter into investment management agreements or in whose funds they invest, to provide them with information on how their investment strategy and the way it is implemented complies with the relevant contractual arrangements entered into with the life Insurance Company and contribute to the medium-to-long-term performance of the relevant assets[197]; and
- publicly disclose, when they invest through Investment Managers, how the agreement they enter into with the relevant Investment Manager incentivises it to engage with investee companies to improve their medium-to-long-term performance[198]

FRANCE

3.4.4 As with the obligations applicable to Investment Managers, the above requirements generally apply on a 'comply or explain' basis[199]. They do not include any specific obligation for the relevant life Insurance Company to actively aim for an improvement of its investments' sustainability impact.

Life insurance: legal freedom to engage for sustainability impact

3.4.5 French law does not prohibit life Insurance Companies from engaging for sustainability impact, including beyond the requirements outlined in section 3.4.3. The FFA noted in its latest report on the integration of ESG and climate criteria in insurers' investment strategies that in 2018, 85 per cent of participating insurers reported engaging with investee companies on ESG or climate-related topics, and 65 per cent and 80 per cent reported engaging with Investment Managers through, respectively, factoring ESG or climate-related criteria when selecting fund and managed accounts[200].

3.4.6 However, a life Insurance Company's engagement for sustainability impact cannot conflict with its duties to policyholders. In this respect, a life Insurance Company would, in particular, need to ensure that its engagement does not jeopardise its ability to meet its contractual undertakings under the policies it has underwritten, and is consistent with the objectives and needs of the relevant policyholders.

FRANCE

4. ASSET OWNERS' ENGAGEMENT IN PUBLIC POLICY WORK TO SECURE SUSTAINABILITY IMPACT

4.1 The following section considers the extent to which, and on what basis, each type of Asset Owner is (a) legally required or (b) legally permitted or able to use its position to engage in public policy work designed to achieve positive sustainability outcomes and minimise negative sustainability outcomes, for example, where these are relevant to the value of portfolio assets.

4.2 **Pension funds**

4.2.1 Under French law, there is no explicit obligation for any of the pension funds covered in this annex to engage in public policy work to secure sustainability impact. However, since there might be certain situations giving rise to a duty to take account of sustainability impact (in particular where ESG or sustainability factors are to be considered *financially material*[201]), we believe pension fund operators might have a duty to engage in public policy work to secure sustainability impact if that can be perceived as mitigating identified sustainability risks to their portfolio.

4.2.2 Although they are not specifically allowed to undertake public policy work, pension funds are not explicitly prohibited from doing so by French law. Pension funds therefore have in our view some leeway to engage in public policy to secure sustainability impact.

4.2.3 However, pension funds would need to ascertain that any such engagement is compatible with their legal and regulatory duties and does not, in particular, conflict with their duties to Beneficiaries. In this respect, pension funds that do not have direct duties to individuals that are Beneficiaries of the plans (*viz*. AGIRC-ARRCO and FRR) probably have more flexibility to integrate engagement in public policy into their activities and justify the associated costs (since they are not subject to any requirement to avoid Beneficiaries bearing undue costs). On the other hand, PER Operators and FRPS would face more difficulties, inasmuch as such engagement does not generate any (measurable) positive financial effects and they cannot, in our view, pass costs associated with public policy engagement to the Beneficiaries.

4.3 **Mutual funds**

4.3.1 Under French law, there is no explicit obligation for OPCVMs to engage in public policy work to secure sustainability impact.

4.3.2 The management company of an OPCVM must manage it in the 'best interest' of the OPCVM and its Beneficiaries, which also applies to engagement in public policy work. Engaging in public policy work may be difficult to align with the 'best interest' of an OPCVM and its Beneficiaries, since it may not result in any quantifiable positive effect on the financial return of the OPCVM. In addition, if such public policy work is paid for by funds of the OPCVM, the costs incurred may be considered 'undue'[202] where the financed activities do not have a measurable positive effect on financial return. In addition, the management company should not conduct any activities that result in the interests of any group of Beneficiaries being placed above the interests of any other group of Beneficiaries. This can be viewed as requiring management companies to ensure that its public policy work be equally beneficial to all Beneficiaries.

4.3.3 However, an Investment Manager could in our view engage in public policy work if the documentation of the OPCVM clearly states that it will (and appropriately inform Beneficiaries on associated costs), or even, in our view, where investing for sustainability impact is an objective of the OPCVM.

4.4 **Insurance undertakings**

4.4.1 Under French law, there is no explicit obligation for non-life and life Insurance Companies to engage in public policy work to secure sustainability impact. However, since there might be certain situations that give rise to a duty to take account of sustainability impact (in particular where ESG or sustainability factors are to be considered *financially material*[203]), we believe Insurance Companies might have a duty to engage in public policy work to secure sustainability impact if that can be perceived as mitigating identified sustainability risks to their portfolio. In any event, French law does not prohibit such engagement and Insurance Companies are free to pursue such work, provided it remains compatible with their legal and regulatory duties and does not, in particular, conflict with their duties to Beneficiaries.

FRANCE

5. ESTABLISHING NEW FUNDS TO INVEST FOR SUSTAINABILITY IMPACT AND AMENDING THE TERMS OF EXISTING ONES

5.1 The following section considers the extent to which it is possible for an Asset Owner to set up a fund, policy or other product with the express objective of IFSI.

5.2 **Pension funds**

5.2.1 Generally, French law does not prohibit pension fund operators from establishing funds with the express objective of IFSI.

5.2.2 In fact, to the extent the relevant pension plans enjoy legal freedom to pursue IFSI, they are also free to establish funds with the express objective of IFSI. As noted in sections 2.2.29 *et seq.*, the contractual framework governing the AGIRC-ARRCO in our view gives Pension Institutions flexibility for IFSI. Similarly, the framework within which the FRR operates allows for IFSI (see section 2.2.36). In the same way as the FRR launched in June 2005 the first call for tenders to invest about €600m in an ESG-conscious manner[204], it could conceivably have launched a call for tenders to invest for sustainability impact. The limits facing the AGIRC-ARRCO and the FRR in this respect are the same as those outlined in sections 2.2.30 and 2.2.37 respectively (ie in broad terms that such investments should still allow them to meet their expected profitability, security, liquidity and performance needs).

5.2.3 It would also be possible to amend the rules applicable to pension funds to include a more express investment objective of IFSI. From a theoretical standpoint, this would be achievable unless the statutory and regulatory provisions setting forth the framework within which the relevant pension funds must operate prevent such an amendment.

5.2.4 In respect of the AGIRC-ARRCO, the relevant framework is set forth by the AGIRC-ARRCO framework agreement[205], which is periodically agreed through a collective bargaining process between employers' and employees' representatives. In addition, the AGIRC-ARRCO federation adopts from time to time the AGIRC-ARRCO financial guidelines[206]. The AGIRC-ARRCO framework agreement states that the plan's reserves must be managed 'in a socially responsible manner' and that 'environmental, social and good governance impacts must be taken into account in the framework of the plan's investment policy'. In our view, nothing would prevent the employers' and employees' representatives from agreeing to make express reference, for instance, to a requirement to manage the plan's reserves with the objective of IFSI (subject always to the plan's overall financial sustainability). The AGIRC-ARRCO financial guidelines could also be similarly amended by the board of the AGIRC-ARRCO federation since, in our view, this would remain consistent with the current AGIRC-ARRCO framework agreement.

5.2.5 As regards the FRR, the only reference to sustainable investment in the statutory and regulatory regime applicable to it is that the executive board (*directoire*) of the FRR must regularly report to its supervisory board (*conseil de surveillance*) on how the FRR's investment policy guidelines have taken into account ESG considerations. This gives considerable leeway to the FRR to shape how its investment guidelines should take account of ESG considerations, including IFSI. On that basis, the FRR has released four successive versions of its Socially Responsible Investment Strategy[207]. In the latest version, the FRR states that it will 'continue to rely on its values as a long-term public investor to take into account and measure the impact of its investments while seeking to safeguard its enduring objective of financial performance'[208]. Under that policy, in order to 'develop its investments' responsible dimension', the FRR notes that it will seek to 'pursue impact' and will 'define indicators and tools to measure its impact'[209]. When selecting the Investment Managers that manage its assets, it will ask them to demonstrate their ability to 'work with and influence' investee companies[210]. In our view, nothing would prevent the FRR from deciding to increase its focus on IFSI in the next version of its Socially Responsible Investment Strategy (subject, as noted by the FRR, to continuing to meet its financial performance objectives).

Duties on those designing, manufacturing and providing pensions

5.2.6 The AGIRC-ARRCO and the FRR are not subject to product governance requirements and have no specific duty in this respect.

5.2.7 The PER plans regime requires that Beneficiaries be offered the possibility to select at least one alternative asset allocation, including notably, for PERcol and PERcat, an allocation allowing them to invest in social impact funds (*fonds solidaires*) that invest in specific social impact companies (*entreprises solidaires*

FRANCE

d'utilité sociale), as defined under article L. 3332-17-1 of the Labour Code[211]. Social impact companies do not directly include companies meeting solely ESG or sustainability criteria[212], but this requirement on PER Operators to design and offer plans that include social impact funds fosters the establishment of such funds. PER Operators that are Insurance Companies are also subject to duties regarding unit-linked contracts (see section 5.4.2), which also fosters investment in ESG or sustainable funds through PERin plans that take the form of an insurance product.

5.3 **Mutual funds**

5.3.1 French law does not prohibit or restrict establishing OPCVMs that pursue IFSI. As noted in section 2.3.13, AMF has acknowledged since 2007 the possibility to use non-financial criteria in the process of selecting financial instruments for investment by French funds[213]. Article 321-120 GRAMF also provides that an OPCVM's prospectus may allow the sharing of the OPCVM's financial returns[214], which shows that an OPCVM may be established with a purpose stated to be other than solely yielding (or maximising) financial return for Beneficiaries.

5.3.2 The French SRI and Greenfin labels[215] are also an indication that an OPCVM can be established to pursue IFSI. In particular, article D. 128-2 of the French Environmental Code (*Code de l'environnement*) states that the Greenfin label must cover funds that 'meet certain criteria, particularly in relation to their direct or indirect contribution to the financing of the energy and ecological transition […].' Upon its creation in 2016, French authorities noted that it was meant 'to spotlight the investment funds that finance the green economy, *to spur the creation of new funds*, and to encourage companies to report the 'green share' of their activities'[216]. As a matter of fact, the growing number of Greenfin-labelled funds[217] reflects the creation of funds on the French market that pursue IFSI.

5.3.3 Appropriate disclosure to Beneficiaries is the overarching condition to be met to establish an OPCVM purporting to invest for sustainability impact, whether in order to protect or enhance the financial performance of their investment (instrumental IFSI) or otherwise (ultimate ends IFSI). As long as the OPCVM's documentation clearly and fairly reflects a corresponding investment objective and strategy, Beneficiaries can make an informed decision (reflecting their preferences, including ESG ones) to invest in such a fund. By the same token, the Investment Manager can have the fund IFSI while abiding by its duties to Beneficiaries when implementing the OPCVM's documentation.

5.3.4 Similarly, existing OPCVMs may amend their documentation to be able to pursue IFSI, subject to the AMF's approval and giving advance notice to existing Beneficiaries.

Duties on those designing, manufacturing and providing mutual funds

5.3.5 Manufacturers of OPCVMs may become subject to the Directive 2014/65/EU on markets in financial instruments (**MiFID II**)[218] product governance requirements.[219] Among other things, a manufacturer must 'precisely identify the potential target market for each financial instrument and specify the type(s) of client for whose needs, characteristics and objectives the financial instrument is compatible.'[220] The manufacturer must also identify any group(s) of clients for whose needs, characteristics and objectives the financial instrument is not compatible (the 'negative target market'). Pending the changes to the product governance regime contemplated in the recent draft delegated directive published by the European Commission[221], the current obligation to define the 'target market' does not expressly require including the Beneficiaries' sustainability or other ESG-related preferences. However, French law neither prevents nor restricts manufacturers (whether or not subject to the MiFID II product governance regime) from integrating such preferences when identifying the target market.

5.3.6 Distributors of OPCVMs are subject to similar requirements, eg to ensure that products and services that are intended to be offered or recommended are compatible with the needs and objectives of the identified target market and an ongoing obligation to review this compatibility[222]. Pending the entry into force of the Draft MiFID II ESG Delegated Directive, these requirements do not extend to Beneficiaries' sustainability preferences. However, in most cases, distributors of financial products, such as OPCVMs, are required to inquire about their clients' or prospective investor's objectives and needs to offer them products that are suitable or at least adequate. In the context of the increasing focus by French investors – whether institutional or retail ones – on ESG and sustainable products and the growing number of such products available on the market, one could argue that distributors' general duty to act honestly, fairly and professionally in accordance with the best interests of their

FRANCE

clients should lead them to systematically inquire about Beneficiaries' ESG or sustainability preferences.

5.4 **Life insurance products**

5.4.1 French law does not prohibit life Insurance Companies from designing and offering new types of products that would include IFSI as their investment objective. Many Insurance Companies already offer unit-linked contracts that include ESG, social impact or sustainable finance funds. Some of them have also created contracts which exclusively include funds which are labelled by the SRI label. Nothing would therefore prevent Insurance Companies from establishing unit-linked contracts including exclusively funds which would pursue IFSI, including in our view ultimate ends IFSI (subject to identifying the relevant target market for such a contract, generally complying with applicable product governance requirements (as to which, see section 5.4.4) and ensuring that policyholders receive appropriate information on the specific features (including risks and costs) of such a contract).

5.4.2 In fact, under article L. 131-1-2 Insurance Code, as amended by the PACTE law, all unit-linked contracts manufactured by Insurance Companies must, since 1 January 2020, include at least one underlying asset that either comprises a minimum percentage of securities issued by companies oriented towards social welfare (*entreprises solidaires d'utilité sociale*, ie social impact companies) or has been awarded a state-recognised label relating to ecological or energy transition financing or socially responsible investment (ie the SRI label or Greenfin label[223]). As from 1 January 2022, unit-linked contracts will have to include at least one underlying asset for each of the three above categories. Life Insurance Companies will also be required to inform their clients of the percentage of underlying assets within each contract meeting these conditions, before they decide to invest. The aim of these changes is to better inform clients of the possibility of investing in funds holding ESG- and sustainability-focused underlying assets and direct investments into such underlying assets.

5.4.3 Life Insurance Companies are therefore generally allowed to create unit-linked contracts with underlying funds that IFSI. Similarly, they can amend contracts to replace existing underlying funds by, and/or add, such funds. Where policies include a *'fonds en euros' part (ie a with-profit policy with a minimum guaranteed return*[224]), in relation to which investment decisions are left to the Insurance Company and not to the policyholder, life Insurance Companies can opt to integrate ESG criteria in the investment strategy of their *fonds en euros*.

Duties on those designing, manufacturing and providing life insurance

5.4.4 French law has implemented the product oversight and governance regime in relation to insurance products of Directive (EU) 2016/97 on insurance distribution (IDD).[225]Under article L. 516-1 Insurance Code, Insurance Companies must specify, within their product approval process, an identified target market for each insurance product and ensure that all relevant risks to such identified target market are assessed. The Commission Delegated Regulation (EU) 2017/2358 with regard to product oversight and governance requirements for insurance undertakings and insurance distributors [226] further determines that the identification of the target market must be carried out at a sufficiently granular level, taking into account the characteristics, risk profile, complexity and nature of the insurance product, and that manufacturers may, in particular with regard to insurance-based investment products, identify groups of clients for whose needs, characteristics and objectives the insurance product is generally not compatible[227]. Additionally, manufacturers are required to only design and market insurance products that are compatible with the needs, characteristics and objectives of the clients belonging to the target market[228]. Insurance Companies must also regularly review their insurance products to assess at least whether the product remains consistent with the needs of the identified target market[229].

5.4.5 As is the case of the MiFID II product governance regime, the current IDD product governance regime does not explicitly address ESG or sustainability preferences of Beneficiaries[230]. However, French law neither prevents nor restricts manufacturers (whether or not subject to the IDD product governance regime) from integrating such preferences when identifying the target market. As mentioned in section 5.4.2, the Insurance Code requires life Insurance Companies that manufacture unit-linked contracts to include at least one underlying asset labelled by the SRI label or Greenfin label or which invests in social impact companies (and from 1 January 2022, to include at least one underlying asset in each of these three categories).

FRANCE

5.4.6 Life insurance distributors are subject to similar requirements, eg to have in place distribution arrangements that ensure that the objectives, interests and characteristics of policyholders are duly taken into account and an ongoing obligation to review this[231]. In addition, insurance distributors must act 'honestly, fairly and professionally with the best interests of [their clients].'[232] They have to ensure that any contract proposed is consistent with the client's insurance demands and needs[233]. They must ensure that the life insurance contract(s) or option(s) they recommend are the most suitable for the relevant client and that they are, in particular, in accordance with that client's risk tolerance and ability to bear losses[234]. In the context of the increasing focus by French investors – whether institutional or retail ones – on ESG and sustainable products and the growing number of such products available on the market, it would seem that the distributors' general duty to act honestly, fairly and professionally in accordance with the best interests of their clients should lead them to systematically inquire about Beneficiaries' ESG or sustainability preferences.
This is supported by the PACTE law requirement that all unit-linked contracts manufactured by Insurance Companies must, since 1 January 2020, include at least one underlying asset that either comprises a minimum percentage of securities issued by companies oriented towards social welfare (*entreprises solidaires d'utilité sociale*, ie social impact companies) or has been awarded a state-recognised label relating to ecological or energy transition financing or socially responsible investment (ie the SRI label or Greenfin label[235]). This statutory requirement makes sense only if distributors inquire about the social and sustainability preferences of Beneficiaries.

FRANCE

6. INVESTMENT MANAGERS' DUTIES TO IFSI

6.1 This section considers the extent to which, and in what circumstances, an Investment Manager is required or permitted to invest for sustainability impact on behalf of an Asset Owner.

6.1.1 Typically, an Investment Manager's investment duties and powers are shaped by the terms of its contractual arrangements with an Asset Owner as well as its duties under French law.

6.1.2 Investment Managers generally act for Asset Owners through managing assets on a discretionary basis under investment management agreements (*mandats de gestion*) or dedicated funds (*fonds dédiés*). From a regulatory perspective, this entails the provision of portfolio management services (*gestion de portefeuille*) or collective management services (*gestion collective*) respectively. Investment Managers may also provide investment advice (*conseil en investissement*) to Asset Owners, which remain responsible for making their own investment decisions based on the Investment Manager's advice.

6.1.3 Irrespective of the service they provide, Investment Managers are subject to a general duty to act honestly, fairly and professionally in accordance with the best interests of their clients[236]. They must also obtain the necessary information regarding their client's investment objectives so as to enable the Investment Manager to recommend to the client services or investments that are suitable for it ('suitability test')[237]. Where they provide investment advice, Investment Managers are also required to 'understand the financial instruments they offer or recommend, assess the compatibility of the financial instruments with the needs of the clients to whom [they provide] investment services, also taking account of the identified target market of end clients [...] and ensure that financial instruments are offered or recommended only when this is in the interest of the client.'[238]

6.2 **Legal obligations with respect to sustainability impact**

Powers of investment and divestment

6.2.1 Assessing the suitability of a service or investment entails, among other things, taking into account the financial situation and investment objectives of the client. Under the standard suitability test, there is currently no express requirement to assess the client's views on sustainability. On the contrary, the statutory requirement rather focuses on determining that the relevant service or investment is suitable and 'in accordance with [the client's] risk tolerance and ability to bear losses'. This lends credence to the traditional view that the primary obligation of Investment Managers towards their clients is to generate financial return. In addition, Investment Managers' duties are owed to their 'clients', ie the Asset Owners. As a general principle, Investment Managers have no duties to act in the 'best interest'[239] of the underlying Beneficiaries and are not meant to consider their objectives or preferences. Finally, even though ESMA considers it a 'good practice' for MiFID firms to consider non-financial elements and collect information on the client's preferences on ESG factors[240], Investment Managers currently have no regulatory duty to proactively ask for the client's objectives with regard to the sustainability of the portfolio.

6.2.2 Similarly, there is no direct duty to pursue IFSI that applies to Investment Managers. In fact, Investment Managers are required to implement their clients' instructions, as incorporated in their contractual arrangements (eg in the investment rules and limits set forth in an investment management agreement). In principle, these contractual arrangements should reflect the rules that apply to the relevant Asset Owner and the Investment Manager is therefore bound to apply the same rules as the relevant Asset Owner would if it managed its assets itself. Where the contractual arrangements between the Investment Manager and the Asset Owner are silent on IFSI, the Investment Manager has no duty to pursue IFSI and may do so only to the extent that it is not inconsistent with the client's best interests and investment objectives, as stated in the agreed contractual arrangements. In this context, the notion of 'best interests' should not be understood to be limited to the Asset Owner's financial interests only. In a contractual relationship between an Asset Owner and an Investment Manager, the Asset Owner might decide to incorporate into the contractual arrangements various views and preferences, including in relation to sustainability, which the Investment Manager is then contractually bound to consider when considering its client's best interests.

6.2.3 The Asset Owners have primary responsibility for ensuring that their Investment Managers are contractually required to consider their ESG requirements or preferences. The FRR paved the way to do so in 2005 when it

FRANCE

launched a call for tenders to invest about €600m in an ESG-conscious manner[241]. More generally, Investment Managers that are appointed to manage the FRR's assets must agree to comply with the FRR's investment policy guidelines.

6.2.4 In order to foster such approach, the PACTE law[242] introduced in 2019 new provisions of the Insurance Code, which apply to life Insurance Companies and FRPS that invest in shares listed on a regulated market (eg Euronext). Where they invest through an Investment Manager, life Insurance Companies and FRPS must include certain specific pieces of information in the investment management agreement[243]. Under articles L. 310-1-1-2 and R. 310-4 Insurance Code, the Insurance Company must make public, in respect of each such agreement, among other things, the following information:

(a) how the agreement incentivises the Investment Manager to align its investment strategy and decisions with the profile and duration of the Insurance Company's liabilities, including in particular its long-term liabilities;

(b) how the agreement incentivises the Investment Manager to make investment decisions based on an assessment of the medium-to-long-term performance, whether financial or non-financial, of the investee companies and to engage with such companies to improve their medium-to-long-term performance; and

(c) how the method and time horizon of the assessment of the Investment Manager's performance and the Investment Manager's remuneration align with the profile and duration of the Insurance Company's liabilities, including in particular its long-term liabilities.

Where an investment management agreement does not include any of the above items, the Insurance Company must publicly disclose why[244].

6.2.5 In any event, an Investment Manager should identify considerations relevant to its investment decision-making against the background (primarily) of the investment management agreement (or other contractual arrangements) it has entered into with the Asset Owner. In order to fulfil its duty of care, an Investment Manager's decisions should always take into account any matters which are financially material to those decisions. This may result in a duty to invest for sustainability impact.

Engagement to achieve sustainability impact

6.2.6 French Investment Managers are subject to the same general engagement requirements as those applicable to management companies pursuant to article L. 533-22 FMFC[245] (as outlined in sections 3.3.1 *et seq.*) when they engage in investment management activities for the account of third parties.

6.3 In order to foster such engagement, FRPS and life Insurance Companies must:

(a) publicly report, where Investment Managers implement on their behalf their engagement policy (including through exercising voting rights), the place where such Investment Managers disclose the required voting information[246];

(b) require Investment Managers, with which they enter into investment management agreements or in whose funds they invest, to provide them with information on how their investment strategy and the way it is implemented comply with the relevant contractual arrangements entered into with the Asset Owner and contribute to the medium-to-long-term performance of the relevant assets[247]; and

(c) publicly disclose, when they invest through Investment Managers, how the agreement they enter into with the relevant Investment Manager incentivises it to engage with investee companies to improve their medium-to-long-term performance[248].

6.4 In any event, an Investment Manager has a duty to take into account matters which are financially material to its investment-related decisions. Where it identifies a sustainability impact risk that is material in this way, it must then decide, what (if any) action to take in respect of it. The Investment Manager may well conclude that engaging with the one or more investee companies is an appropriate way to seek to minimise the relevant risk to its Asset Owners' portfolios.

Public policy work to achieve sustainability impact

6.4.1 There is no requirement under French law for an Investment Manager to engage in public policy work to IFSI. An Investment Manager would, therefore, only be required to engage in public policy work to pursue IFSI if the relevant investment management agreement (or other contractual arrangements) required it to do so.

6.5 **Legal freedom to invest for sustainability impact**

Powers of investment and divestment

6.5.1 The Investment Manager's freedom to pursue IFSI is limited by the investment management agreement (or other contractual arrangements) entered into between the relevant Asset Owner and Investment Manager. Where the investment management agreement

FRANCE

remains silent on IFSI, some level of flexibility may however arise from the duties applicable to Asset Owners. This means, where the Asset Owner has leeway to invest for sustainability impact, the Investment Manager should also find an enhanced degree of flexibility. However, Investment Managers might be reluctant to act on the basis of requirements that they are not necessarily familiar with, and the optimal scenario remains in our view that the investment management agreement should detail the Investment Manager's powers to pursue IFSI.

Engagement to achieve sustainability impact

6.5.2 Assuming that the investment management agreement does not determine the circumstances of engagement, Investment Managers will be able to engage for sustainability impact, as long as this is aligned with the duty to act in the client's best interests. Investment Managers may therefore be reluctant to engage to achieve sustainability impact if that was perceived to be likely to reduce the financial return of the portfolio they manage over the relevant investment horizon, result in undue costs being charged to the portfolio or result in any adverse financial consequences for the portfolios which the Investment Manager manages.

Public policy work to achieve sustainability impact

6.5.3 In the absence of specific conditions resulting from the investment management agreement, an Investment Manager benefits from a broad flexibility to engage in public policy work. However, it should ensure that such work does not raise conflicts with the relevant Asset Owner's interests. This requires consideration of the cost (if any) to the Investment Manager's clients and whether the proposed public policy-related activity is likely to result in any adverse financial consequences for the portfolios which the Investment Manager manages.

FRANCE

7. LEGAL LIABILITY TO THIRD PARTIES FOR THE NEGATIVE SUSTAINABILITY IMPACT OF ENTERPRISES IN WHICH PORTFOLIOS ARE INVESTED

7.1 This section considers the extent to which, regardless of the legal rules under which it is required to operate and its constitution, an Asset Owner could be legally liable to third parties for the negative sustainability impact of enterprises in which it invests, and whether an Investment Manager could also be liable because of its role in assisting the Asset Owner to invest in the relevant enterprise and steward its investment.

7.2 **Asset Owners**

7.2.1 It is possible that Asset Owners could be found to have criminal or civil liability to third parties for negative sustainability impact of assets in which they are invested. While this is generally likely to be a remote risk, the risk of this type of liability could increase as a result of the developing political focus on sustainability issues, which has prompted growing scrutiny from regulators, non-governmental organisations (NGOs) and the public. For example, the Paris Administrative Court recently ruled that a liability action brought by environmental advocacy groups alleging failure by the French state to act in response to climate change, was admissible[249]. This decision follows several rulings by the *Conseil d'Etat*[250],which reveal increasing focus on the French state's obligations regarding climate change and, more generally, environmental matter[251]. It is not impossible that this type of claims could start being brought against Asset Owners, on various civil liability grounds, as outlined below.

Criminal liability

7.2.2 It is unlikely that an Asset Owner would be held criminally liable for the negative sustainability impact of a company it has funded. Exceptionally, criminal liability might exist where a person has knowingly, by aiding or abetting, facilitated the preparation or commission of an offence. The same applies to any person who, by means of a gift, promise, threat, order, or an abuse of authority or powers, provokes the commission of an offence or gives instructions to commit it[252]. On that basis, a French parent company may be held liable as an accomplice in respect of offences committed by a subsidiary. However, the arm's length nature of relationships between an Asset Owner and the activities of its investee companies makes such a liability highly unlikely. The risks would be slightly higher if a relevant investor had close day-to-day involvement in and direction over the activities of the investee company. However, this is not typical of the Asset Owners considered in this annex.

7.2.3 Under the French 'polluter pays' principle, 'the costs of measures carried out to prevent, reduce and control pollution have to be borne by the polluter'[253]. However, the principle does not entail criminal liability. In any event, there would have to be some direct intervention at operational level in order for an Asset Owner to be viewed as a 'polluter' and have to bear such cost so, once again we consider such liability unlikely.

7.2.4 Liability is also theoretically possible, for example, if a nominee director appointed by an Asset Owner assumed managerial responsibility over relevant activities of the investee company, and (a) generally committed or aided or abetted the commission of the same offence as the investee company[254]; or (b) consented to, or instructed, a specific illegal act (such as, for instance, pollution by dumping of wastes[255]). However, only exceptionally would an Asset Owner exercise the required level of engagement in an investee company's operations to attract this type of liability.

Civil liability

7.2.5 Under French tort law, the general rule is that 'any act of man, which causes damage to another, shall oblige the person by whose fault it occurred to repair it'[256]. On that basis, three elements are necessary to engage liability: (i) a fault (*faute*); (ii) a loss or injury (*préjudice*); and (iii) a causal link (*lien de causalité*) between the two. The burden of proof of all these elements falls on the claimant.

7.2.6 Articles 1240 and 1241 Civil Code on liability in tort (*responsabilité extracontractuelle*) are generally interpreted as not including any limitation on the scope or nature of protected rights or interests. There is no need to prove the existence of a duty of care towards the claimant. It is therefore possible that an Asset Owner could be found to be liable towards individuals harmed by an investee company's actions (or inaction) which result in a negative sustainability impact.

7.2.7 However, liability only arises from a fault if there is a direct causal relationship between the fault and the loss or injury.

FRANCE

In addition, French law provides for compensation for the loss or injury suffered, as long as it is, notably, direct and certain[257]. It may be difficult to show such causal link between an Asset Owner's behaviour and harm suffered by a third party following an investee company's actions (or inaction) which result in a negative sustainability impact. Tort law has traditionally played only a relatively limited role in environmental protection. This is principally because liability in tort requires claimants to establish that they have suffered personal harm as a result of the defendant's actions (or inaction). Where the harm is to the environment there is no claimant with standing to bring an action under traditional tort rules.

7.2.8 There are also special grounds under French law to pursue a claim in tortious liability in the context of environmental matters. First, France incorporated in 2005 into its Constitution the 2004 Charter for the Environment (*Charte de l'environnement*). The charter notably includes the following provisions (emphasis added):

(a) Article 1 – 'Everyone has the right to live in a balanced environment which shows due respect for health.'[258]

(b) Article 2 – '*Everyone is under a duty* to participate in preserving and enhancing the environment.'[259]

(c) Article 3 – '*Everyone* shall, in the conditions provided for by law, *foresee and avoid the occurrence of any damage* which he or she may cause to the environment or, failing that, limit the consequences of such damage.' [260]

(d) Article 4 – '*Everyone* shall be required, in the conditions provided for by law, *to contribute to the making good of any damage* he or she may have caused to the environment.' [261]

7.2.9 In a 2011 priority preliminary ruling (*Question Prioritaire de Constitutionnalité – QPC*[262]), the French constitutional court (*Conseil constitutionnel*) held that, in light of articles 1 and 2 of the Charter for the Environment 'everyone is subject to a duty of vigilance in respect of environmental harm that could result from his or her activities'[263]. More generally, articles 1 to 4 of the charter can be used as grounds to pursue a claim in tortious liability.

7.2.10 Second, French law no. 2016-1087 on the recapture of biodiversity, nature and landscapes[264] introduced new legislation in articles 1246 to 1252 Civil Code regarding environmental liability. Article 1246 Civil Code affirms the principle of remediation of ecological prejudice: 'Any person responsible for ecological prejudice is liable for the remediation thereof'[265]. Unlike under the traditional principles of tortious liability, the parties who are permitted to bring a claim for environmental loss need not have suffered a direct and personal loss or injury. Article 1248 Civil Code provides that any individual or legal person with the legal capacity and interest to do so can bring a claim, including (but not limited to) the French state, the French Biodiversity Agency (*Office français de la biodiversité*), local municipal authorities or associations whose role is to protect the environment and that were established at least five years before the commencement of the litigation.

7.2.11 Given the very broad scope of these rules, which are expressed to apply to 'any person', they could theoretically be used as grounds to bring claims against Asset Owners. As noted in section 7.2.9, the French constitutional court held that 'everyone is subject to a duty of vigilance in respect of environmental harm *that could result from his or her activities*'[266]. The ruling of the Paris administrative court mentioned in section 7.2.1 was rendered against the French state on the basis of article 1246 Civil Code[267]. One could argue that Asset Owners' investment activities nowadays encompass taking certain steps to limit or at least mitigate the negative sustainability impact of their portfolio. Given the Asset Owners' greater focus on ESG-related disclosure, prompted not only by wider statutory or regulatory requirements but also voluntary good practices, there is also an increased risk of third parties raising claims on the grounds that Asset Owners have not fully achieved the steps they have publicly stated they would follow.

7.2.12 As mentioned in sections 2.4.14 *et seq*., large companies must draw up, implement and publish a 'vigilance plan', which must include 'reasonable vigilance measures to identify risks and prevent serious harm to human rights and fundamental freedoms, health and safety of persons and environment'[268]. and cover the activities of the relevant company and its direct or indirect subsidiaries. Under this corporate duty of vigilance, a company that would fail to comply with these obligations could be held liable and obliged to compensate for the harm that due diligence would have helped to avoid[269]. On that basis, a parent company could be held liable for harm caused by a subsidiary if, for instance, it did not assess, in accordance with its plan's risk mapping, the situation of its subsidiaries or did not take appropriate action to mitigate risks or prevent serious violations by its subsidiaries[270].

FRANCE

7.2.13 Otherwise, the likelihood of liability for a minority shareholder (as an Asset Owner would generally be) is in our view fairly remote as it would require circumstances that allow piercing the corporate veil (ie where an Asset Owner would have interfered in the investee company's business or given it specific instructions). We consider it unlikely that this would be feasible in relation to the usual activities of an Asset Owner of the type described in this annex.

7.3 **Investment Managers**

7.3.1 It is even less likely that Investment Managers, as agents of their client Asset Owners, would be found to have liability to third parties for the negative sustainability impact of investee companies. However, as for Asset Owners above, the risk of such litigation is increasing, especially as regards potential claims on the basis of the specific grounds outlined in sections 7.2.8 *et seq*.

Criminal liability

7.3.2 As for an Asset Owner, an Investment Manager might have criminal liability where it has direct involvement in an investee company's activities or operations, and where those are determined to be criminal under the relevant legislation. However, Investment Managers would not generally have the necessary degree of direct involvement for criminal liability.

7.3.3 As an Investment Manager would not be a shareholder of the investee company, it would not be possible for them to have secondary liability (as described in section 7.2.13). Liability as an accomplice is theoretically possible in very narrow circumstances where the Investment Manager can be demonstrated to have aided, abetted, facilitated or provoked the preparation or commission of an offence[271] (eg through a nominee director appointed on its behalf) but is highly unlikely.

Civil liability

7.3.4 The civil liability position is broadly similar to that for Asset Owners. It would be typical for the investment management agreement to include indemnification provisions such that the risk of any such liability incurred in fulfilment of its duties to the Asset Owner would in practice be borne by the Asset Owner (absent fraud or similar egregious conduct of the Investment Manager).

Marc Perrone

FRANCE

1 Source: Impact assessment relating to the pension plans reform (*Etude d'impact – Projet de loi organique relative au système universel de retraite – Projet de loi instituant un système universel de retraite*; NOR : SSAX1936435L/Bleue-1; NOR : SSAX1936438L/Bleue-1), 24 January 2020, p. 44.

2 The AGIRC-ARRCO acronym designates both the complementary pension plan for private sector employees covered by the general old-age pensions regime, and the national federation (Fédération AGIRC-ARRCO) that oversees it.

3 *Loi n° 2001-624 du 17 juillet 2001 portant diverses dispositions d'ordre social, éducatif et culturel.*

4 Article L. 135-6 of the French Social Security Code (*Code de la sécurité sociale*).

5 http://www.fondsdereserve.fr/documents/pr-SRI_awarded_mandates_April_27_2006.pdf.

6 As at the end of 2018, the AGIRC-ARRCO had 18.8 million active members and 12.88 million beneficiaries. It managed reserves (*réserve de financement*) amounting to €65.5bn (source: AGIRC-ARRCO, *Chiffres clés 2019*).

7 Accord national interprofessionnel du 17 Novembre 2017 instituant le régime AGIRC-ARRCO de retraite complémentaire.

8 AGIRC-ARRCO Financial Guidelines, 2019, article 6.

9 *Loi n° 2019-486 du 22 mai 2019 relative à la croissance et la transformation des entreprises.*

10 Articles L. 224-13 through L. 224-22 FMFC.

11 Articles L. 224-33 through L. 224-26 FMFC.

12 Articles L. 224-28 through L. 224-39 FMFC.

13 Article L. 224-1 FMFC.

14 Article L. 224-8 FMFC.

15 *Ordonnance n° 2017-484 du 6 avril 2017 relative à la création d'organismes dédiés à l'exercice de l'activité de retraite professionnelle supplémentaire et à l'adaptation des régimes de retraite supplémentaire en unités de rente.*

16 Directive (EU) 2016/2341 of the European Parliament and of the Council of 14 December 2016 on the activities and supervision of institutions for occupational retirement provision (IORPs).

17 Source: *Autorité de contrôle prudentiel et de résolution*, List of authorised insurance institutions as of 1 May 2020.

18 Article 40 of the regulation of the AGIRC-ARRCO federation.

19 AGIRC-ARRCO Financial Guidelines, Title II (*Règlementation des placements des fonds techniques*).

20 AGIRC-ARRCO Financial Guidelines, article 10.

21 AGIRC-ARRCO Financial Guidelines, article 11.

22 Article L. 135-8 SSC.

23 French law sets out a defined timeframe for the pay-outs of the FRR's assets. Indeed, under article L. 135-6 SSC, the sums entrusted with the FRR had to be managed until 1 January 2011. As from that date and up until 2024, the FRR must each year pay €2.1bn to the French social debt amortisation fund (*Caisse d'Amortissement de la Dette Sociale*) to help finance the basic old age pension plan. As from 2025, the FRR must pay a yearly amount of €1.45bn, until it exhausts its financial reserves.

24 Article L. 135-11 SSC. These rules are found in *Arrêté du 24 mai 2016 relatif au fonds de réserve pour les retraites* (as amended).

25 Article L. 224-1 FMFC.

26 Articles L. 224-3 and R. 224-1 FMFC and, for PER plans taking the form of insurance products, articles L. 131-1 and R. 131-1 Insurance Code.

27 "Collective" PER (PERcol) and "mandatory" PER (PERcat (also referred to as PERo)) are employer-sponsored plans. Employee participation in PERcol is voluntary whereas it is mandatory in PERcat (see sections 2.2.9 and 2.2.10).

28 Article L. 224-3 FMFC.

29 Under article 2 of law no. 2014-856, social impact companies include, among other types of companies, those companies that 'aim at contributing to sustainable development or energy transition', but only if their activities also have a socially useful impact.

30 Article L. 385-4 Insurance Code.

31 See further details in section 2.4.8(a).

32 Article L. 354-1 Insurance Code.

33 Article L. 385-5 Insurance Code.

34 Article R. 385-16-2 III Insurance Code.

35 Article L. 385-6 Insurance Code.

36 Articles L. 385-7-2 Insurance Code and L. 533-22-1 FMFC.

37 Article D. 533-16-1 FMFC.

38 Though FRPS are free to choose which exact data to report, article D. 533-16-1 FMFC suggests including the following information: (i) the consequences of climate change and extreme weather events on the assets; (ii) changes in the availability and price of natural resources; (iii) policy risks related to the implementation of national and international climate targets; measures of past, (iv) current or future emissions of GHG (both direct and indirect).

39 Articles L. 385-7-1 II and L. 310-1-1-2 II Insurance Code.

40 Article R. 310-4 II Insurance Code.

41 Article 40 of the regulation of the AGIRC-ARRCO federation.

42 See footnote 22.

43 Since 2011 and until 2024, the FRR must each year pay €2.1bn to the French social debt amortisation fund (*Caisse d'Amortissement de la Dette Sociale*). As from 2025, the FRR must pay a yearly amount of €1.45bn, until it exhausts its financial reserves (article L. 135-8 SSC).

44 Article L. 135-8 SSC.

45 This obligation to manage the AGIRC-ARRCO's reserves in 'a socially responsible manner' is however not a statutory or regulatory requirement but stems from the AGIRC-ARRCO's rules, which are, strictly speaking, contractual.

46 Preamble of the AGIRC-ARRCO Framework Agreement.

47 FRR's investment policy guidelines must be consistent with '*the principles of prudence and risk spreading, taking account of the defined timeframe for utilisation of the Fund's resources*' (article L. 135-8 SSC).

48 FRR, 2013-2017 Responsible Investment Strategy, '*Introduction*', p. 2.

49 The first ESG call for tenders was launched in 2005, with a total investment amount of €600m. FRR's last call for tenders was to award 4 'Responsible active management: Japanese equities' mandates. According to the FRR's press release on this call for tenders, '*responsible active management means that applicants take ESG aspects into account in their management processes, in particular by incorporating the FRR's exclusions policy (banned weapons, tobacco and coal) and voting and engagement policy. Applicants must produce quantitative and qualitative reports illustrating the actions they have taken in this domain.*'

50 FRR, 2013-2017 Responsible Investment Strategy, '*Introduction*', p. 2.

51 *Ibid.*

52 *Ibid.*

53 FRR, 2013-2017 Responsible Investment Strategy, '*Overview of the four strategic priorities and how the FRR intends to implement them over time*', p. 4.

54 See http://www.fondsdereserve.fr/en/socially-responsible-investment/exclusions-list, sections entitled 'Prohibited weapons' and 'Tobacco industry'.

55 See http://www.fondsdereserve.fr/en/socially-responsible-investment/exclusions-list, section entitled 'Coal'.

56 http://www.fondsdereserve.fr/documents/Dexia_AM_termination_mandate_December_28_2009-2.pdf.

57 FRR, 2013-2017 Responsible Investment Strategy, '*Introduction*', p. 2.

58 Article L. 135-8 SSC. See footnote 42.

59 FRR, 2019-2023 Responsible Investment Strategy, p. 4.

60 Article L. 224-3 FMFC.

61 Under article 2 of law no. 2014-856, social impact companies include, among other types of companies, those companies that '*aim at contributing to sustainable development or energy transition*', but only if their activities also have a socially useful impact.

62 See section 2.2.23(d).

63 *Ibid.*

64 Directive 2009/65/EC of the European Parliament and the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities, OJ L 302 17.11.2009, p. 32.

65 Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010, OJ L 174, 1.7.2011, p. 1–73.

66 There are currently 18 different regimes governing FIAs under French law.

67 Articles L. 214-7 for SICAVs) and L. 214-8 (for FCPs) FMFC.

68 Article L. 214-8 FMFC.

69 Article L. 214-8-1 FMFC.

70 Article L. 214-7 FMFC.

71 There are very few self-managed SICAVs in France.

72 Articles L. 214-7-1 FMFC.

FRANCE

73 Article L. 214-9 FMFC.

74 Article 6 of the Commission Delegated Regulation (EU) 2016/438 of 17 December 2015 supplementing Directive 2009/65/EC with regard to obligations of depositaries, OJ L 78, 24.3.2016, p. 11–30.

75 Article L. 214-9 FMFC.

76 The FMFC establishes basic rules for the authorisation, supervision, structure and activities of OPCVMs and the information that they are required to publish. These basic rules comprise, among other things, conduct, organisational and capital rules which management companies must comply with. The FMFC contains statutory provisions on the one hand and regulatory provisions on the other hand. The FMFC's statutory and regulatory provisions applicable to OPCVMs are, respectively, articles L. 214-2 to L. 214-23-2 FMFC and articles D. 214-1 to D. 214-31-2 FMFC.

77 The GRAMF contains regulatory provisions that implement the general requirements set forth in the FMFC. As such, they provide for more detailed and practical rules applicable to OPCVMs (articles 411-2 to 411-140 GRAMF) and their management companies (articles 321-1 to 321-152 GRAMF).

78 Articles L. 214-9 FMFC and 321-100 GRAMF. Management companies are also subject to a 'best interests' rule in article L. 533-22-2-1 FMFC: '*management companies must act honestly, fairly and professionally in accordance with the best interests of investors*'.

79 Article 321-101 GRAMF.

80 Article 321-101 GRAMF.

81 The GRAMF is supplemented by AMF implementing rules and guidance, which can take the form of instructions, positions or recommendations. Instructions set forth AMF's construction of the GRAMF; as such they state how the rules are to be complied with. Positions set forth AMF's construction of statutory and regulatory requirements that fall within the AMF's supervisory authority; as such they state how the AMF expects that such requirements be complied with. Recommendations set forth best practices, which the AMF suggests should be adopted by firms to achieve applicable laws and regulations aim. Recommendations are not mandatory.

82 *Position AMF – Critères extra financiers de sélection des actifs et application aux OPCVM se déclarant conformes à la loi islamique – DOC-2007-19.*

83 *Position-recommandation AMF-DOC-2011-05 – Guide des documents réglementaires des OPC*, 17 July 2020, p. 11.

84 *Position-recommandation AMF-DOC-2011-05 – Guide des documents réglementaires des OPC*, 17 July 2020, p. 8.

85 *Ibid.*

86 Loi 2019-486 du 22 mai 2019 relative à la croissance et la transformation des entreprises.

87 This has been reflected in article L. 621-1 FMFC, which is the provision of French statutory law that defines AMF's responsibilities.

88 *Position-recommandation AMF-DOC-2020-03 – Informations à fournir par les placements collectifs intégrant des approches extra-financières.*

89 Article L. 533-22-1 FMFC.

90 ie how the management company integrates ESG criteria in its investment policy.

91 ie ESG-related information on the relevant fund's investments.

92 Article D. 533-16-1 FMFC.

93 Articles L. 214-9 FMFC and 321-100 GRAMF.

94 ESMA, Guidelines on key concepts of the AIFMD (ESMA/2013/600), Guidelines on 'collective investment undertaking', § 12.

95 *Ibid.*

96 Article 321-101 GRAMF.

97 Article 321-101 GRAMF.

98 See section 2.3.15.

99 Please refer to section 2.2.40.

100 *Position AMF-DOC-2007-19 – Critères extra financiers de sélection des actifs et application aux OPCVM se déclarant conformes à la loi islamique*. Under that guidance, French management companies are, for instance, able to select assets in a way that allows the OPCVM to be Shariah compliant.

101 The types of associations that are eligible recipients of such donations are defined in the GRAMF.

102 *Position AMF-DOC-2007-19 – Critères extra financiers de sélection des actifs et application aux OPCVM se déclarant conformes à la loi islamique.*

103 *Position AMF-DOC-2012-15 – Critères applicables aux placements collectifs de partage.*

104 AMF, Third report on non-financial approaches in collective investment schemes (*Troisième rapport sur les approches extra-financières dans la gestion collective*), December 2020, § 2.3.1

105 *Ibid.*

106 *Position-recommandation AMF-DOC-2020-03 – Informations à fournir par les placements collectifs intégrant des approches extra-financières.*

107 *Loi 2019-486 du 22 mai 2019 relative à la croissance et la transformation des entreprises.*

108 Article 169 PACTE law. This provision of the PACTE law also adjusted articles L. 225-35 and L. 225-64 of the French Commercial Code (*Code de commerce*) so that corporate and management boards take into account 'social and environmental issues' as part of their respective duties.

109 Article 169 PACTE law.

110 Articles L. 210-10 to L. 210-12 Commercial Code, created by Article 176 PACTE law.

111 Article L. 210-10 Commercial Code. In addition, a mission-based company must meet strict conditions to retain its status: quantified objectives and monitoring procedures must be defined and an independent third-party must be responsible for verifying the implementation of the company's objectives.

112 Articles 1833 and 1835 Civil Code do not apply to OPCVMs, including SICAVs.

113 For instance, social impact funds (*fonds solidaires*), which must invest a minimum share of their assets in specific social impact companies (*entreprises solidaires d'utilité sociale*), have played an important role in the development of responsible investment in France. See also sections 2.3.21 *et seq.*

114 *'Label ISR'.*

115 *'Label France finance verte'* or *'Label Greenfin'*, previously known as the *'label TEEC'* (*Transition énergétique et écologique pour le climat* – Energy and Ecological Transition for the Climate Label).

116 *Décret n° 2016-10 du 8 janvier 2016 relatif au label investissement socialement responsable.*

117 The ISR label was extended in July 2020 to also cover managed accounts for institutional investors (ISR Label Guidelines, 23 July 2020).

118 Articles D. 128-1 *et seq.* of the French Environmental Code (*Code de l'environnement*).

119 Source: E. Candus and J.-L. Le Goff, Banque de France Eco Note Pad, § 152, 13 February 2020.

FRANCE

120 As at 31 August 2020. Source: *Association française de la gestion financière* (AFG), https://www.afg.asso.fr/solutions-depargne/presentation-isr/label-isr/.

121 As at October 2020. Source: French Ministry of Ecological and Inclusive Transition, https://www.ecologie.gouv.fr/label-greenfin#e3.

122 Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II).

123 As at 1 May 2020, out of 683 authorised insurance undertakings in France, 455 were Solvency II undertakings (source: ACPR online register of insurance undertakings (*liste des organismes d'assurance actifs au 1er mai 2020*)).

124 As at the end of 2018, the value of French Solvency II insurance undertakings' investment was €2,601bn at market value, representing 35 per cent of the assets managed by insurers in the Eurozone (source: *Banque de France, Bulletin de la Banque de France*, 227/4, Jan.-Feb. 2020).

125 Many policies combine both products, ie policyholders allocate a portion of their premiums to the Insurance Company's *fonds en euros* and another portion to available units.

126 In 2018 and 2019, the proportion of life insurance premiums being invested in unit-linked contracts was approximatively 28 per cent (source: *Fédération française de l'assurance, 2019 Annual Report*, p. 10).

127 Commission Delegated Regulation (EU) 2015/35 of 10 October 2014 supplementing Directive 2009/138/EC of the European Parliament and of the Council on the taking up and pursuit of the business of Insurance and Reinsurance, OJ L 12, 17.1.2015, p. 1–797.

128 EIOPA-BoS-19/241, 30 September 2019.

129 EIOPA-BoS-19/172, 20 April 2019.

130 Article R. 353-1 I Insurance Code.

131 *Ibid*.

132 *Ibid*.

133 Article R. 353-1 I Insurance Code.

134 Articles R. 353-1 III and R. 332-16 Insurance Code.

135 Article 169 PACTE law.

136 See articles L. 225-35 and L. 225-64 Commercial Code, applicable to French companies limited by shares (*sociétés anonymes*).

137 See article L. 225-82-2 I Commercial Code, applicable to French companies limited by shares (*sociétés anonymes*).

138 Article R. 225-56-1 3° Commercial Code, applicable to French companies limited by shares (*sociétés anonymes*).

139 Article R. 225-56-1 6° Commercial Code, applicable to French companies limited by shares (*sociétés anonymes*).

140 FFA is the trade association of French insurance companies (https://www.ffa-assurance.fr).

141 FFA, *Charte de Responsabilité Sociale d'Entreprise*.

142 *Loi 2019-486 du 22 mai 2019 relative à la croissance et la transformation des entreprises*, article 72.

143 Article L. 521-1 I Insurance Code.

144 Articles L. 521-4 I Insurance Code (non-life insurance) and L. 522-5 I Insurance Code (life insurance).

145 Article L. 522-5 II Insurance Code.

146 EIOPA, *Opinion on Sustainability within Solvency II*, EIOPA-BoS-19/241, 30 September 2019, p. 5.

147 This is confirmed by EIOPA's guideline, pursuant to which the '*undertaking should regularly review and monitor the security, quality, liquidity and profitability of the portfolio as a whole by considering at least: [...] (d) the characteristics of the assets including: [...] (iv) sustainability*' (EIOPA, *Guidelines on system of governance*, EIOPA-BoS-14/253, p. 13 *et seq*.).

148 EIOPA, *opinion on sustainability within Solvency II*, EIOPA-BoS-19/241, 30 September 2019, p. 5; *EIOPA, EIOPA's technical advice on the integration of sustainability risks and factors in the delegated acts under Solvency II and IDD*, EIOPA BoS-19/172, 30 April 2019, p. 23 et seq.

149 Articles L. 225-102-4 and L. 225-102-5 Commercial Code. These provisions entered into force in 2017 following the enactment of Law no. 2017-399 of 27 March 2017 on the corporate duty of vigilance for parent and instructing companies (*Loi n° 2017-399 du 27 mars 2017 relative au devoir de vigilance des sociétés mères et des entreprises donneuses d'ordre*).

150 This law covers large companies limited by shares (*sociétés anonymes, sociétés par actions simplifiées* and *sociétés en commandite par actions*) that meet the following criteria: (i) companies headquartered in France that employ at 5,000 employees in France, or at least 10,000 employees worldwide (including through direct and indirect subsidiaries); or foreign companies headquartered outside France, with French subsidiaries, if those subsidiaries employ at least 5,000 employees in France.

151 Article L. 225-102-4 Commercial Code.

152 Article L. 225-102-4 Commercial Code.

153 Articles L. 225-102-4 II and L. 225-102-5 Commercial Code.

154 Article L. 225-102-4 Commercial Code.

155 Article 169 PACTE law.

156 See articles L. 225-35 and L. 225-64 Commercial Code, applicable to French companies limited by shares (*sociétés anonymes*).

157 EIOPA, *Opinion on Sustainability within Solvency II*, EIOPA-BoS-19/241, 30 September 2019, p. 5, 12.

158 EIOPA, *Opinion on Sustainability within Solvency II*, EIOPA-BoS-19/241, 30 September 2019, p. 5, 13.

159 Where they invest directly or through an Investment Manager in shares traded on a regulated market.

160 Article L. 310-1-1-2 II Insurance Code.

161 Article L. 521-4 I Insurance Code.

162 Article L. 522-5 Insurance Code.

163 Article L. 131-1-2 Insurance Code.

164 EIOPA, *Opinion on Sustainability within Solvency II*, EIOPA-BoS-19/241, 30 September 2019, p. 5, 12.

165 Articles L. 310-1-1-3 Insurance Code and L. 533-22-1 FMFC (see section 2.3.15).

166 Article L. 533-22-1 FMFC.

167 Directive (EU) 2017/828 of the European Parliament and of the Council of 17 May 2017 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement, OJ L 132, 20.5.2017, p. 1–25.

168 Article 198 PACTE law.

169 The French Insurance Federation (*Fédération française de l'assurance* – FFA) noted in its second Report on the integration of ESG and climate criteria in insurers' investment strategies (*Baromètre ESG-Climat – Intégration des critères ESG-climat dans les stratégies d'investissement des assureurs, 2e édition*) that, in 2017 and out of the 5 criteria monitored in the study, French insurers' engagement with investee companies and Investment Managers was the one that had progressed more.

170 See section 2.2.27.

171 Articles L. 385-7-1 I Insurance Code and L. 533-22 I FMFC.

FRANCE

172 Article L. 533-22 I FMFC. See section 3.3.1 for details on the required content of the policy.

173 *Ibid.*

174 Article L. 385-7-1 I Insurance Code.

175 Article L. 533-22 II FMFC.

176 Articles L. 385-7-1 II, L. 310-1-1-2 II and R. 310-4 Insurance Code.

177 See section 3.3.2. However, any third-party may bring a claim to the competent French court to have it require the FRPS to comply with its obligations and impose financial penalties pending compliance (articles L. 533-22 III FMFC and L. 385-7-1 II and L. 310-1-1-2 III Insurance Code).

178 *Charte ISR de l'AGIRC-ARRCO*, 26 June 2019.

179 AGIRC-ARRCO's ESG Charter, Annex 1 '*Principles for responsible investing*'.

180 FRR, *Lignes directrices relatives à l'exercice des droits de vote.*

181 FRR Proxy Voting Guidelines, p. 3.

182 FRR Proxy Voting Guidelines, section III, p. 17.

183 Article L. 533-22 FMFC primarily applies to fund management companies (*sociétés de gestion de portefeuille*). Under article L. 533-22-4 FMFC, Investment Managers authorised under MiFID II must comply with article L. 533-22 FMFC when they engage in investment management activities for the account of third parties.

184 Relevant matters also comprise strategy, financial and non-financial performance, risk and capital structure.

185 Article L. 533-22 I FMFC.

186 Article R. 533-16 II FMFC.

187 Articles L. 533-22 I and R. 533-16 I & II FMFC.

188 Article L. 533-22 III FMFC.

189 France Invest is the trade association of French private equity investors (https://www.franceinvest.eu/en/).

190 France Invest, *Charte d'engagements des investisseurs pour la croissance*, see section C.

191 *Position-recommandation AMF-DOC-2020-03 – Informations à fournir par les placements collectifs intégrant des approches extra-financières.*

192 AMF ESG disclosure guidelines, recommendation no. 6, p. 14.

193 Articles L. 310-1-1-2 I Insurance Code and L. 533-22 I FMFC.

194 Article L. 533-22 I FMFC. See section 3.3.1 for details on the required content of the policy.

195 *Ibid.*

196 Article L. 310-1-1-2 I Insurance Code.

197 Article L. 533-22 II FMFC.

198 Articles L. 310-1-1-2 II and R. 310-4 Insurance Code.

199 See section 3.3.2. However, any third-party may bring a claim to the competent French court to have it require the FRPS to comply with its obligations and impose financial penalties pending compliance (articles L. 533-22 III FMFC and L. 310-1-1-2 III Insurance Code).

200 FFA, *Baromètre ESG-Climat – Intégration des critères ESG-climat dans les stratégies d'investissement des assureurs, 3e édition*), see p. 7.

201 See section 2.2.27.

202 Article 321-101 GRAMF.

203 See section 2.2.27.

204 http://www.fondsdereserve.fr/documents/pr-SRI_awarded_mandates_April_27_2006.pdf.

205 *Accord national interprofessionnel du 17 Novembre 2017 instituant le régime AGIRC-ARRCO de retraite complémentaire.*

206 *Règlement financier.*

207 For the periods 2005-2008, 2008-2012, 2013-2017 and 2019-2023.

208 FRR, 2019-2023 Responsible Investment Strategy, '*Introduction – Bilan*', p. 2.

209 Ibid., *'Incarner la gestion responsable'*, p. 3.

210 *Ibid., 'Etendre la dimension responsable des investissements'*, p. 5.

211 Article L. 224-3 FMFC.

212 Under article 2 of law no. 2014-856, social impact companies include, among other types of companies, those companies that 'aim at contributing to sustainable development or energy transition', but only if their activities also have a socially useful impact.

213 *Position AMF-DOC-2007-19 – Critères extra financiers de sélection des actifs et application aux OPCVM se déclarant conformes à la loi islamique.*

214 See section 2.3.21.

215 See sections 2.3.29 *et seq.*

216 Emphasis added.

217 See section 2.3.31.

218 Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU, OJ L 173, 12.6.2014, p. 349–496.

219 Articles L. 533-24 and L. 533-24-1 FMFC. Management companies of OPCVM are not required to observe the MiFID II product governance obligations, unless they offer, recommend or market financial instruments. However, an Investment Manager that collaborates with a management company in establishing a fund may qualify as co-manufacturer of the OPCVM (see ESMA, Guidelines on MiFID II product governance requirements, Final Report, 2 June 2017, ESMA35-43-620, § 60).

220 Article 313-11 GRAMF.

221 Commission Delegated Directive (EU) …/… of XXX amending Delegated Directive (EU) 2017/593 as regards the integration of sustainability factors and preferences into the product governance obligations, Ref. Ares(2020)2955234 (Draft MiFID II ESG Delegated Directive).

222 Articles 313-19 and 313-21 RGAMF.

223 See sections 2.3.29 *et seq.*

224 See section 2.4.4.

225 Directive (EU) 2016/97 of the European Parliament and of the Council of 20 January 2016 on insurance distribution (recast), OJ L 26, 2.2.2016, p. 19-59.

226 Commission Delegated Regulation (EU) 2017/2358 of 21 September 2017 supplementing Directive (EU) 2016/97 of the European Parliament and of the Council with regard to product oversight and governance requirements for insurance undertakings and insurance distributors, OJ L 341, 20.12.2017, p. 1–7.

227 Articles 5(1) and (2) Commission Delegated Regulation (EU) 2017/2358.

228 Article 5 (3) Commission Delegated Regulation (EU) 2017/2358.

229 Article L. 516-1 Insurance Code and Article 7 Commission Delegated Regulation (EU) 2017/2358.

230 EIOPA has taken the view '*that insurance undertakings are not required to take ESG considerations into account when designing and manufacturing insurance products*' (EIOPA, *EIOPA's technical advice on the integration of sustainability risks and factors in the delegated acts under Solvency II and IDD*, EIOPA BoS-19/172, 30 April 2019, p. 14).

231 Article 10 Commission Delegated Regulation (EU) 2017/2358.

232 Article L. 521-1 I Insurance Code.

233 *Ibid.*

234 Article L. 522-5 II Insurance Code.

235 See sections 2.3.29 *et seq.*

236 Article L. 533-11 FMFC.

237 Article L. 533-13 I FMFC.

238 Article L. 533-24-1 FMFC.

239 Except where an Investment Manager acts as investment manager of an OPCVM, in which case it must act '*in the interests of the OPCVM and its investors*' (articles L. 214-9 FMFC and 321-100 GRAMF).

240 ESMA, Guidelines on certain aspects of the MiFID II suitability requirements, 6 November 2018, ESMA35-43-1163; para. 28.

241 http://www.fondsdereserve.fr/documents/pr-SRI_awarded_mandates_April_27_2006.pdf.

242 *Loi n° 2019-486 du 22 mai 2019 relative à la croissance et la transformation des entreprises.*

243 Article 198 PACTE law. The same obligation applies where the life Insurance Company invests through an investment fund. In such a case, the content requirements apply in respect of the subscription agreement that is signed by the Insurance Company.

244 Article R. 310-4 Insurance Code.

245 Under article L. 533-22-4 FMFC, Investment Managers authorised under MiFID II must comply with article L. 533-22 FMFC when they engage in investment management activities for the account of third parties.

246 Article L. 310-1-1-2 I Insurance Code (life Insurance Companies) and Article L. 385-7-1 I Insurance Code (FRPS).

247 Article L. 533-22 II FMFC.

248 Articles L. 385-7-1 II, L. 310-1-1-2 II and R. 310-4 Insurance Code.

249 *Tribunal administratif de Paris*, 3 February 2021, *Association OXFAM France, Association Notre Affaire à Tous, Fondation pour la Nature et l'Homme, Association Greenpeace France*, req. N°1904967, 1904968, 1904972, 1904976/4.

FRANCE

250 The *Conseil d'Etat* is the French highest administrative court.

251 On 10 July 2020, the *Conseil d'Etat* held that the government had not taken the measures requested to reduce air pollution in eight areas in France and imposed a penalty payment of €10m for each semester of delay (CE, Ass., 10 July 2020, *Les Amis de la Terre*, no. 428409). In the so-called 'Grande Synthe' ruling, the *Conseil d'Etat* ruled for the first time on a case relating to compliance with commitments to reduce greenhouse gas emissions (CE, 19 November 2020, *Commune de Grande-Synthe et al.*, no. 427301).

252 Article 121-7 of the French Criminal Code (*Code pénal*).

253 Article L. 110-1 3° Environmental Code.

254 Article 121-2 Criminal Code.

255 See article L. 218-50 Environmental Code.

256 Article 1240 Civil Code: '*Tout fait quelconque de l'homme, qui cause à autrui un dommage, oblige celui par la faute duquel il est arrivé, à le réparer.*' Article 1241 Civil Code further provides that '*One shall be liable not only by reason of one's acts, but also by reason of one's imprudence or negligence.' ('Chacun est responsable du dommage qu'il a causé non seulement par son fait, mais encore par sa négligence ou par son imprudence.').*

257 Civ. 3e, 28 June 2018, no. 17-18.755.

258 '*Chacun a le droit de vivre dans un environnement équilibré et respectueux de la santé.*'

259 '*Toute personne a le devoir de prendre part à la préservation et à l'amélioration de l'environnement.*'

260 '*Toute personne doit, dans les conditions définies par la loi, prévenir les atteintes qu'elle est susceptible de porter à l'environnement ou, à défaut, en limiter les conséquences.*'

261 '*Toute personne doit contribuer à la réparation des dommages qu'elle cause à l'environnement, dans les conditions définies par la loi.*'

262 The QPC is a procedure by which a party to a lawsuit may challenge a law for violating a right or freedom guaranteed by the French constitution.

263 Cons. const. 8 April 2011, no 2011-116 QPC: '*Chacun est tenu à une obligation de vigilance à l'égard des atteintes à l'environnement qui pourraient résulter de son activité.*'

264 *Loi n° 2016-1087 du 8 août 2016 pour la reconquête de la biodiversité, de la nature et des paysages.*

265 Under article 1247 Civil Code, 'environmental loss' means '*a non-negligible* [ie significant] *violation to the elements or functions of ecosystems or to the collective benefits drawn by humans from the environment.*'

266 Emphasis added.

267 *Tribunal administratif de Paris*, 3 February 2021, *Association OXFAM France, Association Notre Affaire à Tous, Fondation pour la Nature et l'Homme, Association Greenpeace France*, req. N°1904967, 1904968, 1904972, 1904976/4.

268 Article L. 225-102-4 Commercial Code.

269 Articles L. 225-102-4 II and L. 225-102-5 Commercial Code.

270 See article L. 225-102-4 Commercial Code.

271 See section 7.2.4.

JAPAN

1. INTRODUCTION

1.1 For the purposes of this annex, we have considered the laws of Japan as at 31 January 2021. Sections 2 to 4 address the ability of Asset Owners to Invest for Sustainability Impact where the relevant portfolio does not have an express Sustainability Impact objective.[1]

1.2 As discussed in the main body of the report, the expression 'Investing for Sustainability Impact' is not a precisely defined legal expression, and it is important to emphasise that the law of Japan does not reference it in that way. Rather, the expression is used here as a type of 'conceptual net' to catch, in broad terms, any activities of an investor of the sort described in the Introduction of the main report (paragraph 1.3.5).

1.3 ***Mandatary's duty***

1.3.1 An Asset Owner is entrusted with the assets of the Beneficiaries and has the power to manage assets on behalf of the relevant Beneficiaries pursuant to the relevant laws, the documents establishing the relevant fund (in the case of pension funds and mutual funds), or insurance policies (in the case of insurance undertakings). The Asset Owner would either invest the assets themselves or use the services of an Investment Manager appointed by the Asset Owner to manage the portfolio. The Investment Manager has the power to manage the portfolio on behalf of the Asset Owner pursuant to the relevant investment management agreement.

1.3.2 Under Japanese law there is a concept of "mandatary's duty" (*jutakusha sekinin*) similar to the concept of fiduciary duty in common law countries. When a client entrusts the management of funds to an investment manager, the investment manager owes the mandatary's duty to the client. An Asset Owner owes the mandatary's duty to the relevant Beneficiaries. An Investment Manager owes the mandatary's duty to the relevant Asset Owner as well as the underlying Beneficiaries in certain circumstances: the Financial Instruments and Exchange Act (the ***FIEA***) provides an investment manager's duty of loyalty and duty of care owed to "right holders"[2] (i.e., Beneficiaries) and the Defined Benefit Corporate Pension Law (the ***DB Law***)[3] and the Defined Contribution Pension Law (the ***DC Law***)[4] provide an investment manager's duty of loyalty owed to pension beneficiaries. The provisions of these laws are interpreted as codifying the general position of Japanese law that an investment manager could owe the mandatary's duty to Beneficiaries.

1.3.3 The core of the mandatary's duty consists of the duty of care (*zenkan chui gimu*) and the duty of loyalty (*chujitsu gimu*). The most fundamental provision is Article 644 of the Civil Code, which provides that a mandatary shall assume a duty to administer the mandated business with the care of a good manager in compliance with the main purpose of the mandate. Article 355 of the Companies Act, which applies to a Relevant Investor which is a stock company formed pursuant to the Companies Act (*kabushiki kaisha*, the most common type of companies in Japan), provides that directors must perform their duties for a stock company in a loyal manner. With respect to the relationship between the duty of care and the duty of loyalty, the Supreme Court held on 24 June 1970[5] that the duty of loyalty is not separate from the duty of care but rather it represents one element of the duty of care as formulated by the courts. Since Article 644 of the Civil Code applies to all types of Relevant Investors, even though some of them are not stock companies and, therefore, Article 355 of the Companies Act does not apply, it does not make a practical difference to the mandatary's duty owed by the Relevant Investors.

JAPAN

1.3.4 There is no published court case where the court clarified what exactly the mandatary's duty means in the context of investment management but, given that the main purpose of the mandate is to gain financial return through investments, a Relevant Investor (i.e., an Asset Owner or an Investment Manager) owes to the relevant client (i.e., Beneficiaries or an Asset Owner) the duty to seek to achieve a positive investment return during the term of the mandate using the care and skill expected for the same profession. We also note that, given that investment inherently involves risks and the investment manager's duty does not necessarily mean it is required to "maximize" investment return, the investment manager has a certain amount of discretion on how to manage investments. The Tokyo District Court[6] held that an investment manager is not held liable for breaching the duty of care unless its investment decision goes beyond the limit of discretion and, since the investment decision is highly professional, it will not be regarded as beyond the limit of discretion unless it is considered to be apparently unreasonable given the relevant factual situations, applicable laws and rules, and the terms of the relevant investment agreement.

1.3.5 Applying the rule above to Investing for Sustainability Impact, a Relevant Investor is required to consider environmental and social factors in its investment decisions where they are financially material to the performance of the investment, balancing returns against risks. On the other hand, while a Relevant Investor is generally prohibited from pursuing environmental and social factors disregarding investment returns, it may pursue environmental and social factors if it reasonably believes it will lead to achieve higher investment return in the middle to long term by maintaining or enhancing the corporate value of investee companies, even if it compromises investment return in the short term. If the relevant documents or insurance policy specifically include an "Investment for Sustainability" requirement, it would change the "main purpose of the mandate" and allow the Asset Owner and Investment Manager to put greater emphasis on environmental and social factors even if it is expected to reduce investment returns (although there could be a limit on how far investment return can be reduced depending on the terms of the relevant document or insurance policy). Please refer to Section 5 for further discussion.

JAPAN

2. ASSET OWNERS' USE OF POWERS OF INVESTMENT AND DIVESTMENT TO INVEST FOR SUSTAINABILITY IMPACT

2.1 The following section considers the extent to which, and in what circumstances, each type of Asset Owner is (a) required or (b) permitted or able to use its powers of investment and divestment to Invest for Sustainability Impact.

2.2 **Pension funds**

Types of pension fund covered

2.2.1 The Japanese pension system is three-tiered. The first two tiers are public pensions consisting of the (a) National Pension (referred to as the "basic pension" and joined by Japanese nationals generally) and (b) Welfare Pension Insurance. Employees of private companies, civil servants, and teachers and employees of private schools aged less than 70 are eligible to join the Welfare Pension Insurance[7] and it is paid in addition to the National Pension. The funds for the National Pension and a part of the Welfare Pension Insurance are managed by the Government Pension Investment Fund (***GPIF***)[8] and GPIF is the largest Asset Owner in Japan. Benefits under the National Pension and Welfare Pension Insurance are guaranteed by statute.

2.2.2 The third tier consists of private pensions paid in addition to the public pensions above. Private pensions are categorised into defined-benefit plans (***DB Plans***) and defined-contribution plans (***DC Plans***).

2.2.3 A DB Plan is a pension plan for which pension payments are pre-determined based on certain factors such as the time a participant enrolled in the plan. DB Plans consist of contract-type plans and fund-type plans. Contract-type plans are operated by the employers and fund-type plans are operated by corporate pension funds (***DB Plan funds***), which have a separate legal personality from the employer.

2.2.4 A DC Plan is a pension plan where pension payments are determined based on the funds contributed and the return from investment of the contributions. DC Plans consist of corporate plans and an individual plan called iDeCo. The corporate plans are operated by employers which have received approval by the Ministry Health, Labour and Welfare (the ***MHLW***) of corporate plan terms and iDeCo is operated by the National Pension Fund Association (the ***NPFA***).

2.2.5 The key entities are:

- ***Asset Owner***: With respect to public pensions, for the National Pension and special accounting reserve portion of the Welfare Pension Insurance, GPIF; for the management institution reserve portion of the Welfare Pension Insurance, the relevant mutual aid association; with respect to private pensions, an employer for a contract-type DB Plan, a DB Plan fund for a fund-type DB Plan, and a participant for a DC Plan.
- ***Beneficiaries***: Participants and ex-participants

(a) ***Investment decision maker***: With respect to public pensions, for the National Pension and the special accounting reserve portion of the Welfare Pension Insurance, GPIF, or Investment Manager(s) appointed by GPIF; for the management institution reserve portion of the Welfare Pension Insurance, the relevant mutual aid association, or Investment Manager(s) appointed by the mutual aid association; for a DB Plan, a DB Plan fund or Investment Manager(s) appointed by an employer or a DB Plan fund; for a corporate DC Plan, a participant and a DC Plan investment adviser; for iDeCo, a participant.

GPIF, a mutual aid association, an employer or a DB Plan fund sets investment strategy but delegates day-to-day investment management to an Investment Manager except for certain classes of assets (e.g., government bonds and passive bond funds).

Overview of investment duties and powers

GPIF (National Pension and Welfare Pension Insurance)

2.2.6 GPIF's investment duties are set out by:

(a) relevant laws and regulations, in particular the Government Pension Investment Fund Law, which provides, among other things:

(i) directors and employees of GPIF shall perform their duties carefully and with utmost attention and utmost effort[9];

(ii) in performing their duties in relation to asset management and investment, directors of GPIF shall pay a "prudent professional's care" (defined as care equivalent to the care that a person who manages and invests assets for others pursuant to a mandate and makes careful decisions based on professional skill recognised generally in relation to such business would take under similar circumstances)[10]; and

(iii) pension reserve must be invested into non-equity type securities, deposits, trusts, life insurance products, loans, bond options, forward foreign exchange trading, currency options, and derivatives, and be managed safely and efficiently[11];

> ANNEXES

> Japan

JAPAN

(b) the Basic Guideline to Have the Management and Investment of Reserve be Made Safely and Effectively from the Long-Term Perspective issued by the Ministry of Internal Affairs and Communications, Ministry of Finance, Ministry of Education, Culture, Sports, Science and Technology and MHLW (the ***Basic Guideline***), which provides, among other things:

(i) investment of pension reserves must be made for the benefit of participants and safely and effectively from a long-term perspective to ensure the Welfare Pension Insurance's stability into the future[12]; and

(ii) based on the understanding that sustainable growth of investee companies and the market is necessary to increase long-term gain by investing pension reserves, a management institution shall consider investment based on ESG (environmental, social, and governance matters)[13];

(c) the mid-term goals issued by the MHLW (the ***Mid-Term Goals***), which provide, among other things:

(i) GPIF shall not manage pension reserves to achieve policies or goals disregarding the benefit to participants[14];

(ii) GPIF shall aim to achieve a gross investment return of 1.7% per annum at the minimum risk in the long run[15];

(iii) to gain long term benefit for the interest of participants, GPIF shall increase its stewardship activities bearing in mind the effect to the market[16]; and

(iv) based on the understanding that sustainable growth of investee companies and the market is necessary to increase long-term gain by investing pension reserves, GPIF shall enlarge ESG investment and review if the ESG investment is in line with the basic policy of investment of GPIF from time to time[17];

(d) the mid-term plan, annual plan, management and investment plan, and business plan prepared by GPIF, which reflect the Mid-Term Goals; and

(e) the mandatary's duty under the Civil Code[18].

Mutual aid associations (Welfare Pension Insurance)

2.2.7 There are many Welfare Pension Insurance schemes for different groups of employees. As an illustration, we describe below the Federation of National Public Service Personnel Mutual Aid Associations (***FNPSPMAA***), which manages Welfare Pension Insurance for national government employees.

2.2.8 FNPSPMAA's investment duties are set out by:

(a) relevant laws and regulations, in particular the Welfare Pension Insurance Law and Federation of National Service Personnel Mutual Aid Law, which provide, among other things:

(i) FNPSPMAA shall particularly note that pension reserves are a part of the pension premiums paid by the Welfare Pension Insurance participants and an important source for future pension payments: FNPSPMAA shall manage pension reserves from a long-term perspective and safely and effectively for the sole benefit of the participants so that the Welfare Pension Insurance business can be safely operated into the future[19];

(ii) FNPSPMAA shall manage and invest retirement benefit reserves in accordance with the Retirement Benefit Reserve Management and Investment Policy[20]; and

(iii) pension reserves shall be invested into certain trades in securities, deposits, trusts, life insurance products, loans, bond options, forward foreign exchange trading, currency options, and derivatives[21];

(b) the Basic Guideline, which provides, among other things:

(i) investment of pension reserves must be made for the benefit of participants and safely and effectively from a long-term perspective to ensure the Welfare Pension Insurance's stability into the future[22]; and

(ii) based on the understanding that sustainable growth of investee companies and the market is necessary to increase long-term gain by investing pension reserve, a management institution shall consider investment based on ESG[23];

(c) the Welfare Pension Insurance Benefit Reserve Management and Investment Policy, which provides, among other things:

(i) FNPSPMAA shall particularly note that pension reserves are a part of the pension premiums paid by the Welfare Pension Insurance participants and a vital source for future pension payments: FNPSPMAA shall manage pension reserves from a long-term perspective and safely and effectively for the benefit of the participants so that the Welfare Pension Insurance business can be safely operated into the future[24];

JAPAN

(ii) FNPSPMAA shall aim to achieve a target investment return at the minimum risk in the long run[25];

(iii) for the sake of the safe and effective management of pension reserves, FNPSPMAA shall invest the pension reserves mainly to bonds by itself as well as delegate investment to an investment manager[26];

(iv) in investing pension reserves to achieve financial return, FNPSPMAA shall take into account and analyse ESG, which are non-financial elements, in addition to financial elements and make ESG investments as necessary[27]; and

(v) FNPSPMAA shall secure function to dutifully fulfil its mandatary's duty (to comply with the duty of loyalty and the duty of care as a good manager) and obtain human resources necessary to perform its business appropriately[28]; and

(d) the mandatary's duty under the Civil Code[29].

Employer / DB Plan fund (DB Plan)

2.2.9 Investment duties of an employer / DB Plan fund are set out by:

(a) relevant laws and regulations, in particular the DB Law, which provides, among other things:

(i) the employer, the directors of the DB Plan fund, the administrators of the DB Plan fund, and any Investment Manager who contracts with the DB Plan fund must perform their duties in good faith on behalf of (in the case of the employer and the administrators of the DB Plan fund) the beneficiaries and (in the case of the directors of the DB Plan fund and the Investment Manager) the DB Plan fund[30]; and

(ii) the employer and the DB Plan fund must invest pension reserves safely and effectively[31];

(b) a plan policy, basic investment plan, and investment plan, which vary by DB Plan, but provide, for example;

(i) investment policy to achieve safe and effective management of pension reserves; and

(ii) asset diversification requirements;

(c) the Guideline on Investment Management Entities' Role and Responsibility in Relation to Defined Benefit Corporate Pensions issued by the MHLW, which provides, among other things, that an employer / DB Plan fund must perform its duties loyally to participants with the care of a good manager and in compliance with the relevant law and the MHLW's orders and rules[32]; and

(d) the mandatary's duty under the Civil Code[33].

Legal requirements to use investment powers to Invest for Sustainability Impact

GPIF (National Pension and Welfare Pension Insurance)

2.2.10 Currently there are no legal requirements directly or indirectly requiring GPIF to use investment powers to Invest for Sustainability Impact except where the GPIF has decided that climate change or any other sustainability factor is a material risk to financial return of its portfolio (please see 2.2.15 (c) below).

2.2.11 ***Mutual aid association (Welfare Pension Insurance) and employer / DB Plan fund (DB Plan)***

2.2.12 Currently there are no legal requirements directly or indirectly requiring mutual aid associations or employer / DB Plan funds to use investment powers to Invest for Sustainability Impact except where the mutual aid association or employer / DB Plan fund has decided that climate change or any other sustainability factor is a material risk to financial return of its portfolio (please see 2.2.16 (d) below)..

2.2.13 ***Legal freedom to use investment powers to Invest for Sustainability Impact***

2.2.14 ***GPIF (National Pension and Welfare Pension Insurance)***

2.2.15 The duties of GPIF are flexible enough to allow GPIF to use investment powers to Invest for Sustainability Impact in certain circumstances (discussed below).

(a) *Good for financial return*. GPIF, as an Asset Owner, needs to manage pension reserves so that guaranteed pension benefits can be paid in future. GPIF's main mandatary's duty owed to beneficiaries with respect to investment is to secure the best realistic return over the long term given the need to control for risks. Further, the Mid-Term Goals prohibit GPIF from managing pension reserves to achieve policies or goals disregarding the benefit to participants[34] (which is understood to mean financial return). In relation to ESG investments, the Mid-Term Goals state, "based on the understanding that sustainable growth of investee companies and the market is necessary to increase long-term gain by investing pension reserves, GPIF shall enlarge ESG investment and review if the ESG investment is in line with the basic policy of investment of GPIF from time to time."[35] In its mid-term plan, GPIF states that based on the understanding that sustainable growth of investee companies and the market is necessary to increase long term financial return of portfolio, GPIF shall consider ESG factors in addition to financial factors in investment and review its effect to

> ANNEXES

> Japan

JAPAN

achieve long term financial return for the beneficiaries interest[36]. Given that, GPIF can Invest for Sustainability Impact only if it leads to financial return (which is not necessarily short-term), and GPIF can Invest for Sustainability Impact where GPIF reasonably believes it will lead to achieving a higher investment return in the middle to long term by maintaining or enhancing the corporate value of investee companies that are held in the portfolio, even if it compromises investment return in the short term. Hence, instrumental IFSI (pursuing sustainability objectives for the purpose of achieving a financial return) is permissible as long as GPIF reasonably believes that a it will lead to a higher investment return in the mid- to long-term.

(b) *"Tiebreak" scenario*. The discussion in (a) above does not necessarily mean that there is no scope to pursue Sustainability Impact separate from investment return to the extent that doing so does not jeopardise investment return and Sustainability Impact can be considered in a "tiebreak" scenario (where investment return would be the same whichever option is pursued), although such situations may be rare.

(c) *Material financial risk*. once the GPIF has decided that climate change or any other sustainability factor is a material risk to financial return of its portfolio, it will then have a duty to decide what, if any, action to take and to act accordingly. GPIF could conclude that instrumental IFSI is the appropriate response if it reasonably determines that it can provide an effective way of addressing the risk

Mutual aid association (Welfare Pension Insurance) and employer / DB Plan fund (DB Plan)

2.2.16 As with GPIF, the duties of mutual aid associations and employer and DB Plan funds are flexible enough to allow them to use investment powers for Investment for Sustainability Impact in certain circumstances (discussed below).

(a) *Good for financial return*. The discussion in 2.2.11(a) equally applies to mutual aid associations and employer and DB Plan funds. This is the flexibility to consider financially material ESG factors relevant to the risk-adjusted financial return of the portfolio over the relevant timeframe.

(b) *"Tiebreak" scenario*. The discussion in 2.2.11(b) equally applies to mutual aid associations and employer and DB Plan funds.

(c) *Beneficiaries view*. Given that mutual aid associations and employer and DB Plan funds owe the mandatary's duty to beneficiaries, the beneficiaries view can shape their mandatary's duty. Therefore, theoretically, if the beneficiaries wish the mutual aid association, or employer or DB Plan fund to Invest for Sustainability Impact, it is possible to argue that the mutual aid association, or employer or DB Plan fund can Invest for Sustainability Impact without the need to consider its financial return. However, there are many practical issues when applying this to reality. Since there is no mechanism to aggregate the beneficiaries' opinion, the view of the beneficiaries' needs will probably need to be shared unanimously, which will be quite rare. Further, to avoid being accused of breaching the mandatary's duty, the mutual aid association, or employer or DB Plan fund would want the beneficiaries view to be clear and specific, which is very difficult especially given that the mutual aid association, or employer and DB Plan is not legally required to confirm the beneficiaries' view. Taking these together it would be difficult in practice for the mutual aid association, or employer and DB Plan fund to rely on the beneficiaries' view to Invest for Sustainability Impact.

(d) Material financial risk. Once mutual aid association, employer or DB Plan fund has decided that climate change or any other sustainability factor is a material risk to financial return of its portfolio, it will then have a duty to decide what, if any, action to take and to act accordingly. Mutual aid association, employee and DB Plan fund could conclude that instrumental IFSI is the appropriate response if it reasonably determines that it can provide an effective way of addressing the risk, i.e leading to achieve a higher investment return in the middle to long term. Also, mutual aid association, employer and DB Plan fund may also conclude that it should pursue ultimate ends IFSI to reflect beneficiaries view, while, as stated above, it is only a theoretical possibility.

2.3 Mutual funds

Types of mutual fund covered

2.3.1 Among various types of collective investment schemes sold in Japan, the most common forms are investment trusts. An investment trust is a special type of trust set up pursuant to the Law concerning Investment Trusts and Investment Corporations (the ***LITIC***) and both, publicly offered and privately-offered, investment trusts exist. The Financial Services Agency (the ***FSA***) is the regulator. A typical investment trust works as follows. An investment management

JAPAN

company sets up a trust as a settlor (an Investment Trust Manager, an ***ITM***) with a trust bank as a trustee and solicits investors to buy units. Investors buy units in the trust and the trustee invests the trust assets in securities and other financial assets in accordance with the instructions of the ITM. The investors share profits and loss from the investment pro rata to the number of units they hold. There is a trade association called The Investment Trust Association, Japan but it has not adopted any guideline or policy relating to Investing for Sustainability Impact.

2.3.2 There are two types of investment funds:

(a) an investment fund where an ITM as a settlor has the investment power[37] (a ***Settlor Managed Fund***); and

(b) an investment fund where a trustee has the investment power[38] (a ***Trustee Managed Fund***)

but since the vast majority of publicly-offered investment trusts are Settlor Managed Funds (as of 31 January 2021, all 5,913 publicly-offered investment trusts were Settlor Managed Funds), we focus on a Settlor Managed Fund below.

2.3.3 The key entities are:

- **Asset Owner:** A trustee but, since an ITM is responsible for day-to-day management of investment and making investment decisions, we analyse below the investment duties and powers of an ITM unless otherwise specified.
- **Beneficiaries:** Current unitholders
- **Investment decision-maker:** An ITM or delegated Investment Manager.

Overview of investment duties and powers

2.3.4 An ITM's investment duties and powers are set out by:

(a) relevant laws and regulations, in particular the LITIC and the FIEA;

the LITIC provides, among other things:

(i) prohibition on acquiring more than 50% of the voting rights of any one company[39];

(ii) disclosure of potential conflicts of interests to unitholders[40]; and

(iii) periodic disclosure of the results of investments to unitholders[41].

the FIEA provides, among other things:

(i) duty of loyalty and duty of care owed to unitholders[42]; and

(ii) prohibition on various activities including self-trading, trades between the assets it manages, loss compensation, unjustifiable trade aimed at benefits for itself or a third party, and trade on abnormal terms detrimental to beneficiaries[43];

(b) the investment fund's investment trust agreement, which provides among other things, the category of assets in which to invest and the investment policy, which is determined by the ITM and filed with the FSA; and

(c) the mandatary's duty under the Civil Code[44].

Legal requirements to use investment powers to Invest for Sustainability Impact

2.3.5 Although there are situations (discussed below) where an ITM is potentially required to use investment powers to Invest for Sustainability Impact, we are of the view that the current law does not generally require an ITM to use investment powers to Invest for Sustainability Impact (but please see 2.3.5 (c) below).

(a) *Material financial harm*. An ITM needs to manage an investment trust in accordance with the investment policy set out in the investment trust agreement and disclosed to unitholders. Its main mandatary's duty with respect to investment owed to the unitholders is to achieve the best possible investment return under the investment policy. As set out in 1.3.5, the ITM is required to consider environmental and social factors in its investment decisions where they are financially material to the performance of the investment, balancing returns against risks. However, the situations in which this comes into play will be limited.

(b) *Systemic risk*. When there is social or environmental systemic risk which does not have a material financial effect over the relevant investment time horizon of the trust but one could materialise in future and cause a material adverse effect on the investment trust assets, the ITM could be required to look at such risk depending on the end date of the investment trust. However, what the ITM can do alone will be not enough to address such systemic risk and cooperation with other investors will realistically be required. Since there is no legal requirement for the ITM to cooperate with other investors, in our view, the ITM is not required to Invest for Sustainability Impact to prevent systemic risk which is not yet financially material to the investment trust assets.

(c) *Material financial risk*. However, if an ITM has decided that climate change or any other sustainability factor is a material risk to financial return of its portfolio, it

JAPAN

will then have a duty to decide what, if any, action to take and to act accordingly. An ITM could conclude that instrumental IFSI is the appropriate response if it reasonably determines that it can provide an effective way of addressing the risk, i.e leading to achieve a higher investment return in the middle to long term.

Legal freedom to use investment powers to Invest for Sustainability Impact

2.3.6 The duties of an ITM are flexible enough to allow the ITM to use investment powers to Invest for Sustainability Impact in certain circumstances (discussed below).

(a) *Good for financial return*. As set out in 2.3.5(a) above, an ITM's main mandatary's duty with respect to investment owed to the unitholders is to achieve the best possible investment return under the investment policy. The discussion set out in 2.2.12(a) will equally apply to an ITM: unless inconsistent with the investment policy. The ITM can Invest for Sustainability Impact where the ITM reasonably believes it will lead to achieving a higher investment return in the middle to long term (but during the life of the investment trust) by maintaining or enhancing the corporate value of investee companies that are held in the portfolio, even if it compromises investment return in the short term. This is the flexibility to consider financially material ESG factors relevant to the risk-adjusted financial return of the portfolio over the relevant timeframe. Please refer to section 9 for further discussion.

(b) *"Tiebreak" scenario*. The discussion in 2.2.12(b) equally applies to an ITM.

(c) *On amending investment trust terms*. An existing investment trust may amend its investment objectives or policy as set out in its investment trust terms (toushi shintaku yakkan) to allow for ultimate ends IFSI. A change of investment objectives or policy in the investment trust terms to permit ultimate ends IFSI, even if an existing financial objective retains its primacy, will amount to a "material" change to the investment trust terms requiring approval by unitholders with a three quarters majority.

2.3.7 Other than in the cases mentioned above, the following requirements cause issues for the IMT wishing to Invest for Sustainability Impact.

(a) *Disclosed investment policy*. The investment policy of the investment trust is disclosed to unitholders through the investment trust agreement and prospectus. Investment activity must be conducted in compliance with the disclosed investment policy. Currently an ITM is not required to disclose whether or not an investment trust's investment policy includes Investment for Sustainability Impact. The ITM could hesitate to Invest for Sustainability Impact where the stated investment policy of the trust does not include Investing for Sustainability Impact due to potential liability to unitholders if investment activity is not conducted in accordance with the disclosed policy.

(b) *Valuation*. The investment trust assets need to be valued periodically based on a valuation method set out in the investment trust agreement and disclosed to unitholders. Investment for Sustainability Impact is inherently difficult to evaluate and poses challenges for valuation.

(c) *Expertise*. The ITM may not be confident that it has sufficient expertise to engage in Investment for Sustainability Impact.

(d) *Undue cost*. While there is no explicit requirement on cost, an ITM may not incur undue costs from the view point of its mandatary's duty. When it is not disclosed to unitholders that investment trust assets will be Invested for Sustainability Impact, associated costs may be regarded as undue costs.

2.4 Insurance undertakings

Types of insurance undertaking covered

2.4.1 A life insurance company is licensed to write life insurance where the insurance company undertakes to make a lump-sum or fixed regular payment on survival or death of a person in exchange for receiving insurance premiums. Contract-based pension policies provided by insurance companies are included within the definition of life insurance. The amount of insurance payments is either fixed or variable and fixed-type life insurance products are common in Japan. Variable-type life insurance products include an investment-result-linked insurance (e.g., certain types of variable annuities, an ***IRLI***) where the amount of insurance payments changes depending on the results of investment to a "specified account" (mainly an investment trust) which a policyholder chooses from the selection of funds provided by the insurance company.

2.4.2 A general insurance company (*songai hoken kaisha* in Japanese, which is literally translated to a "damage insurance company") is licensed to write non-life insurance where the insurance company undertakes to cover damage caused by an accident such as fire insurance, car insurance, and liability insurance. The general insurance company makes insurance payments in an amount

JAPAN

which covers the damage (subject to a pre-agreed cap) when a valid claim is made. Investment risk does not lie with policyholders so long as the insurance company is solvent.

2.4.3 We have excluded from the analysis below: (a) mutual and (b) small short-period insurers, although the analysis may be still relevant to these types of insurers.

2.4.4 The key entities are:

- **Asset Owner:** Insurer.
- **Beneficiaries:** Policyholders. As noted at ([X] front-end), for the purpose of this report we are treating shareholders of an insurer as "Beneficiaries" since their interests are affected by investments made by the insurer.
- **Investment decision maker:** Insurer or an Investment Manager appointed by the insurer.

Overview of investment duties and powers

2.4.5 An insurance undertaking's investment duties and powers are set out by:

(a) relevant laws and regulations, in particular the Insurance Business Act (the ***IBA***);

The IBA provides:

(i) that investment of assets such as money received as insurance premiums as the core business of an insurance company be integrated with underwriting insurance undertaking[45];

(ii) limits on types of assets in which to invest and exposure to a single entity[46];

(iii) policy reserve requirements[47]; and

(iv) solvency margin[48];

(b) for "Specified Insurance" (which is defined as insurance with a risk of loss due to the movement of interest rates, foreign exchange rates, market price or other indices) such as IRLIs, disclosure requirements under the IBA[49] and FIEA[50] including, among other things, the requirement to explain investment policy and the results of the investment;

(c) FSA's Comprehensive Supervision Guideline for Insurance Companies and Inspection Manual for Insurance Companies, which require appropriate monitoring and management of investment risk;

(d) the duty of care and the duty of loyalty a director of a stock company (most insurance companies are stock companies) owed to the company under the Companies Act[51], which generally means that a director should act to increase shareholders' interest; and

(e) for IRLIs, the mandatary's duty under the Civil Code[52].

General insurance: Legal requirements to use investment powers to Invest for Sustainability Impact

2.4.6 Although there are situations (discussed below) where a general insurer is potentially required to use investment powers to Invest for Sustainability Impact, we are of the view that the current law does not generally require a general insurer to use investment powers to Invest for Sustainability Impact.

(a) *Systemic risk*. A director's mandatary's duty requires him/her to act to increase shareholders' interest, which may require him/her to use investment power to prevent systemic sustainability risk which could materialise in future and cause a material adverse effect on the company. However, a director has broad discretion in deciding whether any action is for the interest of the company, which would allow the director to take a range of actions for the interest of the company in light of systemic sustainability risks, which may or may not include Investing for Sustainability Impact.

(b) Once the directors of a general insurer have decided that climate change or any other sustainability factor is a material risk to financial return of its portfolio, the directors will then have a duty to decide what, if any, action to take and act accordingly. Options can include instrumental IFSI where it could provide an effective way of addressing the risk. A general insurer may also pursue ultimate ends IFSI within the limits discussed in 2.4.8 and 2.4.9 below.

General insurance: Legal freedom to use investment powers to Invest for Sustainability Impact

2.4.7 There is flexibility for a general insurer to use investment powers to Invest for Sustainability Impact to some extent.

2.4.8 Vis-à-vis policyholders, a general insurer is only required to pay valid claims and the results of investment by the general insurer do not directly link to payment to policyholders. Given that, we consider that the general insurer is free to exercise investment power so long as it keeps sufficient funds to pay valid claims, although there are some regulatory restrictions on investment (such as regulatory capital requirement and portfolio diversification requirement), which would limit Investing for Sustainability Impact in some way. Unlike a life insurer selling Specified Insurance, a general insurer is not restricted by a particular investment policy.

2.4.9 However, the duty of a general insurer's director owed to the company also needs to be considered especially when Investing for Sustainability Impact is detrimental to

> ANNEXES

> Japan

JAPAN

the shareholders' interest at least in the short term. As stated in 2.4.5, a director is required to act to promote the interests of shareholders but such interests do not necessarily need to be realized in the short term and long-term interests can be pursued. Also, while a company is an entity for profit, not charity, case law[53] allows a director to make donations which answer to the expectation of the society and are in an amount appropriate for the size and financial condition of the company and the recipient. Given all these factors, we are of the view that a director may use investment power to Invest for Sustainability Impact (ultimate-ends IFSI) which could be detrimental to the interest of shareholders if such investment is expected by the society (which is increasingly the case given the spread of support for decisions to Invest for Sustainability Impact in Japan) and any financial detriment to shareholders is appropriate in size. Investing for Sustainability Impact which is not expected to be detrimental to the financial interests of shareholders is also permissible.

Life insurance: Legal requirements to use investment powers to Invest for Sustainability Impact

2.4.10 Discussion in 2.4.6 above for general insurers will equally apply to life insurers. Once the directors of a life insurer have decided that climate change or any other sustainability factor is a material risk to financial return of its portfolio, they will then have a duty to decide what, if any, action to take and act accordingly. Options can include instrumental IFSI where it can provide an effective way of addressing the risk.

Life insurance: Legal freedom to use investment powers to Invest for Sustainability Impact

Investments for general accounts

2.4.11 Except for investments made with respect to insurance where the insurance payment changes depending on the result of investment, such as IRLIs (regarding which we discuss in 2.4.12 below), discussion in 2.4.7 through 2.4.9 above for general insurers will equally apply to life insurers.

Investments for special accounts

2.4.12 A life insurer is required to segregate assets invested for insurance products where the insurance payment changes depending on the results of investment in a special account[54] (***Special Account Insurance***). For Special Account Insurance, investment made by a life insurer directly impacts the payment made to a policyholder. Also, a life insurer is required to disclose investment policy for Special Account Insurance in disclosure documents delivered to policyholders[55]. Given that, a life insurer's main mandatary's duty with respect to investment owed to holders of Special Account Insurance is to achieve the best possible investment return based on the disclosed investment policy. The discussion set out in 2.3.6 will equally apply to a life insurer with respect to investments made for Special Account Insurance: the life insurer can Invest for Sustainability Impact where the life insurer reasonably believes investment returns: (a) will not be jeopardized (a "tie-break" situation); or (b) will be enhanced over the middle to long term (but during the life of the policy), even if it compromises investment return in the short term.[56]

JAPAN

3. ASSET OWNERS' USE OF THEIR POSITION TO ENGAGE IN STEWARDSHIP ACTIVITIES TO SECURE SUSTAINABILITY IMPACT

3.1 The following section considers the extent to which, and on what basis, each type of Asset Owner is (a) required or (b) permitted or able to use its position to influence enterprises in which it invests by engaging in stewardship activities designed to achieve positive sustainability outcomes and minimise negative sustainability outcomes.

General

3.1.1 In general, an Asset Owner's investment duties and powers regarding stewardship activities are determined by the same considerations set out at in the "*Overview of investment duties and powers*" in section 2 for each Asset Owner, plus any additional rules specific to stewardship activities. In many cases there will be more flexibility for an Asset Owner to secure sustainability impact through stewardship activities than through investment or divestment because engagement activities are much less concerned with the composition of an investment portfolio, and more with how an investor uses its position as an investor.

3.1.2 However, where the engagement activities of a single Asset Owner on its own is unlikely to result in any material change in the activities of the relevant enterprise (with positive Sustainability Impact or otherwise), it may be challenging for the Asset Owner to demonstrate that the costs involved in addressing such Sustainability Impact issue are justifiable since the Asset Owner is prohibited from incurring unjustifiable costs due to the mandatary's duty owed to the Beneficiaries. This issue can be mitigated if the Asset Owner collaborates with other investors. While, in our view, the Asset Owner may not legally obliged only in specific circumstances to collaborate with other investors in stewardship activities 9see instrumental IFSI above), the Asset Owner is in any case permitted to do so given its costs to benefits ratio.

3.1.3 Japanese regulators appear to consider some degree of collaboration between investors to be possible and desirable, particularly in relation to stewardship activities. For example:

(a) the Stewardship Code, to which many Relevant Investors are signatories, states that "when an institutional investor engages an investee company, it may do so alone but if necessary, it could be beneficial to engage in collaboration with other institutional investors (collective engagement)"[57]; and

(b) the FSA published its view that normal stewardship activities which do not entail agreement on the exercise of shareholders' rights with other investors will not be regarded as collaborating if investors are acting in concert in the context of the large shareholding disclosure rule and TOB[58].

3.1.4 However, there are several issues which may cause a Relevant Investor to be cautious when collaborating with other investors (discussed below). We are of the view that none of them would completely prohibit collaboration, but they could restrict the extent to which a Relevant Investor may collaborate with other investors.

(a) *Competition law*. If a collaboration involves the exchange of information or the coordination of commercial activities that is anti-competitive, it may breach competition law[59], although that is highly unlikely to happen in the context of collective engagement.

(b) *Market abuse*. For example, an investor's intention in relation to listed shares could be deemed price-sensitive information. If a Relevant Investor knows such intention through collective engagement and disseminates such information or trades shares on such information, the Relevant Investor could be regarded as breaching the market-abuse rule, punishable by civil or criminal sanction[60].

(c) *Disclosure rule*. If a Relevant Investor is deemed as acting in concert with other investors through collective engagement, their shareholding will be aggregated and may trigger the filing of a large shareholding report[61].

(d) *TOB*. If a Relevant Investor is deemed as acting in concert with other investors through collective engagement, it may trigger a mandatory takeover offer or infringe restrictions in place during certain periods[62].

(e) *Industry-specific change in control rules*. For example, if a Relevant Investor is acting in concert with other investor through collective engagement with an FSA-regulated company, it may trigger a requirement for regulatory approval or filing[63].

> ANNEXES

> Japan

JAPAN

3.2 **Pension funds**

Legal requirements to engage for Sustainability Impact

GPIF (National Pension and Welfare Pension Insurance)

3.2.1 As with the position with respect to investment or divestment set out in 2.2.9, currently there are no legal requirements directly or indirectly requiring GPIF to engage for Sustainability Impact.

Mutual aid association (Welfare Pension Insurance) and employer / DB Plan fund (DB Plan)

3.2.2 As with the position with respect to investment or divestment set out in 2.2.10, currently there are no legal requirements directly or indirectly requiring mutual aid associations, or employer or DB Plan funds to engage for Sustainability Impact.

Legal freedom to engage for Sustainability Impact

GPIF (National Pension and Welfare Pension Insurance)

3.2.3 While we are of the view that the duties of GPIF are flexible enough to allow GPIF to engage for Sustainability Impact in certain circumstances due to the reasons set out in 2.2.11, we expect that GPIF generally does not engage in stewardship activities by itself since it does not directly hold individual shares.

3.2.4 GPIF provides "Stewardship Principles"[64], which an Investment Manager appointed by GPIF must comply (or explain if not complying), which require the Investment Manager to:

(a) become a Stewardship Code and United Nations Principles for Responsible Investment signatory[65];

(b) make the content and quality of stewardship activities, including engagement, increase risk-adjusted return from a long-term perspective and avoid "short termism"[66];

(c) engage with a broad range of parties, not just investee companies and index providers, in order to promote sustainable growth of the market[67]; and

(d) set goals for important ESG issues and proactively engage[68].

3.2.5 In its "Policy to Fulfil Stewardship Responsibilities"[69], GPIF notes that consideration of ESG factors will increase risk-adjusted return in long term[70]. This suggests that GPIF views engagement for Sustainability Impact as a tool to increase financial return (instrumental IFSI) and does not expect to engage in Sustainability Impact for its own purpose (i.e., disregarding financial return).

Mutual aid association (Welfare Pension Insurance) and employer / DB Plan fund (DB Plan)

3.2.6 As with GPIF, though we expect that mutual aid associations and employer or DB Plan funds generally do not engage directly in stewardship activities since such entities do not directly hold individual shares, we are of the view that the duties of mutual aid associations and employer and DB Plan funds are flexible enough to allow them to engage for Sustainability Impact in certain circumstances. Engagement for Sustainability Impact which is likely to increase financial return will be permissible, while the law is not clear if engagement which is detrimental to financial return is also permissible, which would make plans less likely to engage for Sustainability Impact.

3.3 **Mutual funds**

Legal requirements to engage for Sustainability Impact

3.3.1 For the reasons set out in 2.3.5, we are of the view that the current law does not generally require an ITM to engage for Sustainability Impact.

Legal freedom to engage for Sustainability Impact

3.3.2 Due to an ITM's mandatary' duty as set out in 2.3.6 (a), the ITM can engage for Sustainability Impact where the ITM reasonably believes it will lead to achieving a higher investment return in the middle to long term (but during the life of the investment trust) by maintaining or enhancing the corporate value of investee companies that are held in the portfolio, even if it compromises investment return in the short term.

3.3.3 Many ITMs are signatories to the Stewardship Code. The Code requires an Asset Owner to report annually to beneficiaries on its plan to fulfil stewardship duties and the activities it has undertaken to implement such plan. In our view, the language of the Code suggests a focus on stewardship to enhance returns, but maintains flexibility to engage for Sustainable Impact. For example, the Code states that "*an institutional investor should increase mid- to long-term investment return for clients and beneficiaries by prompting increases in the corporate value and sustainable growth of an investee company through a deep understanding of such investee company and its business environment and constructive "purposeful dialogue" (engagement) based on consideration of sustainability (mid- to long-term sustainability including ESG elements) based on its investment strategy*"[71] (emphasis added). This ties engagement to long-term financial return to beneficiaries, but clearly recognises the positive Sustainability Impact of doing so.

3.3.4 However, the extent to which Sustainability Impact can be considered will remain subject to general law, and there are other parts of the Code which

JAPAN

place emphasis on stewardship based on the interests and needs of Beneficiaries. For example, the Code provides:

(a) an Asset Owner should prompt the Investment Manager to conduct effective stewardship activities based on the view of the ultimate beneficiaries and for their interests in accordance with its size and capability[72]; and

(b) an institutional investor should act primarily for the benefit of clients and beneficiaries[73].

3.4 **Insurance undertakings**

General insurance: Legal requirements to engage for Sustainability Impact

3.4.1 For the reasons set out in 2.4.6, we are of the view that the current law does not generally require a general insurer to engage for Sustainability Impact.

General insurance: Legal freedom to engage for Sustainability Impact

3.4.2 A general insurer has great flexibility to engage for Sustainability Impact since they will finance the cost involved from their own assets and it is unlikely that the issue of engagement will have been addressed in policyholder documentation. However, the costs involved in engagement for Sustainability Impact must be justifiable since the general insurer may not incur unjustifiable costs due to the mandatary's duty owed to the Beneficiaries (i.e. shareholders). The stewardship would not be detrimental to the interest of shareholders provided the detriment is "appropriate" in size and the stewardship activities are expected by the society, which we believe they are. In addition, many general insurers are signatories to the Stewardship Code and the discussion set out in 3.3.3 and 3.3.4 for the Code applies to a general insurer.

Life insurance: Legal requirements to engage for Sustainability Impact

3.4.3 The position for general insurers set out in 3.4.1 equally applies to life insurers.

Life insurance: Legal freedom to engage for Sustainability Impact

3.4.4 The position for general insurers set out in 3.4.2 equally applies to life insurers.

JAPAN

4. ASSET OWNERS' ENGAGEMENT IN PUBLIC POLICY WORK TO SECURE SUSTAINABILITY IMPACT

4.1 The following section considers the extent to which, and on what basis, each type of Asset Owner is (a) required or (b) permitted or able to use its position to engage in public policy work designed to achieve positive sustainability outcomes and minimise negative sustainability outcomes, for example, where these are relevant to the value of portfolio assets.

4.2 **Pension funds**

4.2.1 Similar to the position with respect to investment or divestment set out in 2.2.9, currently there are no legal requirements directly or indirectly requiring GPIF, mutual aid associations, or employer or DB Plan funds to engage in public policy work to secure Sustainability Impact.

4.2.2 Much like stewardship discussed in 3 above, because policy engagement is much less concerned with the composition of an investment portfolio, and more concerned with how an investor uses its position as an investor, there is more flexibility in some cases to pursue Sustainability Impact through policy engagement activities than through investment/divestment decisions, although there is a limit as discussed in 3.2.5 and 3.2.6.

4.2.3 Policy engagement must not create conflicts of interests with the Beneficiaries. Also, costs involved in policy engagement must be justifiable. As discussed for stewardship in 3 above, collaboration with other Asset Owners will help, perhaps through industry bodies such as the Pension Fund Association.

4.3 **Mutual funds**

4.3.1 Similar to the position with respect to investment or divestment set out in 2.3.5, we are of the view that the current law does not generally require an ITM to engage in public policy work for Sustainability Impact.

4.3.2 There is no explicit prohibition on an ITM engaging in public policy work, but it must act consistently with investment objectives and avoid conflicts of interests. Also, costs involved in policy engagement must be justifiable. As discussed for stewardship in 3 above, collaboration with other Asset Owners will help, perhaps through industry bodies such as the Investment Trusts Association.

4.4 **Insurance undertakings**

4.4.1 Similar to the position with respect to investment or divestment set out in 2.4.6 and 2.4.10, we are of the view that the current law does not generally require an insurer to use investment powers to engage in public policy work for Sustainability Impact.

4.4.2 An insurer has great flexibility to engage in public policy work for Sustainability Impact, since they will finance the cost involved from their own assets and is unlikely that the issue of engagement in public policy work will have been addressed in policyholder documentation. However, an insurer must avoid conflicts of interests and the costs involved in engagement in public policy work for Sustainability Impact must be justifiable since the insurer must not incur unjustifiable costs due to the mandatary's duty owed to the Beneficiaries (shareholders).

JAPAN

5. ESTABLISHING NEW FUNDS TO INVEST FOR SUSTAINABILITY IMPACT AND AMENDING THE TERMS OF EXISTING ONES

5.1 The following section considers the extent to which it is possible for an Asset Owner to set up a fund, policy, or other product with the express objective of Investing for Sustainability Impact.

5.2 **Pension funds**

National Pension and Welfare Pension Insurance

5.2.1 National Pension and Welfare Pension Insurance are established by statute and GPIF and mutual aid associations cannot set up new "funds" or amend the statutory terms of the National Pension or Welfare Pension Insurance.

DB Plan

5.2.2 While there is no explicit prohibition on setting up a new DB Plan with express Sustainability Impact objectives, it is unprecedented and it may be practically difficult if the Sustainability Impact objective could result in a significant reduction in investment return since we understand that, to date, financial products in Japan with Sustainability Impact objectives are expected to pursue Sustainability Impact to the extent it is good for investment return and the regulator might not welcome such plan. If the Sustainability Impact objective is not expected to be a significant reduction in investment return, a new DB Plan with such Sustainability Impact objective could be permissible.

5.2.3 Although theoretically possible, it will be practically difficult to amend the terms of an existing DB Plan to incorporate a Sustainability Impact objective because the amendment requires the consent of a majority of participants.

DC Plan

5.2.4 For a DC Plan, an operator (i.e., an employer and NPFA) must provide 3 to 35 "investment options" (i.e., financial products into which the pension premiums will be invested) from which a participant selects to invest the pension premiums. An operator may provide a default investment option, which a participant is deemed to have selected if such participant did not select investment options of its choice within a specified period. While there is no explicit prohibition on setting up an investment option with express Sustainability Impact objectives, it may be practically difficult if the Sustainability Impact objective could result in a significant reduction in investment return since we understand that to date financial products in Japan with Sustainability Impact objective are expected to pursue Sustainability Impact to the extent it is good for investment return and the regulator might not welcome such product. If the Sustainability Impact objective is not expected to be a significant reduction in investment return, an investment option with such Sustainability Impact objective would be permissible. Also, it will be difficult for a DC Plan operator to select an investment option with express Sustainability Impact objectives as a default investment option since the relevant rule requires the operator to provide a default investment option based on investment return.

5.2.5 It is possible to amend the terms of an investment option to incorporate Sustainability Impact objectives but, given the required process (depending on the type of investment option but at least the consent of participants is required), it is likely to be more straight forward to create a new investment option than amending existing terms.

Duties on those designing, manufacturing, and providing pensions

5.2.6 An operator of a DC Plan must provide 3 to 35 investment options but it is not required to offer an investment option with Sustainability Impact objectives.

5.3 **Mutual funds**

Establishing a new investment trust

5.3.1 An investment trust is set up for investment return so Sustainability Impact cannot be the sole objective of an investment trust but can be pursued in addition to investment return. There are several investment trusts with Sustainability Impact objectives, but we understand that all of them are set up on the understanding that Sustainability Impact is good for investment return and it will be challenging to set up an investment trust with Sustainability Impact objectives which could significantly reduce investment return, although there is no explicit prohibition.

Amending an existing investment trust

5.3.2 Investment objectives or investment policies of an investment trust may be amended but, given the requirements for amendment, it is likely to be more straightforward to establish a new investment trust than amending existing terms. Amendment to investment objectives or investment policies will

JAPAN

constitute material amendments to the trust agreement, which require consent by two thirds of voting rights (each unit carries one voting right) and objecting unitholders can demand the buyback of their units[74].

Duties on those designing, manufacturing, and providing mutual funds

5.3.3 There is no product governance regime in Japan requiring those who design, create, and/or operate investment trusts to do so by reference to the needs of a "target market", although the public disclosure document for an investment trust is reviewed by the FSA in advance and the regulator may look to the need of the market in review. Given that Investing for Sustainability Impact is expected by society in Japan, the FSA would be more likely to find an Investing for Sustainability Impact products to meet the needs of the market.

5.4 Life insurance products

Establishing a new insurance product

5.4.1 It seems theoretically possible to create a new IRLIs with Sustainability Impact objectives since there is no explicit prohibition. However, it is unprecedented and it will be challenging to create an IRLI with Sustainability Impact objectives which could significantly reduce investment return because the FSA may think it is not for consumer's benefit in review of the product. If the Sustainability Impact objective is not expected to be a significant reduction in investment return, an IRLI with such Sustainability Impact objective could be permissible.

5.4.2 *Amending an existing insurance product*
Theoretically it is possible to amend policy documents to incorporate a Sustainability Impact objective, although it requires the FSA's approval[75].

Duties on those designing, manufacturing, and providing life insurance

5.4.3 There is no product governance regime in Japan requiring those who design, create, and/or operate life insurance products to do so by reference to the needs of a "target market", although a new insurance product needs to be approved by the FSA and the FSA may look to the need of the market in review. Given that Investing for Sustainability Impact is expected by society in Japan, the FSA would be more likely to find an Investing for Sustainability Impact products to meet the needs of the market.

JAPAN

6. INVESTMENT MANAGERS' DUTIES TO INVEST FOR SUSTAINABILITY IMPACT

6.1 This section considers the extent to which, and in what circumstances, an Investment Manager is (a) legally required or (b) legally permitted to Invest for Sustainability Impact on behalf of an Asset Owner or otherwise, in each of the three ways contemplated in sections 2-4.

6.1.1 An Investment Manager's investment duties and powers are set out by:

(a) the terms of an investment management agreement (***IMA***) with an Asset Owner. An IMA typically provides:

(i) investment objective(s) against which the Investment Manager's performance will be assessed;

(ii) any investment strategy specified by the Asset Owner;

(iii) any investment restrictions (e.g., asset class);

(iv) the Investment Manager's contractual duty of loyalty owed to the Asset Owner;

(b) the relevant laws and regulations, in particular the FIEA, which provides, among other things:

(i) duty of loyalty and duty of care owed to a client[76]; and

(ii) prohibition on various activities including self-trading, trades between the assets it manages, loss compensation, unjustifiable trade aimed at benefits for itself or a third party, and trade on abnormal terms detrimental to beneficiaries[77]; and

(c) the mandatary's duty under the Civil Code[78].

6.2 Legal obligations with respect to Sustainability Impact

Powers of investment and divestment

6.2.1 If the IMA provides Investing for Sustainability Impact as an investment objective, the Investment Manager is required to make investments in accordance with such objective. The Investment Manager will be put in a difficult position to balance such objective, which is difficult to measure financially, and any other (presumably all financial-return related) investment objective(s).

6.2.2 If the IMA is silent on Investing for Sustainability Impact, the Investment Manager will not be legally required to Invest for Sustainability Impact. The suitability rule under the FIEA[79] requires the Investment Manager to ascertain the Asset Owner's investment objective but not its intention for Investing for Sustainability Impact particularly.

6.2.3 If the Asset Owner wishes the Investment Manager to Invest for Sustainability Impact, such objective should be spelled out in the IMA.

Engagement to achieve Sustainability Impact

6.2.4 As with powers of investments and divestments, if the IMA is silent on Sustainability Impact, the Investment Manager is not legally required to engage with investee companies to achieve Sustainability Impact.

Public policy work to achieve Sustainability Impact

6.2.5 As with powers of investment and divestment if the IMA is silent on Sustainability Impact, the Investment Manager is not legally required to engage in public policy work to achieve Sustainability Impact.

6.3 Legal freedom to Invest for Sustainability Impact

Powers of investment and divestment

6.3.1 There is no explicit prohibition on an Investment Manager using powers of investment and divestment for Sustainability Impact. However, if the IMA is silent on Investing for Sustainability Impact, a financial-return-based objective will make the Investment Manager hesitant to Invest for Sustainability Impact for a fear of a claim by the Asset Owner if the outcome is reduced returns.

6.3.2 The Investment Manager and the Asset Owner can agree to amend the IMA to include Investment for Sustainability Impact as an investment objective subject to the Asset Owner's duty owed to the Beneficiaries.

> ANNEXES

> Japan

JAPAN

Engagement to achieve Sustainability Impact

6.3.3 Since stewardship activities do not have a direct bearing on portfolio composition, there will be more room to pursue Sustainability Impact through stewardship activities. Additionally, the Stewardship Code encourages an institutional investor to appropriately grasp an investee company's situation (including risks related to social and environmental issues and profit opportunities) to enhance the corporate value and capital efficiency of the investee company from the mid- to long-term perspective and appropriately perform its stewardship duty for its sustainable growth[80].

6.3.4 However, the Investment Manager must ensure that stewardship activities are in the best interest of the Asset Owner (which mean that the stewardship activities will not cause financial detriment to the portfolio) and avoid causing conflicts of interests between the Asset Owner and itself or other clients.

6.3.5 Also, unless it is financed from its own assets, the costs for stewardship activities must be balanced with benefits. Collaboration with other investors may reduce such costs, which the Stewardship Code suggests.

Public policy work to achieve Sustainability Impact

6.3.6 An Investment Manager is generally free to engage in public policy work financed out of the Investment Manager's own resources rather than being charged to client portfolios so long as (a) its directors reasonably believe that it is the best interest of the Investment Manager (please refer to discussion in 2.4.9) and (b) it does not cause conflicts of interests between the Asset Owner and itself or other clients.

JAPAN

7. LEGAL LIABILITY TO THIRD PARTIES FOR THE NEGATIVE SUSTAINABILITY IMPACT OF ENTERPRISES IN WHICH PORTFOLIOS ARE INVESTED

7.1 This section considers the extent to which, regardless of the legal rules under which it is required to operate and its constitution, an Asset Owner could be legally liable to third parties for the negative Sustainability Impact of enterprises in which it invests, and whether an Investment Manager could also be liable because of its role in assisting the Asset Owner to invest in the relevant enterprise and steward its investment.

7.2 **Asset owners**

7.2.1 The basic rule is that an Asset Owner will not be liable to a person damaged by negative Sustainability Impact of an investee company, which has a separate judicial personality from the Asset Owner.

7.2.2 It is theoretically possible that an Asset Owner owes tort liability to a person damaged by negative Sustainability Impact of an investee company especially if the Asset Owner is a parent or a controlling shareholder of the investee company as discussed below.

(a) *General Tort Liability*. If a parent proactively prompts a subsidiary to commit a tort, the parent could be liable to a third party damaged by the subsidiary. However, to succeed on this claim, the third party must establish, among other things, that the damage was caused by the parent's wilful misconduct or negligence and the amount of damage and causation between the parent's wilful misconduct or negligent act and the damage, which are very difficult to prove.

(b) *Piercing the Corporate Veil*. Case law[81] admits a shareholder's liability when a company's legal personality is abused to avoid the application of law or the company is totally dormant. This "piercing the corporate veil" theory can be used for a parent's liability to its subsidiary's creditor. However, in the context of investment by an Asset Owner, which is an institutional investor, the applicability of this theory is highly questionable.

7.3 **Investment managers**

7.3.1 The basic rule is that an Investment Manager will not be liable for a person damaged by negative Sustainability Impact of an investee company, which has a separate judicial personality from the Investment Manager.

7.3.2 The discussion set out in 7.2.2 for an Asset Owner generally applies to an Investment Manager and it is theoretically possible that an Investment Manager owes tort liability to a person damaged by negative Sustainability Impact of an investee company. However, given that an Investment Manager is not an Asset Owner, such liability is far more remote for an Investment Manager than for an Asset Owner.

JAPAN

8. THE GROWING IMPORTANCE OF TAKING ACCOUNT OF ESG AND SUSTAINABILITY FACTORS WHERE THESE ARE 'FINANCIALLY MATERIAL'

8.1 It has become increasingly important for Asset Owners and their managers to take ESG and sustainability factors into account in managing portfolios because of the way in which they could be material to achieving the financial investment objectives of the Relevant Investor in accordance with their legal duties. The main reasons are summarised below.

8.1.1 Globalisation and change to social structure led to various social issues coming to the surface and the environment surrounding corporations changing such as heightened climate-change risk, consumers heightened interest in environmental issues, the younger generation's aspiration to contribute to the society when selecting jobs, and strengthened supply chain management involving trading partners. As a result, for the sustainable growth of an investee company and evaluation of and investment decisions based on mid- to long term corporate value, ESG factors become important in addition to financial elements. Given this background, the Relevant Investor needs to take ESG factors into account for investments to increase investment return[82].

8.2 **Financially materiality**

8.2.1 Because of the growing importance of taking ESG and sustainability factors into account in the investment process where financially material, it is important to understand how the law defines what is 'financially material' and the period by reference to which financial materiality must be measured. Taking account of these factors in order to pursue financial objectives may incidentally have Sustainability Impacts and may also be consistent with Investing for Sustainability Impact. However, beyond that point, any attempt to realise positive Sustainability Impact might need to rely solely upon Investing for Sustainability Impact (i.e., because it would no longer be driven by the need to generate financial performance).

8.2.2 As set out in 1.3.5, a Relevant Investor is required to consider ESG factors in its investment decisions where they are financially material to the performance of the investment, balancing returns against risks.

8.2.3 However, it is challenging for a Relevant Investor to evaluate financial materiality of an ESG factor since the understanding of the full financial impact of environmental, social and governance risks, and how to measure them, is still developing. Also, there is no law or official guidance on the level of significance that is necessary for an ESG factor to be taken into account in seeking to secure financial return in the management of a portfolio.

8.3 **Time period by reference to which 'materiality' is to be assessed**

8.3.1 There is no legal standard / definition or official guidance on the time period by reference to which financial materiality should be judged, but we are of the view that financial materiality can be determined on a mid- to long-term basis and not just on a short-term basis. Precisely how long depends on the type of product and the typical investment horizon of the portfolio or length of time beneficiaries are typically invested: i.e. financial materiality only covers risks to financial return which might materialise over the typical investment horizon and another concept (e.g. Investing for Sustainability Impact to address systematic risks) will be required to justify investing to avoid longer-term risks that would materialises beyond that time frame.

KANAGAWA
INTERNATIONAL
LAW OFFICE

Shinsuke Kobayashi

> ANNEXES

> Japan

JAPAN

1 If there is an express sustainability objective, respective asset owners are under a duty to both, instrumental and ultimate ends, IFSI.
2 Article 42 of the FIEA.
3 Article 71 of DB Law.
4 Article 44 of DC Law.
5 Page 625 of the Vol. 24 of the Supreme Court Civil Case Casebook.
6 Tokyo District Court 17 December 1997.
7 Article 9 and 10 of Welfare Pension Insurance Law.
8 Article 3 of Government Pension Investment Fund Law (the GPIF Law).
9 Article 11, Provision 1 of the GPIF Law.
10 Article 11, Provision 2 of the GPIF Law.
11 Article 21 of the GPIF Law.
12 Section 1, Item 1 of the Basic Guideline.
13 Section 3, Item 12 of the Basic Guideline.
14 Section 3, Article1, Provision (1), Item (i) of the Mid-Term Goals.
15 Section 3, Article 3, Provision (1) of the Mid-Term Goals.
16 Section 3, Article 7, Provision (1) of the Mid-Term Goals.
17 Section 3, Article 7, Provision (2) of the Mid-Term Goals.
18 Article 644 of the Civil Code.
19 Article 79-3, Provision 1 of the Welfare Pension Insurance Law.
20 Article 35-3, Provision 6 of the Federation of National Service Personnel Mutual Aid Law.
21 Article 9-3, Provision 1 of the Enforcement Order of the Federation of National Service Personnel Mutual Aid Law.
22 Section 1, Item 1 of the Basic Guideline.
23 Section 3, Item 12 of the Basic Guideline.
24 Chapter 1, Section 1 of the Welfare Pension Insurance Benefit Reserve Management and Investment Policy.
25 Chapter 2, Section 1 of the Welfare Pension Insurance Benefit Reserve Management and Investment Policy.
26 Chapter 3, Section 1 of the Welfare Pension Insurance Benefit Reserve Management and Investment Policy.
27 Chapter 3, Section 5 of the Welfare Pension Insurance Benefit Reserve Management and Investment Policy.
28 Chapter 5 of the Welfare Pension Insurance Benefit Reserve Management and Investment Policy.
29 Article 644 of the Civil Code.
30 Article 69, Provision 1, Article 70, Provision 1, Article 71 and Article 72 of the DB Law.
31 Article 67 of the DB Law.
32 Article 3, Provision (1) of the Guideline.
33 Article 644 of the Civil Code.
34 Section3, Article1, Provision (1), Item (i) of the Mid-Term Goals.
35 Section3, Article7, Provision (2) of the Mid-Term Goals.
36 Section1, Article8 of the mid-term plan.
37 Article 2, Provision 1 of the LITIC.
38 Article 2, Provision 2 of the LITIC.
39 Article 9 of the LITIC and Article 20 of the enforcement regulation of the LITIC.
40 Article 13 of the LITIC.
41 Article 14 of the LITIC.
42 Article 42 of the FIEA.
43 Article 42-2 of the FIEA.
44 Article 644 of the Civil Code.
45 Article 97, Provision 2 of the IBA.
46 Article 97-2, Provision 2 and 3 of the IBA.
47 Article 116 of the IBA.
48 Article 130 of the IBA.
49 Article 300-2 of the IBA and Article 234-21-2, Item 4 and 8 of the enforcement regulation of the IBA.
50 Article 37-3 of the FIEA, as applied mutatis mutandis pursuant to Article 300-2 of the IBA, and Article 234-24 of the enforcement regulation of the IBA, etc.
51 Article 355 of the Companies Act.
52 Article 644 of the Civil Code.
53 For example, Supreme Court 24 June 1970.
54 Article 118, Provision 1 of the IBA.
55 Article 294, Provision 1 of the IBA and the Article 227-2, Provision 3, Item 6 and 10 of the enforcement regulations of the IBA.
56 E.g., the "ESG Investment Guidelines for Investment by Life Insurance Companies" states that, since a life insurance company's business has a public nature, the life insurance company should manage its assets well in consideration of social impact in addition to profitability, safety, and liquidity. While the Guidelines encourage member life insurance companies to promote ESG investments (through incorporating ESG elements into investment processes and investing in assets featuring ESG) in order to contribute to achieving a sustainable society through asset management, it also refers to profitability of investment and not setting Investing for Sustainability Impact as a goal in itself. (https://www.seiho.or.jp/activity/guideline/pdf/esg.pdf).
57 Guidance 4-5 regarding Principle 4 of the Stewardship Code (https://www.fsa.go.jp/en/refer/councils/stewardship/20200324/01.pdf).
58 Section 2 of the "Clarification of Legal Issues Related to the Development of the Japan's Stewardship Code" (https://www.fsa.go.jp/en/refer/councils/stewardship/20140226.pdf).
59 Article 10, Provision 1 etc. of the Antimonopoly Law.
60 Chapter 6 and Chapter 6-2 of the FIEA.
61 Article 27-23 of the FIEA.
62 Article 27-2 of the FIEA.
63 Such as Article 32 of the FIEA, Article 52-2-11 of the Banking Act and Article 271-3 and 271-10 of the IBA.
64 https://www.gpif.go.jp/en/investment/pdf/stewardship_principles_and_proxy_voting_principles.pdf
65 Item (1) and (4) of the Stewardship Principles
66 Item (3) of the Stewardship Principles
67 Item (3) of the Stewardship Principles
68 Item (4) of the Stewardship Principles
69 https://www.gpif.go.jp/en/investment/policy_to_fulfill%20stewardship_2020.pdf
70 Article 1 Item (1) in the Policy to Fulfil Stewardship Responsibilities
71 Guidance 1-1 regarding Principle 1 of the Code
72 Guidance 1-3 regarding Principle 1 of the Code
73 Guidance 2-1 regarding Principle 2 of the Code
74 Article 17 and 18 of the LITIC
75 Article 123, Provision 1 and Article 4, Provision 2 of the IBA
76 Article 42 of the FIEA
77 Article 42-2 of the FIEA
78 Article 644 of the Civil Code
79 Article 40 of the FIEA, Article 38 of the FIEA and Article 117 the enforcement regulation of the FIEA
80 Principle 3 and Guidance 3-1 to 3-3
81 For example, Sendai District Court 26 March 1970 and Tokushima District Court 23 July 1975
82 E.g., Article 1. Item (1) in the Policy to Fulfil Stewardship Responsibilities of GPIF

NETHERLANDS

1. INTRODUCTION

1.1 As discussed in the main body of the report, the expression 'Investing for Sustainability Impact' (IFSI) does not have a fixed legal meaning, including under the laws of the Netherlands. Rather, the expression is used here as a type of conceptual net to catch any legal duty or discretion on the part of asset owners or their investment managers to pursue one or more sustainability impact objectives of any sort, whether in order to protect or enhance the financial performance of their investments or otherwise.

1.2 This memorandum is based on the legal framework applicable in the Netherlands as at 31 January 2021. To a certain extent, Dutch law in the areas covered by this memorandum is either made by the European Union or implements European law. This memorandum considers the way in which EU law applies in the Netherlands. However, the relevant provisions of EU law are considered in the report relating to the EU.

NETHERLANDS

2. ASSET OWNERS' USE OF POWERS OF INVESTMENT AND DIVESTMENT TO INVEST FOR SUSTAINABILITY IMPACT

2.1 The following section considers the extent to which, and in what circumstances, each type of asset owner is (a) legally required or (b) legally permitted or able to use its powers of investment and divestment to pursue IFSI.

2.2 **Pension funds**

Types of pension fund covered

2.2.1 The Netherlands has an extensive second pillar of pension provision operating on a funded basis, alongside the state-run first pillar operating on a pay-as-you-go basis. The Netherlands currently houses some of the world's largest public pension funds by total assets.[1] These funds and their asset managers are often seen as leading practice on integrating ESG factors into their investment decisions and investment policies.

2.2.2 Broadly, the Dutch pension system consists of three pillars.

(a) **State pension**: the basic Dutch state pension under the General Old Age Pensions Act (*Algemene Ouderdomswet* or *AOW*) is the first pillar, based on compulsory tax and social security contributions made by Dutch residents.

(b) **Employment-related pension**: occupational/company pensions form the second pillar and are available to almost all employees. They are typically pre-funded by employer and/or employee contributions, which are subsequently managed/invested by a pension fund (or agents on their behalf) to yield a return anticipated to provide a pension for employees (or their survivors) on retirement or death.

(c) **Individual pension**: as the third pillar, employees and self-employed persons can also arrange private pensions independently without employer involvement and in addition to the AOW pension (eg via life insurance or a bank saving scheme).

2.2.3 Where this memorandum considers asset owners that are pension funds it concerns those in category (b). We note that the Dutch private scheme is in the process of being overhauled.[2] This overhaul should not adversely affect what is set out below regarding IFSI. This memorandum does not address the state pension (category (a)) as this is a pay-as-you-go system.

2.2.4 Individual pensions (category (c)) that are structured as insurance products are essentially covered by the insurance analysis in this memorandum. Those structured as bank saving schemes are not considered further here.

2.2.5 In discussing pension funds in this memorandum, we use the following expressions in the way described:

- **Asset owner**: the pension funds (which are the asset owners).[3]
- **Beneficiaries**: anyone who is entitled to, or who might receive, a benefit from the pension scheme now or in the future – for example, members of the pension fund, survivors of members and others who may receive a benefit in certain circumstances (eg members' spouses, partners or children).
- **Investment decision-maker**: very broadly, two sorts of investment decisions are involved in managing a pension – asset allocation decisions and specific investment decisions. The former would typically lie with the pension fund itself, the latter with its investment manager (whether in-house or appointed externally).

Overview of investment duties and powers, and use of investment powers to pursue IFSI

Summary conclusion

2.2.6 Dutch law imposes various obligations on all investors as to how they may use their investment powers, with the aim of securing positive social outcomes; for example, prohibiting investment in cluster munitions and engaging in transactions that involve money laundering. While these are crafted as restrictions rather than positive obligations to use investment powers to bring about a particular result, using investment powers to realise goals of this sort would be consistent with IFSI. However, this is not the only situation in which pension funds may be required to pursue IFSI. Part I of the report identifies two basic sorts of investment objective that would involve IFSI by a pension fund: first, where bringing about a defined sustainability impact goal is incidental to protecting the financial interests of beneficiaries (which is likely to be especially relevant where a fund has beneficiaries with a financial interest in the fund which will crystallise in the medium or long-term - this is defined as instrumental IFSI); and, second, where the objective is to achieve a particular sustainability impact as an end in itself (defined as ultimate-ends IFSI). Essentially, while each pension fund would need to

> ANNEXES

> Netherlands

NETHERLANDS

consider its own situation, the main duty that governs the investment of pension fund assets in the Netherlands is likely to lead many pension funds to conclude that they should use their powers of investment and divestment with a view to pursuing instrumental IFSI. There is also flexibility under Dutch law to pursue ultimate-ends IFSI.

Analysis

2.2.7 The main governing legislation for Dutch pension funds is the Dutch Pensions Act (*Pensioenwet*) and rules and regulations made under it (the DPA). The prudential supervisor of Dutch pension funds is the Dutch Central Bank (*De Nederlandsche Bank N.V.* (DNB). A key requirement under the DPA is that a pension fund must set its investment policy and invest its assets in the interest of its participants, acting in accordance with the so-called 'prudent person rule'. The rule does not only relate to the investment process, but also to the result. The courts have established that the prudent person rule gives pension funds the freedom to invest within the parameters set by the DPA and the Financial Assessment Framework for Pension Funds (*Besluit financieel toetsingskader pensioenfondsen* (FTK Decree)).[4]

2.2.8 The DPA elaborates upon the basic prudent person rule. However, it is ultimately an 'open' standard in the sense that responsibility for determining and implementing an investment policy that is compliant with the prudent person rule lies primarily with the pension fund.[5] Article 135 sub paragraph 1 of the DPA simply provides that the pension fund must conduct an investment policy in accordance with the prudent person rule, based on the following principles in particular:

(a) investments must be made in the interest of the beneficiaries having regard to their entitlements;

(b) investments in participating companies are limited to 5 per cent of the portfolio as a whole and in case the company that participates is part of a group, investments in the group are limited to 10 per cent. When a group of companies contributes to a fund, investments in these participating companies are to be made in consideration of the prudent person rule considering the necessity of proper diversification;

(c) investments must be reported on a market value basis; and

(d) further rules to safeguard a prudent investment policy are to be set by decree.

2.2.9 The loyalty principle requires that the financial interests of the beneficiaries are prioritised, although recently there has been a change in the manner in which this principle is being fulfilled.[6] See further para. 2.2.29 below on the interplay between these principles.

2.2.10 Article 135 sub-paragraph 4 of the DPA further generically prescribes that pension funds in their management reports must explain how the investment policy takes into account the environment, climate, human rights and social relationships. There is however no prescriptive norm referenced.[7]

2.2.11 Recently, a question has been raised in Dutch literature[8] as to whether Article 135 of the DPA could be revised to go further, thereby in effect stimulating or even requiring a contribution by pension funds. Although, while acknowledging the positive effects of IFSI, this notion has so far been rejected as it would mean the pension fund beneficiaries would disproportionally contribute to addressing climate issues when compared to the public at large.[9]

2.2.12 The FTK Decree attempts to make clear what is expected in the fund's investment policy in the context of the prudent person rule, leaving fully intact the prudent person rule itself as an open standard.[10]

2.2.13 Article 13a of the FTK Decree requires the fund to set a long-term strategic investment policy in line with the fund's objectives and policy principles, including its attitude towards risk, and to demonstrate that this policy and the corresponding investment plan are in accordance with the prudent person rule.[11]

2.2.14 Pursuant to article 18 of the FTK Decree the fund must establish strategies, processes and reporting standards to enable the fund both on an individual and consolidated level to monitor the risks to which the pensions that the fund maintains are exposed, and to permit the fund to identify, measure, monitor, manage and report on these risks. These risks explicitly include the environment, climate, human rights and social relationships regarding the investment portfolio and the management thereof.

2.2.15 The FTK Decree further provides that the assets must be invested in such a manner that the safety, quality, liquidity and returns of the portfolio as a whole are safeguarded.

2.2.16 Article 145 of the DPA further provides that the fund must, every three years, reconsider its statement setting out the fund's investment principles (which is a compulsory part of the fund's annual accounts). Article 29a of the FTK Decree details that this statement must include the manner in which the

NETHERLANDS

investment policy takes into account the environment, climate, human rights and social relationships.

2.2.17 Also the Pension Code, which was established in 2013 and which sets out best practices for the governance of pension funds, determined by way of a general starting position that the boards of pension funds need to consider the environment, climate, human rights and social standards, which was not further elaborated on. Although the Pension Code is soft law it has a legal basis in the DPA, pursuant to article 33 sub-paragraph 2 of the Pension Decree and the law on compulsory vocational pensions. The Pension Code 2018 however no longer includes this general starting position. Instead the pensions funds have entered into the Dutch Pension Funds Agreement on Responsible Investment (see below para [xx]) to further detail their ESG commitments.[12]

2.2.18 In principle the directors of a pension fund are subject to the same rules that apply to directors of companies generally. However, considering the special nature of their role and specialist expertise that these directors are expected to have regarding investment activities (as set by the prudent person rule) and their fiduciary duties under the DPA (including as may be derived from the duty of loyalty), it is presumed that the fund and its directors also have a civil duty of care vis-à-vis beneficiaries of the fund.[13] The liability regime for pension fund directors is tied to the regulatory framework. The fact that the relevant rules in the DPA have been followed does however not mean that liability may not arise.[14] Arguably directors of pension funds may be subject to stricter norms or higher demands may be placed upon them and their conduct.[15]

2.2.19 Liability could arise where the fund has suffered a loss as a result of an investment decision or policy, if it can be shown clearly not to have complied with the prudent person rule, and thereby to have fallen short of the standard of performance that may be expected of an experienced and knowledgeable pension fund director who has diligently sought to discharge his or her task and who can made seriously blamed (*ernstig verwijt*) for his or her conduct. This will in any event be the case if the directors have failed to observe the duty of loyalty. Nonetheless, this is a high hurdle, and it should not impact the conduct of directors as regards instrumental IFSI. It may be more challenging for the directors to demonstrate the same for ultimate-ends IFSI. However, any assessment of their conduct would be made by reference to the prevalence in investment practice, at least until fairly recently, of investment approaches based on variations of modern portfolio theory, which does not cope well with the idea that an investor could have any goal other than achieving a risk-adjusted return.

2.2.20 ***Legal requirements to use investment powers to pursue IFSI***

2.2.21 Pension funds and their investment managers must comply with certain general prohibitions under Dutch law that restrict their ability to invest. While these are generally not drafted as positive obligations to bring about an identified sustainability impact, the purpose of these prohibitions is generally nonetheless to achieve goals consistent with social sustainability, for example, to prevent terrorist activity, tax evasion and the trade in illegal drugs. In that sense, the use of investment powers in a way that complies with these requirements would fall within the definition of IFSI. Examples include legislation prohibiting investing in companies producing cluster munitions or in companies based in jurisdictions that are subject to international sanctions, and legislation prohibiting transactions that would involve money laundering. [16]

2.2.22 Looking more specifically at pension fund investment powers, pension funds have a high degree of autonomy to determine their investment policy. There are no explicit legal requirements requiring investing for sustainability impact. However, pursuant to the DPA, pension funds have the duty to formulate objectives and principles used in their decision-making, accountability, advice and internal supervision. This includes the requirement to adopt a longer-term strategic investment policy in line with the fund's objectives and policy principles, including its attitude to risk, as part of which the fund must also consider the environment, climate, human rights and social relationships (article 18 FTK Decree). The fund must demonstrate that the strategic investment policy and the investment plan are consistent with the prudent person rule. The potential for systemic financial or economic collapse is a risk that should be taken into account while creating an investment policy and it is generally recognised that, for instance, fossil fuels-based investment may be susceptible to a carbon valuation bubble resulting from increased (public) pressure and the need to execute the energy transition. The longer-term strategic investment policy of pension funds in

NETHERLANDS

the Netherlands therefore must take into account the environment, climate, human rights and social relationships in relation to the investment portfolio and the management thereof and consequently the investments by the fund should be made accordingly.

2.2.23 Many pension funds are likely to have beneficiaries with medium- and longer-term financial interests who are more likely than those with short-term financial interests to be exposed to the declining sustainability of the environmental and social systems on which economic activity and, hence, financial return depends – in other words, some of the key sustainability issues that are the target of IFSI. It is clear that the prudent person rule requires that these issues are taken into account, as the FTK Decree identifies each of these, ie the environment, climate, human rights and social relationships, as risks that must be considered as part of determining the long term investment strategy of a fund[17]. In view of the requirement under the prudent person rule to invest in the interests of all beneficiaries, pension funds should consider what, if anything, they are able to do to reduce the risk to these beneficiaries, including ESG-related risks, as also explicitly required by the FTK Decree. Having regard to the multiple cohorts of beneficiaries with their varying financial needs, and the particular exposure of some of them to declining sustainability, there are likely to be situations in which a pension fund concludes that it needs to pursue instrumental IFSI in seeking to protect those longer-term financial needs.

2.2.24 What it comes down to in relation to ESG factors and IFSI in particular is whether a pension fund will be permitted to cause short-term financial sacrifices due to its assessment and evaluation of long-term risks.[18] The prudent person rule affords the directors of a fund the discretion to strike a balance between these interests as the directors may objectively believe to be appropriate, with a view to safeguarding the future interests of longer-term beneficiaries.

2.2.25 As explained in the main body of the report, taking ESG factors into account does not necessarily amount to IFSI (since it may involve no more than seeking to avoid short-term financial damage from ESG risks without pursuing specified sustainability impact objectives). A pension scheme may conclude that it needs to pursue IFSI rather than simply taking ESG factors into account if, for example, an identified sustainability risk affects many or most potential investees (or the system as a whole), so that it is necessary to change investee behaviour rather than simply avoiding investing in certain companies. This might suggest that a pension fund should, for example, adopt investment policies designed to change the behaviour of actual or potential investees (as well as engaging in stewardship activities with the same objectives), provided that it had grounds to consider that there was a reasonable prospect of its actions achieving their objective.

2.2.26 In its report on sustainable investment in the Dutch pension sector[19] the DNB does make the point that the relationship between the ESG performance of businesses (and by extension of an investment portfolio comprised of investments in businesses that take ESG factors into consideration in their business conduct), and the corresponding risk return profile in the longer term, needs further research to better understand any differences compared with a less sustainable investment policy and corresponding investments in businesses. That said, it is apparent also from the aforementioned report of the DNB that sustainable investment in the Dutch pension sector, which impacts both the supervisor's approach and investing by pension funds (and their investment managers), is increasingly seen as a financial opportunity. This is based on the premise that sustainable investments are more profitable (and less risky) than non-sustainable ones[20] and as stated above, the environment, climate, human rights and social relationships must be considered by a fund as part of its investment strategy and are an integral part of the risks that must be considered as part of investing in line with the prudent person rule.

2.2.27 However, the size of a pension fund may in practice result in limitations on the ability of the fund to take ESG factors into account in making investment decisions: a smaller fund will most likely be confronted sooner with the limitations that are imposed by portfolio diversification requirements. This may lead pension funds to conclude that they need to address the risks posed by ESG factors in other ways, for example by engaging with investees (see section 3 below) or through investor alliances.

2.2.28 While each pension fund would need to consider its own situation, we anticipate that many may conclude that they should use their powers of investment and divestment to pursue positive sustainability

NETHERLANDS

impacts where doing so can reasonably be expected to help in achieving to pursue IFSI. Since individual funds are not generally able to bring about change at a system-wide level, perhaps the most important way of pursuing this would be through various forms of investor alliance. Particularly as part of a wider strategy, it may also be possible for an individual pension fund to seek to address system-wide challenges by focusing on the contribution of individual enterprises to the particular sustainability issue concerned. When engaging in activities of this sort, a pension fund would need to set an appropriate balance between the needs of beneficiaries with medium- and longer-term interests in the fund, and those with shorter-term interests.

Legal freedom to use investment powers to pursue IFSI

2.2.29 In essence, because it is an open norm, the discretion afforded under the prudent person rule moves and evolves together with the norm itself, which in turn relies on investment theory and practice and developments on the financial markets.[21] The open and evolving nature of the prudent person rule therefore enables IFSI (regardless of whether it serves to enhance return or reduce investment risk) as long as this is being done with a view to realising the (future) pension entitlements of the beneficiaries.[22]

2.2.30 The application of IFSI under the prudent person rule must not be detrimental to the interests of beneficiaries. This follows from the loyalty principle.[23] However, the loyalty principle does not preclude a pension fund from taking into account non-financial factors in its investment policy.[24] In addition, the board of a pension fund has a degree of flexibility when it comes to demonstrating that the investment policy complies with the prudent person rule.[25]

2.2.31 There is therefore nothing that prohibits IFSI, even where the ultimate goal of doing so does not concern the financial goals of the portfolio. A pension fund would however always need to strike a balance in pursuing ultimate-ends IFSI between the sustainability impact being sought and meeting its financial obligations to beneficiaries.

2.2.32 In its report on sustainable investment in the Dutch pension sector, the DNB expresses the view that the prudent person rule does not prevent taking ESG-factors into consideration when determining the investment policy of the pension fund (rather the contrary).[26] It is clear to us that, in the view of the DNB, sustainability is linked to systemic risk. Since the DNB is the prudential supervisor of Dutch pension funds, its position is clearly significant. The DNB's observations specifically refer to pursuing 'sustainable investment policies' in a way that distinguishes between that activity and seeking to achieve the financial goals of the portfolio.

2.2.33 The DNB has expressly clarified that it would be a misconception to regard the following items as limitations on sustainable investing: (i) the requirement to have adequate control over investments, including sustainable investments; (ii) illiquidity – part of the investment portfolio may be illiquid as long as the portfolio has sufficient diversification and balance; (iii) (higher) costs of sustainable investing are not unacceptable – although it is recognised that the costs associated with an ESG investment policy may create a hurdle for smaller funds; and (iv) required additional own capital due to risks related to sustainable investing. [27]

2.2.34 The position of the DNB is consistent with Article 19(1)(b) of the Second EU Pensions Directive.[28] That provides that member states are to allow pension funds to 'take into account the potential long-term impact of investment decisions on environmental, social, and governance factors'; it specifically uses the word 'impact', and the impact concerned is on environmental and social factors, with no mention of financial return. The drafting therefore suggests that long-term environmental and social outcomes of investment decisions can be a factor in investment decision-making, and the drafting of the provision does not restrict this to circumstances where doing so is for the purpose of securing the financial interests of pension fund beneficiaries in the long-term. In other words, at some level this drafting contemplates the pursuit of long-term environmental and social outcomes as ends in their own right. This also coincides with how the prudent person rule is interpreted under the DPA, and the FTD Decree as detailed above. Pursuant to article 102a of the DPA the board of a pension fund is required to record in consultation with the other governance bodies of the fund the targets, the policy assumptions and the risk attitude of the fund. Through recording the policy assumptions, targets and risk attitude of the fund, these bodies can and should monitor the execution of the pension arrangement as agreed between the beneficiaries, the relevant employee and employment organisation

NETHERLANDS

and the fund. The relevant bodies include the supervisory council of the fund, the representative body of the fund and the council of interested parties associated with the fund. The representative body includes representatives of the workers and of the employers, as well as beneficiaries of the fund and members of the board of the fund. The representative body is entitled to require the board of the fund to provide information and may pass judgement on the conduct by the board. If the fund does not have a representative body, there may instead be a council of interested parties comprised of beneficiaries of the fund, including pensioners, that may provide the board of the fund with advice and is also entitled to information, and any changes to the strategic investment policy of the fund require the approval of this body. We note that the ability of beneficiaries to exercise influence is limited, also in practice, as the board of the fund has ultimately the authority to establish the investment policy and individual beneficiaries that are part of a collective pension arrangement are compulsory members of a fund and cannot leave if they disagree with the fund's policy as implemented in practice. We note also that in practice, the views of beneficiaries on how the fund should invest tend to vary widely, with some participants giving a clear priority to return on investments. The board of a fund will have to consider these differing views.[29]

Observations on investment practices of Dutch pension funds

2.2.35 Dutch pension funds have in practice used the autonomy afforded under the DPA to integrate ESG factors into their investment decisions and have over recent years proactively developed sustainable investment policies which, in particular with the larger pension funds, are integrated in their investment policy, resulting in exclusion lists, engagement strategies, and best-in-class investment strategies being used. Increasingly the thinking has changed from considering sustainable investing as a financial risk, to not investing sustainably being a reputational risk for the fund considering its position in society (also given the size of assets owned), to realising that sustainable or impact investing may in fact be a financial opportunity.[30] There has also been a clear move towards IFSI where this can help to manage medium- to longer-term systemic risk for pension fund portfolios. One of the most notable examples of this is the Dutch Pension Funds Agreement on Responsible Investment (2018) under which a large number of Dutch pension funds have agreed to cooperate to create a more sustainable society by preventing or tackling negative consequences for society and the environment of investments by pension funds. Another example is the recent launch by APG, AustralianSuper, British Columbia Investment Management Corporation (BCI) and PGGM of the Sustainable Development Investments Asset Owner Platform (SDI AOP).[31] The stated purpose of the platform, which is available to the market, is to enable investors to assess companies on their contribution to the UN Sustainable Development Goals (SDGs).[32]

2.2.36 ABP (*Stichting Pensioenfonds ABP*), the national civil pension fund for government and education employees, set itself in 2020 specific sustainable development goals to be achieved by 2025. They include (i) that 20 per cent of total assets under management should go to 'sustainable development investments' (SDIs), (ii) a 40 per cent CO2 reduction in ABP's equity portfolio, (iii) the phasing out of investments in coal mines and tar sands, (iv) the investment of €15bn in renewable and affordable energy, for example through green bonds, and (v) the doubling of 'green building certificate' real estate assets in APG's portfolio.

2.2.37 ABP also states in its sustainable and responsible investment policy that it will be working towards building consensus for the abovementioned SDI-standards among investors.

2.2.38 Another example is the PMT (*Stichting Pensioenfonds Metaal en Techniek*) investment policy which contains, as one of their ten investment beliefs:

Only investments that take account of ESG factors (Environmental, Social, Governance) are profitable in the long term because adverse consequences of an economic activity cannot be passed on to people, society and the environment indefinitely.

ANNEXES

Netherlands

NETHERLANDS

2.2.39 PMT (*Stichting Pensioenfonds Metaal en Techniek*) declares that it takes ESG factors into account in its decision-making around all investments, ie through measuring the CO2 footprint of its equity portfolio and asking companies to report on their activities regarding human rights. Unlike ABP, PMT has not set itself specific goals, but does commit to creating and enlarging its awareness of ESG. As instruments used to operationalise ESG themes, PMT lists: (i) using its shareholders' rights and entering into dialogue, (ii) not investing in countries violating international treaties or products conflicting with the principles of PMT, and (iii) where possible, not only avoiding negative ESG consequences of investments, but investing in solutions to social problems, while maintaining returns.

2.3 Mutual funds

Types of mutual fund covered

2.3.1 This memorandum considers the position of UCITS Directive[33] compliant collective investment schemes regulated by the Dutch Authority for the Financial Markets (*Stichting Autoriteit Financiële Markten* (AFM)). It does not consider alternative investment funds regulated under the EU Alternative Investment Fund Managers Directive[34] (AIFMD), which together with UCITS funds comprise the two categories of collective investment schemes regulated under the Dutch Financial Supervision Act (*Wet op het financieel toezicht*) and the rules and regulations made under it (the DFSA).

2.3.2 In discussing mutual funds in this memorandum, we use the following expressions in the way described.

- **Asset owner**: UCITS funds can either be self-managed or managed by an external/separate management company. Where a UCITS has a separate management company, the asset owner can be regarded as, essentially, a combination of the two. Where the UCITS is self-managed, the asset owner is the UCITS itself. For the purposes of this memorandum, the asset owners in each of these scenarios will be referred to as UCITS managers.
- **Beneficiaries**: the current unitholders in the mutual fund.
- **Investment decision-maker**: the authorised UCITS manager or delegated investment manager. Where the authorised UCITS manager delegates its investment duties to an investment manager, in principle it retains responsibility for the investment manager's decisions.

2.3.3 Briefly, UCITS are open-ended collective investment schemes that comply with the UCITS Directive and are authorised by the AFM for promotion to retail investors (although institutional investors also invest at scale in UCITS). A UCITS fund manager must be established in the form of a company with legal personality and should have at least two directors entrusted with its daily affairs who perform their duties from the Netherlands. A UCITS manager may, in principle, delegate its investment duties to an investment manager, subject to certain requirements under the DFSA.

Overview of investment duties and powers, and use of investment powers to invest for sustainability impact

Summary conclusion

2.3.4 As with pension funds, there are certain circumstances in which UCITS managers are required to use their investment powers (or refrain from using them) in a manner that is consistent with IFSI (for example, so as to prevent the laundering of terrorist finance). Subject to that, since ultimate ends IFSI is a form of investment objective, it is unlikely that a UCITS manager would be required to pursue ultimate ends IFSI where, as is usually the case at present, the disclosed investment objectives and policy of the UCITS, and/or the prospectus of the UCITS, do not contemplate it. However, a UCITS manager is certainly permitted and likely even required to pursue instrumental IFSI even where it is not contemplated in the disclosed investment objectives, policy and prospectus of the UCITS, if such would be in furtherance of achieving the disclosed investment objectives of the UCITS.

2.3.5 A UCITS manager must generally be authorised by the AFM in accordance with the requirements of the DFSA. Many of the requirements applicable to UCITS managers under the DFSA stem from the Dutch implementation of the UCITS Directive, as well as from directly applicable EU legislation.

2.3.6 Under the DFSA, as part of their duty of care, UCITS managers are, among other things, required to treat unitholders fairly and act in unitholders' best interests. The DFSA does not contain any provisions limiting this to *financial* interests. In principle, it could therefore be taken to include other kinds of interest (but see further at paragraph 2.3.12 below). The DFSA also contains requirements around investor protection, valuation and disclosure regarding the UCITS' investment objectives and policies and the assets in which the UCITS may invest.

2.3.7 UCITS managers have a duty to act in a way that is consistent with the constitution of the UCITS and its prospectus, including the fund's

NETHERLANDS

investment objectives. Breaching such duties can lead to liability for breach of contract, regulatory enforcement or liability based on an unlawful act (*onrechtmatige daad*).

2.3.8 UCITS managers can delegate investment decision-making to investment managers subject, among other things, to a duty to exercise due skill, care and diligence in doing so. The UCITS manager nonetheless retains responsibility for compliance with its general duties under the DFSA.

2.3.9 Certain UCITS may be listed on stock exchanges as exchange traded funds (ETFs) and subject to additional requirements of the particular exchange on which the ETF is traded.[35]

Legal requirements to use investment powers to pursue IFSI

2.3.10 As with pension funds, certain sorts of investment activity are prohibited in the Netherlands, such as investment that would facilitate money laundering. Using investment powers in accordance with this legislation can be regarded as a form of IFSI and our comments at paragraph 2.2.21 above apply equally here.

2.3.11 Other than that, there is no general requirement for UCITS to use their investment powers to pursue IFSI.

2.3.12 We have considered whether the general duty of care under the DFSA requires a UCITS manager to pursue sustainability impact, in particular on the basis that it is in the interests of beneficiaries. While each fund would need to be considered on its own terms, unless one of the stated investment objectives of the fund is consistent with IFSI, we do not consider that it does insofar it concerns ultimate ends IFSI. The regulatory rules under the DFSA on the creation and operation of UCITS funds are highly prescriptive. In particular, the DFSA imposes detailed requirements in relation to describing and disclosing the investment objective and policy of the UCITS, including in its prospectus. These features would be fundamental in determining the scope of the UCITS manager's duty to act in the interests of beneficiaries because they are (and as a regulatory matter are intended to be) the basis upon which beneficiaries have invested in the UCITS. Since ultimate ends IFSI is a form of investment objective, it is unlikely that a UCITS manager would be required to use its powers of investment and divestment to pursue ultimate ends IFSI where, as is usually the case at present, the disclosed investment objectives and policy of the UCITS do not contemplate it. This entails that a UCITS manager needs to disclose its intention to pursue ultimate ends IFSI in, for instance, the investment objectives and policy as disclosed. However, we believe that where the disclosed investment objectives, policy and prospectus of the UCITS do not contemplate the pursuit of sustainability impact, the UCITS manager would likely be required to pursue instrumental IFSI if such would be instrumental in achieving the disclosed investment objectives of the UCITS.

Legal freedom to use investment powers to invest for sustainability impact

2.3.13 We have also considered whether the general duty of care under the DFSA permits a UCITS manager to pursue sustainability impact.

2.3.14 Were a UCITS manager to seek to pursue IFSI, it would be essential that it did not result in any divergence from the stated investment objective and policy of the UCITS. However, subject to that, it is at least possible that a UCITS manager could take sustainability impact into account in so-called 'tie break' situations (to choose between two otherwise equal investment options), or where it is demonstrably clear that the investors in the UCITS fund expect it to do so. In considering its approach, the UCITS manager might need to take account of the characteristics of the fund and, in particular, whether unitholders are likely to hold units for a long period of time and therefore be more exposed to systemic sustainability risk.[36]

2.4 Insurance undertakings

2.4.1 In discussing insurance undertakings in this memorandum, we use the following expressions in the way described.

- **Asset owner**: the insurer.
- **Beneficiaries**: natural or legal persons who are entitled to benefit under an insurance policy issued by the insurer, ie the insured.
- **Investor**: means the shareholder of an insurer.
- **Investment decision-maker**: the insurer or an investment manager appointed by the insurer.

Types of insurance undertaking covered

2.4.2 A distinction can be made between life insurance and general/non-life insurance, briefly outlined below. Where not otherwise specified, references to insurers in this memorandum refer to both life and non-life insurers.

General insurance versus life insurance

2.4.3 The concept of general insurance needs little introduction. In return for the payment of a premium, the insurer undertakes to insure against a set of

NETHERLANDS

specified risks. The policyholder's objective is to secure protection from those risks, rather than an investment return (and, in one sense, a policyholder is therefore not concerned with how premiums are invested). The insurer's profit is essentially the difference between premiums plus investment return less its costs and what it has to pay out to cover claims.

2.4.4 Under a life insurance contract, the insurer undertakes, in consideration of payment of a premium, either as a single premium or throughout a specific period, to pay a lump sum or specified regular income on the death of that person, or some other defined event, for example, contracting a critical illness. Contract-based pension policies (see paragraph 2.2.4 above) in principle qualify as life insurance.

2.4.5 There are various sorts of life policies. Among other things, they may be 'with-profits' (also known as 'participating'), where the relevant policyholder would be entitled to at least a guaranteed amount on maturity of the policy. Investment performance is reflected in bonuses that attach to the policy. Bonuses may be declared annually, and final bonuses are added on maturity. It has become much less common for insurers to offer policies of this sort, in part because of the way investment risk falls on the insurer.

2.4.6 An alternative is unit-linked life insurance. The predominant, if not almost exclusive, purpose of this sort of insurance is investment. Relevant policyholder premiums are used to purchase notional 'units' in an investment fund and returns payable to the relevant policyholder reflect the performance of those units. As such, investment risk falls on the policyholder. Policyholders select the funds they wish to invest in from a range available. In reality, the units are contractual claims under the policy against the insurer, the value of which is calculated by reference to the performance of an identifiable pool of assets held within the insurer's fund of assets held in connection with its life assurance business as a whole.

Overview of investment duties and powers, and use of investment powers to pursue IFSI

Summary conclusion

2.4.7 As with pension funds and mutual funds, there are certain circumstances in which insurers are required to use their investment powers (or refrain from using them) in a manner that is consistent with IFSI (for example, so as to prevent the laundering of terrorist finance). However, this is not the only situation where legal duties may require IFSI. Essentially, while each insurer would need to consider its own situation, we anticipate that the duties of directors of insurance undertakings in the Netherlands may lead them to conclude that the insurer should use its powers of investment and divestment with a view to instrumental IFSI, since this is relevant to achieving the success of the insurer in the long term. Indeed, for listed Dutch insurers this is consistent with the approach of the Dutch Corporate Governance Code. Since insurers own their assets as principal, there is also flexibility for an insurer to pursue ultimate-ends IFSI. In each case, the insurer would nonetheless need to comply with Dutch regulatory capital requirements. In addition, the insurer would need to act in a manner consistent with the terms of any policies it has written (which, in the case of existing policies, could impose constraints similar to those discussed above in relation to mutual funds).

Analysis

2.4.8 An insurance undertaking must be operated in the form of a legal entity subject to the Dutch corporate code.[37] The starting point under Dutch corporate law is that the board of an insurance company is responsible for determining the strategy of the company. In doing so the board must act in the company's interest (*vennootschappelijk belang*).[38] Although Dutch law does as such not provide a definition of the concept of 'company's interest', according to case law such interest should be determined on the basis of the circumstances of the case[39], with an emphasis on the long-term success (*bestendige succes*) of the company and its enterprise. In performing their duty to act in the interest of the company, directors must also carefully consider the interests of all relevant stakeholders.[40] These are its shareholders, employees, creditors and in the case of an insurance company, specifically, its insured persons.

2.4.9 Furthermore, as of 1 December 2019, the rules regarding remuneration for listed entities require an explanation as to how the management renumeration policy contributes not only to the company's strategy, its long-term interests, but also to the sustainability of the company.[41]

2.4.10 The starting point is that premiums paid to an insurer are assets of the insurer, to be disposed over as principal, and as such are at the disposal of the board of the company for investing with a view to ensuring the continuity and long-term success (*bestendige success*) of the company, in the interests of the company's

NETHERLANDS

stakeholders. This in principle gives the board of the insurance company wide discretion as to how to set the investment policy, subject to specific regulatory requirements set out further below.

2.4.11 Recently, in Dutch legal literature a debate has ensued between authoritative writers as to whether the legal duty of directors and supervisory directors of companies to properly perform their statutory task should include the legal duty to ensure that the company operates in a sustainable manner, accounting for all ESG factors in the conduct of the company's business as part of society.[42] The legal writers argued for a change of law to the effect that the directors and supervisory directors in the performance of their tasks as (supervisory) directors of the company must take as a guiding principle the conduct of the company and the associated enterprise as a responsible company (*verantwoordelijke vennootschap*) in society. The second suggested change concerns the recording of the company's *purpose* in the articles of association of the company, whereby its purpose would convey the company's voluntary expression of its ultimate goal and its leading principles. In substance, an argument was made for an express legal basis for responsible corporate citizenship and a new contract between the company and society, whereby the (supervisory) directors could be held liable for failing to ensure compliance. The premise for the argument and the call for amendment of the law was the claim that Dutch (listed) companies have in recent years been focused too much on the creation of shareholder value and have become detached from society. The claim attracted some attention and opposition.[43] Both the factual and legal premise of the claim where opposed and considered flawed. In particular in light of the existing Dutch legal framework as already applicable to (listed) companies. In this legal framework ESG factors can be and indeed are in practice part of the consideration of the board and its supervisory directors when determining the strategy of the company. Also, responsible conduct of the business is already set as a standard. This also flows from the Dutch Corporate Governance Code (the Code).[44] The Code in Principle 1.1.1. expressly identifies decent and responsible entrepreneurial activity. See in particular Principle 1.1.1 v and vi where it regards the long term strategy, and that this strategy should consider the interests of stakeholders, employees, social and environmental aspects and the responsibility in the international (supply) chain.

2.4.12 The Code contains the principles and best practices regarding governance which can be considered as widely supported and generally accepted in the Netherlands. These principles are set out in so called best practice provisions.

2.4.13 The Code is statutorily anchored in article 2:391, section 5, of the Dutch Civil Code (DCC) on the basis of which the Code has been designated by legislative decree as the code of conduct in respect of which the board of the company must account for in the management report to the financial accounts.[45]

2.4.14 The Code applies to all companies that have their statutory seat in the Netherlands and whose shares are listed on a regulated market or a comparable system in the Netherlands or elsewhere.[46] The Code is based on a 'comply or explain' approach[47]: where the insurer deviates from the Code, it must disclose its reasons for doing so in its annual board report. The reasons for deviation should in any event include how and why the company deviated from the principle. If applicable, the board should also incorporate a description of any alternative measure that was taken and either explain how that measure served the purpose of the principle departed from. If the departure is of a temporary nature and continues for more than one financial year, an indication of when the company intends to comply with the principle again should be incorporated as well.[48] It is for the general meeting of shareholders to ultimately decide whether it agrees with the explanation for deviations from the Code.[49]

2.4.15 Principle 1.1 of the Code requires the management board (monitored by the supervisory board, as applicable; see Principle 1.1.2 and 1.1.3) to focus on long-term value creation for the company and its affiliated enterprise. In doing so, the management board should formulate a strategy that reflects this focus (Principle 1.1.1). When developing the strategy, attention should in any event be paid to, *inter alia*:

- the interests of the stakeholders (Principle 1.1.1 section v.); and
- any other aspect relevant to the company and its affiliated enterprise, such as the environment, social and employee-related matters, the chain within which the enterprise operates, respect for human rights, and fighting corruption and bribery (Principle 1.1.1 section vi.).

2.4.16 By introducing the environment and social matters as a relevant aspect in long-term value creation, sustainability has found its way into the Code. According to the Monitoring Committee Corporate

NETHERLANDS

Governance Code, corporate social responsibility (*maatschappelijk verantwoord ondernemen*) forms an integral part of the day-to-day operations of a company that aims to create long-term value.[50] While the Code does not impose a binding legal obligation, its content is seen as reflecting widely held general views on good corporate governance (this is emphasised by the fact that deviation is not possible without extensive explanation).[51]

2.4.17 In practice the framework within which an insurer can exercise its investment powers is further set by:

(a) the terms of the policies it has written with its policyholders (to the extent those policies contain provisions that are relevant to the investment process);

(b) rules set out in the DFSA (and, where relevant, the DCC), and

(c) duties to observe reasonable care and skill *vis-à-vis* its clients (ie the policyholders) in carrying out its activities as part of the general duty of care that has been established for financial institutions *vis-à-vis* their clients, in particular in relation to (complex) financial products.

2.4.18 The applicable rules under Dutch law will depend, in part, on whether an insurer is a 'Solvency-II firm', a 'Solvency-II – light firm' or a 'non-Solvency-II firm'. This memorandum only considers Solvency-II firms.

2.4.19 In the Netherlands, insurers must be authorised by DNB pursuant to the DFSA and are regulated by both DNB (for prudential purposes) and AFM (for non-prudential purposes). Many of the requirements for insurers set out below stem from the Dutch implementation of the Solvency II Directive, the Insurance Distribution Directive and Packaged Retail and Insurance-Based Investment Products Regulation, as set out in Dutch implementing legislation (primarily, the DFSA) as well as other directly applicable EU regulations (please refer to the EU law section of this report).[52]

2.4.20 The DFSA also obliges insurers to take the legal form of a public limited liability company (*naamloze vennootschap*), mutual insurance company (*onderlinge waarborgmaatschappij*) or European Company (*Societas Europaea* or *SE*). As a consequence, insurers must also comply with relevant governance and corporate law requirements applicable to such type of legal entities set out in the DCC, including the Code (as discussed above in para 2.4.8 *et seq*.

2.4.21 Similar to pension funds, insurers' investment powers are primarily governed by a prudent person principle, which stems from Article 132 of the Solvency-II Directive[53]. Article 132 Solvency-II has been implemented in Dutch law in Section 3:267h of the DFSA in conjunction with Chapter 12.2 of the Decree on Prudential Rules (*Besluit prudentiële regels Wft*). Pursuant thereto, insurers are required to pursue an investment policy in accordance with the prudent person principle as set out in Articles 132(2) – 132(4) Solvency-II, taking into account Title I of Chapter VIII of the Regulation (EU) 2015/35 on the taking up and pursuit of the business of Insurance and Reinsurance (Solvency II).[54] Essentially, the prudent person principle requires that:

(a) with respect to the whole portfolio of assets, the insurer shall only invest in assets and instruments whose risks it can properly identify, measure, monitor, manage, control and report, and can appropriately take into account in the assessment of its overall solvency needs;

(b) all the assets of the insurer are invested in a manner that ensures the security, quality, liquidity and profitability of the portfolio of assets of the insurer as a whole;

(c) assets held to cover the technical provisions are invested (i) in a manner appropriate to the nature and duration of the insurance liabilities and (ii) in the best interest of all beneficiaries taking into account any disclosed policy objective;

(d) in the case of a conflict of interest, insurers (or their investment manager) must ensure that the investment is made in the best interest of policy holders and beneficiaries.

(e) As part of the prudent person principle, Articles 132 paragraphs 3 and 4 Solvency-II set out certain further requirements in relation to *inter alia* benefits provided under an insurance contract directly linked to the value of units in a UCITS or a share index, the use of derivatives, investment in certain types of assets as well as asset diversification.

2.4.22 Insurers are further subject to the conduct of business requirements under the DFSA, including the duty of care to act honestly, fairly and professionally in accordance with the interests of their policyholders. The DFSA does not define 'interests'; this requirement could therefore in principle be interpreted as extending beyond financial interests (but see further below).

2.4.23 Where insurers distribute their own insurance products, in certain circumstances, such as where they advise potential policyholders on the product

NETHERLANDS

or provide a personal recommendation, the insurer will be required to assess the suitability of that product for the relevant potential policyholder. This entails an assessment of the policyholder's investment objectives, financial position, knowledge, experience and risk tolerance. Suitability is a concept resulting from MIFID II (Section 25(2) MIFID II (Directive 2014/65/EU)). It is important to note that insurance companies fall, in principle, outside the scope of MIFID II (Section 2 MIFID II). However, the Insurance Distribution Directive (IDD) directly requires insurance companies to offer suitable products (Section 30(1) IDD (Directive 2016/97/EU). Section 25(2) of MIFID II and Section 30(1) IDD are both implemented by Section 4:23 DFSA.[55] This section mentions 'financial undertakings', which includes insurance companies (Section 1:1 DFSA).

2.4.24 The European Commission noted in the Action Plan: Financing Sustainable Growth[56] that beneficiaries' preferences as regards sustainability are often not sufficiently considered when advice is given by insurers. As part of the suitability assessment, insurers should ask about their clients' ESG preferences and take them into account when assessing the range of insurance products to be recommended. Therefore, the Commission has adopted and amended MiFID II and IDD delegated acts (Delegated Act 2017/565 (MIFID II)[57] and Delegated Act 2017/2359 (IDD)[58]) on 21 April 2021, to ensure that sustainability preferences are taken into account in the suitability assessment. The amendments to the MiFID II and IDD delegated acts are expected to apply as of October 2022. ESMA considers it would be a good practice for firms to consider non-financial elements when gathering information on the client's investment objectives, and collect information on the client's preferences on environmental, social and governance factors.[59] In a consultation paper on integrating sustainability risks and factors in MiFID II ESMA adds that 'ESG preferences should only be addressed once the suitability has been assessed in accordance with the criteria of knowledge and experience, financial situation and investment objectives. Once the range of suitable products has been identified following this assessment, in a second step the product that fulfils best the client's ESG preferences should be chosen.'[60] In this light, it seems to be the case that ESG preferences can and should fall within the scope of the suitability assessment, but only on a secondary basis. In ESMA's final report on integrating sustainability risks and factors in MiFID II, ESMA stated that the consultation paper also included suggested amendments to guidelines on certain aspects of the MiFID II suitability requirements. ESMA intends to finalise the updates to these guidelines only after the updated MIFID II delegated acts have been fully approved.[61]

2.4.25 Pursuant to article 4:24a sub paragraph 1 of the DFSA any financial service provider, including an insurance company, also has a general duty of care *vis-à-vis* prospective clients and beneficiaries. This general duty of care requires that the insurer must carefully consider the justified interest of the prospective client or beneficiary. This general duty of care for instance extends to how the insurer charges costs to the insured or beneficiaries and how investments are made.

2.4.26 An infringement of a regulatory breach may result in the AFM taking action against the insurer.

2.4.27 In addition to the general duty of care promogulated pursuant to the DFSA, insurers are also subject to duties of care on the basis of the contract between the insurer and the insured. These contractual duties may be invoked by the insured against the insurance company.

2.4.28 However, in addition to basing a claim on a breach of contract, an insured or beneficiary may also attempt to base its claim on tort, relying on the argument that the insurance company infringed its duties pursuant to the DFSA. This because an infringement of a statutory duty – in this case the duty of care created under the DFSA – qualifies as a tort, permitting a claim for damages by the insured.

NETHERLANDS

General insurance / life insurance: legal requirements to use investment powers to pursue IFSI

2.4.29 As with pension funds and mutual funds, certain sorts of investment activity are obviously prohibited in the Netherlands, such as investment that would facilitate money laundering. Using investment powers in accordance with this legislation can be regarded as a form of IFSI and our comments at paragraph 2.2.21 above apply equally here.

2.4.30 Looking more specifically at the investment of an insurer's assets, there are no explicit legal requirements requiring IFSI (except where the terms of a policy written by the insurer require it). However, some insurers may have shareholders with a medium- or longer-term interest in the performance of the insurer who are therefore likely to be exposed if declining social and environmental sustainability damage that performance. In addition, as noted at paragraph 2.3.6, the directors of an insurer established as a company have a legal duty to seek its success, not just for its present owners, but also for its future owners. As further noted at paragraph 2.4.15, the need to operate a business to secure its long-term success for its investors and wider stakeholders, taking account of the impact of environmental and social sustainability among other things, is reflected in the Code. In view of this, [the directors of] insurers should consider what, if anything, they are able to do to reduce the risk to the company's long-term performance from declining environmental and economic sustainability. While the [directors] of each insurer would need to consider the situation of that insurer specifically, we anticipate that in many cases this is likely to lead them to conclude that the insurer should use its powers of investment and divestment to pursue positive sustainability impacts where doing so can reasonably be expected to help in achieving that goal. As mentioned already, for listed insurers this follows from the Code.

2.4.31 The prudent person rule is a measure that applies to setting an investment policy or making investment decisions for the benefit of beneficiaries (ie in this case the insured or policyholders), with a view to safeguarding their future entitlements, and therefore is a different rule than the directors' duty to act in the company's interest and to further its continuity. However, ultimately both rules may in practice require the same or similar actions from the perspective of IFSI when it comes to investment decisions.

2.4.32 As explained in the main body of the report, taking ESG factors into account does not necessarily amount to IFSI (since it may involve no more than seeking to avoid short-term financial damage from ESG risks without pursuing specified sustainability impact objectives). Similar factors to those mentioned above would be relevant for the directors to consider in determining whether they should pursue IFSI rather than simply taking ESG factors into account. Since, by definition, individual insurers are not generally able to bring about change at a system-wide level, one way of doing this would be through various forms of investor alliance. Examples of this in the Dutch context are the SIC and IRBC Agreement. The Sustainable Investing Code (*Code Duurzaam Beleggen* or SIC),[62] was established in 2012, for insurance undertakings in the Netherlands. The SIC was thoroughly updated in 2018 via the IRBC (International Responsible Business Conduct) for the insurance sector (the IRBC Agreement).[63] The idea behind the agreement being that the parties are jointly looking for possibilities to make the improvements in respect of ESG themes. Examples of these themes are: human and labour rights, including freedom of association, collective bargaining, living wage, children's rights, gender, equality and land rights, and climate change, nature, corruption, health (including access to medicines) and animal welfare. Examples of sectors susceptible to ESG violation are: manufacturing industry, energy, mineral extraction, agriculture, food and fishing, and controversial weapons and the trade in controversial weapons. Within the context of the agreement, the parties will endeavour to cooperate on the basis of 'knowing and showing', as they recognise the added value of this approach. The aim of this joint approach is to achieve structural change.

2.4.33 The IRBC Agreement provides the Dutch insurance sector with the opportunity to join forces with the government, trade unions and CSOs to address specific complex problems in a structured and solution-oriented manner. When engaging in activities of this sort, the [directors] of the company would need to set an appropriate balance between the interests of investors with medium- and longer-term interests, and those with shorter-term interests.

NETHERLANDS

2.4.34 In seeking to pursue IFSI, the insurer would need to ensure that its investment approach was not inconsistent with the terms of any policies it has written (which, in the case of existing policies, could impose constraints similar to those discussed above in relation to mutual funds).

2.4.35 The insurer would also need to comply with Dutch regulatory capital requirements for insurers.

General insurance/life insurance: legal freedom to use investment powers to pursue IFSI

2.4.36 Since insurers own their assets as principal, there is also flexibility for an insurer to pursue IFSI more broadly, if the directors conclude that doing so is consistent with discharging their duties to the company. They might do this, for example, in the light of growing evidence that investors wish their investment to 'do good' as well as earning a good investment return.

2.4.37 The expectations set by the Code would be consistent with the use of a listed insurer's investment powers to pursue IFSI, in particular, where doing so could be expected to protect the value of the company in the long-term.[64]

2.4.38 As discussed above in the context of duties to pursue IFSI, the insurer would need to ensure that any course of action it adopts does not breach Dutch capital rules for insurers or the terms of any policies the insurer has written.

NETHERLANDS

3. ASSET OWNERS' USE OF THEIR POSITION TO ENGAGE IN STEWARDSHIP ACTIVITIES TO SECURE SUSTAINABILITY IMPACT

3.1 The following section considers the extent to which, and on what basis, each type of asset owner is (a) legally required or (b) legally permitted or able to use its position to influence enterprises in which it invests by engaging in stewardship activities designed to achieve positive sustainability impacts and minimise negative sustainability impacts. In practice, initiatives have been developed among asset owners in relation to engaging in stewardship activities, although in the main these are all soft law initiatives, including for instance the Dutch Stewardship Code which is further discussed below.

3.2 **Pension funds**

Legal requirements to engage for sustainability impact

3.2.1 In the Netherlands, there are no laws that expressly require pension funds to engage in stewardship activities, whether designed to achieve positive or reduce negative sustainability impact or otherwise.

3.2.2 However, as a general principle, Dutch pension funds are required to determine their investment policy in accordance with the prudent person rule (see Section 2 above). This is not limited to questions of asset allocation or the use of powers to invest and divest. It also includes the way in which pension funds engage with the enterprises in which they invest – ie their stewardship activities. As discussed in Section 2, a pension fund would be required to pursue a sustainability impact goal where that is in line with the prudent person rule. As also discussed in Section 2, this may be the case where the sustainability impact sought is intended to address system-wide risks from declining environmental or social sustainability and the fund has beneficiaries with financial interests in the medium- to long-term; as noted, since steps taken by an individual pension fund on its own are unlikely to be able to address system-wide risks, one of the most important means of advancing sustainability impact goals in these circumstances is through cooperation with other asset owners.

Legal freedom to invest for sustainability impact ,

3.2.3 As also noted in Section 2, the prudent person rule is an 'open standard'. The interpretation and application of the prudent person rule by a pension fund is in principle a matter for the pension fund, and not for, for example, the regulator (although compliance would ultimately be a matter for the courts). This freedom permits pension funds considerable room in pursuing positive sustainability impact, including engaging in stewardship activities, even where the ultimate goal is not to address system-wide risks, as described above. The prudent person rule is certainly more permissive than that as regards stewardship activities and would also permit ultimate-ends IFSI, in particular where this would not adversely affect the rights of beneficiaries. For instance, where there would be only limited costs involved with doing so.

Observations on stewardship activity by Dutch pension funds

3.2.4 As mentioned above, the vast majority of Dutch pension funds have developed an ESG investment policy which covers stewardship activities as well as the use of powers of investment and divestment.

3.2.5 Both ABP and PMT have included in their respective stewardship policies that they shall actively use their voting and meeting (/discussion) rights to engage in IFSI. Both state that they will enter into conversation with companies in which they invest, to influence the companies' strategy and impact on the policy and behaviour of such companies.[65]

3.2.6 ABP had listed some achievements in its 2019 sustainable investing report that show how ABP as part of its stewardship activities has used its shareholder rights.[66] On these items, ABP has cooperated with other pension funds, investors and NGOs. Since ABP wants the companies it invests in to be socially responsible and take into account, among other things, human rights, this cooperation between investors and other stakeholders has for instance resulted in conversations with multiple raw materials companies which have led to human rights being better taken into account and monitored. Furthermore, multiple technology companies, such as Facebook and Alphabet (Google) have been confronted by ABP on issues such as protection of data and privacy.

3.2.7 Also, since 2015, ABP has entered into conversations with 10 large companies in the clothing industry, where the main issue is the human rights/labour conditions (at these companies or with suppliers to these companies) and which also addresses the monitoring and transparency around suppliers and the sustainability of the goods produced.

> ANNEXES

> Netherlands

NETHERLANDS

3.2.8 PMT has set itself some guidance in this regard in its 'responsible investing policy', ie to enter into conversations with companies that are guilty of (severe forms of) bribery, corruption, market abuse and breach of laws regarding human rights and the environment.[67] Also from PMT's 2019 annual report it appears that it has actively used its power as (large) shareholder, to encourage companies to think about ESG topics that raise risks for the environment and society: in these conversations they aim to stress the importance of proper governance, the climate and social factors. It is stated in PMTs annual report that in case such conversations do not lead to the envisaged results, PMT may consider terminating the investment.[68]

3.2.9 As mentioned above, pension funds do not only engage in stewardship activities on an individual basis. There are also examples of pension funds joining with each other, other investors and non-governmental organisations (NGOs) to be more effective in seeking to achieve sustainability impacts. An example is the agreement "*Maatschappelijk Verantwoord Beleggen Pensioenfondsen*" which has been signed by over 80 Dutch pension funds as well as by the Dutch government, six civil society organisations/NGO and trade unions.[69] Under this agreement, the parties aim to prevent or tackle negative consequences for society and the environment of investments by pension funds. The parties contribute their knowledge and expertise to this end. The agreement was arrived at with guidance from the Social and Economic Council of the Netherlands (SER).

3.2.10 With this agreement, the pension funds are joining forces with the other parties to exert influence worldwide and to prevent or tackle problems in the chains of these enterprises in the areas of human rights and the environment.

3.2.11 The pension funds that are signatories have chosen an approach based on the OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights (UNGPs) to identify, prioritise and address such ESG risks. In this agreement, ESG risks refer to risks for society and the environment.

3.2.12 At this time most pension funds have a generic code of conduct or stewardship policy, which refers more generally to the fiduciary duties of directors without containing language indicating that directors specifically have the duty to pursue IFSI. This appears in line with the conclusion that the Association of Investors for Sustainable Development (*Vereniging van Beleggers voor Duurzame Ontwikkeling* or *VBDO*) has drawn in its annual investigation into the status of sustainability at the largest 50 Dutch pension funds. ABP was ranked first, while PMT was ranked fifth on the 2020 ranking, published late October 2020.[70]

3.2.13 VBDO states that most pension funds are advised by responsible investment experts, also noting that the level of knowledge on the topic within board rooms is still not what is should be. VBDO has found, through a specified director's questionnaire, that 55 per cent of the board members of pension funds do not have available knowledge on responsible investment, and that an ESG course or training has only been completed by 16 per cent of the board members of pension funds.

3.2.14 The Dutch Stewardship Code, published by Eumedion in 2018,[71] provides 11 non-binding principles for stewardship by asset owners and investment managers towards Dutch listed investee companies. These require asset owners to consider ESG factors as part of their stewardship engagement with listed investee companies, thereby protecting future financial return from declining sustainability and in order to achieve positive sustainability impact as an end in itself.

3.2.15 Eumedion is a Dutch organisation that represents the interests of Dutch institutional investors in the fields of corporate governance and sustainability. Pension funds, insurers, investment institutions and asset managers affiliated with Eumedion are expected to apply the 'comply or explain' principle with regard to the Dutch Stewardship Code and report on its implementation. The code is soft law and does not have a formal legal basis, although in practice is does provide an important framework for engagement by Dutch investors, such as pension funds or investment managers.[72]

3.2.16 The Dutch Stewardship Code sets out that a stewardship policy should, among other things, promote long-term value creation (Principle 1). Monitoring investee companies on among others social and environmental impact is also one of the principles under the Dutch Stewardship Code. The Code sets out a number of best practices in this area and provides guidance for investor engagement that goes beyond the rules existing as a matter of Dutch 'hard' law. The Code provides that asset owners and investment managers should exercise their voting rights in an informed manner, and that they should disclose voting at individual company level on a quarterly basis.

NETHERLANDS

General voting behaviour should be disclosed annually (Principle 7).

3.2.17 While the Stewardship Code does not expressly address pursuing sustainability impact as a goal in its own right, Eumedion has expressed the view that since asset owners and investment managers hold the bulk of shares in Dutch listed companies and manage other people's and institutions' money, society at large expects both Dutch and non-Dutch asset owners and investment managers to take responsibility in playing an active role in promoting good corporate governance and sustainability practices in (large) public companies.

3.2.18 What pension funds can and should do in practice needs to be understood by reference to their legal powers and duties, summarised in Section 2, rather than social expectations. However, as noted, the prudent person rule sets an 'open' standard and prevailing social expectations may nonetheless have an influence on how the directors of the fund view their duties and consequently what the prudent person rule entails.

3.3 Mutual funds

Legal requirements to engage for sustainability impact

3.3.1 In the Netherlands, there are no specific legal requirements for UCITS managers (acting as or on behalf of the relevant UCITS fund) to engage in stewardship activities.

3.3.2 The Dutch Stewardship Code, discussed at paragraph [3.2.14] above, applies to UCITS managers as they fall within the scope of application of the code. They are therefore expected to apply the 'comply or explain' principle when complying with the Code and report on its implementation. Even though the Dutch Stewardship Code is not legally binding and does not therefore, on its own, result in a requirement to engage for sustainability impact, as a best practice guide it does promote stewardship, including with a view to sustainability impact and not only with a view to financial performance. For UCITS the room for IFSI is further determined by the funds documentation as further set out below.

Legal freedom to engage for sustainability impact

3.3.3 As discussed in Section 2, the Dutch regulations for UCITS are designed to provide a high level of investor protection. Where a UCITS does not have an express sustainability impact investment objective, or at least where engaging for sustainability impact is not contemplated in the investment policy of the UCITS, we consider that the scope, if any, for engaging in stewardship activities with the goal of achieving a sustainability impact is likely to be limited.

3.3.4 In theory, since stewardship activities do not principally concern the composition of a fund's portfolio, it might be possible to engage in stewardship activities with the goal of achieving a sustainability impact even where the fund's investment objective and investment policy are silent on the point. However, since doing so would involve a cost, it is questionable whether that cost could be met out of the assets of the UCITS fund since the cost would not have been incurred in furtherance of the fund's investment objective or in accordance with its policy. A possible exception might be where the fund passively tracks a particular investment market or sector, so that it and its investors will always be exposed to that market or sector; where it is clear that the relevant market or sector is facing sustainability risks that are likely to have a material adverse effect on the value of the fund in the long-term, there may be some justification for the fund seeking to engage with companies in which it invests in order to seek to minimise the damage on the basis that this is in the best interests of investors. Because of the challenges and cost of engagement activity of this sort, unless the fund were unusually large, it would probably need to do this in association with other investors (not least because of the extremely low management charges for passive investment funds.) A further exception might be where the fund accesses the investment management services of an investment manager principally to benefit from the investment manager's expertise as an investor, but where the investment manager operates a stewardship approach across all or most of the portfolios it manages that involves it pursuing sustainability impact goals. However, in this case, the appointment of the investment manager would be motivated by the desire to access its investment services, with its engagement activities being incidental to that.

3.4 Insurance undertakings

Legal requirements to engage for sustainability impact

3.4.1 The law does not expressly require life or non-life insurers to engage in stewardship activities aimed at achieving positive or reducing negative sustainability impact.

3.4.2 However, as noted[73] as a general principle under Dutch corporate law, when performing their duties the directors of an insurance company must act in the

> ANNEXES

> Netherlands

NETHERLANDS

company's interest, which in broad terms is defined as the synthesis of the interest of the company in its own continuity and prosperity, accounting for all of the interests of its stakeholders. Also listed life and non-life insurers would need to apply the Corporate Governance Code. Similarly, the Dutch Stewardship Code also applies to these insurers. For the reasons as set out in Section 2, in many cases the directors of insurance companies are likely to conclude that they should pursue instrumental IFSI where doing so can reasonably be expected to help in achieving the goal of reducing the risk to the company's long-term performance from declining environmental and economic sustainability.

3.4.3 Any decision to pursue sustainability impact would need to take account of the terms of any policies that the insurer has written. In particular, where a life insurer wishes to cover the cost of engagement activity out of funds held and managed by the company in connection with policies that are essentially investment products, doing so would need to be consistent with the terms of the relevant policies and the regulatory requirement to act in the best interests of policyholders, including the prudent person rule as it applies to insurers pursuant to the DFSA.[74] If the policy terms do not expressly contemplate some form of 'sustainable investing' this may prove a constraint. However, each situation would need to be considered on its own facts. For example, it may be that the cost of maintaining different stewardship approaches for different books of business makes it unfeasible, so that it would be reasonable for an insurer to adopt a firm-wide approach to stewardship as the cheapest option for all policyholders, which includes engagement activity designed to achieve positive sustainability impact. Further, the larger the portfolios of the insurance company, the lower the 'unit cost' for any policyholder of engagement activity, including any additional cost resulting from engagement on sustainability issues.

3.4.4 The Dutch Corporate Governance Code and the Dutch Stewardship Code (see paragraph 3.2.14) taken together with the IRBC Covenant (see paragraphs[XX]), support the notion that the duties of directors of Dutch insurance companies may lead them to conclude that their company should engage in stewardship activity with the aim of achieving sustainability impacts so as to protect their business from long-term risk from declining social and environmental sustainability. They may also lead directors of insurance companies to conclude they should cooperate with other insurers when engaging in stewardship activity. Insurance companies should apply the 'comply or explain' principle in line with the codes and report on their implementation. As set out previously, both the Dutch Corporate Governance Code and the Dutch Stewardship Code are non-binding.

3.4.5 The IRBC Agreement (see para 2.4.32) requires insurance undertakings to invest in a responsible manner, whereas the goal of the parties that are signature to the agreement is to effect structural and systemic change regarding positive sustainable impact as part of their investments.

3.4.6 The IRBC Agreement does not specifically address directors, but looks at insurance undertakings as a whole. Through the covenant the insurers agree to cooperate in and, where necessary, hold each other accountable for, compliance with and abiding by the (goals set out in the) covenant. Performing ESG due diligence is listed as one of the priority items under the covenant: insurance undertakings are expected to perform ESG due diligence on an ongoing basis, where not just the main risks for the insurance undertaking itself are addressed, but also the potential and actual risks of negative ESG impact for other stakeholders as well.[75]

General insurance: Legal freedom to engage for sustainability impact

3.4.7 For the reasons set out in Section 2, since insurers own their assets as principal, there is flexibility for an insurer to pursue IFSI, provided that the directors conclude that doing so is consistent with discharging their duties to the company. The same analysis will apply to engaging with a view to pursuing sustainability impacts.

3.4.8 When pursuing an objective for sustainability impact in their engagement as shareholders, insurance companies would also need to abide by the terms of the relevant insurance policy as well as the applicable legal framework under financial regulatory law, including the prudent person principle. Please see paragraph [2.2.60]

NETHERLANDS

Life insurance: Legal freedom to engage for sustainability impact

3.4.9 It is worth noting that for life-insurers the legal freedom may be limited pursuant to the type of life insurance.

3.4.10 Dependent on whether the life insurance is 'with profits' or 'unit-linked', as further explained in paragraphs [2.1.57 and 2.1.58] the investment risk lies with the insurance company or the relevant insurance policyholder.[76] For unit-linked life policies, the relevant policyholder selects the funds they wish to invest in from a range available. Where the relevant policyholder does not have a say in the funds in which the life insurer will invest their premium, the life insurer has less freedom to pursue IFSI than is the case where the policyholder does have a say.

3.4.11 Also, life insurers may be prevented from setting a particular sustainability impact objective, for instance where the insurer has received opposition from relevant policyholders against the view on which the sustainability impact objective is based or where setting the objective is projected to result in significant financial detriment to the fund.

NETHERLANDS

4. ASSET OWNERS' ENGAGEMENT IN PUBLIC POLICY WORK TO SECURE SUSTAINABILITY IMPACT

4.1 The following section considers the extent to which, and on what basis, each type of asset owner is (a) legally required or (b) legally permitted or able to use its position to engage in public policy work designed to achieve positive sustainability impact and minimise negative sustainability impact, for example, where this is relevant to the value of portfolio assets.

4.2 By way of general introduction, Dutch law does not expressly require asset owners to engage in policy discussions and/or to lobby policymakers to achieve positive and/or reduce negative sustainability impacts. However, the duties of asset owners (especially those of trustees/directors of pension funds and directors of insurers), may nonetheless lead them to conclude that they are required to engage in these activities in similar circumstances to stewardship activity, considered above.

Pension funds

4.3 In the Netherlands, the prudent person role grants a pension fund discretion to determine its investment policy, including the extent to which ESG and sustainability factors are part of that policy and how these factors are consequently taken into consideration. Within such framework, a pension fund (or an investment manager acting on its behalf) can certainly engage in policy discussions and/or lobbying, and in practice this also what happens to varying degrees.

Mutual funds

4.4 Pursuant to the DFSA, engaging in policy discussions and/or lobbying by UCITS managers is not expressly prohibited and would be subject to the general framework/restrictions as set out in Section 2 above, including that such engagement should not cause the UCITS manager to act in breach of its duty of care *vis-à-vis* the UCITS and its unit-holders.

Insurance undertakings

4.5 Pursuant to the DFSA, engaging in policy discussions and/or lobbying by insurance undertakings is not expressly subject to the (legal) framework / restrictions in relation to insurers' beneficiaries and stakeholders (as applicable), as set out in the paragraphs above.

NETHERLANDS

5. ESTABLISHING NEW FUNDS TO INVEST FOR SUSTAINABILITY IMPACT AND AMENDING THE TERMS OF EXISTING ONES

5.1 The following section considers the extent to which it is possible for an asset owner to set up a fund, policy or other product with the express objective of pursuing IFSI.

5.1.1 Essentially, the ability to establish new funds or sub-funds that pursue IFSI is greatest with mutual funds and insurance policies since, with these products, there is more flexibility for investors to accept the risk of a reduced level of financial return in return for sustainability impact. In all cases, investor protection rules would need to be carefully considered and complied with. The operating rules for UCITS in particular could impose constraints on the sort of sustainability impact strategy that can be pursued; in particular, it would not be easy to invest in illiquid assets or those that are difficult to value. Amending the terms of existing UCITS and life policies to allow for greater flexibility to pursue IFSI would generally require some form of investor consent and a need to comply with various investor protection requirements, making this a potentially expensive and time-consuming option.

Pension funds

5.1.2 As the prudent person role requires a pension fund to, among other things, protect and safeguard the ability of the fund to satisfy the future entitlements of the beneficiaries, a pension fund would likely not be able to set up a vehicle that solely focuses on sustainability impact without regard to financial return, unless part of a wider and more diversified investment portfolio.

5.1.3 Essentially, the ability to establish new funds or sub-funds that pursue investing for sustainability impact is greatest with mutual funds and insurance policies since, with these products, there is more flexibility for investors to accept the risk of a reduced level of financial return in return for sustainability impact. In all cases, investor protection rules would need to be carefully considered and complied with. The operating rules for UCITS in particular could impose constraints on the sort of sustainability impact strategy that can be pursued; in particular, it would not be easy to invest in illiquid assets or those that are difficult to value. Amending the terms of existing UCITS and life policies to allow for greater flexibility to pursue IFSI would generally require some form of investor consent and a need to comply with various investor protection requirements, making this a potentially expensive and time-consuming option.

5.2 Mutual funds

Establishing a new UCITS/new sub-fund of an existing UCITS umbrella

5.2.1 The main purpose of a UCITS is to act as a collective investment vehicle with the aim of enabling a financial return for its unit holders.[77] Subject to that, UCITS are in principle permitted to have non-financial investment objectives, such as IFSI, provided investor protection requirements such as appropriate disclosures are duly met. An important disclosure aspect is for example that the prospectus of the UCITS would need to set out the risks and/or costs associated with IFSI to allow investors to make an informed judgement of the proposed investment and the risks attached thereto, which in practice may not be easily quantifiable.[78]

5.2.2 Those wishing to set up a sustainability impact UCITS would therefore need to carefully consider its design and the way it is described to investors. Among other things, the sustainability impact aims of a UCITS would need to be reasonably capable of being successfully carried into effect, not least because the policy of the UCITS would otherwise be misleading. The AFM can refuse to authorise UCITS that set objectives that are so overly ambitious that they would mislead investors. Operational challenges would also need to be addressed. For example, under applicable valuation requirements, a UCITS manager must among others be able to demonstrate that participations in UCITS under its management have been accurately valued.[79] In practice, it will likely be challenging to measure and quantify the impact on valuation resulting from the fund's sustainability impact investments. The valuation or evaluation methods used by sustainability impact funds, particularly those with broad sustainability impact objectives or broad discretionary powers for UCITS managers to assess sustainability impact, are therefore likely to come under close scrutiny from regulators.

Amending an existing UCITS

5.2.3 It would be possible to amend the investment objectives or policy of an existing UCITS. However, it could be costly and time-consuming, and a UCITS manager might be cautious about any amendment that could materially affect the financial position of existing investors. Although the regulatory rules and guidance for UCITS do not expressly address a change of

NETHERLANDS

investment objectives or policy to permit IFSI, this is in practice likely to amount to a change that would require approval by the unit holders under the fund rules (*fondsreglement*) or articles of incorporation (*statuten*) of the UCITS. Amendments to the UCITS' objectives or policy laid down in the fund rules or instrument of incorporation would also require AFM approval[80], as well as publication of a revised prospectus and KIID.

Duties on those designing, manufacturing and providing mutual funds

5.2.4 Product governance rules require manufacturers of UCITS to specify a 'target market' for the product and ensure that the product's characteristics are consistent with the target market. Manufacturers must regularly review their products for consistency with the target market that was specified. If a UCITS manufacturer determines that the product is no longer appropriate for its target market, it would need to revise the target market and distribution strategy and consider informing the existing investors. The manufacturer would not be required to amend the characteristics of the product.

5.2.5 The current product governance requirements in relation to specifying and understanding the needs of a target market do not as such refer to sustainability considerations. This focus is reflected in industry guidance. Nonetheless, it is increasingly clear that a significant group of investors have sustainability concerns which they would like to see reflected in their investments, as well as financial goals. Indeed, regulators are increasingly encouraging the consideration of sustainability characteristics in target market specifications. The AFM has indicated that as part of its supervisory duties, it will be expecting financial institutions to integrate sustainability aspects into (among others) their product governance and ensure transparency in that regard.[81] ESMA guidance states that where the product has 'specific investment objectives such as…, "green investment" [and] "ethical investment"', these should be *specified* as part of the target market characteristics.[82] Under current EU proposals, UCITS manufacturers would be required to specify the sustainability preferences of the target market for all UCITS and to ensure that the fund's characteristics are compatible with those preferences.

Life insurance products

Establishing a new policy

5.2.6 Provided that applicable consumer protection requirements, including those concerning product design and marketing requirements, are satisfied it would be permissible for life insurers to create products with investment objectives that seek IFSI.

5.2.7 However, certain factors can make it difficult for an insurer to set a sustainability impact objective. For example, restrictions around the composition of the portfolio (eg under the prudent person rule) could limit the methods through which a sustainability impact objective can be implemented, for instance by limiting opportunities to invest directly in infrastructure projects, real estate and unlisted companies with strong ESG credentials because of the illiquid nature of these type of investments.

Amending an existing policy

5.2.8 Amendments of policy documents to incorporate an express IFSI objective is possible but would typically require policyholder consent. Obtaining it is likely to be expensive and time-consuming.

Duties on those designing, manufacturing and providing life insurance

5.2.9 Similar product governance requirements to those set out in paragraph 5.2.4 above apply in relation to investment life insurance products.

› ANNEXES

› Netherlands

NETHERLANDS

6. INVESTMENT MANAGERS' DUTIES TO INVEST FOR SUSTAINABILITY IMPACT

6.1 This section considers the extent to which, and in what circumstances, an investment manager is (a) legally required or (b) legally permitted to pursue IFSI on behalf of an asset owner or otherwise, in each of the three ways contemplated in Sections 2-4.

6.2 Typically, an investment manager's investment duties and powers are shaped by:

(a) the terms of its investment management agreement (IMA) with an asset owner. The IMA will typically specify:

(i) investment objective(s) against which the investment manager's performance (and performance-related remuneration) will be assessed;

(ii) any investment strategy specified by the asset owner;

(iii) any investment restrictions; and

(iv) any contractual standard of care;

(b) statute and delegated legislation, in particular relevant requirements stemming from the DFSA, include observing a general duty of care (*zorgplicht*) *vis-à-vis* clients and the requirement for an investment manager to ensure the suitability of an investment mandate (and the investment decisions thereunder) for its client, essentially comprising a duty to ensure that the client understands the mandate and the risk it entails and is able to bear those risks. Although there is currently no express requirement to solicit clients' objectives with regard to the sustainability impact as part of the suitability assessment, it is considered best practice.[83] Future amendments to the suitability assessment regime may require that investment managers seek information on client views with respect to sustainability impact[84]; and

(c) any duty of care *vis-à-vis* asset owners or third parties on the basis of tort for the purposes of Article 6:162 of the DCC (see also Section 7 below).

Legal obligations with respect to sustainability impact

Powers of investment and divestment

6.3 Where the IMA requires IFSI, the investment manager must pursue a strategy which complies with that. Investment managers are likely to want to ensure that the mandate is clear about the sustainability impact objective being set and how progress towards it is to be assessed, and specifies how it should be balanced with the financial objectives of the mandate to minimise the investment manager's exposure to complaints and possible litigation.

6.4 Where an IMA has expressed all of the material terms of the agreement between the investment manager and the asset owner and is silent on sustainability impact, we do not consider that an investment manager would be under a duty to pursue IFSI, as the legal relationship between the asset owner and the investment manager will primarily be governed by the IMA, and the DFSA does not supplement it such that absent a specific reference to IFSI, an asset manager may interpret the agreement in such a manner that ultimate-ends IFSI would be permitted. This is different for instrumental IFSI, which shall generally fall within the scope of the IMA, arguably even when not specifically agreed, unless precluded by reference to a specific benchmark that would preclude even instrumental.

Engagement to achieve sustainability impact

6.5 As for powers of investment or divestment, an investment manager would need to comply with the IMA. Where the IMA is silent on sustainability impact, the starting point is that there is unlikely to be any legal requirement for investment managers to engage with portfolio companies to achieve sustainability impact.

6.6 However, the position of the investment manager may be somewhat different in its stewardship activity, as compared with its use of powers of investment and divestment. In particular, it is possible to foresee circumstances in which an investment manager takes a firm-wide approach to stewardship activity across all of the portfolios it manages which involves the investment manager seeking to achieve sustainability impact (believing this to be in the best interests of its clients generally). While each situation would need to be considered on its own facts, in circumstances such as this, where the asset owner's principal motivation is to access the investment manager's investment expertise and the asset owner has not opted its assets out of the investment manager's stewardship programme, it would be reasonable to conclude that the investment manager is authorised to pursue sustainability impact in this way. The investment manager would nonetheless need to be satisfied that its activities would not prejudice the realisation of the agreed financial investment objective under the portfolio.

Public policy work to achieve sustainability impact

6.7 As above, an investment manager's duties would follow the terms of its mandate.

NETHERLANDS

Where the mandate is silent as to sustainability impact, we anticipate that the position is likely to be broadly similar to that in relation to stewardship activities.

Legal freedom to invest for sustainability impact

Powers of investment and divestment

6.8 Where the IMA is silent on IFSI, the investment manager's contractual and non-contractual duties are likely to make them cautious about setting a sustainability impact objective if doing so could create a risk that the financial investment objective of the portfolio would not be achieved. In the event of under-performance, the investment manager's investment approach is likely to be benchmarked against that of other managers operating portfolios with similar risk/return balances. As a result, an investment manager could be exposed to litigation risk even where it takes into account sustainability impact only as a secondary factor where the financial return on the portfolio is weaker than that of other managers that have not attempted to achieve a sustainability impact. Likewise, the suitability assessment requirement under the DFSA, mentioned above, will limit the scope for taking sustainability impact factors into account in its investment policy where the client has not identified this as one of its objectives. Finally, in the absence of contractual clarity as to the client's wishes, there is some risk that it could result in the investment manager breaching its duty not to allow conflicts of interest between itself and its client.

6.9 If the asset owner wishes to incorporate IFSI, the IMA should be amended accordingly; non-contractual discussions would remain subordinate to the terms of the IMA. The investment manager and asset owner could agree to amend the terms of an existing IMA so that it contemplates IFSI. However, an asset owner's ability to do this is limited by its own investment duties (see Sections 2-4 above).

Engagement to achieve sustainability impact

6.10 Since stewardship activities are less likely to affect the composition of an investment portfolio (and hence the achievement of the financial investment objective of the portfolio), there may be more scope to pursue sustainability impact through stewardship activities, even where the IMA is silent upon the point (and the investment manager does not operate a firm-wide engagement policy that contemplates stewardship with a view to achieving sustainability impact, as discussed at paragraph 6.5 *et seq* above). However, the investment manager would need to be able to establish that doing so is in its client's best interests and is unlikely to prejudice the realisation of the financial investment objective of the portfolio. Because of the duty of care an investment manager owes to each of its clients, it would also need to be satisfied that pursuing sustainability impact through its stewardship activity will not bring its obligations to one client into conflict with the duties it owes to other clients (without appropriate disclosures and waivers being in place).

6.11 In the absence of any provision in the IMA, an investment manager is unlikely to feel confident about engaging for sustainability impact where doing so is likely to cost the portfolio more than it can return.

Public policy work to achieve sustainability impact

6.12 An investment manager is broadly free to engage in public policy work on its own behalf and funded from its own resources, provided that doing so does not create a conflict of interest between the investment manager and its clients (or between the duties owed to various clients, to the extent any such work is undertaken on any of their behalf).

6.13 Where an investment manager is undertaking public policy work on behalf of a client, its position is likely to be broadly similar to that for stewardship activities, discussed above.

NETHERLANDS

7. LEGAL LIABILITY TO THIRD PARTIES FOR THE NEGATIVE SUSTAINABILITY IMPACT OF ENTERPRISES IN WHICH PORTFOLIOS ARE INVESTED

7.1 This section considers, regardless of the legal rules under which it is required to operate and its constitution, the extent to which an asset owner could be legally liable to third parties for the negative sustainability impact of enterprises in which it invests, and whether an investment manager could also be liable because of its role in assisting the asset owner to invest in the relevant enterprise and steward its investment. In what follows, we have considered the position where an asset owner invests as a shareholder in a Dutch limited company. Most business enterprise in the Netherlands is conducted through limited companies. However, the position could vary where the vehicle concerned is not a limited company or where investment is not by way of shares. An investor's risk where it invests in business enterprises conducted through non-Dutch vehicles would depend upon the legal nature of those vehicles in the jurisdictions in which they are established and is beyond the scope of this report.

7.2 Essentially, two issues need to be considered.

7.3 First, to what extent are business enterprises in which asset owners invest likely to find themselves subject to legal liability for their negative sustainability impacts; and second, even if the enterprise is liable, how likely is it that an asset owner or its investment manager would be held liable as well?

Liability risk of business enterprises for their negative sustainability impact

7.4 Recently both the Dutch State as well as business enterprises have been taken to court by interest groups wishing to advance issues of broad public concern, such as human rights,[85] environmental issues,[86] and climate change.[87] In a couple of these cases, Dutch courts have rendered landmark rulings due to which the litigation risk regarding negative sustainability impact against business enterprises in general has increased.

7.5 Notably, the Hague District Court on 26 May 2021, in a case brought by the environmental group Milieudefensie/Friends of the Earth Netherlands and co-plaintiffs, including several NGOs that the parent company of the Shell group, Royal Dutch Shell, established in the Netherlands (RDS), found that on the basis of applicable (international) soft law frameworks[88], RDS has an obligation to reduce the CO2 emissions of the Shell group's activities (the Milieudefensie/RDS ruling).[89] Subject to appeals, this is a ground-breaking decision as for the first time, a court has found that a private company owes a duty of care to reduce its CO2 emissions.

7.6 The Milieudefensie/RDS case builds on the landmark Urgenda decision in December 2019.[90] In the Urgenda case, the Dutch Supreme Court considered that human rights offer protection against the consequences of dangerous climate change caused by CO2 emissions and found that the Dutch government's policies to reduce greenhouse gas emissions were insufficiently stringent and the Dutch state violated a similar duty of care to its citizens.

7.7 In the Urgenda case the state was held liable on the grounds of its duty of care under Article 6:162 DCC towards its citizens by failing to take sufficient measures to avert the imminent danger caused by climate change.

7.8 It follows from the judgment that instruments of soft law (considered from a national legal perspective within the Netherlands), including the Paris Agreement, while legally not binding between parties nationally, may influence the court in determining the content of a duty of care. The court also referred to articles 2 and 8 of the European Convention for the Protection of Human Rights and Fundamental Freedoms (ECHR) as important factors in determining the scope and extent of the state's duty of care under Article 6:162 DCC:

'43. In short, the State has a positive obligation under Article 2 ECHR to protect the lives of citizens within its jurisdiction, while Article 8 ECHR creates an obligation to protect the right to home and private life. This obligation applies to all activities, public and non-public, which could endanger the rights protected in these articles, and certainly in the case of industrial activities which by their nature are dangerous. If the government is aware that there is a real and imminent threat, the State must take precautionary measures to prevent the infringement as far as possible. In the light of this, the court shall assess the alleged (imminent) climate dangers.

(…)

69. The State also relied on the trias politica and on the role of the courts in our constitution. The State believes that the role of the court stands in the way of imposing an order on the State, as was done by the district court. This defence does not hold water. The Court is obliged to apply

NETHERLANDS

provisions with direct effect of treaties to which the Netherlands is party, including Articles 2 and 8 ECHR. After all, such provisions form part of the Dutch jurisdiction and even take precedence over Dutch laws that deviate from them.'

7.8.1 Up until recently, it was expected that imposing human rights duties in a similar way on private enterprises would prove to be substantially more difficult as obligations arising from human rights treaties (or the Constitution) do not in principle apply directly to companies under Dutch law. This expectation now seems to have been outdated by the Milieudefensie/RDS ruling.

7.8.2 The Milieudefensie/RDS case is a civil case against a business enterprise in which plaintiffs had requested the Dutch court order Shell to limit the joint volume of all CO2-emissions associated with its business activities and fossil fuel products to zero by 2050, based on Shell's duty of care under Article 6:162 DCC. Miliedefensie bases this duty of care *inter alia* on soft law frameworks and made references to the Urgenda case in this context.

7.8.3 In the Milieudefensie/RDS case, the court, considered that, based on *inter alia* the Paris Agreement's goals and the scientific evidence regarding the dangers of climate change, RDS has a duty of care to take action to reduce its greenhouse gas emissions.[91] This duty of care is based on Article 162 of Book 6 DCC which provides that an act or omission breaching a duty imposed by a rule of unwritten law pertaining to proper social conduct results in a tort. While the court acknowledged that human rights and other soft law instruments cannot be directly invoked by plaintiffs because they only apply in relationships between states and citizens, the court does factor these into its interpretation of the relevant unwritten duty of care in the DCC.

7.8.4 Another important element for the court in interpreting the unwritten duty of care is RDS's role as the top holding company of the Shell group. RDS establishes the overall Shell policy, including the climate policy, and is in fact responsible for having an 'oversight of the climate risk management' and for reporting on the greenhouse gas emissions of the various Shell companies, who are only responsible for implementation and execution

7.8.5 Applying the unwritten duty of care, the court found that RDS has an obligation to reduce the CO2 emissions of the Shell group's activities by net 45 per cent by the end of 2030 compared to 2019 levels through the Shell group's corporate policy. This so-called 'reduction obligation' applies to the Shell group's entire energy portfolio and to the aggregate volume of all emissions (Scope 1 through to Scope 3[92]). The court, however, did distinguish between scope 1, 2 and 3 emissions. The court expresses the reduction obligation as an 'obligation of result' for the activities of the Shell group (Scope 1 emissions) and a 'significant best-efforts obligation' with respect to the activities of parties outside of the Shell group, including suppliers (Scope 2 emissions) and end-users (Scope 3 emissions). The court did not seek to prescribe how RDS should meet the 45 per cent reduction obligation, instead leaving it up to RDS to design the reduction. Nor did the court indicate how the order will be enforced or monitored; the decision is, however, expressed to be provisionally enforceable meaning it will not be automatically suspended pending an appeal. The decision does not render RDS's current activities unlawful: instead, it sets a target to be achieved by 2030 and allows RDS to decide on the pathway to be adopted to achieve this.

7.8.6 The Milieudefensie/RDS ruling is expected to be followed by more strategic climate change litigation initiated by NGO's and/or individuals with the aim of seeking to influence corporate behaviour and hold business enterprises liable.

7.8.7 We note that also prior to the Milieudefensie/RDS case, the Dutch courts have repeatedly used soft law frameworks to assess the nature and scope of the duty of care of enterprises and financial institutions. Indeed, in one case not involving negative sustainability impact, the Supreme Court ruled that even though the case concerned a non-binding code of conduct (and thus not a binding rule of Dutch law) the relevant provisions could be a relevant factor in assessing the nature and extent of the bank's duty of care *vis-à-vis* its customer.[93]

7.8.8 Another example of a recent case in which soft law plays a role are the summary proceedings between Greenpeace and the Dutch state. In December 2020, the interim relief judge dismissed Greenpeace's claim that the state had to attach stricter climate-related conditions to the state aid granted to Dutch airline KLM. Greenpeace argued that this duty is imposed on the state under the UN climate treaties, the ECHR and the judgment of the Supreme Court in the Urgenda case. [94] The court dismissed Greenpeace's claims *inter alia* because the emission reductions called for by Greenpeace go beyond the objectives agreed at international level.

> ANNEXES

> Netherlands

NETHERLANDS

Nor can such duty be inferred from the Urgenda case, because according to the court, the state's conviction in that judgment relates only to greenhouse gas emissions in the Netherlands.

7.8.9 Furthermore, on 29 January 2021, the Hague Court of Appeal issued a decision holding Shell's Nigerian subsidiary liable for causing oil spills in the Niger Delta (the Nigerian farmers/Shell case).[95] However, the decision also affected RDS which was ordered by the court to install a leak detection system (LDS) in order to prevent spills in future.

7.8.10 In 2015, in an interim decision, the court assumed jurisdiction over the matter, as one of the defendants, RDS, is established in The Hague.[96] The claimants used the Dutch parent as a so-called 'anchor defendant', leading the court to assume jurisdiction also with respect to the claims against the non-Dutch defendants (the Nigerian subsidiary, among others) due to the connection between the claims. Shell's arguments that the proceedings should have been conducted before the Nigerian courts because all the facts and evidence lie there, and that the claims against RDS seemed to be without any merit, were dismissed by the court.

7.8.11 This case is part of a wider trend where (collective) actions are brought against non-Dutch and one or more Dutch defendants before Dutch courts in matters that almost exclusively relate to a foreign jurisdiction. When multiple parties are involved, there is a risk that a Dutch court will allow the claims to be brought under the same forum in order to improve efficiency and avoid conflicting decisions. However, in such cases, the Dutch courts are expected to critically assess whether they have jurisdiction. A decisive factor in the Nigeria farmers/Shell case, which led the Dutch court to accept jurisdiction, was probably that the Dutch anchor defendant was the parent company with control over its Nigerian subsidiary, and not merely a holding company without any real ties to the case. This enabled the claimants to formulate a claim against the Dutch anchor defendant that had some merit.[97]

7.8.12 On the basis of the case law set out above, the litigation risk for business enterprises, especially for those that are players on the worldwide market of fossil fuels or otherwise are responsible for (significant) greenhouse gas emissions, has increased. Businesses, and more pertinently holding companies, established in the Netherlands may find themselves held liable for breaching general duties of care for the negative sustainability impact. We note that, while ground-breaking, the Milieudefensie/RDS ruling is a first instance decision and is likely to follow a long appeal process over a number of years.

7.8.13 Apart from the applicable (international) soft law frameworks, which in the Milieudefensie/Shell case have effectively been elevated into hard law principles which can be deployed against private actors, the number of legally binding provisions expressly imposing liability for negative sustainability impact for Dutch enterprises in general is currently limited. However, the Dutch government has recently taken a step in this direction in the context of child labour. As in other jurisdictions, the government has adopted a due diligence law, the Child Labour Due Diligence Act (*Wet zorgplicht kinderarbeid*) which imposes due diligence and reporting obligations on business enterprises selling goods or services in the Netherlands in relation to indications of child labour in their supply chain.[98] More recently, a new bill was also submitted to parliament which entails due diligence obligations covering human rights more broadly, as well as environmental standards, and introduces a duty of care for enterprises to prevent negative impacts on human rights and the environment (including climate). This Bill for Responsible and Sustainable International Conduct (*Wet verantwoord en duurzaam internationaal ondernemen*) proposes replacing the Child Labour Due Diligence Act which consequently may not enter into force. However, we note that the next steps regarding this bill are still uncertain following the elections in March 2021.

Asset owners

7.8.14 We note that we have not yet seen civil actions against asset owners (or against financial institutions) associated with their role as an investor (or financer) in a business enterprise that has been involved in creating a negative sustainability impact. While each situation needs to be considered on its own facts, the risk of an asset owner incurring liability for the negative sustainability impact of an enterprise in which it is invested is, at present, generally likely to be remote. However, as the enterprise risk for liability for negative sustainability impact is broadly increasing due to the developments as set out above, where an investor has a relationship with an enterprise that could result in it being held liable for the acts and omissions of the enterprise, the investor's risk may also increase, particularly where the investor has a controlling interest or significant influence on the policy

NETHERLANDS

of the enterprise. This will be further described below. 7.2.20. In addition to the above-mentioned risk, we note that, as will be described below, there have been complaint procedures under the OECD-Guidelines in the Netherlands concerning the role of banks in relation to financing certain business enterprises. It is possible that such complaints in relation to the financier's duties to prevent and mitigate negative sustainability impact could in the future also be leveled at asset owners.

Civil liability

7.8.15 It is possible that, in certain limited circumstances, an asset owner could be found to have a direct duty of care towards individuals harmed by an investee company's actions (or inaction) which result in a negative sustainability impact, ie liability in negligence. Generally, for a court to find such duty of care to exist there must be a significant level of involvement and control in the day-to-day operations of the investee company and decision-making by the asset owner.

7.8.16 Generally, a minority shareholder (as an asset owner would typically be) would not typically exercise the required level of engagement in an investee company's operations to attract civil liability.

7.8.17 However, we note that the relatively limited legislative attention to negative sustainability impact has induced the judiciary in civil cases to take an increasingly active role in addressing sustainability-related problems. As has been described above, the most striking examples in this regard are the Milieudefensie/RDS case[99], the Nigerian farmers/Shell case[100] and the Urgenda case[101] in which the Dutch courts found RDS liable with regard to Shell's worldwide CO2 emissions and Nigerian oil spills, and held that the Dutch state is obliged to take additional measures to further reduce CO2-emissions respectively.

7.8.18 We expect that in further civil cases against business enterprises, similar arguments will be made and will be tested by the courts in the (near) future. Even though we are not aware of similar cases against asset owners, with the enterprise risk for negative sustainability impact increasing, to the extent that an investor has a relationship with an enterprise that could result in it being held liable for the acts and omissions of the enterprise, the investor's risk is also increasing.

7.8.19 As discussed above, recent case law indicates that liability for negative sustainability impact could potentially be attributed to business enterprises or the state on the basis of the duty of care in the context of the tort article in the Dutch Civil Code, Article 6:162 DCC. In addition, the approach of the courts in the Milieudefensie/RDS and Urgenda cases highlights the importance of 'soft law' (such as commonly recognised industry standards of good practice) in determining the scope and content of the duty of care, specifically in the context of climate cases. Even though we have not seen such civil cases against asset owners or investment managers, this does increase the risk of direct tortious liability for investors for negative sustainability impact in the relatively limited circumstances in which such direct liability could arise. The risk of liability would highly depend on the circumstances of the case and in particular on which soft law instruments a particular entity has committed to.

7.8.20 To our knowledge no civil claim has yet been instituted against asset owners or against financial institutions associated with their role as an investor in a business enterprise that has been involved in creating a negative sustainability impact.

7.8.21 However, a relevant development in this context is that in the past years there have been three complaint procedures under the OECD guidelines in the Netherlands initiated by NGO's against Dutch banks, one against Rabobank and two against ING Bank.[102]

7.8.22 Since these involve the banks' role in relation to financing business enterprises, it is easier to see how complaints of this sort could also be leveled at asset owners and potentially play a role in subsequent litigation against asset owners on negative sustainability impact caused by investee companies. If it would for instance be ruled by the Dutch National OECD Contact Point (NCP) that, on the basis of the OECD Guidelines, an asset owner should make more efforts to mitigate (or prevent) negative sustainable impact in relation to certain investee companies this would likely be a relevant factor for the court in subsequent litigation when determining the extent to which a duty of care existed.

7.8.23 The basis for one of the complaints against ING by a number of NGOs was that ING is still largely financing parties in the fossil fuel sector (eg the coal industry), and so breaching certain OECD principles relating to environment and climate. The NGOs argued that ING should publish its total carbon footprint (including indirect emissions as a result of its loans and investments) and publish ambitious, concrete and measurable emission reduction targets for its loans and investments.

NETHERLANDS

7.8.24 The procedure before the NCP resulted in a statement by the NCP that further dialogue between the NGOs and ING was justified.[103] While not concerning the legal liability of ING (as the OECD standards are not a legally binding instrument), the case illustrates the relevance that soft law instruments can have in establishing and realising sustainability-related obligations.

7.8.25 The other two complaints procedures relate to Rabobank's and ING's business operations in relation to palm oil plantations. In short, a number of NGOs argued that financial institutions like Rabobank and ING should make more effective efforts to mitigate or prevent the adverse impact of palm oil plantations through their business (lending) operations.

7.8.26 In its final statement in the complaint procedure against Rabobank the NCP *inter alia* stated that financial institutions have a responsibility of their own to exercise individual leverage to seek to prevent or mitigate the impact of their business conduct and respond to identified adverse impacts through engagement or potentially divestment. [104]

7.8.27 The complaint procedure against ING is ongoing. In January 2020 the NCP issued a statement that the complaint merits further consideration and that it will facilitate a dialogue to bring parties to agreement on possible improvements of ING's due diligence policies and practices regarding palm oil business financing, and to assess its involvement with actual or potential adverse impacts in order to determine the appropriate responses.[105]

Criminal liability

7.8.28 In theory, it is possible that an asset owner could be held criminally liable for the illegal conduct of a company in which it invests. However, the hurdle for this to occur is very high.

7.8.29 As a general rule, investors are not liable for acts or omissions of an investee company's activities or operations under Dutch law. Broadly, the only limited exception to this is where it could be established that the asset owner had exercised control or acted as a shadow or *de facto* director of the investee company. To qualify as *de facto* director, the asset owner would generally need to have substantial involvement in the day-to-day management and the internal decision-making of the investee company and in effect set aside the formal directors of the company.

7.8.30 Generally, asset owners would not exercise the required level of engagement in an investee company's operations to attract criminal liability if it was found that an attributable criminal offence had been committed at the level of the investee company. The criterion for attribution of liability under civil law and criminal law are broadly the same with minor nuances (see below).

Attribution criminal law

7.8.31 Legal entities may be liable for criminal offences if the conduct can reasonably be attributed to the legal entity. An important point of orientation for attribution is to what extent the conduct took place or was carried out in the 'sphere' of the legal entity. There is no hard and fast rule, but it is established that conduct may be regarded within the sphere of the legal entity, if one or more of the following circumstances apply: (i) the conduct took place by a person employed or working for the legal entity, (ii) the conduct was part of the legal entity's normal course of business, (iii) the legal entity benefited from the conduct and/or (iv) the conduct was at the disposal of the legal entity and such conduct was accepted or could be said to have been accepted by the legal entity which includes not exercising the care that could reasonably be required of the legal person in order to prevent the conduct.

Attribution civil law

7.8.32 According to settled case law, the criterion for attribution of tortious conduct to a legal entity under civil law is whether the act in civil life (*in het maatschappelijk verkeer*) must be regarded as the conduct of the legal person taking into account all circumstances of the case at hand.

7.8.33 In addition, in general, knowledge of a director, is in principle attributed to the company, unless there are specific circumstances proving otherwise.

NETHERLANDS

Investment managers

7.8.34 At present, the possibility that an investment manager would be held liable for the negative sustainability impact of the company it invests in on behalf of the asset owner is generally even lower than for an asset owner. However, here too, recent developments may have consequences for the likelihood of litigation.

Criminal liability

7.8.35 As to the requirements that would need to be satisfied for an investment manager to be held criminally liable (see paragraph 7.8.28 *et seq* above), the likelihood that these conditions would be satisfied in relation to an investment manager seems even lower than for an asset owner. Generally, an investment manager will have an insufficient level of involvement with the activities and the organisation of the company being invested in.

Civil liability

7.8.36 The position on the civil liability of an investment manager is largely similar to that of an asset owner. The risk that an investment manager would be held to have breached a duty of care in relation to the negative sustainability impact of enterprises in which it has invested assets of its clients is low. Indeed, in most cases it is probably even lower than for an asset owner since the investment manager is only the agent of the asset owner.

NETHERLANDS

8. THE GROWINGIMPORTANCE OF TAKING ACCOUNT OF ESG AND SUSTAINABILITY FACTORS WHERE THESE ARE 'FINANCIALLY MATERIAL'

8.1 It has become increasingly important for asset owners and their investment managers to take ESG and sustainability factors into account in managing portfolios because of the way in which they could be material to achieving the financial investment objectives of the relevant asset owner or investment manager in accordance with their legal duties. Some of the main reasons are as follows:

- increasing public, policy and regulatory expectations that they should do so (further details summarised below), which are likely to affect the way in which legal duties are understood and applied in practice;
- a growing trend towards sustainability-based legal actions where business enterprises and others are seen as having contributed to sustainability challenges;
- greater knowledge of the risks that sustainability factors can pose to portfolio performance, particularly in the area of climate change but also as a result of the COVID-19 pandemic, and the opportunities that they can provide;
- greater awareness of the speed with which some sustainability risks may be materialising;
- improving disclosure regimes, making it more feasible to understand the role of individual business enterprises in helping to realise or in undermining sustainability goals;
- growing availability of good-quality investment analysis of the risks posed to business enterprises by sustainability factors and potential opportunities;
- growing expertise and developing conceptual frameworks in the areas of sustainability assessment and the investment management expertise needed to take greater account of sustainability in the investment process; and
- the development of investor alliances and coalitions making it easier for investors to address sustainability risks.

8.2 Political, regulatory and public expectations that asset owners and their investment managers should take account of ESG and sustainability factors in the investment process have grown considerably in recent years.[106] This is partly due to changing sentiment in society and is evidence of a growing realisation in the Netherlands that an exclusive focus on *shareholder value* fails to take sufficient account of the interests of those affected by a company and the role of a company within society. These expectations may not always be framed in terms of IFSI since the concept of 'sustainable investing' covers such a broad waterfront ([see Part I, Section A of the main report]). However, it is nonetheless clear that there is a growing belief that ESG and sustainability factors need greater attention in the way investment portfolios are managed and run. Not only are independent bodies such as Eumedion and investment beneficiaries calling for ESG and sustainability factors to be taken more fully into account in managing investment portfolios, but it has also become a focus of attention among national and international (European) authorities. Heightened awareness of the risks from sustainability factors to portfolio performance make it crucial for those responsible for managing investment portfolios to consider how ESG and sustainability factors could be relevant to achieving the investment objectives of the portfolio and, where appropriate, to act.

Governmental activity relevant to sustainability and ESG in the investment process

8.3 In August 2019, the Dutch government announced its strategy to improve sustainability and reduce the risks of climate change. The three main pillars are: (i) encouraging financial institutions to incorporate the impact of climate change into their policies, looking at the opportunities and risks related to climate and the energy-transition; (ii) improving transparency about the impact of climate change in business and financial enterprises and normalising the incorporation of climate impact in business and financial decision-making; and (iii) accumulating and sharing experience on 'green' financing, for which the government is seeking national and international cooperation.[107] Financial institutions are expected to inform the Dutch government by the end of 2020 of their action plans on contributing to the reduction of CO2 emissions. Also, in 2019 the Dutch government issued the first 'green' government bond to advance sustainability on the capital market. Furthermore, several members of the Dutch House of Representatives have recently launched an initiative suggesting that there is a need to focus on (i) reducing investment in polluting products; and (ii) investigating how the financial impact on big companies of growing biodiversity and climate risks can best be shared.[108]

NETHERLANDS

Academic activity relevant to sustainability and ESG in the investment process

8.4 Academic attention to the place of ESG goals within the existing legal framework has also intensified in recent years. In 2021, 25 Dutch business law professors have proposed new legislation. They have suggested that the Dutch company law regime should be amended to reflect the expectation that companies need to discharge their social responsibilities.[109] They claim that the COVID-19 crisis has refocused public attention on the social responsibilities of companies. They argue that the level of social responsibility of, among others, Dutch companies, is heightened now that part of the entrepreneurial risk these companies would normally carry has fallen on the public in times of crisis (eg through state support).

8.4.1 They have suggested amending the Dutch Civil Code to introduce a legal basis for 'responsible corporate citizenship'. This would include directors of Dutch (listed and unlisted) legal entities being legally obliged to not only serve the interests of the company, but also procure that the company's relationship with wider society is conducted in a responsible way. Furthermore, they have suggested that the DCC should explicitly state that companies can have a business purpose that promotes such socially responsible engagement. Lastly, all legal entities would be obliged to report in their annual reporting how they have engaged in a socially responsible way and illustrate which activities have been undertaken to support the community, the environment and the climate. This reporting obligation may not be a novelty for some types of (regulated) companies but goes further than the existing rules. The DCC currently does not prohibit a company from doing any of these things and certainly in practice many listed companies are already doing so, as also provide for in the Corporate Governance Code. However, it is argued that that explicitly including these tools into the DCC would provide an important signal of a wider move in a more sustainable direction.[110]

8.4.2 Questions have been raised about the practical enforceability of legislation of this sort; the risk of a 'tick-the-box mentality'; and as to the scope of what should be regarded as 'socially responsible'.[111] However, growing discussion of these points suggests that the legal rules may soon change in ways that require greater attention to the social purpose of business.

Regulatory activity relevant to sustainability and ESG in the investment process

8.5 As noted previously, earlier this year the AFM published a position paper on sustainability.[112] In it, the AFM states that it expects financial institutions to integrate and be transparent about sustainability issues in their business operations, including in the area of product development, risk management and investment decisions. This expectation includes informing consumers and other beneficiaries of the possibility of incorporating sustainability factors in their financial (investment) decisions and products. The AFM stresses that the financial sector plays an important role in the transition to a sustainable society, to mobilise capital from governments, businesses and consumers towards sustainable investments. To reach the Dutch government's goal of emitting 49 per cent less CO2 in 2030 and Europe becoming climate neutral by 2050, great effort and great financial resources are required, in which the AFM expects financial institutions to play an active role – in other words, the AFM has identified a purpose for financial activity which involves achieving sustainability impact goals.

8.6 The AFM notes the growth in financial products and services with sustainability characteristics: institutional investors as well as consumers have a growing interest in these products. It indicates that there are two main points of focus in the AFM supervisory mandate in this area: (i) sustainability aspects being incorporated in financial products in a responsible and prudent way, while remaining compliant with legal requirements to protect and inform consumers and beneficiaries; and (ii) providing the information that consumers and investors need to take well-informed decisions, which includes being transparent about the extent to which products are sustainable and how they contribute to ESG objectives (ie the sustainability impact they are designed to achieve).

8.7 The DNB has also issued a number of research reports and other publications on climate-related financial risks and sustainable investment in the Dutch pension sector in recent years.

Practice

8.8 The Federation of Dutch Pension Funds is developing similar initiatives, which encourage its members to conduct a responsible investment policy. For instance, APG and PGGM – considered the two largest pension funds in the Netherlands – have launched several sustainability projects related to their investment policy, such as a sustainable investing platform for asset owners, thereby setting a (high) standard for other pension funds and asset owners.

NETHERLANDS

9. TIME HORIZON OF INVESTMENTS IN PRACTICE

9.1 In practice, an asset owner may find its performance judged by reference to relatively short time periods, both as a commercial matter and by reference to legal duties. There are various reasons for this. First, it is challenging to assess progress towards a long-term goal except by looking at shorter-term performance.

9.2 Secondly, the situation is further complicated by the fact that long-term investors may need to access the expertise of investment managers who are appointed under investment management agreements, the term of which is generally much shorter than the investment time-horizon of the asset owners appointing them. The investment manager's own performance is then likely to be judged by reference to the financial performance of the portfolio over that period or even shorter periods. In this context, the legal terms of the contract may therefore effectively set shorter-term goals, so that financial materiality comes to be judged by reference to these. The relatively long time it takes for the positive financial impact of environmental factors (and some sustainability factors more broadly) to show therefore involves a risk for investment managers seeking to base investment decisions on them. With an investment horizon of 10 years or more, for example, an investment manager making a decision based on a long-term sustainability factor may prove to have been right. However, a standard evaluation period for an investment strategy and investment returns is three years or less; over that period there could be *underperformance*. This then brings into play a complex mixture of incentives. It could have an impact on the firm's or the individual portfolio manager's compensation (for example, the manager might miss out on variable performance-related pay), funds could be withdrawn from the portfolio, the mandate could be terminated on the basis of poor performance or an investment manager's personal involvement in managing a portfolio could be terminated for similar reasons.

9.3 Several working groups (such as the Working Group on the Integrity of Pension Funds under the chairmanship of Jean Frijns[113]) have considered the possibility that the standard investment policy will result in too much attention to the short-term and result in a tendency to follow 'the market' because the market is as of yet unable to assess the value of the long-term sustainability risks correctly. Assessing financial materiality by reference to shorter-term goals may help to protect a portfolio from shorter-term sustainability risks within investee enterprises and realise opportunities. In doing so, in some cases, this may also have results that are similar to those that would be realised by IFSI. However, it seems likely that many, if not most, investment risks and opportunities arising from sustainability factors are likely to crystallise within a longer timeframe.

Freshfields Bruckhaus Deringer

Marit Balkema, Michael Broeders, Igor Dovgaliouk, Hakan Gargili, Charlotte Kriekaard, Maxine Lemstra, Sharon Sloof and Marco Vogels Barbara Slooter

NETHERLANDS

1 SWFI Institute, '*Top 100 Largest Public Pension Rankings by Total Assets*' (https://www.swfinstitute.org/fund-rankings/public-pension).

2 Representative associations of employers and employees have together with the government agreed on an adjustment to the existing pension system with a view to ensuring its future viability. The intension is to develop a new legislative framework which is to be presented shortly, but not yet available, which would become effective on 1 January 2022 and would require pension funds to commence transition to the new system on 1 January 2024. The transition phase would end on 1 January 2026. One of the new features is that beneficiaries will have more flexibility in choosing a particular type of pension, including by opting for a 'green pension' or a 'pension which is created through sustainable and fairer investing'. The introduction of these choices will impact on the obligations of the fund *vis-à-vis* the beneficiary, including on assisting the beneficiary in making the right choices, providing information, the application of the prudent person rule and liability of the fund. The legislative framework will also include requirements for lifecycle investing, requiring appropriate consideration of investment risk in relation to beneficiaries' age and retirement date, with investment risk decreasing closer to the retirement date. Another important change will be that the system whereby younger participants and older participants all pay the same contributions, resulting in a transfer of value from younger participants to older participants, will be phased out. This raises complicated issues for the transition phase where the middle-aged participants are at risk of carrying the largest burden as they – without compensation – would neither have the benefits of the new or the old system. Compensation to the middle group can be paid over a period of 10 years. One of the other changes considered includes the abolishment of the use of notional interest (*rekenrente*) to calculate the present value (*contante waarde*) of future obligations, which in practice may potentially provide pension funds with more flexibility as to the substance of their investment policy.

3 Under the Dutch Pensions Act (*Pensioenwet*), a pension fund is considered Dutch if its seat is in the Netherlands. However, under article 199 Dutch Pensions Act, pension funds seated in other member states may implement pension schemes for Dutch beneficiaries provided (i) they are licensed in another member state, and (ii) have notified the relevant supervisory authority of the other member state. Foreign pension funds implementing pension schemes for Dutch beneficiaries are obliged to take Dutch social security and employment laws into account whilst implementing the pension schemes (article 199a Dutch Pensions Act). In this memorandum we consider only Dutch pension funds, ie those with their seat in the Netherlands.

4 Court of Amsterdam 19 January 2018, PJ 2018/114 with annotation by V. Gerlach. See also regarding the application of the prudent person rule, Court of Rotterdam, 25 April 2013, JOR 2013/178 (DNB – Pf J&J) annotation by J.A. Voerman and court of Rotterdam 16 February 2015, ECLI:NL:RBROT:2015/53 with annotation by I. Witte and CBp 10 September 2013, JOR 2013/312 annotation by S.H. Kuiper and J.A. Voerman.

5 Rene Maatman & Esther Huijzer, 15 years of prudent person rule, in Sustainability and Financial Markets, Deventer 2019, page. 266 with reference to CBp 10 September 2013, JOR 2013/312 with annotation by S.H. Kuiper and J.A. Voerman. See Also V.P.G. de Serière, Ondernemingsrecht, 2020, 12.

6 Rene Maatman & Esther Huijzer, 15 years of prudent person rule, in Sustainability and Financial Markets, Deventer 2019, page. 281.

7 V.P.G. de Serière, Ondernemingsrecht, 2020, 12.

8 V.P.G. de Serière, Ondernemingsrecht, 2020, 12.

9 V.P.G. de Serière, Ondernemingsrecht, 2020, 12.

10 Rene Maatman & Esther Huijzer, 15 years of prudent person rule, in Sustainability and Financial Markets, Deventer 2019, page. 264.

11 Rene Maatman & Esther Huijzer, 15 years of prudent person rule, in Sustainability and Financial Markets, Deventer 2019, page. 265.

12 V.P.G. de Serière, Ondernemingsrecht, 2020, 12 and https://pensioenfederatie.nl/website/publicaties/servicedocumenten/code-pensioenfondsen-2018.

13 R.M. Maatman, The Prudent person-rule, duty of care and the new pension contract, Journal of Company Law, 2017/135, including with references to further literature.

14 Dutch Supreme Court, JOR 2009/199, r.o. 4.11.

15 L. Timmerman, Liability of directors and supervisory directors (VDHI nr. 140), 2017/2.7.

16 See the Dutch Anti-Money Laundering and Anti-Terrorism Financing Act (*Wet ter voorkoming van witwassen en financieren van terrorisme*), the Dutch Sanctions Act 1977 (Sanctiewet 1977) and ministerial regulations (*ministeriële regelingen*) promulgated thereto. Further, also refer to section 21a of the Dutch Decree on Market Abuse DFSA (*Besluit marktmisbruik Wft*) regarding the prohibition to invest in cluster munition.

17 Rene Maatman & Esther Huijzer, 15 years of prudent person rule, in Sustainability and Financial Markets, Deventer 2019, page. 281.

18 Rene Maatman & Esther Huijzer, 15 years of prudent person rule, in Sustainability and Financial Markets, Deventer 2019, page. 264, with reference to the report 'Kijken in Spiegel" pp. 27ff. The working group responsible for drawing up the report took into account that the investment policy will devote too much attention to short term and following the market because the market is unable to assess the value of the long term ESG risks correctly and further literature.

19 See DNB, *Sustainable investment in the Dutch pension sector* https://archief20.archiefweb.eu/archives/archiefweb/20161014152700/https:/www.dnb.nl/en/binaries/Sustainable%20investement%20in%20the%20Dutch%20pension%20sector_tcm47-346418.pdf?2020102815

20 DNB, *Sustainable investment in the Dutch pension sector*, p. 27.

21 R.H. Maatman, The Prudent person rule, duty of care and the new pension contract, Journal for Company law, 2017/135.

22 This follows from the text and rationale of article 135(1) DPA. See also Rene Maatman & Esther Huijzer, 15 years of prudent person rule, in Sustainability and Financial Markets, Deventer 2019, page. 283.

23 J.H. Langbein et al, Pension and Employee benefit law. St. Paul 2015, p. 507. See also J.M.G. Frijns et al., Transparancy International, *Looking in the mirror* (2013) and article 18 Pension Directive.

24 Rene Maatman & Esther Huijzer, 15 years of prudent person rule, in Sustainability and Financial Markets, Deventer 2019, page. 283.

25 Rene Maatman & Esther Huijzer, 15 years of prudent person rule, in Sustainability and Financial Markets, Deventer 2019, page. 285.

26 See DNB, *Sustainable investment in the Dutch pension sector*, p. 32 (https://archief20.archiefweb.eu/archives/archiefweb/20161014152700/https:/www.dnb.nl/en/binaries/Sustainable%20investement%20in%20the%20Dutch%20pension%20sector_tcm47-346418.pdf?2020102815 where DNB explicitly states: '*In our study, we looked at potential obstacles to sustainable investment originating in rules and regulations or supervision. This has as yet not resulted in any specific follow-up steps, but we continue to be receptive to signs from the sector. Pension funds are responsible for defining what sustainability means to them and how they intend to put it into practice, motivated by their ambitions as well as risk management considerations. They are encouraged to do so by current legislation. The prudent person principle leaves ample scope to design sustainable investment policies, provided that they are compatible with the fund's objectives and in the members' interest and the investment portfolio is sufficiently diversified. Pension funds basing their operations on sustainability are expected to embed this principle in the elaboration and implementation of their investment policies and to be transparent about their sustainable investment activities. Another key aspect is the match between a pension fund's management and expertise and the nature of its investments, which, naturally, also applies to non-sustainable investments.*'

27 DNB '*Sustainable investment in the Dutch pension sector*', September 2016, p. 33 (https://archief20.archiefweb.eu/archives/archiefweb/20161014152700/https:/www.dnb.nl/en/binaries/Sustainable%20investement%20in%20the%20Dutch%20pension%20sector_tcm47-346418.pdf?2020102815).

28 Directive (EU) 2016/2341.

29 See for example for an illustration of this issue *Volkskrant May 1, 2021, Koen Haegens, Does your pension fund also invest in harmful businesses? and Volkskrant May 4, 2021, Hans van Meerten & Hanine Al-Nassar, Harmful Investment by your Pension fund, take them to court.*

30 See, for example, the report of APG (Verslag verantwoord beleggen) page 11, which can be consulted at https://apg.nl/media/o2kdbas4/nl-verslag-verantwoord-beleggen-apg-2019-2020_1.pdf).

31 https://www.pggm.nl/en/press/us-1-trillion-asset-owner-platform-launches-solution-for-identifying-sdg-investments/ (accessed 24 October 2020).

32 ABP Sustainable and responsible investment policy 2020-2025 (https://www.abp.nl/images/summary-sustainable-and-responsible-investment-policy.pdf).

33 PMT Strategic Investment Framework 2020-2022 (https://www.pmt.nl/media/lguj3nrk/pmt302e_strategic_investment_framework_2020-2022.pdf)

34 Directive 2009/65/EC of the European Parliament and the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities, OJ L 302, p. 32

35 Directive 2011/61/EU of the European Parliament and the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010, OJ L 174, 1.7.2011, p. 1–73

36 This report does not consider requirements under any particular exchanges.

37 Please refer to the EU section of this report for further detail on investor protection in the context of UCITS.

38 An insurance undertaking can take various legal forms, including a form of cooperative association (*cooperatie*), or an NV (*Naamloze Vennootschap*, public limited liability company) or BV (*Besloten Vennootschap*, private limited liability company)

39 See Sections 2:129(5) and 2:140(2) DCC in respect of Dutch public limited liability companies (*naamloze vennootschappen*).

40 See Dutch Supreme Court (*Hoge Raad*), 4 April 2014, NJ 2014/286; *JOR* 2014/290 (*Cancun*).

41 See Section 2:8 DCC, See also Dutch Supreme Court (*Hoge Raad*), 4 April 2014, JOR 2014/290 m.nt. R.G.J. de Haan (*Cancun*), and (*Hoge Raad*), 9 July 2010, NJ 2010/544 (*ASMI*), 12 July 2013, NJ 2013/461 (*VEB c.s. / KLM*) and 14 September 2007, NJ 2007/610 (*Versatel I*).

42 Article 2:135a paragraph 6 DCC.

NETHERLANDS

43 J.W. Winter, J.M. de Jongh, J.B.S. Hijink. L. Timmerman, G. van Solinge and L.M. Lennarts, To a duty of care for directors and supervisory directors for responsible participation to society, Journal for Company Law, 2020, nr. 7, 86 and also P.F. van der Heijden, Eastern winds, or: from soft law to hard enforcement action, Ondernemingsrecht, 2021, 2.

44 H.J. de Kluiver, On the responsible conduct of a business, towards a Paradise by the dashboard light. Journal for Company Law, 2020, nr. 13/14, 126

45 Code of 8 December 2018, www.mccg.nl.

46 This article provides that more detailed requirements can be imposed for the annual report on compliance with, amongst other things, a code of conduct to be designated by an order in council. On 7 September 2017, the publication of the designation order (Stb. 2017, 332) in the Dutch Bulletin of Acts and Decrees legally enshrined the Code 2016 as of 1 January 2018.

47 See the preamble of the Netherlands Corporate Governance Code (unofficial English translation, p. 7). (link)

48 See 'Compliance with the Code', Netherlands Corporate Governance Code (unofficial English translation, p. 11). (link)

49 See 'Compliance with the Code', Netherlands Corporate Governance Code (unofficial English translation, p. 11). (link)

50 See 'Compliance with the Code', Netherlands Corporate Governance Code (unofficial English translation, p. 11). See also R.T.L. Vaessen, 'Bestuurdersaansprakelijkheid en corporate governance', *MvV* 2017, afl. 12, p. 322. (link)

51 R.H. Kleipool e.a., *Commentaar & Context Corporate Governance Code*, Den Haag: Boom Juridisch 2019, p. 30. (link)

52 See the preamble of the Netherlands Corporate Governance Code (unofficial English translation, p. 7). (link)

53 See the relevant sections in the DFSA, Decree on Prudential Rules (*Besluit prudentiële regels*) and Decree on Conduct Supervision of Financial Undertakings (*Besluit Gedragstoezicht financiële ondernemingen*).

54 Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II).

55 Commission Delegated Regulation (EU) 2015/35 of 10 October 2014 supplementing Directive 2009/138/EC of the European Parliament and of the Council on the taking up and pursuit of the business of Insurance and Reinsurance , OJ L 12, p. 1-797.

56 *Kamerstukken* II 2016/17, 34583, nr. 3, p. 33 and *Stb.* 2018, 147.

57 COM/2018/097 final

58 Final version of amended delegated act 2017/565: mifid-2-delegated-act-2021-2616_en.pdf (europa.eu)

59 Final version of amended delegated act 2017/2359: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=PI_COM:C(2021)2614&from=EN

60 Paragraph 28 ESMA Guidelines on certain aspects of the MiFID II suitability requirements.

61 ESMA Consultation paper on integrating sustainability risks and factors in MiFID II, p. 23.

62 ESMA Final report on integrating sustainability risks and factors in MiFID II, p. 9.

63 https://www.asrnl.com/-/media/files/asrnederland-nl/duurzaam-ondernemen/duurzame-belegger/sustainable-investing-code.pdf?la=en

64 https://www.imvoconvenanten.nl/en/insurance/convenanten.

The Dutch non-life and life insurance sector currently manages some €500bn for insured parties. A large part of this is invested in shares, in loans to public authorities and businesses, and in real estate. Some of it is invested outside the Netherlands. With the IRBC Covenant the industry does not only want this to be safe and profitable, but also to be invested responsibly. According to the explanation to the agreement, the agreement creates the opportunity to exert influence and to prevent and tackle problems within the chain. Also, the explanation states that with the new agreement, Dutch insurers are the first in the world in this sector to enter into a broader and more ambitious agreement that addresses issues relating to the environment and social aspects such as corporate governance. The commitments in the agreement are based on the OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights; among other things the agreement also promotes animal rights.

65 It is, however, advocated that a stakeholder approach is not sufficient to take social and ecological aspects into account in a full and balanced way. See D. Schoenmaker, 'Een financiële sector ten dienste van een duurzame economie', *FR* 2020, afl. 10, p. 465. (link)

66 https://www.abp.nl/images/stewardship-beleid.pdf

67 https://www.abp.nl/images/abp-verslag-duurzaam-beleggen-2019.pdf

68 https://www.pmt.nl/media/whqdwfgs/samenvatting_verantwoord_beleggen_beleid.pdf

69 https://www.pmt.nl/media/ygucljvb/pmt_verantwoord_beleggen_jaarverslag_2019

70 https://www.imvoconvenanten.nl/en/pensionfunds/partijen

71 https://www.vbdo.nl/en/2020/10/dutch-pension-funds-challenged-to-translate-sustainable-policy-into-practice/

72 See https://www.eumedion.nl/nl/public/kennisbank/best-practices/2017-09-consultatiedocument-stewardship-code.pdf. The Dutch Stewardship Code is based on the provisions regarding the shareholders' engagement from the revised EU Shareholder Rights Directive II.

73 See https://www.eumedion.nl/nl/public/kennisbank/best-practices/2017-09-consultatiedocument-stewardship-code.pdf. The Dutch Stewardship Code is based on the provisions regarding the shareholders' engagement from the revised EU Shareholder Rights Directive II.

74 See paragraph [2.3.44].

75 3:267h of the DFSA in conjunction with Chapter 12.2 of the Decree on Prudential Rules (*Besluit prudentiële regels Wft*).

76 IRBC paragraph 4, link to Dutch version: https://www.imvoconvenanten.nl/-/media/imvo/files/verzekeringssector/convenant-verzekeringssector.pdf

77 See also L.J. Silverentand en F.W.J. van der Eerden (red.), *Hoofdlijnen Wft (Recht en Praktijk nr. FR6)*, Deventer: Wolters Kluwer 2018, p. 115.

78 For the definition of a UCITS (*icbe*), please refer to Section 1:1 of the DFSA. Although not explicitly reflected in the definition itself, the main goal of a UCITS is normally presumed to enable a financial return for its unit holders.

79 Please refer to Section 4:49(2) DFSA in conjunction with Section 118 of the Decree on Conduct Supervision of Financial Institutions under the DFSA (*Besluit Gedragstoezicht financiële ondernemingen Wft (BGfo))* in respect of the general prospectus content requirements for UCITS.

80 See Section 4:61(1) DFSA in conjunction with Section 126j BGfo, implementing Article 22(3) of Commission Directive 2010/43/EU of 1 July 2010 implementing Directive 2009/65/EC of the European Parliament and of the Council as regards organisational requirements, conflicts of interest, conduct of business, risk management and content of the agreement between a depositary and a management company.

81 See Section 91(4) BGfo.

82 See the AFM's position paper "AFM en duurzaamheid" dated June 2020, page 13.

83 See ESMA's Guidelines on MiFID II product governance requirements (ESMA35-43-620) of 5 February 2018, page 7.

84 ESMA Guidelines on certain aspects of the MiFID II suitability requirements (2018), paragraph 28, and also statement from the European Commission that firms "*should ask about their clients' preferences (such as environmental, social and governance factors) and take them into account when assessing the range of financial instruments and insurance products to be recommended*" See also para [above].

85 [Final version COMMISSION DELEGATED REGULATION (EU) …/… of 21.4.2021 amending Delegated Regulation (EU) 2017/565 as regards the integration of sustainability factors, risks and preferences into certain organisational requirements and operating conditions for investment firms (June 2020).][check for updates ahead of publication]

86 Examples of cases include *Amnesty International cs. vs. Government of the Netherlands* (https://www.amnesty.nl/content/uploads/2020/02/Press-Release_Dutch-border-police-in-court-for-ethnic-profiling.pdf?x48668). In this case, the Dutch state was summoned for alleged ethnic profiling by the Dutch border police during border control operations. We also refer to *Kiobel cs. vs. Shell cs.* (ECLI:NL:RBDHA:2019:4233) in which case four widows held several entities within the Shell group liable for not preventing the execution of their spouses (the Ogoni 9) in Nigeria in 1995. The Ogoni 9 was a group of nine environmental activists who opposed to the oil-pollution by Shell in the Niger Delta. On 1 May 2019 the District Court of the Hague accepted jurisdiction and ordered the plaintiffs to provide evidence.

87 *Milieudefensie cs., vs. Shell cs.* (https://en.milieudefensie.nl/shell-in-nigeria), in which case Friends of the Earth Netherlands (*Milieudefensie*) together with four Nigerian farmers, initiated litigation in 2018 against Shell and its Nigerian subsidiary Shell Petroleum Development Company (SPDC) for alleged pollution of fish ponds and soil by oil spills in the Niger Delta.

88 *Urgenda Foundation vs. Government of the Netherlands* (ECLI:NL:HR:2019:2006), as well as *Milieudefensie et al. vs. Royal Dutch Shell plc* (ECLI:NL:RBDHA:2021:5337 and ECLI:NL:RBDHA:2021:5339).

89 Examples of soft law instruments include: the UN Guiding Principles on Business and Human Rights; the United Nations Global Compact; the OECD Guidelines; Responsible business agreements (in Dutch: IMVO convenanten); the Equator Principles; and various mission statements, internal codes of conduct and commitments of enterprises

90 *The Hague District Court 26 May 2021 Friends of the Earth and others v. Royal Dutch Shell plc* (ECLI:NL:RBDHA:2021:5337 and ECLI:NL:RBDHA:2021:5339). For the English version of the judgment, see: https://uitspraken.rechtspraak.nl/inziendocument?id=ECLI:NL:RBDHA:2021:5339.

91 *Urgenda Foundation v. Government of the Netherlands* (ECLI:NL:HR:2019:2006).

NETHERLANDS

92 In interpreting the specific unwritten duty of care that applies to RDS, the court used the following circumstances: (a) Articles 2 and 8 of the European Convention on Human Rights which guarantee the right to life (Article 2) and rights to a private life, family life, home, and correspondence (Article 8); (b) the equivalent rights in the International Covenant on Civil and Political Rights (Articles 6 and 17); (c) the climate goals of the Paris Agreement; (d) scientific evidence on the dangers of climate change of the United Nations panel on Climate Change; (e) the UN Guiding Principles on Business and Human Rights (the UNGPs), and (f) the OECD Guidelines for Multinational Enterprises.

93 RDS reports on greenhouse gas emissions on the basis of the World Resources Institute Greenhouse Gas Protocol (GHG Protocol). The GHG Protocol categorises greenhouse gas emissions in Scope 1, 2 and 3: Scope 1: direct emissions from sources that are owned or controlled in full or in part by the organisation; Scope 2: indirect emissions from third-party sources from which the organisation has purchased or acquired electricity, steam, or heating for its operations; and Scope 3: all other indirect emissions resulting from activities of the organisation, but occurring from greenhouse gas sources owned or controlled by third parties, such as other organisations or consumers, including emissions from the use of third-party purchased crude oil and gas.

94 *Kouwenberg/Rabobank* (ECLI:NL:HR:2003:AF7419).

95 *Greenpeace/Dutch State* (ECLI:NL:RBDHA:2020:12440).

96 *Nigerian farmers/Shell* (ECLI:NL:GHDHA:2021:132).

97 *Nigerian farmers/Shell* (ECLI:NL:GHDHA:2015:3588).

98 The recent Dutch Act on redress of mass damages in a collective action (WAMCA), which allows a claim vehicle to claim monetary damages on behalf of injured parties, does however include a limited-scope rule preventing the Netherlands becoming too popular a forum for collective actions without sufficient nexus with the Netherlands.

99 Similarly to legislation such as the UK Modern Slavery Act and the French 'duty of vigilance', the law *inter alia* requires companies to produce a statement, in this case attesting that they have carried out a certain level of due diligence in their entire supply chains.

100 The Hague District Court 26 May 2021 Friends of the Earth and others v. Royal Dutch Shell plc, (ECLI:NL:RBDHA:2021:5337 and ECLI:NL:RBDHA:2021:5339). For the English version of the judgment, see: https://uitspraken.rechtspraak.nl/inziendocument?id=ECLI:NL:RBDHA:2021:5339.

101 *Nigerian farmers/Shell* (ECLI:NL:GHDHA:2021:132).

102 *Urgenda Foundation v. Government of the Netherlands* (ECLI:NL:HR:2019:2006).

103 *Milieudefensie et al. vs Rabobank* (https://www.oecdguidelines.nl/documents /publication/ 2016/1/15/fs-foe-milieudefensie-rabobank), *Milieudefensie et al. vs. ING* (https://www.oesorichtlijnen.nl/documenten/publicatie/2020/01/20/initial-assesment-friends-of-the-earth-vs.-ing) and *4 NGO's v ING* https://www.oecdguidelines.nl/documents/publication/2019/04/19/ncp-final-statement-4-ngos-vs-ing

104 *4 NGO's v ING* https://www.oecdguidelines.nl/documents/publication/2019/04/19/ncp-final-statement-4-ngos-vs-ing

105 *Milieudefensie et al. vs Rabobank* (https://www.oecdguidelines.nl/documents /publication/2016/1/15/fs-foe-milieudefensie-rabobank)

106 *Milieudefensie et al. vs. ING* (https://www.oesorichtlijnen.nl/documenten/publicatie/2020/01/20/initial-assesment-friends-of-the-earth-vs.-ing)

107 F. Beekhoven van den Boezem, C. Jansen & B.A. Schuijling (red.), *Sustainability and financial markets (Law of Business and Finance volume 17)*, Deventer: Wolters Kluwer 2019, p. 273.

108 Letter Ministry of Finance dated 29 August 2019 (*Parliamentary Documents II* 2018-2019, 32013, no. 220).

109 Initiative policy document 'Van oliedom naar gezond verstand: verduurzaming van de financiële sector' (*Parliamentary Documents II* 2020-2021, 35446, no. 2).

110 J.W. Winter *et al.*, 'Naar een zorgplicht voor bestuurders en commissarissen tot verantwoorde deelname aan het maatschappelijk verkeer', *Ondernemingsrecht* 2020/86.

111 J.W. Winter *et. al.*, 'Naar een zorgplicht voor bestuurders en commissarissen tot verantwoorde deelname aan het maatschappelijk verkeer', *Ondernemingsrecht* 2020/86.

112 K.A.M. van Vught, 'Gaan de tijden veranderen?', *Weekblad voor Privaatrecht, Notariaat en Registratie* 2020/7291.

113 AFM position paper 'AFM en duurzaamheid', June 2020 (available at https://www.afm.nl/~/profmedia/files/onderwerpen/duurzaamheid/position-paper-afm-duurzaamheid.pdf?la=nl-nl).

114 Working Group on the Integrity of Pension funds, 'Kijken in de Spiegel' ('Looking in the Mirror'), available for consultation at https://www.transparency.nl/wp-content/uploads/2016/12/TI-NL-Kijken-in-de-spiegel.pdf.

SOUTH AFRICA

1. INTRODUCTION

1.1 This Annex considers the extent to which IFSI is required, or may be permitted, under the laws of South Africa as at 31 January 2021. As discussed in the main body of the report, the expression 'Investing for Sustainability Impact' (**IFSI**) is not a precisely defined legal expression, and it is important to emphasise that South African law does not reference it in that way. Rather, the expression is used here as a type of 'conceptual net' to catch any approach on the part of Asset Owners or their Investment Managers that involves intentionally seeking, either through instrumental IFSI or ultimate ends IFSI (each as described below and in more detail in Part A), to increase the positive Sustainability Impact and reduce the negative Sustainability Impact of investee enterprises.

1.2 There is a distinction drawn in this Annex between "**instrumental IFSI**" and "**ultimate ends IFSI**". Instrumental IFSI is where achieving the relevant sustainability impact is 'instrumental' in realising the investor's financial return goals, for example, where an investor concludes that its financial return goals may not be realised (and beneficiary interests damaged) unless a particular sustainability outcome can be achieved and the particular Sustainability Impact sought can help with that. Ultimate ends IFSI is where achieving the relevant Sustainability Impact is a goal in its own right, pursued alongside the investor's financial return objectives, but not as a means to achieving them. There may be some overlap between the two, but the key distinction between instrumental IFSI and ultimate ends IFSI is that the latter involves the pursuit of particular Sustainability Impacts as an end in and of itself, rather than as a means to achieving targeted financial returns.

1.3 The investment and stewardship activities of Asset Owners and Investment Managers are shaped by legal and regulatory obligations and guidance, industry and market practice, and stewardship codes such as CRISA and the UN PRI. They are also often informed and prescribed by individual agreements concluded between Investment Managers and Asset Owners.

1.4 This Annex does not set out detailed analysis nor address all potentially relevant issues or rules, but rather provides a high level overview of and commentary on the legal framework generally applicable to IFSI by certain Asset Owners and Investment Managers in South Africa. It is no substitute for legal advice in individual circumstances.

1.4.1 This Section 1 briefly touches on certain aspects of the context applicable to IFSI in South Africa: the legal context; National Treasury's Sustainable Finance Initiative; the responsible investment and stewardship code, CRISA; and the corporate governance codes, King IV. Sections 2 to 4 address the ability of Asset Owners to IFSI where the relevant portfolio does not have an express Sustainability Impact objective. Section 5 looks at the possibility of establishing funds to Invest for Sustainability Impact and amending the terms of existing ones. Section 6 considers Investment Managers' duties to IFSI. Section 7 addresses the issue of legal liability to third parties for the negative Sustainability Impact of enterprises in which portfolios are invested. Lastly, Section 8 briefly touches on the growing importance of taking account of ESG and sustainability factors where these are "financially material".

Legal Context

1.5 This Annex should be read in the light of the constitutional framework that applies in South Africa. South Africa is a constitutional democracy, subject to the doctrine of constitutional supremacy in that the Constitution[1] is the supreme law, law or conduct inconsistent with the Constitution is invalid, and the obligations imposed by it must be fulfilled.

1.6 The Constitution includes a Bill of Rights comprising various justiciable political and social and economic rights that apply in South Africa both vertically (from the state to its citizens) and horizontally (between one natural or juristic person and another).[2] For example, the environmental right provides, among other things, that "Everyone has the right to have the environment protected, for the benefit of present and future generations, through reasonable legislative and other measures that secure ecologically sustainable development and use of natural resources while promoting justifiable economic and social development." A number of the rights in the Bill of Rights concern matters – such as education, housing and health – that align with sustainability goals and would benefit from IFSI.

1.7 As regards possible future development of the law, the Constitution places an obligation on the courts, when applying a provision of the Bill of Rights to a natural or juristic person to apply or, if necessary,

SOUTH AFRICA

develop the common law to the extent that existing legislation does not give effect to a right.[3] Additionally, when interpreting the Bill of Rights, a court, tribunal or forum must consider international law (for example, in respect of climate change and sustainable development), and may consider foreign law.[4]

1.8 Within this constitutional framework, the overarching legislation relevant to the financial sector is the Financial Sector Regulation Act, 2017 (**FSRA**). It came into operation on 1 April 2018 and introduced a 'twin peaks' model of financial sector regulation in South Africa in that it established two regulators: the Prudential Authority, within the South African Reserve Bank, tasked with prudential regulation; and the Financial Sector Conduct Authority (**FSCA**), tasked with market conduct regulation.

1.9 The FSRA's main object is to achieve a stable financial system that works in the interests of financial customers and that supports balanced and sustainable economic growth in South Africa.[5] It includes a broad compliance obligation whereby, if a financial sector law imposes an obligation to be complied with by an entity that is a juristic person/legal entity, such as an Asset Owner or an Investment Manager, the members of the governing body[6] of that juristic person must ensure that the obligation is complied with.[7]

1.10 The Prudential Authority is responsible for, among other things, the prudential regulation of insurers. The FSCA's functions include regulating and supervising the conduct of various financial institutions (particularly in relation to the provision of financial services), including: pension funds, insurers and collective investment schemes (**CISs**), (the most prevalent type of regulated mutual fund in South Africa), in accordance with applicable "financial sector laws", including: the Pension Funds Act, 1956; the Long-term Insurance Act, 1998; the Short-term Insurance Act, 1998; the Financial Advisory and Intermediary Services Act, 2002; the Collective Investment Schemes Control Act, 2002; the Financial Markets Act, 2012; and the Insurance Act, 2017.[8]

1.11 In order to achieve their respective objectives, the Prudential Authority and the FSCA are empowered to make prudential standards[9] and conduct standards[10] respectively, or joint standards, in respect of financial institutions. These standards relate to various matters including the governance of financial institutions, the duties and responsibilities of members of governing bodies and their substructures, and the operation of financial institutions, including investment activities – and therefore have a bearing on IFSI. Industry-specific guidance from regulators is relevant to investment-related decision-making. And in carrying out regulatory enforcement action, a regulator will look to establish whether such guidance has been followed.

1.11.1 Also informing investment activities and decision-making is a body of common law, or so called "judge-made" law, relevant to fiduciary duties, and the exercise of powers by fiduciaries and trustees, among other matters.

Sustainable Finance Initiative

1.12 Globally, the legal and policy landscape relevant to IFSI is changing rapidly, and South Africa is no exception. In 2017, National Treasury convened a Working Group of financial sector regulatory agencies and industry associations to develop a framework document on sustainable finance.[11] Following stakeholder engagements, National Treasury in May 2020 published a Draft Technical Paper on Financing a Sustainable Economy (***Sustainable Finance Paper***).[12]

1.12.1 The objectives of the Sustainable Finance Paper include:

(a) defining sustainable finance for all parts of the South African financial sector including: banking, retirement funds, insurance, asset management and capital markets;

(b) taking stock of the global and national financial sector policy, regulatory and industry actions taken to date in dealing with environmental and social (***E&S***) risks and opportunities;

(c) identifying market barriers to sustainable finance and the implementation of E&S risk management best practices;

(d) identifying gaps in the existing regulatory framework and recommending actions required of regulators, financial institutions and industry associations;

(e) enhancing financial stability through better understanding of E&S factors, including the concept of a just transition; and

(f) making recommendations for implementing sustainable finance in South Africa through regulatory and industry actions. These encompass general recommendations applicable to all financial services and industries, and recommendations specific to certain sectors.

These objectives stem from a recognition "that there is a need for greater policy coherence for the [financial] sector, regulatory guidance and oversight. There

SOUTH AFRICA

is also real urgency to rapidly increase local financial sector capability to respond to the prevailing social and environmental challenges, which will increasingly have a major impact on our economic resilience and national well-being".[13]

1.12.2 The Sustainable Finance Paper makes recommendations for a process to establish minimum practice and standards with regard to climate change and emerging environmental and social risks. It recommends the adoption of the following definition of "sustainable finance": "Sustainable finance encompasses financial models, products, markets and ethical practices to deliver resilience and long-term value in each of the economic, environmental and social aspects and thereby contributing to the delivery of the sustainable development goals and climate resilience. This is achieved by the financial sector by:

(a) evaluating portfolio as well as transaction-level environmental and social risk exposure and opportunities, using science-based methodologies and best practice norms;

(b) linking these to products, activities and capital allocations;

(c) maximising opportunities to mitigate risk and achieve benefits in each of the social, environmental and economic aspects; and

(d) contributing to the delivery of the sustainable development goals."[14]

This proposed definition of "sustainable finance" informs proposed revisions to the Code for Responsible Investing in South Africa (CRISA), described at paragraph 1.14 onwards below.

1.12.3 Insofar as IFSI is concerned, the Sustainable Finance Paper briefly touches on "impact investment" as a sector innovation in sustainable finance, which it describes as "investments made into companies, organisations and funds with the intention to generate positive E&S impact alongside a financial return".[15] It goes on to note that and suggests that "Impact investing is on the radar of the South African private equity sector but appears to be mostly funded by big corporates looking to build their B-BBEE supply chains and enterprise development corporate social investment initiatives, where a financial return is not always expected."[16]

1.12.4 Both instrumental IFSI and ultimate ends IFSI are consistent with the objectives and proposed definition of sustainable finance set out above. While we believe the current legal and regulatory framework in South Africa permits IFSI, subject to limitations and constraints described in Section 2 below, there is certainly scope for legal and regulatory action to encourage and facilitate IFSI in South Africa.

1.12.5 In June 2021, pursuant to the Sustainable Finance Paper's recommendation to "develop or adopt a taxonomy for green, social and sustainable finance initiatives, consistent with international developments, to build credibility, foster investment and enable effective monitoring and disclosure of performance", a working group chaired by National Treasury published a Draft Green Finance Taxonomy.[17]

The Code for Responsible Investing in South Africa (CRISA)

1.13 Published in 2011, CRISA[18] is a voluntary code that applies to both institutional investors (for example, pension funds, insurers and CISs discussed in this Annex) and their service providers (asset managers, fund managers and consultants).[19]

1.14 CRISA provides guidance on how institutional investors should execute investment analysis and investment activities and exercise their rights so as to promote responsible investment and sound governance. It comprises a set of five "apply or explain" principles, which are similar to those of the UN PRI. Institutional investors demonstrate their endorsement of CRISA by applying the CRISA principles, and by publishing annual reports and disclosures on their application of CRISA.[20]

1.14.1 Principle 1 of CRISA recommends that institutional investors should incorporate sustainability considerations, including ESG, into investment activities as "part of the delivery of superior risk-adjusted returns" to Beneficiaries. The principles do not refer to the achievement of positive Sustainability Impact as a goal in itself.

1.14.2 Additionally, CRISA recommends that an institutional investor should:

(a) Principle 2: Demonstrate its acceptance of ownership responsibilities in its investment arrangements and investment activities;

(b) Principle 3: Where appropriate, consider a collaborative approach to promote acceptance and implementation of the principles of CRISA and other codes and standards applicable to institutional investors;

(c) Principle 4: Recognise the circumstances and relationships that hold a potential for conflicts of interest and should proactively manage these when they occur; and

(d) Principle 5: Be transparent about the content of its policies, how the policies are implemented and how CRISA is applied to enable stakeholders to make informed assessments.

SOUTH AFRICA

1.15 The CRISA Committee – recognising "a growing consensus that investment needs to be aligned with the direction of change, [and] seeking out opportunities to influence and contribute to the environment and society through investment arrangements and activities that target an economy which is both green and inclusive", and that "further innovations … are needed to achieve a systemic shift from commitment into action with more impact" – has recently initiated a project to develop a revised CRISA Code, a draft of which it published for public comment in November 2020.[21]

1.15.1 It is proposed that the revised CRISA will and can be applied on a proportionate basis by investors, using an "apply and explain" regime (rather than the current "apply or explain" regime).

1.15.2 The draft revised CRISA comprises of the following principles, each of which represents ideal states of being or operation at an institutional investor:

(a) Principle 1: Integration of sustainable finance. Investment arrangements and activities reflect a systematic approach to integration of sustainable finance practices, including the identification and consideration of materially relevant ESG and broader sustainable development considerations;

(b) Principle 2: Diligently discharging stewardship duties. Investment arrangements and activities demonstrate the acceptance of ownership responsibilities (where applicable) and enable diligent discharge of stewardship duties through purposeful engagement and voting;

(c) Principle 3: Capacity building and collaboration. A collaborative approach is taken where appropriate to promote acceptance and implementation of the principles of CRISA and other relevant codes and standards, to support the building of capacity throughout the investment industry and enhance sound governance practices;

(d) Principle 4: Governance. Sound governance structures and processes are in place to enable oversight of and accountability for investment arrangements and activities towards diligent stewardship and responsible investment, including proactively managing conflicts of interest; and

(e) Principle 5: Transparency. Meaningful disclosure is made at set time intervals in relation to the investment arrangements and activities across asset classes that support the integration of sustainable finance practices, discharging of stewardship duties and collaborative initiatives.

1.15.3 Under each principle the revised CRISA sets out practice recommendations focusing on implementation and reporting to support action and transparency. Although not legally binding, the revised draft CRISA is significant in that it adopts an outcomes-based approach that will:

(a) provide guidance designed to promote good and responsible investment practices among institutional investors;

(b) through its practice recommendations set and inform market practice standards, which standards regulators may take into account in considering applicable rules and duties, and in exercising oversight of Asset Owners or Asset Managers;

(c) more explicitly encourage the diligent discharge of stewardship duties, by which it means "managing investment arrangements and activities towards the creation of long-term value for the economy, the environment and society as part of the delivery of superior risk-adjusted returns to clients and beneficiaries"; and

(d) contribute to the disclosure and transparency of endorsers' investment activities, stewardship and collaboration initiatives, thereby contributing to beneficiaries and stakeholders' information, oversight and expectations.

King IV

1.16 The King Codes prepared by the Institute of Directors of Southern Africa, of which The King IV Report on Corporate Governance for South Africa, 2016 (*King IV*) is the latest iteration, set out "voluntary principles and leading/recommended practices" as guidelines to promote good corporate governance across all kinds of organisations in South Africa.[22]

1.17 Many Asset Owners and Investment Managers subscribe to King IV and take it into account in their governance. Insurers and public companies whose shares are listed on the Johannesburg Stock Exchange are obliged by the JSE Listings Requirements to apply King IV, and to report on their application of King IV principles and recommendations in their annual integrated reports.

1.18 King IV sets out various principles that an organisation either should apply in order to substantiate a claim that it is practising good governance, reflected in four outcomes: ethical culture, good performance, effective control and legitimacy. It asserts that these outcomes may be achieved by careful consideration and application of the recommended

SOUTH AFRICA

practices that underpin the principles.

1.19 King IV adopts an "apply and explain" regime, i.e. apply the principles and explain that application with reference to the practices demonstrating such application. This is intended to generate an account that allows stakeholders, including shareholders, to evaluate and independently assess the extent to which the company or group is applying the principles and recommendations in King IV. The recommended practices ought to be applied proportionally in line with the organisation's size and resources, and extent and complexity of the organisation's activities.

1.20 Sustainable development is an overarching concept that informs the principles and recommendations of King IV. King IV regards sustainability as an element of the value creation process relevant to all organisations, whilst emphasising sustainable development as "a primary ethical and economic imperative" and "a fitting response to the organisation being an integral part of society, its status as a corporate citizen and its stakeholders' needs interests and expectations. The survival and success of organisations are intertwined with, and related to, three interdependent subsystems: the triple context of the economy, society and the natural environment". King IV is informed by trends towards more sustainable capital markets and the need to create value in a sustainable manner over the longer term.

1.21 Additionally, the philosophies underpinning the approach to good governance adopted under King IV are directly and indirectly relevant to IFSI. The stated philosophies reflect and recognise three paradigm shifts that appear to be taking place:

(a) First, the shift from financial capitalism to inclusive capitalism, which takes account of all sources of capital which are involved in the value-creation process.

(b) Second, that from short-term capital markets to long-term, sustainable capital markets, arising from the need to create value in a sustainable manner, and assess performance over the longer term.

(c) Third, the shift from silo reporting to integrated reporting, a process founded on integrated thinking.

1.22 The following King IV principles are relevant to IFSI:

(a) Principle 17: Responsibilities of Institutional Investors. The governing body of an institutional investor organisation [such as a pension fund, insurer or CIS] should ensure that responsible investment is practiced by the organisation to promote the good governance and the creation of value by the companies in which it invests;

(b) Principle 4: The governing body should appreciate that the organisation's core purpose, its risks and opportunities, strategy, business model, performance and sustainable development are all inseparable elements of the value creation process;

(c) Principle 3: The governing body should ensure that the organisation is and is seen to be a responsible corporate citizen; and

(d) Principle 16: In the execution of its governance role and responsibilities, the governing body should adopt a stakeholder-inclusive approach that balances the needs, interests and expectations of material stakeholders in the best interests of the organisation over time.

> ANNEXES

> South Africa

SOUTH AFRICA

2. ASSET OWNERS' USE OF POWERS OF INVESTMENT AND DIVESTMENT TO INVEST FOR SUSTAINABILITY IMPACT

2.1 The following Section considers the extent to which and in what circumstances, each type of Asset Owner is:

(a) required; or

(b) permitted, or able, to use its powers of investment and divestment to IFSI.

2.2 **Pension funds**

Types of pension fund covered

2.2.1 A variety of occupational and other retirement funds are provided for in South Africa, the majority of which are regarded as "pension funds" under the Pension Funds Act, 1956 (***Pension Funds Act***).[23]

2.2.2 The following organisations are regulated as "pension funds" under the Pension Funds Act:

(a) any association of persons established with the object of providing annuities or lump sum payments for members or former members of the association when they reach retirement, or for the dependants those members or former members upon their death; or

(b) any business carried on under a scheme or arrangement established with the object of providing annuities or lump sum payments for persons who belong or belonged to the class of persons for whose benefit that scheme or arrangement has been established, when they reach retirement or for dependants of those persons upon their death; or

(c) any association of persons or business carried on under a scheme or arrangement established with the object of receiving, administering, investing and paying benefits that became payable in terms of the employment of a member on behalf of beneficiaries, payable on the death of more than one member of one or more pension funds.

2.2.3 Occupational retirement funds are pension funds to which members belong by virtue of the terms of their employment, voluntary retirement funds include preservation funds (where there is no employer/employee relationship and the fund is established for preserving benefits from other approved pension funds on termination of membership) and retirement annuity funds (no employer/employee relationship, and members contribute voluntarily to a fund, with the benefits becoming accessible at age 55 or later), and are also regulated as pension funds.

2.2.4 Pension funds are special purpose not-for-profit legal entities, through which members and/or their employers (in the case of occupational retirement funds) provide for the payment of benefits on the happening of certain events (e.g. death, retirement, withdrawal, ill-health) in accordance with the rules of the fund and the Pension Funds Act.

2.2.5 Funds are required to be registered under the Pension Funds Act before commencing any retirement fund business.[24] Upon registration, a pension fund becomes a body corporate capable of suing[25] and being sued in its corporate name, of having assets and liabilities, rights and obligations, and of doing all such things as may be necessary for or incidental to the exercise of its powers or the performance of its functions in terms of its rules.[26]

2.2.6 Many pension funds are "underwritten funds". An underwritten pension fund's only asset is a policy of insurance in terms of which, when a beneficiary becomes entitled to a retirement or risk benefit in terms of the fund's rules, the insurer must pay a corresponding, equivalent benefit to the fund so that it may meet its obligation to the beneficiary. Underwritten funds are required to comply with the same prudential investment regulations as other pension funds, and accordingly insurers are obliged to develop policies whose underlying asset allocations and strategies are compliant with those regulations in order for those policies to be marketable to underwritten funds. The pension fund's board will choose from the available suite of investment portfolios to align with the fund's investment strategy.

2.2.7 Certain retirement funds are not subject to the Pension Funds Act and have been established under their own statute. The largest of these is the Government Employees Pension Fund (***GEPF***), with more than 1.2 million active members, in excess of 450,000 pensioners and beneficiaries, and assets of over R1.6 trillion. The GEPF is a defined benefit pension fund. The fund operates under the Government Employee Pension Law and Rules, which prescribes how the GEPF is to be governed, and how pension and related benefits of members, pensioners and beneficiaries are to be administered.

2.2.8 In discussing pension funds in this memorandum, we use the following expressions in the way described:

- **Asset Owner:** Pension funds, being legal entities, are the owners of the assets that

> ANNEXES

> South Africa

SOUTH AFRICA

they hold in the best interests of their members;

- **Beneficiaries:** A pension fund's beneficiaries are its members and include those who belong or belonged to a class of persons for whose benefit that fund has been established, either by virtue of the terms of their employment or by voluntary association. Beneficiaries of funds also include a dependant of a member who is entitled to a benefit in terms of the rules of the fund (i.e. a spouse, a child or any other person who was found to be dependent on a member prior to his or her death); and
- **Investment decision maker:** Every pension fund has a board consisting of at least four board members who are tasked with directing, controlling and overseeing the operations of the fund, including investment strategy, in accordance with the applicable laws and the rules of the fund. The board of the fund consists of various sub-committees, including and investment subcommittee who is tasked to deal with the fund's investment and its investment strategy. The investment sub-committee is typically assisted by an Investment Manager appointed by the fund to assist the board in carrying out its duties.

Underwritten retirement funds only maintain an insurance policy, while the insurer owns the underlying assets under its policy, and accordingly it is the insurer's investment management arrangements that determine the investment of the underlying portfolios, in accordance with the regulations applicable to insurance companies (although the product must comply with the regulatory requirements for pension funds in order for it to be marketable).

The GEPF's investment manager is the Public Investment Corporation SOC Limited (***PIC***), a state-owned corporation and registered financial services provider (***FSP***), which has the Minister of Finance as its shareholder representative.

2.3 **Overview of investment duties and powers, and use of investment powers to Invest for Sustainability Impact**

Summary conclusion

2.3.1 Pension funds are legally required to pursue instrumental IFSI (i.e. IFSI as an intermediate goal to achieve a financial return), but not ultimate ends IFSI (i.e. as a goal in itself in parallel with financial return). A pension fund could be legally required to pursue ultimate ends IFSI where it, or a particular investment portfolio within it, is established with that express, recorded mandate. The requirement for a pension fund, under Regulation 28 of the Pension Funds Act to give appropriate consideration to any factor which may materially affect the sustainable long-term performance of its assets, including ESG factors, before investing in and while invested in any asset, obliges the board to pursue an instrumental IFSI investment process. However, it does not go so far as to require a fund or its board to exercise its powers to achieve particular prescribed or described IFSI outcomes.

2.3.2 It is permissible for a pension fund to pursue instrumental IFSI. And it is permissible for a pension fund to have an objective for a portfolio that would involve ultimate ends IFSI (in addition to having an investment objective to achieve a particular investment return) subject to the board's duty to ensure that the fund is on the whole finically sound and its board takes all reasonable steps to ensure that the interests of the fund's members are protected in terms of the fund's rules and the Pension Funds Act. This would mean that the financial return and Sustainability Impact goals would have to be pursued in parallel.

Analysis

2.3.3 The board of a pension/retirement fund is tasked with directing, controlling and overseeing the operations of the fund in accordance with applicable laws and the rules of the fund, its principal, and is the directing mind and will of the fund.

2.3.4 The board:

(a) must take all reasonable steps to ensure that the interests of members in terms of the rules of the fund and the provisions of the Pension Funds Act are protected at all times. These interests would be primarily in the receipt of adequate benefits in retirement or upon the occurrence of the relevant defined event, in accordance with the terms of the policy;

(b) must act with due care, diligence and good faith;

(c) must avoid conflicts of interest;

(d) must act with impartiality in respect of all members and beneficiaries;

(e) must act independently;

(f) has a fiduciary duty to members and beneficiaries in respect of accrued benefits or any amount accrued to provide a benefit; and

(g) has a fiduciary duty to the fund (its principal), to ensure that the fund is financially sound, responsibly managed, and governed in accordance with the fund's rules, the Pension Funds Act and applicable laws. The FSCA has published

SOUTH AFRICA

a notice which sets out a minimum basis on which the financial position of a fund should be evaluated and calculated to determine whether or not it is financially sound. How and if a fund will remain financially sound depends on, amongst other things, the investment of the fund's assets to meet its liabilities.[27]

2.3.5 It is worth noting that:

(a) the board has a fiduciary duty in respect of the fund's long-term interests which may on occasion override the interests of individual members and stakeholders of the fund;

(b) the separate but narrower statutory fiduciary duty that the board owes to members and beneficiaries pertains only to accrued benefits (in effect, amounts held in trust for specific beneficiaries) or any amounts accrued to provide a benefit (which may be attributable to individual members or beneficiaries, or identifiable groups, for example, pending transfer of membership to another pension fund); and

(c) the board does not have a general fiduciary duty in relation to its members and beneficiaries, rather it is obliged to take reasonable steps to ensure that their interests as set out in the Pension Funds Act and the rules of the fund are protected.

2.3.6 Further duties of the board include ensuring that adequate and appropriate information is communicated to the members and beneficiaries of the fund informing them of their rights, benefits and duties in terms of the rules of the fund, and that the rules and the operation and administration of the fund comply with the Pension Funds Act, the Financial Institutions (Protection of Funds) Act, and all other applicable laws.[28]

2.3.7 A retirement fund's object is ordinarily to pay benefits to its members and other beneficiaries (current and future) in terms of its rules. Different benefits are payable upon the happening of different events, such as withdrawal, death and retirement. To achieve its object, the principal duty of the board of a fund is to ensure that the fund is and will remain financially sound throughout the lifetime of the fund.

2.3.8 The powers of the board are derived from and limited by legislation and the fund's rules. The rules of a fund describe the purpose and business of the fund, the type of fund, the objects of the fund, the rights and obligations of the members and employers (if any) participating in the fund, and establish the powers of the board of trustees of the pension fund. Investment duties and powers may therefore be shaped by the rules of the fund.

2.3.9 Subject to the provisions of the Pension Funds Act, the rules of a registered fund are binding on the fund and its members, officers, and on any person who claims under the rules or whose claim is derived from a person so claiming.[29] As the Supreme Court of Appeal put it: "The trustees of a fund are bound to observe and implement the rules of that fund. Their powers and responsibilities and the rights and obligations of members and participating employers are governed by the rules, applicable legislation and the common law. The rules of a fund form its constitution and must be interpreted in the same way as all documents."[30] And: "What the trustees may do with the fund's assets is set forth in the rules. If what they propose to do (or have been ordered to do) is not within the powers conferred upon them by the rules, they may not do it."[31]

2.3.10 Insofar as investment powers are concerned, retirement funds generally have broad investment powers, provided that such powers are exercised in accordance with applicable laws, the rules of the fund and the fund's investment policy statement (***IPS***).

2.3.11 The board is required to prepare an IPS under Regulation 28 of the Pension Funds Act. The IPS:

(a) describes a fund's general investment philosophy and objectives, as determined by its liability profile and risk appetite;

(b) must be appropriate and adequate for its liabilities. There is no duty on the board or fund to pursue maximum return on investments at all costs; its object is to ensure that the fund is and remains financially sound. Regulation 28 contemplates "adequate", "appropriate", "responsible" investment of a fund's assets. The trustees "mandate" is descriptive rather than prescriptive;

(c) addresses principles with which a retirement fund and the board must at all times comply,[32] including:

(i) understanding the changing risk profile of assets of the fund over time, taking into account comprehensive risk analysis, including but not limited to credit, market, liquidity and operational risk, and currency, geographic and sovereign risk of foreign assets; and

(ii) before investing in and whilst invested in an asset consider any factor which may materially affect the sustainable long-term performance of the asset including, but not limited to, those of an environmental, social and governance character (***ESG factors***);[33] and

(d) must be reviewed annually.

> ANNEXES

> South Africa

SOUTH AFRICA

2.3.12 Regulation 28 also regulates a fund's assets spreading requirements. Among other things, it stipulates that a fund must only hold assets and categories of assets referred to in Table 1 to the Regulation and must comply with the limits set out in Regulation 28.

2.3.13 Regulation 28 promotes responsible investing of fund assets, based on sustainable, long-term, risk aligned and liability driven investment philosophy. Its preamble sets out the expectations on funds when investing their assets:

"A fund has a fiduciary duty to act in *the best interest of its members* whose benefits depend on the responsible management of fund assets. This duty supports the adoption of a responsible investment approach to deploying capital into markets that will earn adequate risk adjusted returns suitable for the fund's specific member profile, liquidity needs and liabilities. Prudent investing should give *appropriate consideration to any factor which may materially affect the sustainable long-term performance of a fund's assets, including factors of an environmental, social and governance character*. This concept applies across all assets and categories of assets and should promote the interests of a fund in a stable and transparent environment." (Emphasis added.)

2.3.14 The suggestion in the preamble above that a fund (through its board) has a blanket fiduciary duty to act in the best interests of members, seems to be inconsistent with the narrower fiduciary duty on the board in the Pension Funds Act mentioned above: a fiduciary duty to members and beneficiaries in respect of accrued benefits or any amount accrued to provide a benefit. Although the preamble is not legally prescriptive, to the extent that a provision prescribed in the Regulation is inconsistent with a statute the provisions of the statute, in this case, the Pension Funds Act, the provisions of statute would prevail. Further, the fund (through its board) is not obliged to act in the best interests of its members, it is obliged to take their interests into account.

2.3.15 The principles with which a retirement fund must comply under Regulation 28(2)(c) include:

(a) in contracting services to the fund or its board, consider the need to promote broad-based black economic empowerment (***B-BBEE***) of those providing services;[34]

(b) before making a contractual commitment to invest in a third party managed asset or investing in an asset, perform reasonable due diligence taking into account risks relevant to the investment including, but not limited to, credit, market and liquidity risks, as well as operational risk for assets not listed on an exchange;

(c) in performing due diligence a fund may take credit ratings into account, but such credit ratings should not be relied on in isolation for risk assessment or analysis of an asset and should not be to the exclusion of a fund's own due diligence; and

(d) understand the changing risk profile of assets of the fund over time, taking into account comprehensive risk analysis, including but not limited to: credit, market, liquidity and operational risk, and currency, geographic and sovereign risk of foreign assets.

2.3.16 Neither the Pension Funds Act, nor Regulation 28, defines the concepts "materially", "sustainable" or "sustainable long-term performance". Guidance Notice 1 of 2019 (***Guidance Notice 1***), which is not hard law but FSCA guidance on Regulation 28 defines "sustainability" as: "the ability of an entity to conduct its business in a manner that primarily meets existing needs without compromising the ability of future generations to meet their needs. Conducting business sustainably includes managing the interaction of the business with the environment, the society and the economy in which it operates towards a better long-term outcome. Evaluating the sustainability of the business of an entity includes the consideration of economic factors and ESG factors. The "sustainability of an asset" implies the sustainability of the entity giving rise to the underlying value of the asset."

2.3.17 The reference to "any factor" which may materially affect the sustainable long-term performance of a fund's asset in Regulation 28 and the guidance above suggests that both traditional economic factors (such as credit, market and liquidity risks) and ESG factors should be taken into account where they may materially affect the long-term financial performance of an asset. Guidance Notice 1 defines "ESG factors" as "environmental, social and governance factors. In the South African context, and specifically in respect of assets located in South Africa, these factors include, but are not limited to, the manner in which [B-BBEE] is advanced".

2.3.18 Guidance Notice 1 also describes the sustainability of investments and assets in the context of a fund's IPS, and notes that the sustainability of a fund's assets is a key factor that should inform its IPS. To this end, Guidance Notice 1 says that

SOUTH AFRICA

"where a fund holds assets that limit the application of ESG factors, sustainability criteria or the full application of active ownership policy, the IPS should also state the reasons as to why this limitation is to the advantage of both the pension fund and its membership". Moreover, where the IPS does not state the reasons for the limitation described above, Guidance Notice 1 says it should "set out the remedial action the fund has taken or intends taking to rectify the position. Where no remedial action is being considered or taken, the fund should set out the reasons therefor."

2.3.19 While South Africa's retirement fund industry has for many years been legally required to consider material ESG factors in their investments, it is clear that they are now being asked to increase the transparency of their ESG disclosure and reporting. It remains to be seen how funds and members respond to Guidance Notice 1, and what the FSCA will do if funds do not meet its expectations set out in Guidance Notice 1.

2.3.20 Regulation 28 should not be interpreted in isolation of the fund's object. Where the object of a retirement fund is to provide benefits to members and their beneficiaries in terms of the rules of the fund, then the primary duty of the board of that fund is to ensure that the fund remains financially sound to fulfil its obligations to the members and their beneficiaries in terms of the rules.

2.3.21 Separately, the GEPF is required in terms of its governing statute, the Government Employees Pension Law, 1996 (*GEP Law*), to determine the investment policy of the fund in consultation with the Minister of Finance.[35]

2.3.22 The GEPF's core business is to manage and administer pensions and related benefits for government employees in South Africa. The GEPF's assets include money contributed by and on behalf of State employees, and they belong to the GEPF and are invested in the name of the GEPF and for its account. The executive authority of the GEPF is the Board of Trustees, which is responsible for both administrative and investment performance of the fund.

2.3.23 The duties and powers of the GEPF Board are prescribed by the GEP Law and Rules,[36] which require, among other things, that investments are made and maintained in accordance with the GEPF's investment strategy.

2.3.24 The GEPF has adopted an IPS, the objectives of which include:

(a) to apply a responsible investment approach by ensuring the integration of ESG factors into investment processes, so as to better manage risk and generate sustainable, long-term returns; and

(b) to contribute to B-BBEE (described above at footnote 33) and the transformation of the South African economy and its investment industry[37] The investment policy can be changed by the GEPF board, provided that any change in the investment policy which may affect the Government's financial obligation towards the GEPF, shall be subject to the approval of the Minister of Finance.

Legal requirements to use investment powers to Invest for Sustainability Impact

2.3.25 Although the concept of being obliged to pursue a goal other than financial return is not totally unknown (for example, contributing to B-BBEE or transitioning away from carbon intensive investments), looking specifically at pension fund investment powers:

(a) a pension fund is not legally required to have an objective for a portfolio that would involve IFSI, rather than or in addition to having an investment objective to achieve a return that enables a fund to meet its obligations towards its members or beneficiaries; and

(b) the board and trustees are not generally subject to a duty to exercise investment powers to achieve positive Sustainability Impact but are required to pursue an instrumental IFSI approach.

2.3.26 This would not prevent a pension fund board from selecting investment options on the basis of the anticipated financial return which effectively involve instrumental IFSI, for example, should they decide to invest in traditional impact investment funds in the interests of portfolio diversification.

2.3.27 Where a pension fund board concludes that sustainability factors present a systemic risk which could prevent it from ensuring that the fund is financially sound over the long-term, the board might decide that it should engage in one or more instrumental IFSI activities, ranging from disinvestment to stewardship with investee enterprises designed to avert that risk in order to discharge its duties (see further paragraph 3.1.5 below). In that context, it might also conclude from time-to-time that it should under or overweight a particular investee company in order to strengthen its voice as part of those activities.

SOUTH AFRICA

Legal freedom to use investment powers to Invest for Sustainability Impact

2.3.28 The duties and powers as discussed above appear to be sufficiently flexible for a pension fund to have an objective for a portfolio that would involve ultimate ends IFSI (in addition to having an investment objective to achieve a particular investment return) subject to the board's duty to ensure that the fund is on the whole finically sound and its board takes all reasonable steps to ensure that the interests of the fund's members are protected in terms of the fund's rules and the Pension Funds Act. This would mean that the financial return and Sustainability Impact goals would have to be pursued in parallel. Depending on the fact-specific circumstances, this flexibility may include scope for more selective over-weighting or under-weighting investments in individual issuers from time-to-time in order to strengthen stewardship activities and scope to select individual investments for the portfolio based on the desire to achieve a Sustainability Impact in relation to the relevant enterprise as well as the requisite financial return (on the assumption that this can be done in a way that does not detract from maintaining the financial soundness of the portfolio and taking all reasonable steps to ensure that the interests of the fund's members are protected in terms of the fund's rules and the Pension Funds Act).

2.3.29 If, based on information available to a fund's board at the time of making (and reviewing) investment decisions that target Sustainability Impact, there appears to be a reasonable prospect of sufficiently positive long-term financial outcomes, then the decision making process is sound and legally defensible, and is likely to withstand scrutiny even if the investment outcomes are poorer than anticipated, even adverse (financially or otherwise).

2.3.30 While Beneficiaries' views or a wider measure of Beneficiary welfare than solely financial welfare may be relevant to a pension fund board's decision to conduct ultimate ends IFSI on the bases set out above, there is no legal requirement to ascertain Beneficiaries' views on IFSI, or for their views to inform an IPS. Guidance Notice 1 "encourages" pension funds, in the interest of transparency, accountability and fair treatment of its members, to:

(a) make their IPSs available on request to each member and each participating employer, and available on their website so that it is accessible to any person; and

(b) at least annually, provide a copy or inform stakeholders that the IPS and any changes thereto are available on its website.

2.4 Mutual funds

Types of mutual fund covered

2.4.1 A CIS is a scheme, in whatever form, in pursuit of which members of the public are invited or permitted to invest money or other assets in a portfolio, and in terms of which:

(a) two or more investors contribute money and hold a participatory interest in a portfolio of the scheme through shares, units or any other form of participatory interest; and

(b) the investors share the risk and the benefit of investment in proportion to their participatory interest in a portfolio of a scheme, or on any other basis determined in the deed of the scheme.[38] CISs include unit trusts, exchange traded funds, hedge funds, and open-ended investment companies.[39]

2.4.2 The establishment and administration of CISs is primarily regulated by the Collective Investment Schemes Control Act, 2002 (***CISCA***). CISs regulated under CISCA are:

(a) CIS in securities, where the portfolio consists mainly of securities;

(b) CIS in property, which includes property shares and immovable property;

(c) CIS in participation bonds; and

(d) hedge funds, funds which use any strategy or take any position which could result in the funds incurring losses greater than their aggregate market value at any point in time, and which strategies or positions include but are not limited to leverage; or net short positions.

2.4.3 CISCA also provides for a "declared collective investment scheme", which is a CIS other than a CIS in securities, property or participation bonds, declared by the FSCA to be a CIS.[40] Hedge funds were declared a CIS in terms of this provision. Additionally, a manager or operator of a foreign CIS may apply to the FSCA for approval to solicit investments in the foreign CIS from members of the public in South Africa.[41]

2.4.4 In discussing CISs in this memorandum, we use the following expressions in the way described:

(a) **Asset Owner**: A CIS is the legal owner of the underlying assets of each portfolio.[42]However, it is the authorised CIS manager that is responsible for day-to-day administration of the fund and making investment decisions;

SOUTH AFRICA

(b) **Beneficiaries:** A CIS's beneficiaries are its current investors, who hold beneficial ownership of the underlying assets of each portfolio; and

(c) **Investment decision-maker:** In terms of CISCA, the investment decision-maker is the manager authorised by the FSCA to administer the CIS. Authorised CIS managers usually delegate investment decision-making powers to their own Investment Managers but will retain responsibility for the Investment Manager's decisions.

Overview of investment duties and powers, and use of investment powers to IFSI

Summary conclusion

2.4.5 Given that CIS' investment and a CIS manager's investment duties and powers are driven by the CIS' investment policy/objectives, it is unlikely that the CIS manager would be required to use its investment powers to pursue instrumental IFSI where the investment policy and objectives of the CIS do not provide for IFSI. Where the investment policy and objectives of the CIS provide for IFSI, the CIS manager would be legally required or permitted to use its investment powers to ultimate ends IFSI. There is scope for a CIS manager to engage in instrumental IFSI and ultimate ends IFSI stewardship and public policy work, subject to any limitations inherent in the CIS' deed and investment policy/objectives.

Analysis

2.4.6 The investment of money or other assets[43] in respect of a CIS, is primarily regulated by CISCA.

(a) A CIS manager must:

(b) organise and control the CIS in a responsible manner, and maintain adequate financial resources to meet its commitments and manage the risks to which the CIS is exposed;[44]

(c) administer a CIS honestly and fairly, with skill, care and diligence;

(d) administer a CIS in the interest of investors, being the Beneficiaries who hold participatory interests in a CIS, and the collective investment scheme industry;[45] and

(e) appoint, depending on the structure of the CIS, a trustee or custodian, which has various duties relating to the CIS assets, its administration, and overseeing compliance with CISCA.

2.4.7 For the purposes of CISCA:

(a) any moneys or assets received from an investor are, and an asset of a portfolio is, regarded as being trust property for the purposes of the Financial Institutions (Protection of Funds) Act, 2001 (***FIA***). Under the FIA, a financial institution or nominee company[46] that invests, holds, controls, administers or alienates any funds of a financial institution or any trust property:

(i) must observe the utmost good faith and exercise proper care and diligence with regard to such funds;

(ii) must, with regard to the trust property and the terms of the trust deed, observe the utmost good faith and exercise the care and diligence required of a trustee in the exercise or discharge of his/her powers and duties; and

(iii) may not alienate, invest, pledge, hypothecate or otherwise encumber or use the funds or trust property or furnish any guarantee in a manner calculated to gain, directly or indirectly, any improper advantage for any person to the prejudice of the financial institution or principal concerned;[47] and

(b) a manager, its authorised agent, trustee or custodian must deal with such assets in terms of CISCA and the deed of the CIS, and in the best interests of investors.

2.4.8 Investment duties and powers may also be shaped by the deed of the CIS. CISCA prescribes that the requirements for the administration of a portfolio must be set out in a "deed": an agreement between a manager and a trustee or custodian, or the document of incorporation that regulates establishment, administration and management of the CIS.[48] A deed must contain provisions to regulate various matters specified in CISCA, including the investment policy to be followed in respect of each portfolio.

2.4.9 The investment activities of a CIS will be limited to some extent by the nature of the CIS. The FSCA may determine the manner in which, and the limits and conditions subject to which, a particular asset type may be included in the portfolio of a CIS.[49] Additionally, the FSCA has published Board Notices that apply to different types of CIS, which set the limits and conditions subject to which securities or classes of securities may be included in a sub-fund or portfolio of a CIS.[50]

Legal requirements to use investment powers to Invest for Sustainability Impact

2.4.10 Generally, a CIS is not subject to a duty to instrumental IFSI rather than, or in addition to having an objective to achieve a particular investment return. This is because the manager's investment powers must be exercised in accordance with the

SOUTH AFRICA

investment policy set out in the CIS deed, which (in the absence of an IFSI object, as to which see Section [5] below) are likely to be driven by a financial return, often by reference to a particular market or benchmark. Therefore, the motivation to invest or divest in an individual entity is likely to need to be the anticipated financial return on that investment, and the decision must be consistent with the CIS's investment policy.

2.4.11 This would not prevent a CIS manager from selecting investment options on the basis of the anticipated financial return which effectively involve instrumental IFSI. As an example, if a CIS' investment policy broadly permits a CIS manager to invest in shares, the CIS manager could invest in an entity seeking equity capital to advance a Sustainability Impact related project, taking into account its duties outlined in paragraphs 2.3.7 and 2.3.8 above.

Legal freedom to use investment powers to Invest for Sustainability Impact

2.4.12 CISs are required to have explicit investment objectives, including investment objectives for each sub-fund or portfolio and to disclose such objectives to prospective Beneficiaries prior to their investing in the CIS. If Sustainability Impact is not included among the disclosed investment objectives, a CIS cannot pursue ultimate ends IFSI, but its duties outlined in paragraphs 2.3.7 and 2.3.8 above may require an instrumental IFSI approach in relevant circumstances (management of Sustainable Impact related risk).

2.5 Insurance undertakings

Types of insurance undertaking covered

2.5.1 Insurers are persons registered to conduct insurance business – life insurance, non-life insurance, microinsurance, and reinsurance – under the Short-term Insurance Act, 1998 (***STIA***) or Long-term Insurance Act, 1998 (***LTIA***), or licensed to conduct insurance business in South Africa under the Insurance Act, 2017 (***Insurance Act***).

2.5.2 The Insurance Act serves as umbrella legislation for prudential regulation of the insurance sector under the Prudential Authority. An insurer may not, without the approval of the Prudential Authority, conduct any business other than insurance business in South Africa.[51] The STIA, LTIA and Insurance Act are supplemented by their respective regulations and Policyholder Protection Rules published by the FSCA.

2.5.3 The key entities are:

- **Asset Owner:** Insurers are the legal owner of the assets derived from shareholder funds and premiums collected from policyholders;
- **Beneficiaries:** An insurer's Beneficiaries are its policyholders, and the policyholders' nominated beneficiaries, should a claim arise. Additionally, for the purposes of this report, we treat shareholders of insurers as "Beneficiaries" due to their economic interest in the management of the insurer's assets; and
- **Investment decision maker:** The investment decision maker is the insurer itself and/or any delegated investment manager and/or asset manager it mandates in accordance with its investment policy, to the extent of the delegation.

Overview of investment duties and powers, and use of investment powers to Invest for Sustainability Impact

Summary conclusions

2.5.4 South African legislation is primarily focused on treating policyholders fairly and ensuring prudential stability. Therefore, while each insurer would need to consider its own situation, it is unlikely that the main duties of directors of insurers would require them to conclude that the insurer is required to use its investment power to IFSI. However, there is flexibility and scope within the legal framework for an insurer to pursue and engage in instrumental IFSI or discretionary ultimate ends IFSI via its investment powers, stewardship or public policy work, subject to obligations to generate the financial return necessary to discharge the insurer's contractual obligations, and provided it does not prejudice the customer, is in accordance with the investment policy of the insurer, and does not adversely impact the financial stability of the insurer.

SOUTH AFRICA

Analysis

2.5.5 An insurer's investment duties are shaped by, among other things:

(a) the terms of policyholder documentation;

(b) the requirement for an insurer and its controlling company to, at all times:

(i) conduct its business with integrity, and with due skill, care and diligence;

(ii) act in a prudent manner;

(iii) organise and control its affairs responsibly and effectively; and

(iv) deal with the Prudential Authority in an open and cooperative way;[52]

(c) requirements to maintain its business in a financially sound condition, by holding eligible own funds that are at least equal to the minimum capital requirement or solvency capital requirement, as prescribed by the Prudential Authority, whichever is the greater;[53]

(d) requirements to adopt, implement and document an effective governance framework that provides for the prudent management and oversight of:

(i) in the case of an insurer, its insurance business, and which adequately protects the interests of its policyholders;[54] or

(ii) in the case of a controlling company, the insurance group's business (including the business of all persons that are part of the group), and which adequately protects the interests of policyholders of the insurers that are part of the insurance group.[55]

This framework requires the adoption of board-approved risk management policies, including an insurer's investment policy prepared in compliance with Prudential Standard GOI 3 (described below);

(e) duties of directors to act in good faith, for a proper purpose, in the best interests of the company, and with skill care and diligence.[56] In exercising powers or performing functions as a director, a director will have satisfied obligations to act in the best interests of the company and with the requisite degree of skill, care and diligence if that director:

(i) has taken reasonably diligent steps to become informed about the matter; and

(f) made his or her decision with a rational basis for believing, and did in fact believe, that the decision was in the best interests of the company.[57]

This is a limited form of business judgement rule that affords directors some protection from liability for breaches of the aforementioned statutory obligations and requires a court to defer to director's judgement as to what constitutes the best interests of the company, provided that the above requirements were met at the time of making an impugned decision; and

(g) duties of directors of insurers, including those to:

(i) act in the best interests of the insurer and policyholders; and

(ii) exercise independent judgment and objectivity in decision-making, taking into account the interests of insurers and policyholders.[58]

2.5.6 Insofar as investment activities are concerned, the Prudential Authority has published Prudential Standard GOI 3 in respect of insurers' investment policies, which prescribes that an insurer's investment policy must:

(a) specify the nature, role and extent of the insurer's investment activities, and how the insurer will ensure compliance with the asset requirements prescribed under the financial soundness standards by the Prudential Authority in the Prudential Standard: Financial Soundness Standards for Insurers;

(b) set out the insurer's strategy for investing, including asset allocation strategies, how these will be managed, and how they relate to the asset-liability management policy;

(c) establish explicit risk management procedures with regard to more complex and less transparent classes of assets, including investments in markets or instruments that are subject to low levels of governance or regulation;

(d) take into account any factor which may materially affect the sustainable long-term performance of assets, including ESG factors;

(e) adhere to the 'Prudent Person Principle' by establishing measures that will assist in ensuring that:

(i) the insurer invests only in assets and instruments whose risks the insurer can properly identify, assess, monitor, manage, control, and report on; and

(ii) assets are invested in a manner appropriate to the nature and duration of the insurer's liabilities and the best interests of policyholders and beneficiaries;

(f) ensure that investments are made in a manner that ensures the security, quality, liquidity and profitability of the insurer's whole portfolio;

(g) ensure that investments are diversified in

SOUTH AFRICA

a manner that avoids excessive reliance on any particular asset, issuer or group of companies, or geographical area and excessive concentration of risk in the portfolio as a whole;

(h) ensure that where assets are held in respect of long-term policies, where the investment risk is borne by the policyholders, the corresponding liabilities are:

(i) in the case of insurance obligations that are directly linked to the value of units, represented as closely as possible by those units; and

(ii) in the case of insurance obligations that are linked directly to a share index or a reference value other than units, represented as closely as possible by the units deemed to represent the reference value or, in the case where units are not established, by assets of appropriate security and marketability which correspond as closely as possible with those on which the particular reference value is based; and

(i) ensure that, in the case where investment performance is guaranteed, appropriate assets are held to support the guarantee.

2.5.7 The board of directors must ensure an insurer maintains an appropriate level and quality of own funds commensurate with the type, amount and concentration of risks to which the insurer is exposed.[59]

2.5.8 An insurer's actuarial function is responsible for:

(a) expressing an opinion to the board of directors regarding the accuracy of the calculations and the appropriateness of the assumptions underlying the valuation of the insurer's technical provisions, and calculation of the insurer's capital requirements; and

(b) evaluating and providing advice to the board of directors on various issues, including the insurer's investment policy and the actuarial soundness of the terms and conditions of insurance contracts.

2.5.9 Prudential Standard GOI 3 does not define or provide guidance on the meaning of "sustainable long-term performance of assets" in the insurance context. The interpretation of the term depends on the interaction between a particular insurer's board, management and statutory actuary, which may result in a broader meaning along the lines contemplated in FSCA Guidance Notice 1 referred to at paragraph 2.2.22 above (which does not purport to apply to insurers) or a narrower meaning that focuses on the "sustainability" of an asset's risk rating with reference to financial impact on the portfolio capital, rather than "the ability of an entity to conduct its business in a manner that primarily meets existing needs without compromising the ability of future generations to meet their needs".

2.5.10 The National Treasury's Sustainable Finance Paper (discussed at paragraph 1.12) recommends that the Prudential Authority should enhance insurer's "Own Risk and Solvency Assessment" reporting requirements to "deal with the management of sustainability and specifically climate risks". It remains to be seen whether this recommendation will be acted on by the Prudential Authority.

General insurance: Legal requirements to use investment powers to Invest for Sustainability Impact

2.5.11 While sustainability factors which may materially affect the sustainable long-term performance of an insurer's assets should be taken into account in an insurer's investment policy, we do not consider that South African law currently supports general insurers being generally subject to a duty or legal requirement to exercise investment powers to IFSI. The motivation to invest or divest in an individual entity is likely to need to be the anticipated financial return on that investment. This is because, in relation to assets being invested in connection with policies issued by the insurer, the directors would be under a duty to generate the financial return necessary to discharge the company's contractual obligations and to ensure the prudential stability of the business. That said, the factors that shape the duties and investment activities of insurers described in paragraph 2.4.5 *ff* above (including the requirements to act in the best interests of the insurer and policyholders and to protect the interests of policyholders) may lead an insurer to conclude it should engage in ultimate ends IFSI in the way it manages assets in connection with its insurance policies, or may lead the directors to conclude that IFSI would be in the best interests of the insurer and its shareholders, i.e. to conduct business in an ethical manner that reaches beyond financial return (alongside achieving financial returns).

> ANNEXES

> South Africa

SOUTH AFRICA

2.5.12 In relation to the investment of the insurer's own funds, although the duty to secure a financial return would be dependent on how the purpose of the insurance company has been defined (and therefore what would be in the best interests of the insurer), it is assumed that profit will be part of that purpose and therefore the directors will be under a duty to invest the insurers assets in such a way as to generate an appropriate financial return , which would run parallel to any objectives to IFSI. In specific circumstances this may oblige an insurer, or Investment Manager acting on its behalf, to select investment options on the basis of the anticipated financial return which effectively involve instrumental IFSI. And there would also be room, in our view, for an insurer to select investments on the basis of anticipated financial returns which involve instrumental IFSI. For example, members of ClimateWise, an insurance industry group convened by the Cambridge Institute for Sustainability Leadership, endorse principles that seek to "guide members' contributions to the transition to a low carbon, climate-resilient economy and integrate a response to the climate risk protection gap – the growing divide between economic and insured losses – across their business activities".[60] Members are required to take active steps towards positive Sustainability Impacts by incorporating climate-related issues into their strategies and investments (Principle 2) and by reducing the environmental impact of their businesses (Principle 4).[61] Leading South African insurers, Sanlam and Santam are both members of ClimateWise. Sanlam has interests in the Climate Investor One Fund for renewable energy projects and public infrastructure projects, and a proposed Climate Investor Two Fund, a water fund, and Santam's Resilient Investment Fund, which invests in the private sector credit market with the intention of generating financial and social returns, are examples of investments involving instrumental IFSI.[62]

2.5.13 An argument could be made, that directors' duties could in certain circumstances require an insurer's directors to adopt an investment policy which aims to prevent systemic sustainability risks which may eventually negatively impact the insurer financially (instrumental IFSI) particularly where the insurer is exposed to sustainability risks because of the sort of risks it insures.[63] However, it would be very difficult for a shareholder to establish that a director had breached their statutory duties by failing to IFSI. South African courts are reluctant to intervene in good faith commercial decisions made by directors, and a challenge would only likely succeed if it can be shown that the director failed to take reasonably diligent steps to become informed about the matter, and made the decision without a rational basis for believing, or did not in fact believe, that the decision was in the best interests of the company (see paragraph 2.4.5(e) above).

General insurance: Legal freedom to use investment powers to Invest for Sustainability Impact

2.5.14 In our view, there is flexibility for a general insurer to conduct ultimate ends IFSI, albeit subject to contractual obligations, limitations in the legislative and regulatory rules and duties of directors to invest the insurer's wider assets with a view to generating an appropriate financial return. As such these two objectives can run parallel to one another as insurers would be able to engage in discretionary ultimate ends IFSI. For example, the requirement to maintain the business in a financially sound condition at all times, and prudential standards, means that financial return and impact goals would have to be pursued in parallel. Depending on the fact-specific circumstances, this flexibility may include scope for more selective over-weighting or under-weighting investments in individual issuers from time-to-time in order to strengthen stewardship activities and scope to select individual investments for the portfolio based on the desire to achieve a Sustainability Impact in relation to the relevant enterprise as well as the requisite financial return (on the assumption that this can be done in a way that does not detract from achieving the security, quality, liquidity and profitability of the insurer's whole portfolio).

SOUTH AFRICA

2.5.15 Moreover, whilst the factors that shape the duties and investment activities of insurers described in paragraph 2.4.5 *ff* above do not in our view require an insurer to IFSI, they do support flexibility for a South African insurer to IFSI. Any IFSI by an insurer ought to adhere to the Prudent Person Principle, which requires that an insurer invest only in assets and instruments whose risks the insurer can properly identify, assess, monitor, manage, control and report on. Given the lack of common standards for evaluating, measuring and reporting on Sustainability Impact, an insurer may find it difficult to pursue Sustainability Impact, though this will become less of an issue as common standards are developed and adopted more widely.

Life insurance: Legal requirements to use investment powers to Invest for Sustainability Impact

2.5.16 The position for life insurers is generally the same as that for general insurers above. The motivation to invest or divest in an individual entity is likely to need to be the anticipated financial return on that investment. This is due both to the reasons set out for general insurers above and because where a life insurance policy contains a duty to pay an amount determined by reference to its success in pursuing a financial investment objective, the directors required to ensure that appropriate assets are held to support the guaranteed performance. Although investment horizons are typically longer for life insurance contracts and therefore long-term sustainability risks more acute, we do not consider that life insurers are subject generally to a duty to use investment powers to IFSI. However, in specific circumstances where IFSI is necessary to achieve financial return, an obligation to instrumental IFSI would arise.

Life insurance: Legal freedom to use investment powers to Invest for Sustainability Impact

2.5.17 In South Africa, the position for life insurers is generally the same as that for general insurers as discussed at paragraphs paragraph 2.4.14 above. That said, while there is flexibility and scope for a life insurer to IFSI, there would be less flexibility to do so where assets are held in relation to life policies with a stated investment objective (e.g. unit-linked funds).

SOUTH AFRICA

3. ASSET OWNERS' USE OF THEIR POSITION TO ENGAGE IN STEWARDSHIP ACTIVITIES TO SECURE SUSTAINABILITY IMPACT

3.1 The following Section considers the extent to which, and on what basis, each type of Asset Owner is:

(a) required; or

(b) permitted, or able to use its position to influence enterprises in which it invests by engaging in stewardship activities designed to achieve positive sustainability outcomes and minimise negative sustainability outcomes.

Overarching considerations

3.1.1 In general, Asset Owners' investment duties and powers regarding stewardship will be shaped by the same considerations set out in the "*Overview of investment duties and powers*" in Section 2 for each Asset Owner, plus any additional rules specific to stewardship.

3.1.2 Although there is no express legal requirement on Relevant Investors in South Africa to engage in IFSI stewardship activities, IFSI stewardship activities regarding legitimate concerns may be important for Relevant Investors to demonstrate responsible investment and fulfilment of their fiduciary duties. Ultimately all Relevant Investors are subject to the common law duty of care and given that our laws recognise that omission can amount to unlawful conduct in circumstances where the duty envisages intervention, it is conceivable that in exceptional circumstances liability may be incurred for a failure to undertake reasonable engagement where such failure can be linked to consequent harm or infringement of rights. For more information, please refer to paragraphs 7.2 and 7.3.

Contractual obligations.

3.1.3 Investment Managers are often contractually obliged to carry out stewardship activities with reference to ESG factors or Sustainability Impact by their investment management agreements/mandates.[64] The scope of such activities will depend in part on whether or not the mandates are discretionary or administrative. For example, in respect of exercising voting rights at general meetings, as a shareholder in an investee company, an Investment Manager may be directed by the ultimate beneficiary/investor how to exercise voting rights, and in others the exercise of voting rights may be left to the discretion of the Investment Manager. Where this is the case Investment Managers will often, in the exercise of their discretion, take into account any proxy/voting guidance from the Asset Owner.

3.1.4 To the extent engaging for Sustainability Impact is required or permitted by law, it may be challenging for a Relevant Investor to demonstrate that the costs involved in addressing certain systemic issues, such as climate change, poverty or inequality, are justifiable given the likely negligible effect a Relevant Investor acting alone could reasonably hope to achieve. The concern could be mitigated if Relevant Investors were obliged, or permitted, to cooperate with other investors.

3.1.5 There is no express requirement in South African law for Relevant Investors to collaborate to instrumental IFSI or ultimate ends IFSI.

3.1.6 While we do not think South African law imposes a duty on Relevant Investors to collaborate to IFSI pension funds could in some circumstances be required to collaborate to conduct instrumental IFSI. In certain some circumstances a pension fund may conclude it is legally required to engage in stewardship to achieve Sustainability Impact in discharging a duty to secure financial return. Such a duty could potentially be reached in two ways:

(a) a pension fund board could conclude that it is legally obliged to engage in stewardship in relation to a particular investee enterprise where doing so can help the enterprise to achieve a given Sustainability Impact which will maintain or enhance its value within an investment portfolio; and

(b) a pension fund board is subject to a duty to ensure that the fund is financially sound and to take all reasonable steps to ensure the interests of members are protected in terms of the rules of the fund and provisions of the Pension Funds Act. The board has to act impartiality in respect of all members and beneficiaries and, for some members, their financial needs are short-term and immediate, while others will not require a pension income until long into the future. The second category, particularly, is more exposed to the declining sustainability of the environmental and social systems on which economic activity and, hence, financial return depends. A pension fund board could therefore potentially be under a duty to consider what, if anything, it can do to address these systemic risks. A pension fund board could conclude it is legally obliged to engage in stewardship

SOUTH AFRICA

activities designed to minimise systemic risk where investee enterprises are creating negative Sustainability Impacts and changing their behaviour could make a difference, or where investee companies have the potential to create positive Sustainability Impacts that could reduce systemic risks.

3.1.7 In either of the above situations, it is unlikely that a pension fund acting in isolation would have a reasonable prospect of success in tackling systemic risks at a reasonable cost. Therefore, a pension fund board could conclude that their duties require them to catalyse, or at least join existing, collective action in this regard and it may be an efficient way to manage risks and preserve the value of assets.65 Indeed, many Investment Managers in South Africa already engage collaboratively with other Relevant Investors to pursue stewardship and annually publish stewardship guidelines and reports, particularly in the listed equity space.

3.1.8 As noted above, the CRISA principles recommend that an institutional investor (such as a pension fund, a CIS or an insurer) and their Investment Managers, should:

(a) incorporate sustainability considerations into its investment and investment analysis;

(b) demonstrate its acceptance of ownership responsibilities in its investment arrangements and investment activities; and

(c) consider a collaborative approach to promote acceptance and implementation of the principles of CRISA and other codes.[66] The proposed revised CRISA will make stewardship principles and recommendations more explicit (see paragraph 1.14.2(b) above).

3.1.9 Relevant Investors engaging in collective stewardship activity would need to do so in a way that does not breach rules designed to regulate collaboration in financial markets. In our view, none of these rules would prohibit collaboration in all forms, and, in particular the types of collective stewardship which are currently commonly undertaken should be permissible. However, if stewardship activities were to become more intensive the extent to which Relevant Investors would need to consider the following:

(a) *Acting in concert*. Where Relevant Investors pursue collaborative engagement in stewardship activities in relation to “regulated companies” (i.e. public companies, state-owned companies, and certain private companies incorporated in South Africa), care should be taken in respect of “acting in concert” rules under the Companies Act and Takeover Regulations promulgated under that Act. The Companies Act regards concert party conduct as any action pursuant to an agreement between or among two or more persons, in terms of which any of them co-operate for the purpose of entering into or proposing an affected transaction (statutory merger, scheme of arrangement, or a disposal of all or a greater part of a company’s assets or undertaking) or offer. As a general rule, provided the collaboration among Relevant Investors is not for the purpose of proposing or entering into an affected transaction or offer, such conduct would not amount to acting in concert, and there is considerable scope for Relevant Investors to come up with collaborative engagement plans to conduct stewardship activities to pursue legitimate Sustainability Impact objectives;[67]

(b) *Concert party disclosures*. If Relevant Investors are acting in concert, certain disclosure obligations will be triggered: after coming into concert, or coming out of concert, each involved must make a declaration and deliver it to the regulated company concerned, and to the Takeover Regulation Panel;

(c) *Mandatory offer requirements*. Additionally, concert party conduct by a Relevant Investor could trigger a requirement for it to make a mandatory offer to the remaining shareholders of the investee company if the Relevant Investor (or its concert party) acquires a beneficial interest in voting rights attaching to the regulated company’s securities with the result that its beneficial interest (alone or aggregated that of its concert parties) increases to 35% or more;[68]

(d) *Disclosure and transparency rules*. There is a risk that collective shareholder action in respect of listed securities may trigger notification obligations regarding combined shareholdings or aggregated “beneficial interests” in listed securities;[69]

(e) *Insider trading and market abuse*. The Financial Markets Act, 2012 (***FMA***) includes rules prohibiting insider trading and market abuse.[70] Relevant Investors must adhere to these provisions when pursuing stewardship activities, whether alone or collaboratively with other Relevant Investors, or risk sanctions. Whilst engaging in stewardship activities, a Relevant Investor may become an “insider” by becoming privy to “inside information” for the purposes of the FMA, at which point insider trading rules would apply to it. The FMA defines “inside

SOUTH AFRICA

information" as "specific or precise information, which has not been made public and which –

(i) is obtained or learned as an insider; and

(ii) if it were made public, would be likely to have a material effect on the price or value of any security listed on a regulated market";

(f) *Competition / Antitrust*. Collaboration between competitors amounting to price fixing, collective boycotts, or the sharing of territories, markets and customers is prohibited outright, and even a first-time contravention can result in significant administrative penalties being imposed. These arrangements cannot be justified on the basis that they give rise to pro-competitive, efficiency or technological benefits.[71] There is no specific exemption for arrangements designed to achieve Sustainability Impact;

Where Relevant Investors are competitors and seek to engage collaboratively in stewardship activities, they should take care to ensure that no competitively sensitive information is shared between them in contravention of applicable competition rules, or in a manner that could facilitate anti-competitive conduct. However, there remains a wide range of collaborative actions that Relevant Investors may take, as long as they do not result in or amount to price-fixing, market allocation or collusive tendering, and do not result in a substantial lessening or prevention of competition in any relevant markets (or if it does, these effects are outweighed by its pro-competitive, efficiency or technological benefits). These include, for example:

(i) collaboration towards non-binding and non individualised sustainability targets (especially where parties are afforded a high level of discretion as to the means by which they attain such an objective);

(ii) joint initiatives to develop standard investment classification or measurement tools (provided there are fair and equal rights to their use);

(iii) exchanging information and best practice insights on IFSI (provided the information is not competition sensitive);

(iv) joint initiatives to enable the rise of new markets and services; and

(v) joint advocacy/dialogue with policy makers and stakeholders.[72]

(g) *Conflicts of interest*. In engaging in stewardship activities, Relevant Investors must take care in identifying and dealing with any actual or potential conflicts of interest:

(i) A pension fund would need to consider conflicts of interest as between Beneficiaries (noting that it may be fairer as between different cohorts of Beneficiaries to spread certain costs, such as the transition costs of climate change, over multiple generations by taking early action, rather than a "cliff-edge" which would be extremely costly for the relevant generation);

(ii) Under General Code Board Notice 92 of 2014, to the extent that a relationship between an Investment Manager and an issuer may constitute a conflict of interest, the Investment Manager would be required to avoid such conflict and, if unavoidable, mitigate and disclose the conflict to its clients. Similar requirements apply to CISs under Board Notice 92 of 2014;

(iii) An insurer would need to consider conflicts of interests when conducting stewardship, for example, between its shareholders and its policyholders, and as between policyholders; and

(h) *Investment Managers*. The Discretionary Code prohibits an Investment Manager from directly or indirectly, without the relevant client's prior written approval exercise voting rights on behalf of clients to gain control of a listed or unlisted company, except where such voting rights are exercised to protect the interests of clients on whose behalf the financial products involved are held as investments or on the instructions of such clients.

3.2 **Pension funds**

Legal requirements to engage for Sustainability Impact

3.2.1 For the reasons set out at paragraph 1.1.1 above, we do not consider that the boards of pension funds are generally subject to a duty to engage in stewardship activities for Sustainability Impact. The requirement under Regulation 28 for a pension fund when invested in an asset to consider factors, including ESG factors, which may materially affect the long term sustainable performance of an asset does not amount to a requirement to conduct stewardship for Sustainability Impact.

3.2.2 That said, FSCA Guidance Notice 1 recommends that a fund's IPS and a fund's investment mandate reflects, among other things:

(a) how the fund intends to monitor and evaluate the ongoing sustainability of the

SOUTH AFRICA

asset which it owns (or which it intends to acquire), including the extent to which ESG factors have been considered by the fund, and the potential impact thereof on the assets of the fund; and

(b) the fund's active ownership policy.[73] It defines "active ownership" as the prudent fulfilment of responsibilities relating to the ownership of, or an interest in, an asset. These responsibilities include, but are not limited to:

(i) guidelines to be applied for the identification of sustainability concerns in that asset;

(ii) mechanisms of intervention and engagement with the responsible persons in respect of the asset when concerns have been identified and the means of escalation of activities as a holder or owner of that asset if these concerns cannot be resolved; and

(iii) voting at meetings of shareholders, owners or holders of an asset, including the criteria that are used to reach voting decisions and the methodology for recording voting.

3.2.3 Where a fund holds assets that limit the application of ESG factors, sustainability criteria or the full application of an active ownership policy, the IPS should state the reasons why the limitation is advantageous to the fund and its members. Alternatively, the IPS should set out the remedial action the fund has taken (or intends to take) to rectify the position. If no such remedial action is being considered or taken, the fund may set out the reasons for that.

3.2.4 Bearing in mind the above guidance and recommendations, the board of a pension fund could conclude, for example in situations similar to those described in paragraph 3.1.5 above, that it is required to conduct instrumental IFSI and engage in stewardship for Sustainability Impact.

Legal freedom to engage for Sustainability Impact

3.2.5 In our view, there is flexibility within the law to engage in stewardship for instrumental IFSI or ultimate ends IFSI, subject to the overriding duty to ensure the fund is financially sound and protect the interests of members. Guidance Notice 1 appears to focus on sustainability on an asset by asset basis. Such activities could be addressed in a fund's active ownership policy. The potential costs and benefits of proposed stewardship activities would have to be borne in mind in light of the duties to ensure the fund is financially sound and protect the interests of members, as well as the potential issues described at paragraph 3.1.8 above where collaborative engagement is pursued. While there is no legal requirement to ascertain Beneficiaries' views on IFSI, Beneficiaries' sustainability preferences or a wider measure of Beneficiary welfare than solely financial welfare may be relevant to a pension fund board's decision to conduct ultimate ends IFSI stewardship.

3.2.6 Stewardship activities are relatively common practice, with King IV, and the principles in CRISA and UN PRI setting good practice standards. In practice, very few pension funds conduct direct stewardship activities; instead such activity, and even the specific philosophy and approach for stewardship, is usually outsourced to the Investment Manager to deal with pursuant to its contracted stewardship and ESG undertakings to the fund.

3.2.7 In appointing and mandating an Investment Manager for these purposes, a pension fund should take reasonable steps to ensure that the Investment Manager has the resources and ability to engage in the manner required, that it is not subject to conflicts of a sort that are likely to prejudice its activities, and that the Investment Manager's stewardship policy is sufficiently aligned with the objectives/ active ownership policy of the pension fund. It should also consider taking remedial action when that is not the case.

3.3 Mutual funds

Legal requirements to engage for Sustainability Impact

3.3.1 In our view, for the reasons set out in paragraph 2.3.9 above, CISs are not generally subject to a duty to engage in stewardship for Sustainability Impact. That said, it is conceivable that a CIS manager could, given the specific CIS deed and facts specific to its situation (including the obligation to manage assets in terms of deed of the CIS, and in the best interests of investors), conclude that it is subject to a duty to engage in stewardship for instrumental IFSI or ultimate ends IFSI. This duty may be of general application or specific, for example where engaging in instrumental IFSI or ultimate ends IFSI stewardship activity could protect its portfolio from a material adverse financial impact, and it is likely to be in the interests of longer-term investors in the fund (for example, pension funds invested in the CIS) for its value not to be damaged by systemic sustainability risk (i.e. as a result of the declining sustainability of the market being benchmarked).

SOUTH AFRICA

Legal freedom to engage for Sustainability Impact

3.3.2 There is scope for a CIS to engage in stewardship for Sustainability Impact, subject to any limitations inherent in the CIS's deed and investment objectives (including subject to any requirements to generate a financial return in accordance with those objectives). The potential issues described at paragraph 3.1.7 above would also be relevant to a CIS's engagement activities. While there is no legal requirement to ascertain Beneficiaries' views on instrumental IFSI or ultimate ends IFSI which is aligned with the CIS's investment objectives, Beneficiaries' sustainability preferences or a wider measure of Beneficiary welfare than solely financial welfare may be relevant to a CIS manager's decision to conduct stewardship for instrumental IFSI or ultimate ends IFSI.

3.3.3 In appointing and mandating an Investment Manager to carry out stewardship for Sustainability Impact, a CIS manager should take reasonable steps to ensure that the Investment Manager has the resources and ability to engage in the manner required, that it is not subject to conflicts of a sort that are likely to prejudice its activities, and that the Investment Manager's stewardship policy is sufficiently aligned with the objectives/active ownership policy of the CIS manager. It should also consider taking remedial action if and when that is not the case.

3.4 Insurance undertakings

Legal requirements to engage for Sustainability Impact

3.4.1 For the reasons set out at paragraph 2.4.5 ff above, we do not consider that life or general insurers are generally subject to a duty to engage in stewardship for Sustainability Impact.

3.4.2 That said, an insurer that is exposed to sustainability risks may conclude that it is required, either generally or in specific circumstances, to engage in stewardship for instrumental IFSI. Insurers may also choose to endorse the CRISA principles. The discussion at paragraph 2.4.11 above applies equally to the engagement decision-making process of insurers and, as indicated there, depending on their particular circumstances, the directors of an insurer could conclude that it is necessary to, for example, to engage with one or more investor companies in relation to a sustainability risk (such as climate change) or with a particular systemically important company in order to achieve their investment goal and stay within their risk appetite.

3.4.3 For example, where an insurer concludes that sustainability factors present a systemic risk which could prevent it from ensuring that the fund is financially sound over the long-term, the board could conclude that it should engage in stewardship for Sustainability Impact with investee enterprises designed to avert that risk, so long as such investment decisions are made in accordance with the insurer's investment policy and comply with the insurer's duties outlined in the Prudential Standards. In that context, it might also conclude from time-to-time that it should under or overweight a particular investee company in order to strengthen its voice as part of those activities.

Legal freedom to engage for Sustainability Impact

3.4.4 In our view, both life and general insurers have flexibility to engage in stewardship activities for ultimate ends IFSI in certain circumstances, subject to the duties and requirements described at paragraph 2.4.5 *ff* above, including the requirement to maintain their business in a financially sound condition. The former have a little less flexibility, given the overlay of policy terms and related policyholder protections, which add complexity.

3.4.5 Stewardship activities for Sustainability Impact may be incorporated into an insurers' investment policies. Prudential Standard GOI 3 requires an insurer's investment policy to "specify the nature, role and extent of the insurer's investment activities", "set out the insurer's strategy for investing" and "take into account any factor which may materially affect the sustainable long-term performance of assets", including ESG factors which leaves scope for IFSI.

3.4.6 In appointing and mandating an Investment Manager to carry out stewardship for Sustainability Impact, an insurer should take reasonable steps to ensure that the Investment Manager has the resources and ability to engage in the manner required, that it is not subject to conflicts of a sort that are likely to prejudice its activities, and that the Investment Manager's stewardship policy is sufficiently aligned with the objectives/active ownership policy of the insurer. It should also consider taking remedial action if and when that is not the case.

SOUTH AFRICA

4. ASSET OWNERS' ENGAGEMENT IN PUBLIC POLICY WORK TO SECURE SUSTAINABILITY IMPACT

4.1 The following Section considers the extent to which, and on what basis, each type of Asset Owner is:

(a) required; or

(b) permitted or able to use its position to engage in public policy work designed to achieve positive sustainability outcomes and minimise negative sustainability outcomes, for example, where these are relevant to the value of portfolio assets.

4.2 **Pension funds**

4.2.1 There is no express requirement in South African law for pension funds to engage in public policy work with a view to IFSI. We do not consider that boards of pension funds are generally subject to a duty to conduct public policy work for Sustainability Impact, but in our view, they would have the flexibility to do so. This is not to say that circumstances may not arise (for example, those described in paragraph 3.1.5 above) where the board of a pension fund may feel it is required to engage in public policy for IFSI.

4.2.2 The board of a pension fund is required to take all reasonable steps to ensure that the interests of the fund's members (as a collective) in terms of the rules of the fund and the provisions of the Pension Funds Act are protected. There may be circumstances in which engaging in policy discussions and lobbying policy makers with a view to achieving positive and/or minimising negative Sustainability Impacts, is consistent with this requirement. While there is no legal requirement to ascertain Beneficiaries' views on IFSI, Beneficiaries' sustainability preferences or a wider measure of beneficiary welfare than solely financial welfare may be relevant to a pension fund board's decision to conduct ultimate ends IFSI public policy work.

4.2.3 Associations such as the Batseta Council for Retirement Funds, the Institute for Retirement Funds Africa and ASISA offer platforms for such policy engagement, including participation in technical working committees with the FSCA and tax authorities, and those and similar associations have occasion to engage in forums like NEDLAC and other summit-style forums with national policy makers regarding the macro-economic environment for retirement funds, including the theme of Sustainability Impact.

4.3 **Mutual funds**

4.3.1 We do not consider CISs to be generally subject to a duty to conduct public policy work for Sustainability Impact. While such public policy work is not prohibited, a CIS may be restricted by its investment objectives and the terms of its deed. Costs considerations may also restrict such activities, where they can be pursued by a CIS. While there is no legal requirement to ascertain Beneficiaries' views on instrumental IFSI and ultimate ends IFSI, Beneficiaries' sustainability preferences or a wider measure of beneficiary welfare than solely financial welfare may be relevant to a CIS manager's decision to conduct instrumental IFSI or ultimate ends IFSI public policy work.

4.3.2 National Treasury's Sustainable Finance Paper recommends in respect of CISs, among other things, the "identification of financial policy innovations in order to increase sustainable or green finance in SA", and that industry and regulators "increase technical collaboration".[74] In practice, many of the large Investment Managers that operate CISs will engage in policy work for Sustainability Impact, funded from their own resources, as part of their own responsible business practices. They may do so acting alone or collaboratively with other Investment Managers.

SOUTH AFRICA

4.4 **Insurance undertakings**

4.4.1 There is no express requirement in South African law for insurers to engage in public policy work to IFSI. We do not consider general or life insurers to be subject to a duty to conduct public policy work for Sustainability Impact. However, there may be circumstances where an insurer is exposed to sustainability risks (for example climate change related risks) such that its board concludes that it is required to engage in public policy with a view to IFSI.

4.4.2 Insurers do have sufficient flexibility to conduct public policy work to IFSI, funded from their own resources; provided that they do so in a manner that does not prevent an insurer complying with its statutory and regulatory obligations (such as financial soundness requirements, and meeting obligations to policyholders) and consistent with directors' duties. We cannot easily identify a conflict in doing this between the interests of the insurer and the duties it owes its policyholders. Any conflicts of interest that are identified would need to be considered and managed.

4.4.3 The costs of such public policy engagements would need to be assessed against the likely benefits. Again, collaborative public policy engagements with other insurers or through industry associations are an option that insurers may consider.

4.4.4 The ClimateWise initiative (referred to at paragraph 2.4.12 above), of which Sanlam and Santam are members, encourages members to disclose how they "inform public policy making" on climate-related issues.

SOUTH AFRICA

5. ESTABLISHING NEW FUNDS TO INVEST FOR SUSTAINABILITY IMPACT AND AMENDING THE TERMS OF EXISTING ONES

5.1 The following Section considers the extent to which it is possible for an Asset Owner to set up a fund, policy or other product with the express objective of IFSI.

5.2 **Pension funds**

5.2.1 It is permissible for a pension fund to have a mandate to IFSI either as well as, or having priority over, financial return, to some extent. Funds are not-for-profit legal entities which aim to achieve and maintain sustainable long-term performance. Provided that a fund is financially sound it may feasibly adopt and pursue a strategy that includes or prioritises Sustainability Impact. The regulatory framework contemplates responsible investment approaches and a mandate to IFSI would not necessarily be inconsistent with the requirements of Regulation 28. The Registrar of Pension Funds may of course impose conditions or restrictions on a fund with such a mandate at its registration.

5.2.2 Retirement funds that provide for "member investment choice" (in which members may choose from a range of investment strategies / investment portfolios) may include portfolios that prioritise Sustainability Impact (provided the fund remains financially sound). In the ordinary course, a fund's "default investment strategy" applies to all members unless a member chooses his or her own investment strategy or portfolio.

5.3 **Mutual funds**

5.3.1 A CIS may set up a portfolio/sub-fund with the express objective of instrumental IFSI or ultimate ends IFSI either as well as, or having priority over, financial return. The portfolio/sub-fund (and its investment objective) would have to be registered under CISCA by the FSCA. As mentioned above, the FSCA may impose conditions or restrictions on such a portfolio/sub-fund on its registration. Additionally, the CIS deed would need to expressly document the investment objective to instrumental IFSI or ultimate ends IFSI. The investment objective to instrumental IFSI or ultimate ends ISFI would need to be disclosed to investors prior to their investing in the portfolio/sub-fund.

5.3.2 Insofar an existing CIS is concerned, the investment policy of a CIS may be amended by amending the deed subject to the FSCA's approval. No amendment will be valid unless consent of a majority in value of investors has been obtained in the manner prescribed in the deed.

5.3.3 It must be borne in mind that a CIS with an object to instrumental IFSI or ultimate ends IFSI may encounter difficulties in measuring and valuing Sustainability Impact, which may result in regulatory compliance challenges. There are detailed requirements regarding the valuation of participatory interests in CISs and the disclosure thereof. For example, Schedule 1 of CISCA requires that a deed must contain provisions regarding the manner in which the assets of a portfolio are to be valued for the purposes of calculating the selling and repurchase prices of participatory interests. The lack of standardised and generally accepted methods of measuring or evaluating non-financial factors such as Sustainability Impact may give rise to difficulty. It could also make it difficult for Beneficiaries to compare and evaluate the performance of a CIS.

5.4 **Life insurance products**

5.4.1 It is permissible for an insurer to set up a fund or other vehicle that IFSI either as well as, or having priority over, financial return, on the assumption that it has been financially modelled. The insurer would need to reflect the investment approach in its board approved investment policy, which must address how the insurer will ensure compliance with the financial soundness requirements under the Insurance Act, i.e. maintain its business in a financially sound condition, while pursuing ultimate ends IFSI.

5.4.2 There is no prohibition on life insurers from setting up a life fund / insurance wrapper / linked policy that pursues ultimate ends IFSI either as well as, or having priority over, financial return in which targeted investors or beneficiaries can choose to invest, or by reference to which have their benefits determined. The investment policy of the Insurer required by Prudential Standard GOI 3, as explained in our response at paragraph 2.4.6 above, must be borne in mind, as well as Policyholder Protection Rules.

5.4.3 Amendment to policy documents to incorporate an express IFSI objective typically requires policyholder consent. Gaining consent may only be practical in

SOUTH AFRICA

relation to those types of policy held by a single policyholder. For other types of policy, the policyholder outreach required to incorporate IFSI into a significant proportion of an insurer's existing policies may nonetheless make such amendment impracticable.

Duties on those designing, manufacturing and providing insurance

5.4.4 In terms of the Policyholder Protection Rules (Long-Term Insurance), 2017 and Policyholder Protection Rules (Short-Term Insurance), 2017 (Policyholder Protection Rules) (this rule applies to the development of any new products and any material change in design of an existing product), an insurer must in developing products, among other things, make use of adequate information on the needs of identified types, kinds or categories of policyholders or members.

5.4.5 The fair treatment of policyholders encompasses achieving the following outcome (among others): "products are designed to meet the needs of identified types, kinds or categories of policyholders and are targeted accordingly".

SOUTH AFRICA

6. INVESTMENT MANAGERS' DUTIES TO INVEST FOR SUSTAINABILITY IMPACT

6.1 This Section considers the extent to which, and in what circumstances, an Investment Manager is:

(a) required; or

(b) permitted to instrumental IFSI or ultimate ends IFSI on behalf of an Asset Owner or otherwise, in each of the three ways contemplated in Sections 2 to 4.

6.1.1 Typically, an Investment Manager's investment powers and duties are shaped by:

(a) the terms of its contractual investment management agreement (*IMA*) with an Asset Owner. The terms of such IMAs tend to be heavily influenced by the regulatory requirements applicable to the financial product or service being provided. The IMA will typically specify:

(i) investment objective(s) against which the Investment Manager's performance (and performance related remuneration) will be assessed;

(ii) the Investment Manager's mandate (discretionary or non-discretionary);

(iii) any investment strategy specified by the Asset Owner;

(iv) any investment parameters or restrictions; and

(v) any contractual standard of care;

(b) statutory obligations in that Investment Managers, as financial service providers (*FSPs*), are regulated by the Financial Advisory and Intermediary Services Act, 37 of 2002 (*FAIS*);

(c) the FIA, mentioned at paragraph 2.3.8 above, which prohibits financial institutions or nominees which administer trust property from causing it to be invested otherwise than in a manner directed in or required by the IMA or investment mandate;

(d) applicable codes of conduct published under FAIS, with which an Investment Manager must take reasonable steps to ensure that its representatives comply.[75] The General Code of Conduct for Authorised Financial Services Providers and Representatives, 2003 (*General Code*), among other things:

(i) places a general duty on Investment Managers to, at all times, render financial services honestly, fairly, with due skill, care and diligence, and in the interests of clients and the integrity of the financial services industry;

(ii) spells out various duties that Investment Managers must comply with when rendering a financial service, including that the service must be rendered in accordance with the contractual relationship and reasonable requests or instructions of the client, which must be executed as soon as reasonably possible and with due regard to the interests of the client which must be accorded appropriate priority over any interests of the Investment Manager;

(iii) obliges an Investment Manager that receives funds or holds financial products on behalf of a client to take reasonable steps to ensure that at all times such financial products or funds are dealt with strictly in accordance with the mandate given to the Investment Manager by the client; and

(e) duty of care to the Asset Owner in delict (tort), requiring the exercise reasonable care and skill in the carrying out of services.

6.2 **Legal obligations with respect to Sustainability Impact**

Powers of investment and divestment

6.2.1 Investment Managers are legally required to ascertain a client's investment objectives before concluding an investment mandate with the client. Where an IMA (including those informed by a pension fund's IPS or an insurer's investment policy) requires instrumental IFSI or ultimate ends IFSI, the Investment Manager is obliged to pursue a strategy which complies with such requirements, subject to applicable laws and any restrictions or limitations imposed on it by the IMA and its licence granted under FAIS. Investment Managers will be concerned to ensure that the mandate specifies how any Sustainability Impact objectives should be balanced with the financial objectives to minimise its exposure to complaint and possible litigation.

6.2.2 Where the mandate is silent as to Sustainability Impact, we do not consider that an Investment Manager would be subject to a duty to instrumental IFSI or ultimate ends IFSI.

6.2.3 As regards powers of investment or divestment, an Investment Manager's duties would follow the terms of its mandate.

6.2.4 If the Asset Owner wishes to incorporate instrumental IFSI or ultimate ends

SOUTH AFRICA

IFSI, the IMA should be amended to incorporate these, as non-contractual discussions would remain subordinate to the terms of the IMA.

6.2.5 Although an Investment Manager is not generally subject to a legal obligation to contribute to B-BBEE (see footnote 33 above), it may (on its own initiative as a corporate citizen) seek to achieve improve its B-BBEE contribution through its own activities.

Engagement to achieve Sustainability Impact

6.2.6 The Investment Managers' duties in respect of a specific client would follow the terms of its mandate. Where an Investment Manager's mandate is silent as to Sustainability Impact, we do not consider there to be any legal requirement for the Investment Manager engage to with portfolio companies to achieve Sustainability Impact.

Public policy work to achieve Sustainability Impact

6.2.7 As above, an Investment Manager's duties in respect of a specific client would follow the terms of its mandate. Where the mandate is silent as to Sustainability Impact, we do not consider there to be any legal requirement for Investment Managers to engage in public policy work to IFSI.

6.2.8 Should Investment Managers (in their own capacity as corporate citizens) wish to engage to achieve Sustainability Impact, they are able to do so, whether that be with the respective Asset Owner and/or that Asset Owner's clients, the FSCA, or other stakeholders. For those Investment Managers who are ASISA members, the engagements may be bolstered and guided by such membership.

6.3 Legal freedom to Invest for Sustainability Impact

Powers of investment and divestment

6.3.1 There is no explicit prohibition on an Investment Manager exercising powers of investment to instrumental IFSI or ultimate ends IFSI. However, where the IMA is silent on instrumental IFSI or ultimate ends IFSI, it may be challenging to do so in light of an Investment Manager's duties. Financial return-based objectives (perhaps by reference to a benchmark) and related remuneration structures for the Investment Manager may militate against consideration of Sustainability Impact. Investment Managers may be reluctant to consider factors additional to financial return absent clear instructions to do so as it may expose them to litigation risk if the practical outcome is reduced returns. Of course, Investment Managers would not be precluded from speaking in favour of instrumental IFSI as a means to achieving financial return in specific circumstances.

6.3.2 Investment Managers are not generally obliged to offer sustainability-focussed products to Asset Owners but are free to do so, and it may be considered good practice. In this regard, CRISA recommends that institutional investors (Asset Owners such as CISs, pension funds, and insurers) and Investment Managers (as service providers "should incorporate sustainability considerations, including ESG, into its investment analysis and investment activities as part of the delivery of superior risk-adjusted returns to the ultimate beneficiaries").[76]

6.3.3 The General Code requires Investment Managers to render financial services to the Asset Owner client in accordance with, in addition to their contractual relationship, any reasonable requests or instructions of the client, which may include requests or instructions with regard to Sustainability Impact. Any such reasonable requests or instructions must be executed as soon as reasonably possible with due regard to the interests of the client.[77]

6.3.4 The Investment Manager and Asset Owner could agree to amend the terms of an existing IMA to instrumental IFSI or ultimate ends IFSI. There are no limitations on the Investment Manager's ability to do so, but the extent to which such an objective may be pursued depends in part on:

(a) the nature of the Asset Owner, and its own power and capacity to pursue an objective of instrumental IFSI or ultimate ends IFSI;

(b) regulatory limits or restrictions applicable to the Asset Owner;

(c) the Asset Owner's obligations to its Beneficiaries; and

(d) whether investment mandate is administrative or discretionary (full or specified limited discretion).

6.3.5 Should Investment Managers (in their own capacity as corporate citizens) wish to engage in public policy work to instrumental IFSI or ultimate ends IFSI, they are able to do so.

Engagement to achieve Sustainability Impact

6.3.6 Given the general duty on Investment Managers at all times to render financial services in the interests of clients and the integrity of the financial services industry; and since stewardship activities are less likely to affect the composition of an investment portfolio, there may be more scope to pursue Sustainability Impact through stewardship activities,

SOUTH AFRICA

even where the IMA is silent upon the point. However, the Investment Manager would have to ensure that such actions do not bring its obligations to one client into conflict with the duties it owes to other clients (without appropriate disclosures or waivers in place).

6.3.7 Costs are also a consideration. Investment Managers will need to conduct cost-benefit analyses for their portfolios in respect of engagement for Sustainability Impact. As discussed above at paragraph 3.1.3 above, the costs associated with engagement may be easier to justify where the engagement is collaborative. So too are the investment horizons of the IMA; a shorter investment horizon may entail less flexibility for engagement for Sustainability Impact where financial return is prioritised.

6.3.8 Insofar as good practice is concerned, CRISA encourages a collaborative approach by institutional investors, including Investment Managers, to promote acceptance and implementation of the principles of CRISA and other codes and standards applicable to institutional investors. It is increasingly common practice in South Africa for Investment Managers to engage co-investors in relation to promotion of positive, and mitigation of negative, Sustainability Impacts. See discussion at paragraph 3.1.3 to 3.1.7 above.

Public policy work to achieve Sustainability Impact

6.3.9 Investment Managers are not generally required to engage in public policy work to achieve Sustainability Impact. An Investment Manager is broadly free to engage in public policy work on its own behalf, funded from its own resources provide that doing so:

(a) is considered by the directors to be in the best interests of the company; and

(b) does not create a conflict of interest between the Investment Manager and its clients (or between the duties owed to various clients, to the extent any such work is undertaken on any of their behalf).

6.3.10 Where an Investment Manager is undertaking public policy work on behalf of a client, it will need to ensure that it does so in compliance with its mandate and any conflicts of interest between clients, or between itself and clients, are appropriately managed.

SOUTH AFRICA

7. LEGAL LIABILITY TO THIRD PARTIES FOR THE NEGATIVE SUSTAINABILITY IMPACT OF ENTERPRISES IN WHICH PORTFOLIOS ARE INVESTED

7.1 This Section considers the extent to which, regardless of the legal rules under which it is required to operate and its constitution, an Asset Owner could be legally liable to third parties for the negative Sustainability Impact of enterprises in which it invests, and whether an Investment Manager could also be liable because of its role in assisting the Asset Owner to invest in the relevant enterprise and steward its investment.

7.2 **Asset owners**

7.2.1 It is possible that Asset Owners could be found to have criminal or civil liability to third parties for negative Sustainability Impact of assets in which they are invested. While this is generally likely to be a remote risk, the risk of this type of litigation may well be increasing as a result of the increasing political focus on sustainability issues, which has prompted growing scrutiny from regulators, non-governmental organisations (**NGOs**) and the public.

Criminal liability

7.2.2 It is unlikely that an Asset Owner would be held criminally liable for the negative Sustainability Impact of an enterprise it has funded. In exceptional circumstances primary criminal liability might exist where an Asset Owner has direct involvement in the investee company's activities or operations, and where those are determined to be criminal under the relevant legislation (for example, failure to take reasonable measures to prevent pollution or polluting water resources).[78]However, the arm's length nature of relationships between an Asset Owner and the activities of the enterprises included in its portfolio makes such a liability highly unlikely. The risks would be slightly higher if an Asset Owner had close day-to-day involvement in and direction over the activities of the investee company.

7.2.3 Secondary liability is also theoretically possible, for example, if a nominee director appointed by an Asset Owner assumed managerial responsibility over relevant activities of the investee company, and consented to or connived in an illegal act or omission (such as pollution of a waterway, or operation of a regulated facility without the appropriate environmental permit). However, only exceptionally would an Asset Owner exercise the required level of engagement in a portfolio company's operations to attract this type of liability.

Civil liability

7.2.4 It is possible that, in certain limited circumstances, an Asset Owner could be found to have a duty of care towards persons harmed by an investee company's acts or omissions which result in negative Sustainability Impact, i.e. liability in negligence. For example, South Africa's National Environmental Management Act, 1998 (***NEMA***) recognises an environmental duty of care, which places an obligation on everyone who causes, has caused or who is likely to cause significant pollution or degradation to the environment to take reasonable measures to prevent or stop such harm to the environment, or where the harm is authorised under law or cannot reasonably be avoided, to minimise and/or rectify such pollution or degradation.[79] The ambit of this duty of care is relatively wide and includes land owners, persons in control of land or entities which causes pollution and those with land use rights. A similar duty of care applies under the National Water Act, 36 of 1998 in relation to water pollution. An Asset Owner and/or Investment Manager liability may be established if it is shown they are "in control" of an entity or activity which causes pollution (e.g. through holding equity, involvement in management, oversight of a project, or the exercise of step-in rights). The standard of care will be assessed on a case by case basis and depend on the facts of each particular scenario.

7.2.5 The NEMA allows a person or group of persons to seek appropriate relief for any breach or threatened breach of statutes concerned with environmental protection or the use of natural resources, whether in their own interest, the public interest, the interest of a class of persons (class actions are recognised in South Africa), or in the interests of the environment itself.[80] For liability to arise the claimant(s) would need to prove the elements of a delict (conduct, wrongfulness, fault, causation and damage). Of these elements, causation (i.e. that the caused the harm) is often the most difficult to prove.

7.2.6 There are, however, challenges when it comes to the enforcement of the duty of care, including in respect of causation, the measure of damages, the attachment to and proving of liability of a particular person. The likelihood of liability in negligence for a minority shareholder (as an Asset Owner would typically be) is fairly remote: not only must the harm

SOUTH AFRICA

caused by the negligent act or omission have been reasonably foreseeable, but there must be sufficient proximity between the parties (i.e. between the Asset Owner and the investee company which causes harm, which would likely require a degree of direct involvement or operation control on the part of the Asset Owner), and it must be reasonable to recognise the conduct as wrongful and therefore attracting liability, based on policy and the legal convictions of the community to impose liability to a third party on the investor entity. Generally speaking, it is unlikely that these requirements would be met in relation to the usual activities of an Asset Owner of the type described in this report.

7.2.7 Certain environmental statutes require development of certain infrastructure to be authorised prior to development and failure to obtain requisite authorisation would attract significant sanctions. If a person fails to comply with the duty of care or permitting obligations imposed by these statutes, such failures may attract civil liability and the environmental perpetrator may have to pay a fine and/or remedy the harm done to the environment.

7.2.8 Separately, direct clean-up/remediation liability can be incurred where a person causes or negligently fails to prevent pollution. Again, though, there would need to be some element of “control” or involvement at operational level by the Asset Owner to incur liability.

7.2.9 The potential of liability for an Asset Owner means that Asset Owners in South Africa have become accustomed to carrying out due diligences and considering the ESG risk of an enterprise/project in deciding whether to invest/fund.

Regulatory and reputational risks

7.2.10 Aside from litigation risks, South Africa’s environmental and other NGOs are active in seeking to hold companies and institutional investors to account with regard to Sustainability Impact and disclosures.[81] There is a developing trend of shareholder activism in respect of negative Sustainability Impact, from NGOs but also other institutional investors. Recent campaigns by NGOs have sought to have resolutions tabled at listed company AGMs, which would require the companies to disclose and/or report to shareholders on: climate risk; plans to address climate-related transition risks; assessments of greenhouse gas emissions in financing portfolios; and policies on lending to coal-fired power projects and coal mining operations, oil & gas, or carbon-intensive, fossil fuel activities and commit to a hard deadline for enhanced disclosures related to climate risk. Such campaigns have the potential to cause significant reputational damage to the investee companies and/or Asset Owners invested in them.

7.3 Investment managers

7.3.1 It is even less likely that Investment Managers, as agents of their client Asset Owners, would be found to have liability to third parties for the negative Sustainability Impact. However, as for Asset Owners above, the risks of such litigation is increasing.

Criminal liability

7.3.2 As for an Asset Owner, an Investment Manager might have primary criminal liability where it has direct involvement in an investee company’s activities or operations, and where those are determined to be criminal under the relevant legislation. However, Investment Managers would not typically have the necessary degree of direct involvement for criminal liability.

7.3.3 As an Investment Manager would not be a member of the company, it would not be possible for them to have secondary liability (as described at paragraph 7.2.2 above). Liability as an as accessory is theoretically possible in very narrow circumstances where the Investment Manager can be demonstrated to have aided, abetted, counselled or procured the commission of an offence (e.g. through a nominee director appointed on its behalf) but is highly unlikely.

Civil liability

7.3.4 The civil liability position is similar to that for Asset Owners save that, to the extent that an Investment Manager acts in an execution-only capacity, the Investment Manager will be further removed from any relevant negligent conduct/conduct in breach of the duty of care and thus less likely to be found liable. Under the FAIS, an Investment Manager is liable only for its own acts and/or omissions, and would not be liable for a breach of duty by an Asset Owner.

7.3.5 It is common in almost all investment management agreements for an Investment Manager to seek some indemnity from the client for any claim made against the Investment Manager for any loss suffered by the client or its related parties as a result of the Investment Manager performing its obligations under the agreement. Any contractual liability would be limited by the principle of privity of contract, and an Investment Manager would typically only owe contractual duties towards its immediate client, the Asset Owner.

SOUTH AFRICA

8. THE GROWING IMPORTANCE OF TAKING ACCOUNT OF ESG AND SUSTAINABILITY FACTORS WHERE THESE ARE 'FINANCIALLY MATERIAL'

8.1 It has become increasingly important for Relevant Investors to take ESG and sustainability factors into account in managing portfolios because of the way in which they could be material to achieving the financial investment objectives of the Relevant Investor in accordance with their legal duties.

8.2 Recent developments include:

8.2.1 from 2011 onwards, Regulation 28 of the Pension Funds Act has required pension funds to consider any factor, including ESG factors, which may materially affect the sustainable long-term performance of an asset. It also obliges a pension fund and its board to understand the changing risk profile of assets of the fund over time, taking into account comprehensive risk analysis, including but not limited to credit, market, liquidity and operational risk, and currency, geographic and sovereign risk of foreign assets;

8.2.2 the regulatory guidance published by the FSCA in Guidance Notice 1 of 2019, described at paragraph 2.2.24 above, promoting consideration of ESG and sustainability factors and objectives by pension funds;[82]

8.2.3 for insurers, Prudential Standard GOI 3 requires an insurer's investment policy to take into account any factor which may materially affect the sustainable long-term performance of assets, including ESG factors, opening greater opportunities for insurers to engage in instrumental IFSI. Insurers are also required to adhere to the 'Prudent Person Principle' by establishing measures that will assist in ensuring that: (a) the insurer invests only in assets and instruments whose risks the insurer can properly identify, assess, monitor, manage, control, and report on; and (b) assets are invested in a manner appropriate to the nature and duration of the insurer's liabilities and the best interests of policyholders and beneficiaries.

8.2.4 as of 1 July 2018, insurers became subject to a risk-based regulatory framework and are required to have a documented risk management strategy which must, among other things, describe current material risk and emerging risk, and the insurer's approach to managing those risks. Physical climate risk is dealt with by explicitly requiring insurers to calculate capital requirements for natural catastrophe risk (although it is currently only calibrated for certain types of catastrophes); and

8.2.5 a four-year multi-jurisdiction project recently carried out by UN PRI and UNEP-FI, *Fiduciary Duty in the 21st Century*, which concluded that "investors that fail to incorporate ESG issues are failing their fiduciary duties and are increasingly likely to be subject to legal challenge".[83] The project included a consideration of fiduciary duty in the context of retirement funds in South Africa.[84]

8.3 Additional reasons for the growing importance of Relevant Investors taking into account ESG and sustainability factors where they are financially material include:

8.3.1 growing public, policy and regulatory expectations that they should do so (including those mentioned above), which is likely to affect the way in which legal duties are understood and applied in practice;

8.3.2 international collaboration among regulators in respect of sustainability issues. For example, in 2017, the Prudential Authority became a member of the Sustainable Insurance Forum, a network of leading insurance supervisors and regulators working together to strengthen their understanding of, and responses to, sustainability issues for the business of insurance;[85]

8.3.3 a growing trend towards sustainability-based legal actions where business enterprises and others are seen as having contributed to sustainability challenges;

8.3.4 increasing stakeholder engagement and shareholder activism around sustainability issues generally, as has been experienced by a number of JSE-listed companies in recent years;

8.3.5 greater knowledge of the risks that sustainability factors can pose to portfolio performance, particularly in the area of climate change but also as a result of the COVID-19 pandemic, and the opportunities that they can provide;

8.3.6 greater awareness of the speed with which some sustainability risks may be materialising;

8.3.7 improving disclosure regimes, making it more feasible to understand the role of individual business enterprises in helping to realise or in undermining sustainability goals;

8.3.8 growing availability of good quality investment analysis of the risks posed to business enterprises by sustainability factors and potential opportunities;

> ANNEXES

> South Africa

SOUTH AFRICA

8.3.9 growing expertise and developing conceptual frameworks in the areas of sustainability assessment and the investment management expertise needed to take greater account of sustainability in the investment process; and

8.3.10 the development of investor alliances and coalitions making it easier for investors to address sustainability risks.

8.3.11 We anticipate that Beneficiaries, particularly institutional investors, will increasingly expect Relevant Investors to explain the basis on which they determine their investment criteria, and how they have incorporated the consideration of ESG and sustainability factors into their investment and stewardship activities. So too will activists, NGOs and civil society groups, for example Centre for Environmental Rights,[86] Raith Foundation,[87] and Just Share, who use advocacy, engagement and activism to support active ownership and responsible investment.[88]

8.4 **Financial materiality**

8.4.1 It can be challenging for Relevant Investors to determine which ESG or sustainability factors are financially material to their portfolio. As Boston Consulting Group put it recently:

Because not every ESG factor will be material to all businesses and sectors, it is essential for both companies and investors to be able to identify and manage those that are. That said, what is financially material will change over time—and with rapidly increasing speed. This requires the ability to understand what makes ESG issues become financially material over time and to adapt to the changes. In a new age of materiality, investors must proactively work to understand ESG facto rs and incorporate these trends into investment decision making in a more agile way."[89]

Generally, Relevant Investors should employ the mechanisms they would apply to any other factor to determine whether an ESG or sustainability factor is "financially material".

8.4.2 We have not identified any case law on what "financial materiality" is in this particular context. As to guidelines, there are a number of entities and bodies that have published guidance on "financial materiality" at the enterprise level which regard financially material factors as those that could have a significant impact on a company's business model and value drivers:

(a) National Treasury recently worked with the University of Cambridge Institute of Sustainability Leadership (CISL) Centre for Sustainable Finance to promote the use and integration of "environmental scenario analysis as a key tool to allow financial firms to analyse, measure and manage material sources of environmental risk";[90]

(b) GRI and RobecoSAM, the Swiss extra-financial rating agency, suggest the following working definition of "financially material", which is used by some investors in South Africa: "Financially material is any factor which might have a present or future impact on companies' value drivers, competitive position, and thus on long-term shareholder value creation." The assessment of materiality is made from a Relevant Investor's perspective, not generally, and will differ from one sector to another. The time frame factor of sustainability is taken into account, most importantly long-term shareholder value creation. Lastly, it focuses on a company's value drivers: growth, profitability, capital efficiency and risk exposure; [91] and

(c) King IV defines "material" or "materiality" as a "measure of the estimated effect that the presence or absence of an item of information or identified subject matter may have on the accuracy or validity of a statement or decision. Materiality is judged in terms of its inherent nature, impact (influence) value, use value, and the circumstances (context) in which it occurs". This definition would cover financially material matters. Insofar as reporting and disclosures are concerned, King IV describes "materiality" in relation to the inclusion of information in an integrated report as referring to matters that "could substantively affect the organization's ability to create value over the short, medium and long term".92

SOUTH AFRICA

8.4.3 There are various other initiatives currently underway to consider materiality with regard to sustainability issues. The Sustainability Accounting Standards Board, for example, is giving a lot of attention to financially material issues from a Sustainability Impact perspective, with a view to helping businesses report such matters.[93]

8.5 **Time period by reference to which 'materiality' is to be assessed**

8.5.1 Financial materiality should be measured over the appropriate time-horizon, considering the nature of the investment and the purpose for which it is made:

(a) pension funds should assess financial materiality with reference to a long-term period, since Regulation 28 requires that trustees give appropriate consideration be given to any factor, including ESG factors, which may materially affect the sustainable long-term performance of a fund's assets. This does not mean that short-term and medium-term performance may be ignored. Other Relevant Investors' regulatory frameworks do not address the time period with reference to which materially should be determined;

(b) insurers are required to take into account any factor, including ESG factors, which may materially affect the sustainable long-term performance of assets, and ensure that assets are invested in a manner appropriate to the nature and duration of the insurer's liabilities and the best interests of policyholders and beneficiaries; and

(c) for CISs, the period by which to assess financial materiality is likely to be guided by the investment period defined in the CIS (typically three to five years for a CIS in securities), informed by minimum investment periods.

8.5.2 Investment Managers will agree their investment horizons in their IMAs with Asset Owners and will invest with respect to those in accordance with industry best practice. This can cause Investment Managers to take particularly short-term views with respect to their portfolio construction.

8.5.3 King IV takes into account short-, medium- and long-term time horizons, with an emphasis on the long term: "performance in terms of all-inclusive value should be assessed over the longer term. The capital market system must reward long-term decision-making". RobecoSAM's definition (set out at paragraph 8.4.2(b) above) takes into account short-term impacts but emphasises long-term value creation.

Carmen Bradfield, David Geral, Richard Griffin, Ryan Kitcat, Wandisile Mandlana, Deirdre Phillips, Christine Rodrigues, Kirsten Serrurier and Bright Tibane

SOUTH AFRICA

1 Constitution of the Republic of South Africa, 1996.

2 See Chapter 2 of the Constitution.

3 Section 8.3 of the Constitution.

4 Section 39(1).

5 Section 7 of the FSRA.

6 The "governing body" means, in relation to a financial institution, a person or body of persons, whether elected or not, that manages, controls, formulates the policy and strategy of the financial institution, directs its affairs or has the authority to exercise the powers and perform the functions of the financial institution, and includes the board of directors of a company, the board of a pension fund, and the trustees of a trust.

7 Section 6 of the FSRA.

8 Copies of the legislation are available at: www.fsca.co.za, www.resbank.co.za and www.treasury.gov.za.

9 Prudential standards must be aimed at one or more of the following: (i) ensuring the safety and soundness of financial institutions; (ii) reducing the risk that financial institutions and key persons engage in conduct that amounts to, or contributes to, financial crime; and (iii) assisting in maintaining financial stability.

10 A conduct standard must be aimed at one or more of the following: (i) ensuring the efficiency and integrity of financial markets; (ii) ensuring that financial institutions and representatives treat financial customers fairly; (iii) ensuring that financial education programs, or other activities promoting financial literacy are appropriate; (iv) reducing the risk that financial institutions, representatives, key persons and contractors engage in conduct that is or contributes to financial crime; and (v) assisting in maintaining financial stability.

11 The Working Group consisted of representatives of: South African Reserve Bank, Financial Sector Conduct Authority (FSCA), Prudential Authority (PA), Department of Environment Affairs (DEA), The South African Insurance Association (SAIA), The Banking Association of South Africa (BASA), The Association for Saving and Investment South Africa (ASISA), The Johannesburg Stock Exchange (JSE), Batseta – Council for Retirement Funds of South Africa.

12 National Treasury, Draft Technical Paper 2020: Financing a Sustainable Economy, available online at: http://www.treasury.gov.za/publications/other/Sustainability%20technical%20paper%202020.pdf.

13 Sustainable Finance Paper, at page 11.

14 Sustainable Finance Paper, at page 5.

15 Sustainable Finance Paper, at page 18.

16 Sustainable Finance Paper, at page 38.

17 See Taxonomy Working Group, Working Draft: Draft Green Finance Taxonomy, June 2021, Version 1.5, available online at: https://sustainablefinanceinitiative.org.za/wp-content/uploads/2021/06/Draft-Green-Finance-Taxonomy.pdf (accessed 2 July 2021).

18 CRISA is available online at: www.iodsa.co.za/page/CRISACode. CRISA has been endorsed by the Institute of Directors in Southern Africa (IoDSA), the Principal Officers Association (POA), and the Association for Savings and Investment South Africa (ASISA). The principles of CRISA are supported by the FSCA and the Johannesburg Stock Exchange (JSE). Many Asset Owners (including those who are members of ASISA and adhere to CRISA by virtue of that membership) and Investment Managers support the principles espoused by CRISA, and incorporate them into their responsible investment policies. There is no signatory mechanism for CRISA.

19 There is a wide variation in the quality of annual disclosures regarding the implementation of responsible investment practices. In 2017 Kigoda Consulting, a consultancy offering responsible investment advisory services, carried out a study, the results of which suggested that although many asset managers claim to endorse the CRISA there is limited analysis on how they actually perform against the CRISA's five principles. The Kigoda Responsible Investment Ranking 2017 used CRISA's five principles and its practice recommendations to assess, publicly disclosed information, whether 10 of South Africa's largest asset managers have the policy frameworks and governance structures in place to implement sustainable and responsible investment. It also assesses whether they adequately disclose information on their responsible investment performance. These 10 managers account for around two-thirds of total assets under management in South Africa by asset managers, including multi-managers.

20 On disclosure, see CRISA Practice Note: Guidance on disclosure of the application of CRISA, May 2017, available online at: https://cdn.ymaws.com/www.iodsa.co.za/resource/collection/58CA7BC8-8C67-4CF7-A644-0EDB06165C8B/Guidance_on_disclosure_of_application_of_CRISA.pdf.

21 CRISA Committee, CRISA Code for Responsible Investment in South Africa: 2020 Revision Consultation Draft, available online at: https://cdn.ymaws.com/www.iodsa.co.za/resource/collection/1D7CF73B-B95B-453F-A8E3-D19829D18FBD/CRISA_2.0_Draft_for_public_comment._November2020__00000004_.pdf.

22 Accessible online at: http://www.iodsa.co.za/page/KingIVReport. The Institute of Directors in Southern Africa NPC owns all copyright and titles in the "King IV Report on Corporate Governance for South Africa, 2016". King IV™ and King IV Code™ are trademarks of the IoDSA.

23 According to the FSCA, as at 31 March 2020 there were 1 528 active retirement funds registered with the FSCA. FSCA Annual Report 2019-20, available online at: https://www.fsca.co.za/Annual%20Reports/FSCA%20Annual%20Report%202019-2020.pdf.

24 Section 4 of the Pension Funds Act.

25 A retirement fund can sue its board members and/or service providers (including Investment Consultants and Investment Managers) for wrongful losses occasioned to the fund.

26 Section 5 of the Pension Funds Act.

27 Section 7C of the Pension Funds Act. In addition to the duties under the Pension Funds Act, a pension fund's board is subject to fiduciary duties at common law. Common law duties that apply to retirement funds include the duty to act with due care, diligence and good faith, avoid conflicts of interest and to act with impartiality.

28 Section 7D of the Pension Funds Act.

29 Section 13 of the Pension Funds Act.

30 *Sasol Limited & others v Chemical Industries National Provident Fund* [2015] JOL 33910 (SCA) at para [13].

31 *Tek Corporation Provident Fund and Others v Lorentz* [1999] 4 All SA 297 (A) (3 September 1999). The board may, by way of a resolution, amend the rules in accordance with the Pension Funds Act and the fund's rules. A fund may, in the manner directed by its rules, alter or rescind any rule or make any additional rule subject to approval by the FSCA. If the FSCA finds that the amendment is consistent with the Pension Funds Act, and is satisfied that it is financially sound, the FSCA must register the amendment.

32 The principles are in Regulation 28(2)(c) of the Pension Funds Act.

33 Regulation 28(2)(c)(ix).

34 B-BBEE is a central part of the South African government's economic transformation strategy. The key legislation in this regard is the Broad Based Black Economic Empowerment Act, 1998 (BEE Act) and the Codes of Good Practice published in terms thereof (Codes). The Codes set out certain targets in relation to the various elements of B-BBEE – black equity ownership, management, employment equity, enterprise development, preferential procurement, skills development and socio-economic development initiatives – against which companies' South African operations are measured. There are generic Codes and sector-specific Codes. For example, the financial sector code applies to banking, long and short-term insurance, the management of collective investment scheme assets as well as asset management, consulting and administration (amongst others)
A measured entity's contribution to black economic empowerment is assessed against a B-BBEE scorecard, with its overall score then translating to a B-BBEE rating, with Level 8 being the lowest rating and Level 1 being the highest (and best) rating that can be achieved
In terms of the BEE Act, every organ of state and public entity in South Africa is legally bound to take into account and, as far as is reasonably possible, to apply the Codes in, amongst other things, determining criteria for the issuing of licences and developing a procurement policy for selecting their service providers. For example a state owned company's procurement policy may require that its suppliers achieve at least a Level 4 B-BBEE rating.
Other than in certain state licensing, permitting and authorisation processes, there is no "hard law" requiring that any private entity in South Africa must meet specific B-BBEE targets or must implement a B-BBEE policy. The BEE Act does not provide for offences or penalties relating to B-BBEE performance but rather seeks, through the economic measures discussed below, to facilitate a uniform approach to B-BBEE in the South African economy. However, from a commercial perspective, although there are no absolute requirements in relation to achieving specific B-BBEE targets, any company wishing to do business in South Africa must consider and develop its B-BBEE position. This is because, in addition to the pressures from government, an entity which does not have a good B-BBEE rating or which fails to take steps to improve its B-BBEE rating may be hampered in the conduct of its day-to-day business with government, organs of state and private sector customers.

35 This means that the adoption of an investment policy would be procedurally defective if the Minister (or his or her delegate) has not been included in the relevant deliberations preceding such adoption, notwithstanding that the Minister is not empowered to determine (or reject) the investment policy except on prescribed grounds.

36 See https://www.gepf.gov.za/gepf-law-and-rule/.

37 The GEPF IPS is available at: https://www.gepf.gov.za/wp-content/uploads/2020/11/INV-C-0002112.pdf.

38 The deed of a CIS is the agreement or document that regulates establishment, administration and management of the scheme.

39 An open-ended investment company is a company with an authorised share capital, which is structured in such a manner that it provides for the issuing of different classes of shares to investors, each class of share representing a separate portfolio with a distinct investment policy.

40 Section 62 of CISCA.

41 Section 65 of CISCA.

42 *Yarram CC t/a Tijuana Spur vs Absa Bank Ltd*, 2007 (2) SA 570 (SCA).

43 CISCA defines "assets" as "investments comprising or constituting a portfolio of a CIS and includes any income accruals derived or resulting from the investments in the portfolio which are held for or are due to the investors in that portfolio".

44 Section 4 of CISCA.

45 Section 2 of CISCA.

ANNEXES

South Africa

SOUTH AFRICA

46 A "nominee company" is controlled by a financial institution, which: (i) is incorporated under the provisions of the Companies Act (ii) has as a special condition contemplated in section 15(2) of the Companies Act the requirement to act as nominee for, or representative of, any person in the holding of any property in trust for such person or persons; (iii) is precluded as a special condition in its Memorandum of Incorporation from incurring any liabilities other than to the persons on whose behalf it holds assets, to the extent of their respective rights to, and interest in, such assets and (iv) has entered into an irrevocable written agreement with a financial institution which controls the company, and in terms of which such financial institution has undertaken to pay all the expenses of, and incidental to, its formation, operations and liquidation. The obligations also extend to a director, member, partner, official, employee or agent of a nominee company.

47 Section 2 of the FIA.

48 Section 97 of CISCA.

49 Section 85 of CISCA.

50 The FSCA in Board Notice 90 of 2014, determined the securities, classes of securities, assets or classes of assets that may be included in a portfolio of a CIS in securities, as well as the manner in which, limits and conditions to which such securities or assets are subject. General Notice 572 of 2008 and Board Notice 126 of 2013 provides for investment limits/restrictions for CISs in property. Board Notice 65 of 2014 provides for investment limits/restrictions for CISs in participation bonds. Board Notice 52 of 2015 provides for investment limits/restrictions for CISs in hedge funds

51 Section 5(4) of the Insurance Act.

52 Section 4 of the Insurance Act.

53 Section 36 of the Insurance Act. Ultimate responsibility for the prudent management of the financial soundness of an insurer, rests with the insurer's board of directors. The board of directors must have in place procedures to monitor the financial soundness of an insurer and to identify any deterioration in its actual or expected capital resources or business conditions. The Prudential Authority notes that prudent investment management extends beyond meeting the regulatory minimum financial soundness requirements.

54 A policyholder is the holder of a life insurance policy or a non-life insurance policy, or his or her successor in title.

55 Section 30(1) of the Insurance Act. The governance framework must: (i) be proportionate to the nature, scale and complexity of the insurance business and the risks of the insurer, or the business and risks of the insurance group; (ii) include effective systems of corporate governance, risk management and internal controls; and (iii) address, and provide for, the matters prescribed under the Insurance Act.

56 See section 76 of the Companies Act, and the common law fiduciary duties owed by a director to a company.

57 Section 76(4)(a). This statement assumes the director's decision is not tainted by a conflict of interest. It is an additional requirement of section 76(4)(a) that the director's decision must not be tainted by a conflict of interest (the obligations on directors in respect of personal financial interests in matters/decisions are set out in section 75 of the Companies Act).
The Companies Act states only that a director must take reasonably diligent steps to become informed about the matter, and is entitled (in making an informed decision) to rely upon: the performance of: any employee whom the director reasonably believes to be reliable and competent in the functions performed or information provided; legal counsel, accountants or other professional advisors retained by the company, the board or a committee as to matters which the director reasonably believes are within that person's expert/professional competence, or as to which that person merits confidence; a committee of the board of which the director is not a member, unless the director has reason to believe that the actions of the committee do not merit confidence; or any person to whom the board may reasonably have delegated, formally or informally by course of conduct, the authority or duty to perform one or more of the board's functions that are delegable under applicable law; and any information, reports, opinions, recommendations, reports or statements (including financial statements and other data) prepared or presented by any of those persons.

58 Prudential Standard GOI 2: Governance of Insurers, available online at: https://www.masthead.co.za/wp-content/uploads/2019/01/Prudential-Standard-GOI-2-Governance-of-Insurers.pdf.

59 Section 39 of the Insurance Act provides that in circumstances where an insurer has failed to maintain a financially sound condition, the Prudential Authority may restrict or prohibit certain activities or transactions of an insurer, controlling company or insurance group until the capital requirements are complied with and the financial soundness of the insurer or insurance group has been restored.

60 CISL ClimateWise Principles accessible online at: www.cisl.cam.ac.uk/business-action/sustainable-finance/climatewise/images/climatewise-principles.png/view.

61 Sanlam and Santam's ClimateWise reports are available online at: https://www.sanlam.com/investorrelations/downloadscentre/Documents/Sustainability%20reports/Sanlam_ClimateWise_Report_2020.pdf and https://www.santam.co.za/products/climatewise-report/, respectively.

62 For further details on these funds see: https://climatefundmanagers.com/funds/; https://www.santam.co.za/media/2416227/resiliant_fund.pdf; and https://www.sanlam.co.za/campaigns/financialresilience/Documents/Darryl_Moodley_August.pdf.

63 For example, the Sustainable Finance Paper (at paragraph 10.7.1, page 46) refers to the following climate related risks as presenting substantial challenges to the business model of insurers:
"The ways in which the insurance sector, and hence the PA's objectives, could be impacted by climate change are diverse, complex and uncertain. The primary channels ('risk factors') through which such impacts might be expected to arise are:

Physical risks: the first-order risks, which arise from weather-related events, such as floods and storms. They comprise impacts directly resulting from such events, such as damage to property and those that may arise indirectly through subsequent events, such as disruption of global supply chains or resource scarcity.

Transition risks: the financial risks, which could arise for insurance firms from the transition to a low-carbon economy. These can come about through changes in regulation, changes in technology or consumer pressure. For insurance firms, this risk factor is mainly about the potential re-pricing of carbon-intensive financial assets, and the speed at which any such re-pricing might occur. There is potential for rising costs, and therefore decreasing affordability, of insurance premiums given the increase in risks. To a lesser extent, insurers may also need to adapt to potential impacts on the liability side resulting from reductions in insurance premiums in carbon-intensive sectors.

Liability risks: risks that could arise for insurance firms from parties who have suffered loss and damage from climate change, and then seek to recover losses from others who they believe may have been responsible. Where such claims are successful, those parties against whom the claims are made may seek to pass on some or all of the cost to insurance firms under third-party liability contracts such as professional indemnity or directors' and officers' insurance.

Infrastructure risks: For each of these risk factors, it is vital to explore the nature of the risk, the possible impacts on the liability and/or asset sides of insurance firms' balance sheets, and the actions firms are taking to mitigate them. The clearest risk is from the first category – physical risks. The other two risk categories are less well developed and more uncertain – nonetheless, they could have a meaningful impact on the PA's objectives over time."

64 The CRISA Committee has published a model mandate, which is informed by the ICGN Model Mandate, to be used between Asset Owners and Investment Managers in the South African context, available online at: https://cdn.ymaws.com/www.iodsa.co.za/resource/collection/2BB91484-C408-4372-A045-FAF4E98560F5/Position_Paper__Model_Mandate.pdf.

65 See, for example, UN-PRI Guide to Collaborative Engagement, available online at: https://www.unpri.org/download?ac=4156.

66 For example, the ICGN Global Stewardship Principles, available online at: https://www.icgn.org/sites/default/files/ICGNGlobalStewardshipPrinciples.pdf.

67 See the UN-PRI commissioned guidance on collaborative engagement and acting in concert, available online at: https://www.unpri.org/addressing-system-barriers/6270.article and https://www.unpri.org/pri-podcasts/acting-in-concert-in-south-africa/5857.article. In 2010, the Takeover Regulation Panel reviewed a guide published by UN-PRI with regard to collaborative engagement in the context of Principles 2 and 5 of the PRI, available online at: https://cdn.ymaws.com/www.iodsa.co.za/resource/collection/58CA7BC8-8C67-4CF7-A644-0EDB06165C8B/2013.05.14_PRI_Collaborative_Engagement_Guidance.pdf.

68 Section 123 of the Companies Act.

69 Section 56 and section 122 of the Companies Act.

70 See Chapter X of the FMA. There are three broad categories of insider trading offences under the FMA, each of which a Relevant Investor would have to bear in mind:

Dealing offences: First, when an insider, who knows they have inside information relating to securities listed on a regulated market, deals (whether directly or indirectly or through an agent) in those securities to benefit himself or herself, or to benefit another person. Second, when any person, who knows that an insider possesses inside information, deals (whether directly or indirectly or through an agent) for the insider in listed securities in respect of which the insider possesses inside information.

Disclosure offences: When an insider, in the knowledge that they have inside information, discloses such inside information.

Influencing offence: When an insider, in the knowledge that he or she has inside information encourages or causes another person to deal, or discourages or stops another person from dealing, in listed securities which are likely to be affected by inside information. There are limited exceptions to each of the above offences, which we do not go into in this annex.

71 Competition rules are contained primarily in the Competition Act, 1998.

72 There is no case law in South Africa dealing specifically with these categories of conduct, or the sustainability context in particular, but the general principle in section 4(1)(a) of the Competition Act is that collaboration between competitors which does not amount to price-fixing, market allocation or collusive tendering is allowed as long as it does not harm competition (or if it does, this effect is outweighed by its pro-competitive, efficiency or technological benefits).

73 Paragraph 4.1 of Guidance Notice 1 of 2019.

74 Sustainable Finance Paper, page 35.

SOUTH AFRICA

75 Section 13(2) of the FAIS. The FAIS prescribes that a code of conduct must ensure that the clients will be able to make informed decisions, and that their reasonable financial needs regarding financial products will be appropriately and suitably satisfied. Two key codes have been published under FAIS: (i) the Code of Conduct for Administrative and Discretionary FSPs, 2003 (Discretionary Code); and (ii) the General Code of Conduct for Authorised Financial Services Providers and Representatives, 2003.
The Discretionary Code draws a distinction between administrative FSPs and discretionary FSPs: (1) An administrative FSP is a FSP, other than a discretionary FSP, that renders intermediary services in respect of various financial products on the instructions of a client or another FSP through bulking. Bulking is the aggregation by an administrative FSP of: (a) clients' funds when buying or investing in financial products on behalf of clients, and the subsequent allocation of such financial products to each client separately in the records of the FSP; (b) the financial products belonging to clients when selling such financial products on their behalf, and the subsequent allocation of the proceeds of such sale to each client separately in the records of the FSP. (2) A discretionary FSP is one that renders intermediary (financial) services of a discretionary nature as regards the choice of a particular financial product, but without implementing any bulking. Whether an Investment Manager is an administrative or a discretionary FSP will depend on whether its mandate is discretionary in nature (which is generally typical for Investment Managers' and Fiduciary Managers' Mandates) and whether any bulking, as described (which is less typical of Investment Managers' and Fiduciary Managers' mandates), is intended to be implemented. Both administrative FSPs and discretionary FSPs act in accordance with the Discretionary Code, the General Code, FAIS and applicable laws, and invest in accordance with mandates concluded with their clients.
The Discretionary Code prescribes that a discretionary FSP must: (i) provide to the client (Asset Owner), on request, any reasonable information regarding the financial products of the client, market practices and the risks inherent in the different markets and products; and (ii) before entering into a mandate with the client: obtain information with regard to the client's financial circumstances, needs and objectives and such information that is necessary to enable the FSP to render suitable intermediary services to the client; identify the financial products that best suit the client's objectives, risk profile and needs, subject to the limitations and restrictions imposed on the FSP by its licence.
The FSP must obtain a signed mandate before rendering any intermediary services to that client. The mandate records the arrangements made between a client and a discretionary FSP and must, among other things: authorise the discretionary FSP to act on behalf of the client, indicating whether the authorisation is given with full or specified limited discretion state the investment objectives of the client and whether there are any investment or jurisdiction restrictions that apply to the rendering of intermediary services in relation to the financial products involved.

76 CRISA, principle 1.

77 Section 3 of the General Code.

78 Criminal liability is provided for in: Section 49 of the National Environmental Management Act, 1998; Section 151(1) of the National Water Act, 1998; sections 51 and 52 of the National Environmental Management: Air Quality Act, 2004; section 67 of the Hazardous Substances Act, 1973; and the Asbestos Prohibition Regulations.

79 Section 28 of NEMA.

80 Section 32 of NEMA provides for *locus standi* in respect of any breach or threatened breach of any statutory provision concerned with the protection of the environment or the use of natural resources.

81 See, for example, Centre for Environmental Rights (https://cer.org.za/programmes/corporate-accountability); Just Share (https://justshare.org.za/about/what-we-do); and The Raith Foundation (https://www.raith.org.za/index.php/responsible-investment).

82 See Intellidex (Pty) Ltd Research Report August 2020 'Investing for Impact: Pension funds portfolio strategies', available online at: https://www.intellidex.co.za/reports/investing-for-impact-report/.

83 UN-PRI and UNEP FI, Final Report: Fiduciary Duty in the 21st Century, available online at: https://www.unpri.org/download?ac=9792. Also see: https://www.unpri.org/fiduciary-duty/fiduciary-duty-in-the-21st-century/244.article. See Fasken opinion 'The duty of a board of a pension fund to take climate change into account when making investment decisions' 4 April 2019, addressed to Just Share NPC and ClientEarth, available online at: https://justshare.org.za/wp-content/uploads/2019/04/2019_Pension-fund-legal-opinion-by-Fasken.pdf. Also see M Isa 'Ignore sustainable investment at your own peril' FinWeek 6 November 2019, available online at: https://www.fin24.com/Finweek/Investment/ignore-sustainable-investment-at-your-own-peril-20191105.

84 https://www.genfound.org/media/1433/fiduciary-duty-in-the-21st-century-sa-roadmap.pdf.

85 SIF has recognised climate change as a significant risk on human and environmental systems, including an increasing frequency and severity of natural catastrophes. The SIF's objective is to raise awareness for insurers and supervisors of the challenges presented by climate change, including current and contemplated supervisory approaches for addressing these risks. Climate change risk is recognised by the Prudential Authority although insurance regulation has not formalised and explicitly included climate risk in all parts of its legislative and supervisory frameworks. South Africa's inclusion as a member affords the country valuable insights into global insurance initiatives, critical in an emerging market and developing economy like South Africa. The learnings since assuming membership in SIF has been exponential for South Africa as it continues to refine and enhance its insurance regulatory framework. South Africa has seen an increase in natural catastrophes (droughts, floods and hailstorms) over the past few years. Apart from the increase in physical climate risk, there is also an increasing risk associated with the transition to a low-carbon economy.

86 See https://cer.org.za/programmes/corporate-accountability.

87 See https://www.raith.org.za/index.php/responsible-investment.

88 See https://justshare.org.za/about/what-we-do.

89 Boston Consulting Group 'Unlocking Tomorrow's ESG Opportunities' at https://www.bcg.com/en-za/publications/2020/future-esg-environmental-social-governance-opportunities. See also: World Economic Forum White Paper 'Embracing the New Age of Materiality: Harnessing the Pace of Change in ESG' in collaboration with Boston Consulting Group, available online at: http://www3.weforum.org/docs/WEF_Embracing_the_New_Age_of_Materiality_2020.pdf.

90 University of Cambridge Institute for Sustainability Leadership (CISL) (2018). Embedding environmental scenario analysis into routine financial decision-making in South Africa, UK: the Cambridge Institute for Sustainability Leadership, available online at: https://www.cisl.cam.ac.uk/resources/publication-pdfs/embedding-environmental-scenario-analysis-into-financial-decision-making-in-south-africa.

91 See RobecoSAM and Global Reporting Initiative 'Defining Materiality: What Matters to Reporters and Investors', available online at: https://www.globalreporting.org/resourcelibrary/Defining-Materiality-What-Matters-to-Reporters-and-Investors.pdf

92 Definition of "materiality" taken from the International Integrated Reporting Council, The International <IR> Framework (13 December 2013), p 5, available online at http://integratedreporting.org/resource/internationalirframework/.
Sustainability Accounting Standards Board: https://www.sasb.org/standards-overview/materiality-map/.

93 Also see: The IFC Beyond the Balance Sheet: IFC Toolkit for Disclosure and Transparency: https://www.ifc.org/wps/wcm/connect/d4bd76ad-ea04-4583-a54f-371b1a7e5cd0/Beyond_The_Balance_Sheet_IFC_Toolkit_for_Disclosure_Transparency.pdf?MOD=AJPERES&CVID=morp0vo;
https://www.accountability.org/wp-content/uploads/2017/02/Redefining-Materiality-2.pdf; https://www.unepfi.org/news/themes/ecosystems/groundbreaking-new-tool-enables-financial-institutions-to-see-their-exposure-to-natural-capital-risk/.

UNITED KINGDOM

1. INTRODUCTION

1.1 This Annex considers the extent to which IFSI is required, or may be permitted, under the laws of England and Wales as at 31 January 2021[1], including relevant EU legislation in force or implemented prior to that date[2]. As the UK has left the EU, it is not obliged to implement EU legislation with an end implementation date later than 31 December 2020.

1.2 Terms defined in the Report Glossary apply in this Annex, as do the additional terms defined in its own glossary located at Appendix 1 to this Annex. The terms Asset Owner and Beneficiary are examined in detail at Appendix 1 to this Annex, which also identifies the investment decision-maker in relation to each of the Asset Owners covered in this Annex.

1.3 The expression "IFSI" is explained in Part 1A of the Report. Currently, the most widely discussed example of a sustainability factor is climate change.[3] This may well be because it is generally perceived as the most urgent sustainability risk.[4] For this reason, most of the examples included in this Annex are climate change-related. They nevertheless provide helpful guidance as to how Asset Owners could approach other sustainability factors, for example, water usage, biodiversity loss[5] and widespread antibiotic resistance.

1.4 In seeking to influence the activities of portfolio companies or regulatory or relevant government policy, Asset Owners and their Investment Managers have three principal tools to deploy - their powers of investment and disinvestment, their powers of stewardship[6] and public policy engagement. Once an Asset Owner has decided that a particular sustainability factor presents a material financial risk to its investment goal or an investment objective,[7] it will then need to decide which (if any) of these tools to deploy to address that risk and whether to wield that tool itself or to ask its Investment Manager or another agent[8] to do so. This will include consideration of whether the chosen tool is most effectively deployed on a solo or collective basis.[9]

1.5 This Annex deals primarily with situations where an Asset Owner is not obliged to pursue an express sustainability factor-related investment goal or objective (by contrast with, for example, a mutual fund specifically established with a sustainability-related objective as well as a financial return objective).

1.6 As noted at Part A.3.2.2 of the Report different Asset Owners will adopt different investment strategies. This Annex comments where differences potentially arise between passive (or index-tracking) and active strategies.

1.7 The precise circumstances surrounding each Asset Owner or Investment Manager are critical to its investment-related decisions (i.e. those concerning investment, holding or disinvestment, stewardship or public policy engagement - the expression is used in this Annex as a convenient shorthand to cover all three). This Annex seeks to summarise the framework of legal and regulatory issues within which those decisions should be made, but it is no substitute for legal advice in individual circumstances.

Legal context and market practice relating to investment decisions

1.8 As noted at Part B.3 of the Report, an intricate web of law, regulation, guidance and regulatory expectation, together with contractual or trust-based rights for some Beneficiaries and expectations based on marketing material, surrounds investment-related decision-making by the Asset Owners considered in this report, especially decisions relating to investment and stewardship.

1.9 It is also usual for Asset Owners to appoint one or more Investment Managers to manage their assets on a discretionary basis.[10] Investment Managers' investment and stewardship decisions on behalf of clients and public policy engagement are similarly shaped by law, regulation, guidance and regulatory expectation and by the agreements made with the Asset Owners for whom they act. All this adds further layers of complexity. These are potentially compounded when the Asset Owner is established in one jurisdiction and the Investment Manager in another.[11]

1.10 Delegation also means that the investment-related decisions made by an Asset Owner are, in the main, at a strategic (rather than investment-by-investment) level. It will not decide which equity or fixed income investment to buy or (generally) how to exercise stewardship powers and rights, but it will set an investment and risk framework.[12] This is the background against which it will determine its investment goals, its strategic asset allocation and its investment strategy. These, in turn, underlie the detailed investment objective and investment policy it sets for each of its Investment Managers, together with any other investment-related terms of the arrangements between them[13] and

UNITED KINGDOM

what it will expect reports and review meetings to cover. These decisions are not static ones; the Asset Owner will keep all of these matters under review at appropriate intervals and will monitor the activities of its Investment Manager. In this Annex, in relation to an Asset Owner which delegates management, the term "investment-related decision" is used to describe these high-level and strategic decisions. A further detail to note is that, for a Mutual Fund, it is the AFM (rather than the Asset Owner) which is the investment decision-maker and references to "Asset Owner" in the remainder of this section should accordingly be read, in relation to a Mutual Fund, as if they included the fund's AFM.

The Stewardship Code[14]

1.11 The UK Stewardship Code is published by the FRC, the UK's regulator of audit and corporate governance standards. It is aimed at both Investment Managers and Asset Owners and is also applicable to service providers which do not directly manage investments but provide other services that enable clients to deliver stewardship (for example, investment consultants, proxy advisors and data and research providers). The first sentence of the code explains that "stewardship" is the responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society.

1.12 The Stewardship Code is not legally binding; institutional investors and other relevant bodies can choose whether to apply to become signatories.[15] For those who do, the code comprises a set of "apply and explain" principles. Signatories are required to report annually on the activities they have undertaken and the outcomes they have achieved in relation to the code's principles, which may require disclosure of background information or policies in order to explain their approach. The Stewardship Code is nevertheless legally significant in several ways:

(a) it is designed to promote good investment-related practices among institutional investors. Although, on the face of it, the code is about disclosure, in order to make the relevant disclosures, a signatory needs to consider, and address any issues with, its governance structure and relevant policies and procedures and identify, assess and manage any relevant risks;

(b) it is relevant to market practice standards (which are in turn relevant to, for example, duty of care (see 1.57 below);

(c) regulators may well take into account standards set by the code in applying their rules and also take an interest in the annual reports published by Asset Owners or Investment Managers; and

(d) it contributes to the transparency of signatories' investment-related decision-making and outcomes and thus to beneficiaries' information and expectations.

Most Asset Owners, and all Investment Managers, covered in this Annex are, at a minimum, encourage d by their regulators to become signatories and some are, in effect, required by FCA rules to do so.

1.13 Under the Stewardship Code, signatories should:

(a) explain the organisation's purpose and outline its culture, strategy and investment beliefs and actions taken to ensure that these enable effective stewardship. They should disclose how their purpose and investment beliefs have guided their stewardship, investment strategy and decision-making and include an assessment of how effective they have been in serving the best interests of clients and beneficiaries (Principle 1);

(b) identify and respond to market-wide and systemic risks, including explaining how they have aligned investments and any collective action and relevant industry initiatives they have participated in (Principle 4);

(c) disclose the issues (including ESG issues of importance to them) they have prioritised for assessing investments prior to purchase, monitoring during holding and disinvesting, including how this has differed for funds, asset classes and geographies. They should explain how information gathered through stewardship has informed acquisition, monitoring and exit decisions, with reference to how those decisions have best served clients or beneficiaries (Principle 7); and

(d) if they appoint an Investment Manager, explain how that manager has been monitored to ensure that the signatory's assets are managed in alignment with their investment and stewardship strategy and policies (Principle 8).

1.14 "Investing with Purpose", the recently published report of the Stewardship and Stakeholder Working Parties of the UK Asset Management Taskforce,[16] is subtitled "placing stewardship at the heart of sustainable growth". It includes twenty recommendations designed to improve stewardship still further in the UK, in large measure focused around

UNITED KINGDOM

the Stewardship Code and financial and narrative disclosure by portfolio companies.

Importance of industry guidance

1.15 A court which is asked to consider whether an Asset Owner or Investment Manager has fulfilled applicable requirements will want to consider any pertinent official or regulatory guidance related to investment-related decision-making and, in some cases, may be required to do so.[17] As regards regulatory enforcement action, a regulator is likely to be keenly interested in whether such guidance has been followed. Especially in relation to climate change, the regulators are promoting initiatives which are industry-led and are designed to share and promote good practice in the industries they regulate - for example, the DWP's publication of the PCRIG Guide 2020 and the PRA and FCA's joint establishment of the CFRF (membership of which includes insurers and investment managers) and publication of its 2020 guide.[18]

Judge-made law

1.16 The law covered below may be primary (e.g. the FSMA) or delegated (e.g. the LGPS Investment Regulations or rules made by the PRA or FCA[19]) or it may be judge-made. As far as judge-made law is concerned, there are some broad principles of general application to Asset Owners and Investment Managers. As regards insurers, the FCA rules discussed in this section apply to them but otherwise these principles take the form of similar, but not identical, statute-based directors' duties, which are covered in 2.4 below.

Fiduciary duties

1.17 The answer to the legal questions of "who is a fiduciary" and "what is a fiduciary duty" are not straightforward. Not all of the Asset Owners covered in this Annex owe fiduciary duties to those we have identified as Beneficiaries. In the relevant parts of section 2 below, we identify which is (or arguably is) a fiduciary and which is not and to whom those duties are owed. Although there is no express authority on this point, it is generally accepted that an Investment Manager owes fiduciary duties to its client Asset Owners, which (as noted in 6.2(c) below), it may seek to modify or exclude in its agreement with an Asset Owner.[20]

1.18 In relation to each Asset Owner, the relevant part of section 2 identifies whether, and by and to whom, fiduciary duties are owed.

1.19 The term "fiduciary duty" is used in this Annex in the strict sense of duties which are peculiar to a fiduciary; the key duty in the current context is the duty of loyalty.[21] The primary relevance of this duty in this Annex is the "no conflict rule"; a fiduciary must avoid any unauthorised conflict between its duty and its interest and any unauthorised conflict between duties it owes to different beneficiaries.

1.20 The Law Commission's summary of the 2014 Report contains the important reminder (emphasis added) that "fiduciary duties focus on what a fiduciary should *not* do, rather than what they should do. Positive duties derive from other sources, such as duties connected to the exercise of a power (see 1.25 to 1.42 below) and duties of care (see 1.43 to 1.58 below)."[22] Fiduciary duties support, and are moulded by, other duties.[23]

1.21 An Asset Owner regulated by the FCA, whether or not a fiduciary, is subject to the requirement to "manage conflicts of interest fairly, both between itself and its customers and between a customer and another client".[24] This requirement also applies to an Investment Manager. The consequences of a breach of this requirement are potentially different from a breach of fiduciary duties, but the content is broadly similar.[25]

1.22 Those Asset Owners and Investment Managers who are signatories to the Stewardship Code, should disclose their conflicts policy under its Principle 3 and how that policy has been applied to stewardship, including how conflicts have been identified, managed and addressed. The Stewardship Code gives as examples, conflicts that arise as a result of differences between the stewardship policies of Investment Managers and their clients, differing bond and equity managers' objectives within the same organisation and client or beneficiary interests diverging from each other.

1.23 These conflict descriptions mainly focus on the position of Investment Managers. However, the conflicts faced by many Asset Owners are at least as acute. Consider, for example, the position of a pension scheme, with pensions in payment, but also with members who will not receive a pension for 40 or more years. An insurer's position is potentially similar, with policies already in payment or maturing in the short-term and policies under which payments will not be due for decades. Those with long-term interests are keenly interested in steady long term growth (whether contributed by increasing market value or accumulated income or a mixture of both) and those with shorter-term interests are interested

UNITED KINGDOM

in the security of the often fixed payments due to them. Such conflicts must be addressed and resolved not only in relation to strategic asset allocation and investment decisions, but also in relation to stewardship and public engagement policy-related decisions because the anticipated benefit of those decisions may well not accrue to the same Beneficiaries as will bear any direct and indirect[26] costs of actions taken now. In practice, these conflicts may be less acute than might immediately appear as the interests of those members or policyholders with shorter-term horizons may, in fact, be provided for by investment wholly, or to a greater extent in fixed income (although see 1.22 above for the possibility of conflict here). Further, the board of the portfolio company itself is first in line in seeking to balance the interests of its current and future shareholders and will resist stewardship efforts that it considers do not strike this balance appropriately. Sustainability risks may, in any event, also crystallise in the short-term, or earlier than expected[27]: "If poorly managed, [the physical and transition risks related to climate change] could be the source of consumer harm and potentially a future financial crisis stemming from financial losses and sudden adjustments in asset values. Covid-19 has demonstrated more than ever the need for firms to be prepared for the rapid crystallisation of global risks".[28] Addressing and resolving conflicts fairly (as required by the duties outlined here and 1.43 below) are among the key issues that will underlie an Asset Owner's investment-related decisions in practice.

1.24 The considerable uncertainties surrounding sustainability risks, including the timing of impact, mean these are complex decisions.

Duties connected to the exercise of a power

1.25 The 2014 Report identifies duties which have been developed to guide and constrain the exercise of fiduciary powers.[29] We consider that they broadly apply to the investment and stewardship powers of both Asset Owners and Investment Managers, although the position of insurers is somewhat different (as explained in sections 2.4 and 3.4 below). Some of these duties are more relevant in the current context than others.

1.26 *Purpose-related requirements* - these require a person to:

(a) *act within the scope of a power* - in other words, observe any conditions or restrictions placed on its exercise; and

(b) *exercise a power for the purpose for which it is conferred* - in context, it would be wrong for a person who has been given a power to invest solely for financial return to exercise that power in a way that is intended to achieve some other purpose.[30]

1.27 By long-standing convention, trustees and others exercising a fiduciary power have tended to be described as being subject to a duty to act in the "best interests" of their beneficiaries when exercising their powers and discretions and this has often been perceived as a distinct legal duty.

1.28 The 2014 Report[31] notes "this phrase appears in the case law, in the [Private Scheme] Investment Regulations and in the IORP II. However, it has no statutory definition. Its meaning is discussed in a small number of cases, of which the most significant is *Cowan v Scargill*[32]…a particularly difficult case which has generated considerable controversy". The Law Commission goes on to say that it considers the "best interests" requirement to be a "short-hand" reference to a "bundle" of more specific duties that apply to trustees in relation in the exercise of their powers.[33]

1.29 More recent case law has confirmed this. In *Re Merchant Navy Ratings Pension Fund; Merchant Navy Ratings Pension Trustees Ltd v Stena Line Ltd*[34] the court held that "the 'best interests of the beneficiaries' should not be viewed as a paramount stand-alone duty. In my judgment, it should not be treated as if it were separate from the proper purposes principle… It is necessary first to decide what is the purpose of the trust and what benefits were intended to be received by the beneficiaries before being in a position to decide whether a proposed course is for the benefit of the beneficiaries or in their best interests… In my judgment, it is clear from *Cowan v Scargill* that the purpose of the trust defines what the best interests are and that they are opposite sides of the same coin." Accordingly, it is now clear that for the purposes of equity and trust law "best interests" forms part of the general purpose-related requirements that apply to the exercise of powers, and is not a stand-alone duty.[35]

1.30 In these contexts, it seems that the "best interests" maxim serves to keep the decision-maker's focus firmly on the purpose for which the relevant power has been given to it, on the identity of those for whose benefit that power is to be exercised and on the fact that, in exercising it, the decision-maker cannot simply exercise that power as it thinks fit (and, in particular, may not do so in

UNITED KINGDOM

what it considers to be its own interests or on the basis of its own moral or social beliefs).[36]

1.31 Various regulatory rules also impose 'best interests' obligations, some of which reflect EU legal standards. Asset Owners regulated by the FCA and Investment Managers are required by the FCA's rules to "pay due regard to the interests of [their] customers and treat them fairly" and to "act honestly, fairly and professionally in accordance with the best interests of [their] client".[37] For an AFM, this second rule is modified so that it applies separately in relation to any UCITS scheme the AFM manages. Again, "best interests" are not defined and the rule may well be intended to have a broader focus than simply the exercise of powers. However, it is clear from recent cases that any duties under the "best interests" rule are shaped by the relevant factual context, including, in particular, any agreement with the relevant client.[38]

1.32 *Own decision requirement* - a person exercising a fiduciary power must not:

(a) *act under the dictation of another* - the relevant decision-maker can take advice, and they can decide to follow advice, but they must generally make their own decision;[39] or

(b) *fetter their discretion* - the holder of a power must not improperly bind themselves in advance to exercise a power in a particular way.[40]

1.33 These duties mean, for example, that the trustees of a pension scheme must take care not to fetter their discretion improperly in entering into any agreement with the sponsor or a scheme member about the future exercise of their powers. Trustees can (and should) take appropriate advice from their investment, legal, actuarial and other advisers, but must ultimately make their own decisions.

1.34 The 2014 Report discusses the significance of the views of non-employer beneficiaries in this context and concludes that trustees may consult beneficiaries, and consider their views in making their investment decisions, but there is no legal requirement for them to do so.[41] What beneficiaries may want is not necessarily the same thing as what will promote the success of the trust.[42]

1.35 *Proper information requirement* - in the decision-making process, a person must take into account relevant considerations and ignore irrelevant considerations. This requirement is closely linked to the duty of care (see 1.43 below) and the rationality requirement (see 1.40 below). Although this test is similar to the 'process' limb of the standard applied to public authorities by *Associated Provincial Picture Houses v Wednesbury Corporation*[43] (i.e. whether the right matters have been taken into account in reaching the relevant decision), the full rigour of this aspect of the *Wednesbury* test has not historically been applied to trustees[44]. However the Supreme Court decision in *Braganza v B P Shipping Ltd*[45] has arguably changed the position; in this case, the *Wednesbury* test was applied to the exercise of a contractual discretion by a person (BP Shipping Ltd) which is not a public authority and was not acting in a fiduciary capacity. It seems very likely that it will be applied to the exercise of powers by trustees and to the exercise of a fiduciary power by others.

1.36 There is very little guidance about the identification of relevant considerations. This is probably one area in which the duty of care (itself context specific) has a role to play not only as regards the identification of those factors, but as to how far to go in seeking to discover them; "if a factor could not be discovered on reasonable enquiries or at an appropriate cost, then failure to consider it will not be a breach of this test".[46] It further appears that the weight that an Asset Owner gives to particular relevant considerations is a matter for it, subject to the due consideration requirement (see 1.43 below) and the test described in 1.40 below.[47]

1.37 The 2014 Report draws a distinction, to which we return below, between:

(a) financial factors - i.e. considerations which are likely to contribute positively or negatively to anticipated returns or factors which increase or reduce financial risk; and

(b) non-financial factors – i.e. considerations which do not fall within (a).

This broad distinction has subsequently been adopted by their regulators in relation to Pension Funds and life insurers (see further below).

1.38 Deciding whether a particular sustainability factor is a financial factor or a non-financial factor is not necessarily easy and the financial relevance of what are often referred to as ESG factors is not universally understood.[48] The most widely discussed example of a sustainability factor which is likely to be a financial factor for Asset Owners is climate change.[49] A factor which may look, on the face of it, to be non-financial, can be a financial factor in disguise because, for example, it may have a very real impact on a portfolio

UNITED KINGDOM

company's reputation, business model or governance standards and thus its value. For example, State Street Global Advisers is pro-actively engaging with its largest US and UK portfolio companies in an effort to enhance their human capital management disclosures and practices. Its January 2021 guidance on lack of racial and ethnic diversity notes "Research has shown the positive impacts diverse groups can have on improved decision making, risk oversight, and innovation, as well as how management teams with a critical mass of racial, ethnic, and gender diversity are more likely to generate above-average profitability…homogenous boards and workforces tend to refrain from challenging prevailing views. The preponderance of evidence demonstrates clearly and unequivocally that racial and ethnic inequity is a systemic risk that threatens lives, companies, communities, and our economy — and is material to long-term sustainable returns."

1.39 Where a decision maker concludes, or ought to conclude (see 1.36 above), a financial factor is material to an investment-related decision, that factor must be taken into account (see further 1.55 below).

1.40 *Requirement of rationality*[50] - following the *Braganza* case referred to in 1.35 above, this part of the overall "rationality" test derived from the *Wednesbury* case can usefully be described as the "outcome" limb. It focusses on whether, even though the proper information requirement has been met, the decision reached is so outrageous that no reasonable decision-maker could have reached it. It is far less easy to show a breach of this limb of the rationality test,[51] than it is of the "process" limb.[52]

1.41 *Requirement of impartiality* - A decision-maker must treat those whom the power is intended to benefit even-handedly; "It is of the essence of the duty of every trustee to hold an even hand between the parties interested under the trust. Every trustee is in duty bound to look to the interests of all, and not of any particular member."[53] So:

(a) those in the same position should be treated equally; and

(b) those in different positions should be treated fairly.[54]

1.42 An Asset Owner regulated by the FCA and an Investment Manager are each required by FCA rules to "pay due regard to the interests of its customers and treat them fairly".[55]

Duty of care

1.43 *Basis of duty* - as the 2014 Report notes, "the law… has long recognised that trustees owe a duty of care to their beneficiaries. A trustee who breaches this duty is personally liable to their beneficiaries for the loss caused."[56]

1.44 Investment Managers and other Asset Owners are likely also to be subject to a duty of care as an express or implied term of contracts relevant to investment-related decisions or as a matter of tort.[57]

1.45 A firm regulated by the FCA is also subject to requirements to "conduct its business with due skill, care and diligence"[58] and "take reasonable care to ensure the suitability of its…discretionary decisions for any customer who is entitled to rely upon its judgment".[59]

1.46 *Content of duty* - in *Re Whiteley*, as regards trustees' duties it was held that, when investing, "the duty…is not to take such care only as a prudent man would take if he had only himself to consider; the duty rather is to take such care as an ordinary prudent man would take if he were minded to make an investment for the benefit of other people for whom he felt morally bound to provide".[60] It was also noted that the decision-maker must (where relevant) have regard "not only to the interests of those who are entitled to the income, but to the interests of those who will take in the future".[61]

1.47 The 2014 Report explains (emphasis added) "the primary purpose of the investment power given to pension trustees is to secure the best realistic return over the long-term, *given the need to control for risks*. We would emphasise that this is a question of broad judgment rather than mathematical formulae … we think it would be helpful to make it clear that trustees should take account of risks to their investments … It is a matter for trustees and their financial advisers to consider what these risks might be and how they should be evaluated".[62]

1.48 *Risk mitigation* - the way in which investors evaluate, and manage, risk has evolved over time. Part 2D of the Report outlines how prevailing portfolio theory has tended to focus attention on managing risk and return at investment portfolio level, structuring the portfolio as a whole to realise the most efficient "risk-adjusted return". It is this aspect of risk management which has received attention by the courts, notably in *Nestle v National Westminster Bank plc*[63] from which it appears that, at minimum, those subject to duties of care are now required to manage investment risk through diversification[64] and by considering the suitability of investments.[65]

UNITED KINGDOM

1.49 However, as also noted in Part 2D of the Report, although reliance on the theories and models described there is widespread, they suffer from some well-known limitations. Perhaps the most relevant in the current context is that diversification does not address systemic risk[66] unless the relevant risk has been fully reflected in market prices.[67]

1.50 Many sustainability factors pose a risk to the long-term health of social and environmental systems on which businesses and financial markets depend and thus to whole markets and the investment return on all portfolios that are exposed to them. They therefore need to be taken into account by Asset Owners in their investment-related decisions where they are financially material to the Asset Owner's investment goals or the investment objective of one of its portfolios. As the Chief Executive of TPR said in 2019[68] of one sustainability risk "climate change is no longer simply a social responsibility issue. It is a core financial risk impacting broadly across business, the economy and markets. Climate change is a risk to long-term sustainability pension trustees need to consider when setting and implementing investment strategy." And the CFRF 2020 Guide[69] says "many chronic risks will not fully materialize for many years. This could lead to a temptation to avoid making potentially revenue-reducing decisions now with an undefined rationalization that the [Asset Owner] could always exit the [investment] later."

1.51 The potential systemic impact of these risks means that they require a different risk management approach. As the PRA has said "the financial risks from climate change have a number of distinctive elements which present unique challenges and require a strategic approach to financial risk management… while firms are enhancing their approaches to managing the financial risks from climate change, few firms are taking a strategic approach that considers how actions today affect future financial risks."[70] These are risks the potential future impact of which is understood in broad terms, but the timing and manifestation of that impact is uncertain. An examination and assessment of historic data is unlikely to be an appropriate risk management tool; the use of future scenarios, metrics and targets is more likely to be appropriate.

1.52 *Relevant judge-made law and legal commentary* - we are not aware of any cases which have examined the duty of skill and care of Asset Owners or Investment Managers against the evolving background of the appropriate approach to management of sustainability risks. Nor are we aware of any which have considered the standards to be observed in relation to the exercise of powers of stewardship in this context.[71]

1.53 However, the 2014 Report, though focused on the position of pension fund trustees, does provide some assistance as to how a court might go about considering this question. Its paragraph 6.53 recognises that "damage to the wider economy might be considered a financial factor, as it will impact on the scheme's portfolio as a whole". In other words, it recognises the possibility that a sustainability factor can be financially material to an investment-related decision. It goes on to say "However, for the decision to be justified on financial grounds, the anticipated benefits to the portfolio should outweigh the likely costs to the portfolio. In other words, the financial benefit must not be "too remote and insubstantial" [*Cowan v Scargill* [1985] Ch 270 at 292] and must accrue to the fund itself, not to the social good in a more general way".

1.54 This, we would suggest, points to the distinction described in Part A.1.2.3 of the Report between instrumental IFSI and ultimate ends IFSI. In other words, an investment-related decision may, indeed should, take into account a sustainability factor which is financially material to that decision, but cannot *necessarily* take into account one that is not.[72] The passage says nothing about the potential balancing act an Asset Owner or Investment Manager must perform in deciding whether it is appropriate to incur costs or forego benefits now in the expectation of benefits in the future (through greater return or risk reduction). These considerations are of crucial relevance not only to the duty of care, but also to the conflicts of interest and fairness requirements already referred to (and, in extreme cases, the duty of rationality).

1.55 As regards the requirement that the financial benefit must not be too remote and insubstantial, the facts of *Cowan v Scargill* itself are helpful in casting light on what this may mean, at least for pension fund trustees, in the context of a sustainability factor. In the case, five trustees of the Mineworkers' Pension Scheme who were appointed by the National Union of Mineworkers, refused to approve the scheme's investment plan unless it excluded investments in overseas companies or in oil and gas, on the basis that such investments were against union policy, damaging to the coal industry and

UNITED KINGDOM

therefore against beneficiaries' interests. The court held that:

(a) the relevant trustees were in breach of their duty to put first the interests of their beneficiaries (which normally meant their best financial interests);

(b) there may be circumstances in which financially disadvantageous arrangements may be in the beneficiaries' best interests, but the burden of proving this would rest very heavily on the trustee proposing to make such arrangements;

(c) in this case, the proposed exclusion of certain types of investments was not in the beneficiaries' best interests. Retired miners, and the widows and children of deceased miners, did not have the same interests as the union and the coal industry as a whole. The connection between the coal mining industry and the beneficiaries was "too remote and insubstantial", so the trustees should not have based their investment decisions on whether it would benefit the industry.

1.56 Looked at from a different perspective, the trustees sought to take into account a consideration which was not financially material to their investment-related decisions. There needs to be a genuine connection between the Asset Owner's investment goal and the sustainability factor it is taking into account. Again, we would suggest that, where appropriately deployed, instrumental IFSI is capable of being consistent with the judgment in *Cowan v Scargill*.

1.57 *Market practice* - because the duty of care involves (essentially) the application of an external, objective standard to the outcome of a person's decision-making process (often described as a requirement to take reasonable care), the behaviour of others whose circumstances are similar is generally relevant in determining required standards of skill and care. It should nevertheless be relied upon discerningly; courts are likely to recognise that there are different schools of professional thought, and that market practice should not be followed where it is not appropriate in the relevant circumstances, for example, where it would be disproportionate to do so.[73] The conduct of the investment decision-maker is to be judged by the standards and context applying at the time the decision was made, and not with hindsight. As Hoffmann J noted in *Nestle v National Westminster Bank* "one must be careful not to endow the prudent trustee with prophetic vision or expect him to have ignored the received wisdom of his time".[74] Equally, standards do evolve, and decision makers need to take care to keep up-to-date with investment thinking; as the CFRF 2020 Guide notes "this is the beginning of a long journey and best practice will continue to evolve rapidly".[75]

1.58 *Publicly available information* - a court will also want to look at what information about the sustainability risks facing an Asset Owner's investment portfolio is available to them and their Investment Managers. Portfolio companies are required, or are being strongly encouraged, to publish increasingly granular narrative information about the risks their businesses now, or will in the future, face (see 1.60 to 1.62 below). Investors are also asking for even more pertinent information, for example, the Institutional Investors Group on Climate Change (**IIGC**), which represents European investors with over $9 trillion in assets under management or advice, has recently written to 36 of Europe's largest companies[76] asking them "to [ensure] material climate risks associated with the transition onto a 2050 net zero pathway are fully incorporated into [their] financial statements".[77] Investing with Purpose is clear about the need for increased and internationally consistent reporting standards for sustainability and Investment Managers' support for the early adoption of TCFD by portfolio companies and the use of other reporting standards, such as those set by SASB, in the interim.[78]

Consumer protection - products marketed to retail investors

1.59 Mutual funds and insurers sell investment products to retail investors. The marketing materials used to do this do not become irrelevant following sale because they shape investors' reasonable expectations.[79] Accordingly, if there is to be a material change in investment approach, it would be necessary to consider whether a communication with relevant Beneficiaries is appropriate, if indeed such a change is permitted under FCA rules and by any applicable contractual terms.

Narrative disclosure by portfolio companies[80]

1.60 As noted at 1.58 above, UK companies are required to disclose an increasing amount of information on the impact of sustainability factors on their business.[81] A company's annual strategic report must include information on the risks, development and performance of the company[82] and describe how the directors have had regard to the matters set out in section 172(1) when performing their duty under section 172[83]. Guidance on the contents of the strategic report makes clear that this should include relevant

UNITED KINGDOM

environmental and social matters.[84] Broadly, larger companies are also required to include specific sustainability-related disclosures in annual reporting, including:

(a) narrative information addressing (i) environmental matters (including the impact of the company's business on the environment), (ii) the company's employees, (iii) social matters, (iv) respect for human rights, (v) anti-corruption and anti-bribery matters;[85]

(b) to the extent practical to obtain, specific climate-change related information, including annual greenhouse gas emissions;[86] and

(c) a statement of the steps the company has taken to ensure that their business and supply chains are slavery free, or that they have taken no such steps.[87]

1.61 For accounting periods beginning from 1 January 2021, premium listed companies must make disclosures consistent with the TCFD recommendations, on a comply-or-explain basis[88] and the FCA has published proposals in CP21/18 to introduce equivalent requirements for most issuers of standard listed equity shares for accounting periods beginning from 1 January 2022. In March 2021 the BEIS issued a consultation on requiring mandatory climate-related financial disclosures by publicly quoted companies, large private companies and Limited Liability Partnerships. This proposes that [mandatory, lower level] TCFD-aligned disclosure requirements should apply in respect of accounting periods starting from 6 April 2022 to:

(a) all UK companies that are currently required to produce the statements referred to in 1.60(a) above;

(b) UK registered companies with securities admitted to AIM with more than 500 employees;

(c) UK registered companies not within (a) or (b) which have more than 500 employees and a turnover of more than £500m.

More broadly, the UK government has announced proposals to introduce mandatory TCFD-aligned reporting "across the economy" by 2025.[89]

1.62 As regards reporting standards on other sustainability issues, the UK Government, the Bank of England, the FCA, the FRC and TPR have jointly announced their support for the proposals relating to sustainability reporting, on which the International Financial Reporting Standards Foundation is currently consulting. These proposals include the establishment of a new Sustainability Standards Board, to sit alongside the International Accounting Standards Board within the Foundation's structure and create global sustainability standards.[90] The UK has also committed to "match the ambition" of the Taxonomy Regulation as regards sustainability-related disclosures.[91]

UNITED KINGDOM

Expressions used in Sections 2 to 4

N.B: The use of the term "Beneficiaries" is for convenience and should not be taken to imply that the persons identified are necessarily owed fiduciary duties by an Asset Owner or Investment Decision-Maker.

	Pension Fund	Mutual Fund	Insurer
Asset Owner	Pension scheme trustees[92] in relation to funded occupational pension schemes and each LGPS authority in relation to LGPS	OIEC or the trustees of the AUT	Insurance company
Beneficiaries	Active, pensioner and deferred members and anyone else who is entitled to, or who might receive, a benefit from the scheme in the future.[93] Arguably this includes the funding employer of the pension scheme, as the scheme is fulfilling an objective of the employer by providing benefits to its current and former employees, and in the case of a DB scheme the employer is directly exposed to the investment performance of the scheme due to its obligation to fund the scheme over time.[94] Arguably, a broadly similar analysis applies in relation to the LGPS[95]	Current unitholders	Each party to a policy contract with the insurer (i.e. the "customer" for the purposes of the FCA's rules) and any other person entitled to enforce the contract (for example, under the Contracts (Rights of Third Parties) Act 1999) As regards shareholder funds, as noted at Part B.2.1.1, we are treating shareholders of an insurer as "Beneficiaries" due to their economic interest in the management of the insurer's assets.
Investment Decision-Maker	Pension scheme trustees, in relation to private sector schemes, and each LGPS authority, in relation to LGPS	AFM – in the case of an OIEC, this is its authorised corporate director	Insurance company

UNITED KINGDOM

2. ASSET OWNERS' USE OF POWERS OF INVESTMENT AND DIVESTMENT

2.1 This section considers the extent to which and in what circumstances, each type of Asset Owner is required, or permitted, to use its dispositive powers to IFSI. The freedom of each of the Asset Owners discussed below to invest is constrained by some laws designed to enhance environmental or social sustainability.[96] For example, anti-money laundering legislation (which aligns with SDG 16.4) is designed to prevent terrorist and criminal activities since they are inconsistent with social wellbeing[97] and sanctions regimes could be characterised in a similar way. In the UK, to date, initiatives intended to influence behaviour on specific sustainability-related issues have generally been confined to disclosure requirements (for example on modern slavery, as mentioned in 1.60(c) above), although stronger approaches could emerge in the future.[98] Unlike some other countries, UK law does not prohibit the indirect funding of cluster munitions.[99]

2.2 **Pension Funds**

Types of pension fund covered

Private sector schemes

2.2.1 Funded occupational pension schemes in the private sector are typically set up under trust and comprise either **DC** and/or **DB**. Many schemes provide a mix of DB and DC benefits to members and some schemes also provide hybrid benefits that contain elements of both DB and DC.[100] Most commonly, a trust-based occupational pension scheme will be set up for the employees of a particular company or group of companies, though there are also some large industry-wide schemes for multiple employers (such as in the railways, electricity, water and maritime sectors). Some insurers and other financial providers also operate master trusts, which are single multi-section occupational pension schemes made available to employers on commercial terms. Some major public sector employers (such as the universities) also use funded trust-based schemes that are subject to the same legal regime as the private sector.

2.2.2 Many private sector employers also use contract-based pensions (the most common being personal pensions) operated by insurers. These are covered in 2.4 below.

2.2.3 For both DB and DC occupational schemes, the investment strategy of the scheme is determined by the trustee and must be set out in a statement of investment principles (**SIP**),[101] which must be reviewed by the scheme trustee at least every three years. However, the employer must be consulted before the strategy is adopted or changed, and the employer can be closely involved in shaping the strategy.

2.2.4 In addition, section 123 and Schedule 10 to the Pension Schemes Act 2021 (which have not yet come into force) will amend the Pensions Act 2004 to insert a requirement on defined benefit scheme trustees prepare a "funding and investment strategy" (**FIS**), which is a strategy for ensuring that the benefits under the scheme can be provided over the long term. Broadly speaking, the FIS must specify both the funding level that the trustee intends the scheme to have achieved at a specified target date and the investments that the trustee intends to hold on the relevant date. For many schemes, the FIS will need to be agreed by the trustee and the employer (in schemes where the trustee has a unilateral power to determine the contributions payable by the employer, consulting the employer will be sufficient, as with the SIP). Regulations (not yet made) will provide more details as to the content of the FIS and the frequency with which it should be reviewed. As the content of the FIS will play an important role in shaping the investment strategy of the scheme, the interaction (and demarcation of roles) between the SIP and the FIS is not yet generally understood and those regulations may clarify this.

2.2.5 In a DB scheme, a member receives a pre-agreed level of income on retirement, often expressed as a percentage of their final or average salary. Under the Pensions Act 2004, such schemes must undergo an actuarial valuation at least every three years, in which the value of the scheme benefit liabilities or technical provisions are determined by reference to actuarial assumptions that are either (depending on the scheme rules) agreed between the scheme trustee and employer or chosen by the scheme trustee, following consultation with the employer. The actuarial assumptions will often take account of the expected returns on the scheme assets. Any shortfall between the assets and the technical provisions must be met by the employer in a recovery plan setting out the amount of funding to be paid in over time. Hence a solvent funding employer bears the financial risk of the scheme's investments failing to generate the necessary level of return.

2.2.6 In a DC scheme, a member's benefit at

> ANNEXES

> United Kingdom

UNITED KINGDOM

retirement depends on the contributions paid into the scheme by member and employer, and the investment performance associated with those contributions, and therefore the member bears the investment risk. The resulting amount can be used in several ways including payment to the member as a lump sum, the purchase of an annuity for the member and setting up a drawdown arrangements under which the member can receive a non-guaranteed income stream and later convert it to a single lump sum payment. Hence, a DC scheme investment strategy aims to generate a capital sum which provides the largest possible benefit for the member, though typically as a member approaches retirement age, this aim needs to be balanced against that of protecting the value already built up (with "lifestyling" investment strategies being designed to reduce investment risk, and hence returns, over time accordingly).

2.2.7 Usually the trustee of a DC scheme will offer the member a range of different investment options (or chosen funds) with specific investment strategies or asset classes, and the member has the choice as to how to allocate their funds as between these options, which members can exercise depending on their individual risk appetites. Many schemes will offer "ethical" chosen funds and it is common for environmental issues to be a key factor in their design. DC schemes' trustees must provide a "default fund" in which members' funds are invested in the absence of any choice by the member. It is estimated that currently around 95% of members are in a default fund.[102]

2.2.8 DB schemes were traditionally more common. However, it is estimated that 59% of the members of private sector workplace pension schemes are now members of DC schemes.[103] Following the introduction of an automatic enrolment regime by the Pensions Act 2008, most employees are automatically enrolled into a workplace pension, unless they opt out. Private sector auto-enrolment schemes can be DB but are usually DC.

Funded public sector schemes[104]

2.2.9 Most public sector pension schemes are unfunded DB schemes (though it is normal to offer DC arrangements for the investment of additional voluntary contributions alongside the main scheme). An important exception is the LGPS, which is the largest funded statutory public sector pension scheme in England and Wales.[105] It is a DB scheme for the employees of local authorities with a common set of rules governing benefits. Benefits are guaranteed by statute. There is no single pool of investments; these are administered at a local level in a number of separate funds, under the responsibility of the relevant local authority (or in some cases a stand-alone pensions authority acting on behalf of a number of local authorities) and subject to various investment-related duties under the LGPS legislation and the general requirements that apply to decision-makers under administrative law.

Overview

Private sector schemes

2.2.10 Investment decision-making by occupational pension scheme trustees takes place within a legal framework, the key elements of which are:

(a) the terms of the trust deed governing the scheme;

(b) statute and secondary legislation,[106] in particular the Pensions Act 1995,[107] the Pensions Act 2004[108] and regulations made under the former Act, most relevantly the Private Scheme Investment Regulations.[109] These specify, in particular, that.[110]

(i) the trustees must establish and operate an effective system of governance, including internal controls, which is proportionate to the size, nature, scale and complexity of the activities of the occupational pension scheme[111]. Regulations imposing additional requirements on scheme trustees with a view to securing effective governance of the scheme with respect to the effects of climate change are to be made under sections 41A to 41 C Pensions Act 1995;[112]

(ii) trustees must usually obtain proper advice before exercising their investment powers;

(iii) investment powers must be exercised in a manner calculated to ensure the security, quality, liquidity and profitability of the portfolio as a whole, to keep the portfolio properly diversified and are subject to certain rules regarding the portfolio composition and, as regards assets covering a DB scheme's technical provisions, must be invested in a manner appropriate to the nature and duration of the expected future retirement benefits payable under the scheme;

(iv) scheme assets must be "invested in the best interests of members and beneficiaries" and, in the case of a

UNITED KINGDOM

potential conflict of interest, in their sole interests;[113]

(v) trustees must exercise investment powers "so far as reasonably practicable" with a view to giving effect to the principles contained in the fund's SIP (which the trustee must ensure is written and maintained). This must cover, among other things, the trustees' policies[114] in relation to:

(A) financially material considerations over the appropriate time horizon of the investments,[115] including how those considerations are taken into account in the selection, retention and realisation of investments;

(B) the extent (if at all) to which non-financial matters are considered in the selection, retention and realisation of investments;

(C) risks, including the ways in which risks are measured and managed; and

(D) their arrangements with any investment manager[116] including, among other things, how those arrangements incentivise the investment manager to make decisions based on assessments about medium to long-term financial and non-financial performance of an issuer;[117] and

(c) judge-made law, as described at 1.16 to 1.59 above. Trustees may not exclude liability for any breach of the duty of care "in the performance of any investment functions".[118]

2.2.11 Under the Occupational Pension Schemes (Disclosure of Information) Regulations 2013 (SI 2013/3274) trustees must publish the fund's SIP online and they must also publish, by 1 October 2020 (1 October 2021 for trustees of DB schemes), a statement in their annual report on how the policies in the SIP have been followed.

2.2.12 TPR encourages pension scheme trustees to sign up to the Stewardship Code "with a view to improving long-term returns and reducing the risk of poor outcomes due to poor strategic decisions".[119] Investing with Purpose recommends that a government-sponsored dedicated council of UK pension schemes should be established to promote and facilitate high standards of stewardship of pension assets.[120] This is expected to lead to a significant increase in pension fund signatories to the code.

2.2.13 Under the Occupational Pension Schemes (Climate Change Governance and Reporting) Regulations 2021[121] it is expected that trustees of schemes with £5 billion or more in net assets on their first scheme year end date to fall on or after 1 March 2020 will become subject to the climate governance requirements from the later of 1 October 2021 and the date on which they obtain audited accounts in respect of the relevant scheme year. For trustees of schemes with £1 billion or more in net assets these dates are set one year later. For authorised master trusts, the commencement date for the new requirements is 1 October 2021. Schemes will be required to publish a TCFD report (including covering the new governance requirements) online by the date falling 7 months after the end date of scheme year current on 1 October 2021 or 2022 (as the case may be). The DWP will carry out an interim review of the requirements in 2023 to identify best practice and with a view to extending the measures to smaller schemes. The DWP will consult again in 2024 before deciding whether to extend the measures to schemes with less than £1 billion in net assets from late 2024 or early 2025 and is encouraging smaller schemes to begin to report on a voluntary basis in the interim period.[122]

LGPS

2.2.14 LGPS authorities are not trustees but are subject to broadly similar obligations[123]. Under regulation 7 of the LGPS Investment Regulations they must formulate an ISS which relevantly must cover, as relevant:

(a) "the authority's assessment of the suitability of particular investments and types of investments";

(b) "the authority's approach to risk, including the ways in which risks are to be assessed and managed";

(c) "how social, environmental and corporate governance considerations are taken into account in the selection, non-selection, retention and realisation of investments"; and

(d) "the authority's policy on the exercise of the rights (including voting rights) attaching to investments".

An LGPS authority is also required[124] to prepare a Funding Strategy Statement which addresses the issue of managing the need to fund benefits over the long term. It must be revised whenever there is a material change in policy on the matters set out in the ISS.

2.2.15 Governmental guidance provides that LGPS authorities should become signatories to the Stewardship Code and Investing with Purpose asks that

UNITED KINGDOM

this expectation is fulfilled by the end of 2022.[125] The Ministry of Housing, Communities and Local Government also intends to consult in 2021 on implementation by LGPS of mandatory TCFD-aligned disclosures by 2023.[126]

Legal requirement to use investment powers to IFSI

Financial materiality and investment horizons

2.2.16 As noted at 1.39 above and as reflected in the requirements for a private pension scheme SIP, trustees must take into account a financial factor if they conclude, or ought to conclude, it is material. The judgement of whether something is material is inextricably linked to the investment time horizon of the scheme.[127]

2.2.17 For the purposes of a pension scheme's SIP, "financially material considerations" are defined as including (but not limited to) "environmental, social and governance considerations (including but not limited to climate change), which the trustees of the pension scheme consider financially material".[128] For the purpose of the SIP, "appropriate time horizon" is defined as "the length of time that the trustees of a scheme consider is needed for the funding of future benefits by the investments of the scheme".[129]

2.2.18 TPR provides guidance to help trustees of DC schemes identify and assess whether financial factors are material. For example, it says:[130]

(a) "a relatively minor negative financial factor for the default fund or default arrangement may have an impact on a very high proportion of the scheme membership and may be of a material concern to you. On the other hand, a material negative financial factor for an additional [chosen] fund, in which only a handful of members are invested, will still be a significant issue to members impacted by it, and therefore will also be a material concern to you; and

(b) determining what will constitute a financially material consideration will often involve professional judgement."

2.2.19 The PCRIG Guide 2020 provides extensive guidance on how to make this assessment in respect of climate-related risk.[131] The August 2020 consultation which preceded the DWP Climate Risk 2021 consultation includes a letter from the relevant minister to the 50 largest pension schemes which says "…I have sought to put beyond doubt …the duties for pension scheme trustees to take account of financially material considerations arising from environmental, social and governance (ESG) considerations, including climate change – just as they would any other financial risk…I believe that the circumstances in which neither climate risks, nor ESG risks more broadly, are financially material are likely to be extremely limited – and therefore that it is part and parcel of trustees' fiduciary duties to take account of these risks when setting out investment strategy."

2.2.20 As regards an LGPS authority, its ISS is not required to distinguish between financially material and other considerations. However, it is clear from accompanying government guidance[132] that its position is similar to that of a private sector scheme trustee. In particular this guidance says:

the overall aim of the fund must be to consider suitability [of investments] against the need to meet pension obligations as they fall due. Assessing the suitability of different investment classes involves a number of factors including, for example, performance benchmarks, appetite for risk, policy on non-financial factors and perhaps most importantly, funding strategy…The appetite of individual administering authorities for taking risk when making investment decisions can only be a matter for local consideration and determination, subject to the aim and purpose of a pension fund to maximise the returns from investment returns within reasonable risk parameters…The law is generally clear that schemes should consider any factors that are financially material to the performance of their investments, including social, environmental and corporate governance factors, and over the long term, dependent on the time horizon over which their liabilities arise."

We have not found any specific guidance on what is material.

Trust-based occupational pension schemes

2.2.21 The purpose of a pension trust is to provide pension benefits to Beneficiaries over a long period of time.[133] Beneficiaries range from members with pensions already in payment to those who do not expect to receive a benefit for decades. As a March 2020 open letter sent by USS Investment Management Ltd[134] (***March 2020 Open Letter***) says "As asset owners, our ultimate responsibility is to provide for the post-retirement financial security

ANNEXES

United Kingdom

UNITED KINGDOM

of millions of families across multiple generations. Since our commitment to providing financial stability spans decades, we do not have the luxury of limiting our efforts to maximizing investment returns merely over the next few years".

2.2.22 As noted at 1.47 above, and as this passage makes clear, it is not simply a question of simply maximising short-term returns; this would potentially favour Beneficiaries close to retirement. The context and circumstances of each particular scheme are critical to the investment decisions of the trustees; "the starting point is the duty of the trustee to exercise their powers in the best interests of the present and future beneficiaries of the trust, holding the scales impartially between different classes of beneficiary".[135]

2.2.23 While the legal duties of trustees are, in substance, identical (whether the scheme is DB, DC or combined), their application does differ, particularly given the ability of members to select chosen funds (and choose particular strategies) on the basis of investment option guides and other explanatory materials. The trustee's duties in designing the default fund for DC schemes have broad similarities to the selection of investment strategies for DB schemes, but the time horizon of the default fund investment strategy would typically be shorter and the trustee would not need to take account of the employer interest as it has no ongoing financial exposure.

2.2.24 To support investment decision-making generally, TPR[136] has emphasised the need for:

(a) an appropriate governance framework; and

(b) an appropriate approach to risk management, an area in which appropriate training and advice may well be essential in any event.[137]

2.2.25 The discussion in the following paragraphs focusses on climate change. However, much of what is said potentially applies to any other sustainability factor. Other such factors may be less discussed, and there may be relatively sparse information about them, but, as paragraph 55 of the statutory "Guidance for trustees of occupational schemes on governance and reporting of climate change risk" makes clear, the process of review is a continuing one; "trustees must, on an ongoing basis, assess the impact of the climate-related risks and opportunities they have identified on the scheme's investment strategy, and the funding strategy, where the scheme has one." Trustees should also remain alert to new and emerging risks which are relevant to their scheme.[138]

2.2.26 The trustees must identify considerations relevant to investment decision-making (see 1.35 to 1.40 above) against this background and in the context of their scheme's own circumstances, including its profile and maturity.

Financial factors

2.2.27 As noted in 1.39 above, a trustee's investment decisions should always take into account any matters which it has concluded, or ought to have concluded, are financially material to those decisions.[139] This is not restricted to historic and immediate risk factors: "If we were to focus purely on short-term returns, we would be ignoring potentially catastrophic systemic risks to our portfolios…As asset owners with the longest of long-term investment horizons, more inclusive, sustainable, dynamic, strong and trusted economies are critical for us to fulfil the responsibility we have to multiple generations of beneficiaries… Skeptics that continue to question the growing role of sustainability within the global investment community should realize that they are quickly becoming the minority" (March 2020 Open Letter).

2.2.28 The fact that a sustainability risk such as climate change, is a systemic, and macro-economic risk which diversification is not designed to address does not mean that trustees can ignore it[140] or assume that it is a consideration that they can leave to any Investment Manager they have appointed.[141] Nor can they assume that it is "priced in".[142]

2.2.29 The PCRIG Guide 2020 notes that "all pension schemes are exposed to climate-related risks, whether investment strategies and mandates are active or passive, pooled or segregated, growth or matching, or have long or short time horizons. Many schemes are also supported by employers or sponsors whose financial positions and prospects are dependent on current and future developments in relation to climate change…. The impact on pension schemes as investors may not be immediately obvious or uniform. For example, whilst the utility sector is one of the most strongly exposed to climate policy risk, it may contribute a relatively small proportion of a typical pension scheme's investment portfolio. On the other hand, manufacturing may have a lower sectoral risk but may constitute a larger part of a pension scheme's portfolio and may therefore have a greater overall effect.

UNITED KINGDOM

Trustees need to consider the impacts across their portfolios as a whole."[143]

2.2.30 This is not the same as saying that climate change is a financially material consideration in relation to investment decision-making for every pension scheme; the trustees of each scheme must make that decision, taking into account the circumstances of their own scheme,[144] and in compliance with the duties described in 2.2.10 above. Equally, if trustees do conclude that climate change is a financially material consideration to be taken into account, that decision does not dictate which, if any, of the tools they have available (power of investment and disinvestment, power of stewardship or public policy engagement) they may decide to deploy and how - again that decision will be highly fact dependent. For example, for trustees who have chosen a passive investment strategy, the power of investment and disinvestment may not be available at all or only to a very limited degree.[145]

2.2.31 The ministerial foreword to the DWP Climate Risk 2021 Consultation is helpful in explaining that although there may be climate change-related investment opportunities "risk is the focus – but when pension scheme trustees seize opportunities to decarbonise and therefore reduce climate risk in their portfolios we unleash the productive power of our pension funds. They can be at the forefront of seizing sustainable opportunities – in the financial interests of their members – by financing the green tech and green energy revolution we will need for the transition".

2.2.32 The PCRIG Guide 2020 provides a roadmap of how trustees could approach the decision whether to integrate climate change considerations into their investment beliefs,[146] in setting their scheme's investment strategy and in investment manager selection[147] review and monitoring. It also identifies a range of decisions (for example, a change of investment strategy, a change in strategic asset allocation, a change in the timing of the move from growth to matching assets or a change within asset mandates or portfolio construction) to which climate change considerations could be material.

2.2.33 In this context, the recent settlement in the Australian case of *Rest v McVeigh*[148], is instructive. McVeigh, a young beneficiary who will not be able to access his pension savings until 2055, alleged that Rest (a superannuation fund) was (most relevantly) in breach of its duty of care by failing properly to take into account the risks of climate change. In announcing the settlement, the trustee of Rest acknowledged that climate change was a material, financial risk to the superannuation fund across many risk categories, that required active risk identification and management.

2.2.34 The settlement does not imply that a similar challenge to a UK pension scheme would necessarily succeed, merely that it could.[149] In the face of such a challenge, trustees who have taken a careful and reasoned decision, taking into account relevant considerations and ignoring irrelevant ones, supported by appropriate advice, that climate change risk is not material in the particular circumstances of their scheme or that it is material but the appropriate response is not to change the current investment or stewardship strategy, should currently stand a good chance of defending their position successfully. However, the 2014 Report contains a useful "rule of thumb" reminder: "the law requires that trustees go through the right procedure to reach their decision, keeping the purpose of the trust at the front of their minds. In practice, the more unusual the decision, the more trustees will need to show that they have reached the decision in the right way." The more unusual this kind of decision becomes, the harder it will be to defend. Trustees should also ensure that they keep up-to-date with evolving standards (see 1.57 above).

2.2.35 Once trustees have decided that a sustainability factor is financially material, their next decision is what (if anything) it is appropriate to do to manage the relevant risk. Depending on their particular circumstances, they may decide that IFSI is the appropriate approach. This could include divesting from some significantly affected companies as part of a wider strategy directed at influencing the activities of portfolio companies.

2.2.36 On the whole, it seems unlikely that a trustee would choose the power of investment and disinvestment as its primary IFSI tool, considered in isolation. If the chosen sustainability factor is relevant to more than a very small proportion of a pension scheme's portfolio, a decision to divest completely might, in practice, limit the diversification of the portfolio to an extent which gives rise to unacceptable risk of another kind or might adversely impact the return on the portfolio. Further, divestment removes the scope to influence the activities of relevant portfolio companies through stewardship activities[150]. The

UNITED KINGDOM

power of investment and divestment might, nonetheless, be deployed to support stewardship activities directed at influencing portfolio company behaviour with a view to achieving positive sustainability outcomes, through selective over or under-weighting of particular portfolio companies (or the possibility of it) to reinforce the message.[151] In the course of pursuing a wider IFSI strategy, and viewed in the context of investment market activity more broadly, it seems reasonable to suppose that there could be times when investment or divestment might become the primary focus.

2.2.37 Although risk is likely to be the key focus in relation to sustainability factors, trustees should also remain alive to investment opportunities too, where these are consistent with the scheme's investment goal. For example, we are aware of investment strategies that involve investment in companies with poor governance, combined with stewardship designed to improve governance and enhance value. It is possible to envisage sustainability-based strategies that might work in a similar way.[152]

Non-financial harm to beneficiaries

2.2.38 As noted at 1.35 above, trustees must have regard to all considerations relevant to a given decision. In its 2017 report on pension funds and social investment,[153] the Law Commission expressed the view that trustees cannot simply refuse to take account of "non-financial" factors that may affect scheme members in all circumstances, however serious the potential non-financial harm to their members, because to do so would amount to an impermissible fetter on their discretion (see 1.32 above).[154]

2.2.39 It went on to give the hypothetical example of a DC scheme catering largely for construction workers which had invested in a construction project with a particularly poor safety recording and expressed the view that the scheme could not simply refuse to consider the risk of injury caused to its members by its investment.

2.2.40 We agree with the Law Commission's conclusion that such situations are likely to be rare and, as such, of very limited practical relevance to IFSI, especially because the trustees would still need to apply the two step Non-financial Factors Test described at 2.3.44 below.

LGPS

2.2.41 In our view, the position of an LGPS authority is similar to that of private sector scheme trustee.[155]

Legal freedom to use investment powers to IFSI

2.2.42 We have explained above that, where a trustee concludes that a sustainability factor is financially material to the provision of pension benefits, it must take that factor into account. This section deals with non-financial factors. A sustainability factor will fall within this category where it is not considered by the trustees to be a material financial factor.

Private sector schemes

2.2.43 TPR guidance notes that non-financial matters in the Private Scheme Investment Regulations are not necessarily non-financial factors in the sense used in the 2014 Report; "here, 'non-financial factors' means the views of members and beneficiaries[156], including in relation to ethical matters and their views on social and environmental impact and present and future quality of life of the members and beneficiaries[157]. While these are given as examples of non-financial factors, [trustees] may instead consider these financial factors due to the way [they] view their impact on investment returns."[158]

2.2.44 The Law Commission concluded in the 2014 Report that the law is flexible enough to accommodate a trustee taking account of non-financial concerns in its investment decision-making process where:

(a) trustees have good reason to think that beneficiaries would share the concern; and the decision does not involve a risk of significant financial detriment to the fund;

(b) (the **Non-Financial Factors Test**).[159]

2.2.45 So how should trustees proceed when faced with evidence of the views of members and beneficiaries that they wish their investments to address an identified sustainability factor? As TPR notes, trustees should first consider whether the identified sustainability factor is a "financially material consideration". If it is not, the trustees could still be permitted to take it into account if the circumstances meet the Non-Financial Factors Test.

2.2.46 The Non-Financial Factors Test has been referred to with approval by the Supreme Court (albeit in a case relating to the LGPS)[160] and forms the basis of regulatory guidance from TPR for pension scheme trustees.[161] We therefore consider it likely that the Non-Financial Factors Test would at least be considered, and potentially applied, by a court in the event of challenge to a trustee's use of a sustainability factor it did not consider to be financially material in its investment

UNITED KINGDOM

decision-making process.

2.2.47 There is nevertheless some legal uncertainty about the basis of the Non-Financial Factors Test[162] and applying it in practice may not be straightforward. For example, trustees need to establish whether they have a sufficient consensus among beneficiaries.[163] They will also need to determine whether their decision involves a risk of "significant financial detriment,"[164] taking into account, for example, any lost opportunity cost due to lower returns relative to other investments.

2.2.48 It seems likely that it will not be common for trustees to be comfortable taking into account a sustainability factor which they consider to be a "non-financial factor" in their investment decision-making process.

LGPS

2.2.49 The position is likely to be the same as for private sector trustees. The principles in the 2014 Report have been generally taken to apply to LGPS authorities and wording based on the Non-Financial Factors Test has been adopted in governmental guidance for LGPS authorities.[165]

2.3 Mutual Funds

Types of mutual fund covered

2.3.1 This Annex covers UK UCITS, which are the most common form of regulated retail mutual fund.[166] At present, the UK regime for mutual funds is broadly the EU's UCITS regime brought onshore. It therefore has the potential, in the future, to diverge from the UCITS regime. In what follows, matters which are particular to the UK are described using "UK UCITS", whilst generally applicable features of the regime are simply labelled "UCITS".

2.3.2 There are two principal UK UCITS fund structures:

(a) investment companies with variable capital, commonly known as open-ended investment companies (**OEICs**);[167] and

(b) authorised unit trusts , which are constituted as trusts.[168]

Some OEICs are listed and traded on exchange as 'exchange traded funds' (or ETFs)[169] and so will also be subject to listing and exchange rules, which we do not consider in this Annex.[170]

2.3.3 Investors acquire interests in the UK UCITS, known as "units", and are generally referred to as unitholders. UCITS must be "open-ended" so that there is no fixed number of units and units are generally bought and sold on investor demand.[171]

Overview

2.3.4 The OIEC, trustees of the authorised unit trust and the AFM are all regulated by the FCA. It is an important feature of the UCITS regime that the AFM is responsible for day-to-day management of the fund and the making of investment decisions.[172]

2.3.5 Investment decision-making by an AFM takes place within a legal framework the key elements of which are:

(a) the fund's constitutional documents;

(b) the terms of the fund's prospectus and other marketing materials, such as the "key investor information document".[173] These must set out (or in the case of the KIID summarise):[174]

(i) the fund's objectives and investment policy - a passive fund must also give a prominent explanation of its nature[175];

(ii) for certain funds,[176] the investment period over which the fund aims to achieve a positive return;

(c) statute and delegated legislation, most significantly:

(i) the FSMA;

(ii) for an OIEC, the Open-Ended Investment Companies Regulations 2001 (SI 2001/1228));

(iii) the FCA requirements described in 1.21, 1.30, 1.43 and 1.46 above[177] and the further requirement that a firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems (PRIN 2.1.1R(3));

(iv) the FCA rules specific to mutual funds including:

- restrictions on the types of assets in which the fund may invest, including a limit on investment in illiquid assets, and a requirement imposed on the AFM to ensure a prudent spread of risk;[178]
- a requirement imposed on the AFM to invest in accordance with the fund's investment objectives and investment policy;[179] and
- a requirement imposed on the AFM to act honestly, fairly (including as between different groups of unitholders), professionally, independently and solely in the interests of the fund and its unitholders in carrying out its functions[180];
- a requirement imposed on the AFM to comply with all regulatory requirements applicable to the conduct of

UNITED KINGDOM

its business activities so as to promote the best interests of unitholders and the integrity of the market.[181]

(d) duties of care (see 1.43 to 1.58 above); and

(e) fiduciary duties and duties connected to the exercise of a power (see section 1 above).[182]

The AFM is responsible for drawing up the prospectus and KIID and ensuring that they comply with relevant regulatory rules (including ensuring that the prospectus does not contain any untrue or misleading statement) and is liable to pay compensation to any person who has acquired any units in the fund and suffered loss as result of a breach of these requirements.[183]

2.3.6 The UCITS structure and FCA rule book provisions makes for a complex series of duties, broadly as follows:

(a) the trustee of the authorised unit trust or the OIEC owes duties under the constitution, relevant judge-made law and regulatory rules to unitholders[184];

(b) the AFM owes duties under the regulatory rules to:

(i) the OIEC[185] or trustee as its client in respect of all of its activities, including its investment decisions. It seems likely that a court would also conclude it owes the OIEC or trustee fiduciary duties, duties connected to the exercise of a power and a duty of care (see section 1);

(ii) unitholders, who are its clients at least in respect of the activity of issuing and redeeming units. Separately, they may have claims against it in respect of any material inaccuracies in the marketing documents which have led to losses. It is also possible that a unitholder may have a direct claim against it under section 138D(2) FSMA.[186]

2.3.7 An AFM is subject to disclosure requirements under COBS 2.2B.9R, where the investors in a scheme include a pension fund or a life insurer. The AFM must disclose annually (either to relevant unitholders or generally) how its investment strategy and the implementation of it comply with its arrangements with the fund or insurer and contribute to the medium- to long-term performance of the scheme, including reporting on:

(a) the key material medium- to long-term risks associated with the investments;

(b) portfolio composition;

(c) turnover and turnover costs;

(d) whether and, if so, how, the firm makes investment decisions based on evaluation of medium- to long-term performance of a portfolio company, including non-financial performance.

2.3.8 The FCA has now published (in CP21/17) its proposals for publicly available, annual entity and product level TCFD disclosures for AFMs and OEICs without a separate manager.[187] Its underlying intent is clearly stated in paragraph 1.22; “improved transparency enables clients and consumers to hold their financial services providers to account. This should encourage them to manage climate-related risks and opportunities effectively and direct capital towards projects and activities that better support the transition to a more sustainable, low-carbon economy”. It aims to bring in rules for the larger firms (broadly those with £50 billion or more assets under management) by 2022 with first disclosure by 30 June 2023 and for those with £5 billion or more of assets a year later in each case. It is proposed that, at entity level:

(a) governance, strategy and risk management disclosures may be broad, but where there are material differences for specific investment strategies, asset classes or products, these will need to be explained;

(b) as regards scenario analysis, the disclosure should cover approach, application of analysis in investment and risk decision-making process and, where reasonably practicable, give illustrative quantitative examples;

(c) as regards metrics and targets, a description of the target, including the key performance indicators it uses to measure progress or an explanation as to why it has not set a target; and

(d) where investment management is delegated, a TCFD-related explanation .

As well as being published on the website, product level disclosures will need to be included in the fund’s the annual long report or half-annual report (whichever follows most closely after 30 June), provided that the disclosures are always included in the annual report. FCA is proposing that, as regards the product level disclosures, a baseline set of core, mandatory, carbon emissions and carbon intensity metrics would be included with a historical time series, after the first year. Further less established, mostly forward-looking metrics would be provided on a “best efforts” basis. Product level targets should be included where relevant and there are detailed proposals for scenario

UNITED KINGDOM

analysis. There are also proposals designed to support the flow of information along the investment chain, so that clients can carry out their own scenario analysis based on consolidated holdings across their investment products and mandates, under which a client could annually request data on the underlying holdings of products in order to satisfy their own climate-related financial reporting obligations. Where permissible, this should include the relevant climate, emissions or carbon-related data.

Legal requirement to use investment powers to IFSI

Financial materiality and investment horizons

2.3.9 FCA rules include governance and risk management requirements which are relevant to these questions. For example, COLL 6.6A.4R provides that the AFM must:

(a) ensure a high level of diligence in the selection and ongoing monitoring of scheme assets, in the best interests of the scheme and the integrity of the market;

(b) establish effective due diligence policies and procedures for ensuring that investment decisions on behalf of the scheme are carried out in compliance with the scheme's objectives and the investment strategy and its risk limit system[188];

(c) when implementing its risk management policy, and where it is appropriate after taking into account the nature of a proposed investment, formulate forecasts and analyse the investment's impact on the portfolio composition, liquidity and risk and reward profile of the scheme before carrying out the investment and use reliable and up-to-date quantitative and qualitative information in this analysis.[189]

2.3.10 As to the AFM's risk management arrangements, Article 38(1) of the UCITS Implementing Directive requires an AFM's risk limit system to deal with the scheme's exposure to market, liquidity and counterparty risks, and all other risks (including operational risks), which may be material to that scheme.[190] "Market risk", in this context, includes systemic risk impacting across a fund's portfolio, as well as idiosyncratic risk relating to the value of individual assets.[191]

2.3.11 As regards when such a risk may be material CESR's risk management principles for UCITS (CESR/09-178) state in paragraph 27 that "material risks should be understood as those risks that can be expected, with reasonable level of confidence, to directly affect the interest of unit-holders." There is no more specific guidance than this; probably because the answer to this question is so context specific. However, the UCITS' investment purpose (see 2.2.12 below), is the starting point for determining which risks are relevant, and may be material. The CFRF 2020 Guide provides useful context, and indicates that sustainability factors can be material to a mutual fund for reasons other than their obvious relevance to value (eg through their impact on liquidity). As regards longer-term investments which may lose value due to climate risk, it notes that "an important consequence of falling asset prices, or 'fear of falling asset prices' can be illiquidity in the markets or the triggering of other erratic market behaviour. With regards to funds, this can lead to gating events and cash liquidity problems".[192]

2.3.12 UCITS regulation does not specify a time horizon for determining financial materiality. A mutual fund is different from a pension fund in that it does not have an in-built, potentially decades long, time horizon in the same way as a pension scheme does. However, this does not mean it should take a short-term view. Unless (unusually) the fund has a specified or otherwise limited life,[193] we think it is reasonable for the AFM to assume that the fund will continue in existence. It also seems reasonable to assume that its unitholders plan to hold units for, at minimum, the investment period (if any) it has stated in its marketing materials as the period over which the fund aims to achieve a positive return and to recognise that, since a fund will be open for subscription and redemption on an on-going basis, this period is effectively a rolling one from the perspective of the fund.[194] Further, unitholders can be expected to want value growth over the period for which they hold. For the purposes of the risk limit system, the AFM will need to determine an appropriate time horizon against the background of the investment purpose of the relevant UCITS and in doing so, it will need to ensure that it is acting in the best interests of the scheme (see 1.30 above), acting in the best interests of unitholders and acting fairly as between different groups of unitholders (see 2.3.5(c)(iv)(D) and (C) above).[195]

Other considerations

2.3.13 The object (or purpose) of a mutual fund provides the starting point within which decisions about the exercise of its investment powers are to be made. This must be set out in its constitutional document which is required to specify types of investments and assets in which

UNITED KINGDOM

it may invest and that it "is to invest in property of that kind with the aim of spreading investment risk and giving unitholders the benefits of the results of the management of that property".[196] This broad purpose is generally refined by the investment objectives (which are invariably, but not exclusively, financial) and investment policy set out in the fund's prospectus and KIID (see 2.3.5(b)(i) above. The FCA has provided further guidance on the degree of specificity required "the FCA considers that it would generally be necessary for an adequate description of the objectives and investment policy to include relevant elements of the investment strategy. This description should explain those features of the investment strategy that are fundamental to how the product is managed… If it is not the manager's strategy to invest in a particular area where the investment policy permits investment, this should be made clear… If the manager's strategy is to focus on investments with particular characteristics, for example companies who are growing their business rapidly, this should be explained. If the manager's strategy is to be flexible about which opportunities they consider best, depending for example on their view of the market cycle, this should be made clear."[197]

2.3.14 So between them, the constitutional document, prospectus and KIID establish the purpose by reference to which the AFM's investment decisions are to be made, taking into account various other requirements described above and the output of the governance and risk management requirements referred to in 2.3.9 above.

2.3.15 In our view, an AFM should always consider what factors are financially material to the fund, including sustainability factors where relevant, and then take into account any it has determined, or ought to have determined, are financially material.

2.3.16 If an AFM concludes that a particular sustainability factor is financially material, it must then address the further question of what (if any) action to take. In principle, this could include the question of whether it should pursue sustainability impact goals. The matters which are likely to have the greatest influence on this decision would seem to be:

(a) the published investment objectives and policy - so, for example, it is likely to be difficult, if not impossible, for an AFM of a passive fund to take a decision to invest outside the components of its index or to divest one of those components. Given that the FCA has said that it is necessary to be clear in marketing material where it is not the AFM's strategy to invest in a particular area where the investment policy permits investment, even for other funds, the introduction of some kind of sustainability exclusion may, depending on the number, importance and potential financial impact of the companies likely to be excluded, be difficult, without (at minimum) appropriate notice to unitholders (see further 5.3.3 below);[198] and

(b) the timing of the impact of any costs associated with that decision (including opportunity costs) and of any anticipated benefits from it. In this context, unitholders' desire for growth over the period for which they are invested in the fund is likely to be relevant as are the balancing considerations referred to in 2.3.12 above.

2.3.17 Overall, where an AFM concludes that it needs to pursue a sustainability impact objective (as compared with, for example, moving investment away from assets with high sustainability exposures) in order to respond to a financially material sustainability factor, we think it is most likely that an AFM will decide that stewardship is the most appropriate tool to use, not least because of the potentially quite prescriptive framework set by a fund's investment objective and policy. However, in the course of pursuing a wider IFSI strategy, and viewed in the context of investment market activity more broadly, it seems reasonable to suppose that there could be times when use of investment powers could become a distinct focus. The power of investment and divestment could also be coupled with stewardship activities directed at influencing portfolio company behaviour with a view to achieving positive sustainability outcomes, through selective over or under-weighting of particular portfolio companies (or the possibility of it) to reinforce the message (where this possibility is available in relation to the fund in question).

2.3.18 Regulatory intervention in relation to an AFM which has not considered whether climate change risk or any other sustainability risks are financially material to its Mutual Fund, seems a more likely outcome in the short term than successful action by a unitholder. If challenged by unitholders, an AFM which has taken a careful and reasoned decision (taking into account relevant considerations and ignoring irrelevant ones) that a particular

UNITED KINGDOM

sustainability factor is not material in the particular circumstances of the relevant Mutual Fund or that it is material, but that the appropriate approach is not to change anything or take any action should currently stand a good chance of defending their position successfully. However, the AFM should be alert to changes in market practice and should keep its decisions under review.

2.3.19 Although risk is likely to be the key focus in relation to sustainability factors, the AFM should also remain alive to related investment opportunities, where these are consistent with the scheme's purpose (see 2.2.37 above).

Legal freedom to use investment powers to IFSI

2.3.20 We have explained above that, where an AFM concludes, or ought to have concluded, that a sustainability factor is financially material to a scheme's investment objective, it must take that factor into account. This section deals with non-financial factors. A sustainability factor will fall into this category where it is not considered by the AFM to be a material financial factor in relation to the relevant Mutual Fund. Regulation and regulatory guidance indicate that for a UCITS to be permitted to take into account a sustainability factor for non-financial reasons, it would need to be consistent with its disclosed investment objectives and policies to do so. FCA guidance states that "sometimes funds set out non-financial objectives, for example environmental or social objectives, or state that they are aiming to achieve a non-financial return. We expect, if a fund has such objectives, that it will set them out in its prospectus and its KIID".[199] As a result, in the absence of a disclosure in respect of that Mutual Fund which permits the relevant sustainability factor to be taken into account as a non-financial factor, the AFM will not have legal discretion to pursue it in its investment decisions in respect of the Mutual Fund.

2.4 **Insurance undertakings**

2.4.1 This Annex covers insurance undertakings which are subject to Solvency II. It does not cover any additional or different considerations for (a) smaller insurers which are not so subject;[200] (b) life insurance policies written in trust;[201] (c) self-invested personal pensions (in which the individual member selects the investments); (d) insurers operating in the Lloyd's insurance market; and (e) insurers structured as mutuals,[202] although the conclusions we reach may nevertheless be relevant to these types of insurer and policy.

2.4.2 A significant percentage of the investable assets of life and general insurers are invested in public or private sector fixed income investments (approx. 65% and 72% respectively) and a much smaller percentage in equities (approx. 4% and 6% respectively).[203] The aggregate value of the investable assets of UK life insurers is significantly greater than that of general insurers.[204]

Types of insurance undertaking covered

General insurers

2.4.3 The insurer underwrites property, accident and sickness, travel, liability, and other non-life insurance policies. The insurer's liability is to pay out when a valid claim is made by the relevant policyholder. Any profits of investment activity are retained by the insurer.

Life insurers

2.4.4 The insurer undertakes, as a matter of contract, to pay out a lump sum or regular income on death or another defined event. The amount payable may depend wholly or partly on profits from investment activity. The main relevant policy types are:

(a) *"With-profits" policies* - these entitle the relevant policyholder to at least a guaranteed amount on maturity, with the total amount received based on the investment performance of the relevant portfolio (through the addition by the insurer of annual and a final discretionary bonuses). Although the investment risk is with the insurer in relation to the guaranteed amount (as supplemented by each annual bonus when declared) the bulk of the investment risk is with the policyholder due to the usually significant size of the final bonus. With-profits funds are considered to be of declining importance to insurers' businesses and many with-profit funds are now closed;[205]

(b) *Unit-linked policies* - these are the main alternative form of life policy[206] and are now much more common.[207] Policyholders select the notional "units" they wish to "purchase" with their premiums from a range of funds made available by the insurance company. Returns payable to the relevant policyholder reflect the performance of the fund held and managed by the insurer in connection with those "units". Thus the investment risk is with the policyholder; and

(c) *Group personal pension schemes*[208] these are defined contribution workplace personal pension schemes chosen by an employer to offer to employees, structured as a series of individual contracts between

UNITED KINGDOM

each employee and the insurer. The insurer will typically offer a range of unit-linked[209] funds in which a member may choose to invest. However, under auto-enrolment the provider cannot compel a choice.[210] All schemes must offer a default fund, to be used in the absence of member choice. As with DC pension schemes, the investment risk is with the policyholder.

Overview

2.4.5 Insurers are regulated by the PRA (as regards prudential matters) and the FCA (as regards conduct of business matters).[211] They are not, as regards policyholders, subject to fiduciary duties and nor are the powers they exercise fiduciary powers, so the judge-made law described in section 1 under "duties connected to the exercise of a power" is not relevant, save:

(a) to the extent reflected in FCA and PRA rules; and

(b) it would be prudent to assume that decisions relating to the investment of policyholder funds[212] may well be subject to a rationality test comprising a "process" limb (as described in 1.35 above) and an "outcome" limb (as described in 1.40 above). This follows from *Equitas Insurance Limited v Muncipal Insurance Limited*[213] in which it was held "in identifying the scope of any term which it is necessary to imply for the contract to work in the way that the parties must have intended or reasonably expected it to work, the courts recognise that, where the contract permits a party to make a choice or requires it to make an evaluative judgment, it is for that party and not the court to make the relevant choice or evaluation. Consequently, the term implied often imports a standard of review similar to that applied in judicial review of administrative action whereby the decision-maker is required only to act honestly and reasonably in the *Wednesbury* sense: see…*Braganza v BP Shipping Ltd* [2015] UKSC 17…paragraphs 19-30. What is honest and reasonable is judged by reference to the purpose(s) which the contract requires or permits the party exercising the relevant power to pursue."

2.4.6 Investment decision-making by an insurer takes places within a legal framework the key elements of which are:

(a) primary and delegated legislation, including:

(i) FCA and PRA requirements described in 1.21, 1.30, 1.43, and 1.46 above[214] and the further requirement that a firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems (PRIN 2.1.1R(3)). The PRA Fundamental Rules split these requirements into two (rules 5 and 6), with rule 5 giving extra emphasis to risk - "a firm must have effective risk strategies and risk management systems";

(ii) requirements to maintain adequate capital resources[215] and sufficient liquid assets[216] and comply with governance requirements;[217]

(iii) requirements to invest in accordance with the "prudent person principle" which broadly requires an insurer to make investments "the risks of which it can properly identify, measure, monitor, manage, control and report and appropriately take into account in the assessment of its overall solvency needs"[218] and that all the assets of the insurer are "invested in such a manner as to ensure the security, quality, liquidity and profitability of the portfolio of assets of the firm as a whole";[219]

(iv) the requirement that, in a conflict of interests, the insurer "must, or must procure that any third party which manages its assets will, ensure that the investment of assets is made in the best interest of policyholders";[220]

(v) portfolio diversification requirements,[221] investable asset class restrictions and obligations to ensure that assets held to cover its technical provisions[222] are invested in a manner appropriate to the nature and duration of its liabilities and in the "best interests of all policyholders", taking into account any disclosed policy objectives;[223]

(vi) FCA rules specific to specific types of policy. For example:

- for with-profits policies, specific COBS 20 requirements including to "take reasonable care to ensure that all aspects of its operating practice are fair to the interests of its with-profits policyholders";[224]
- for unit-linked policies, specific COBS 21 requirements, some of which only apply where the policyholder is a natural person;[225] and
- for group personal pensions, requirements for the insurer to establish an IGC or (for smaller, less complex schemes) a GAA to act solely in the interests of relevant policyholders[226]and the purpose

UNITED KINGDOM

of each of which includes independent consideration of the insurer's policies (if any) in relation to, "ESG financial considerations", "non-financial matters", "stewardship" and "other financial considerations to the extent that they pose a particular and significant risk of financial harm to the relevant policyholders"[227];

(vii) the provisions of the Companies Act 2006 and, in particular, the duties of its directors:[228]

(A) under section 172, to act in the way the director considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole[229];

(B) to act within their powers and only exercise them for the purposes of which they are conferred[230];

- to exercise independent judgement[231]; and
- to act with reasonable care, skill and diligence[232].
- When discharging the duty described above, a director must "have regard (amongst other matters)" to the likely consequences of any decision in the long term, the interests of the company's employees, the need to foster the company's business relationships with suppliers, customers and others, the impact of the company's operations on the community and the environment, the desirability of the company maintaining a reputation for high standards of business conduct and the need to act fairly as between members of the company;

(viii) judge-made law as to directors' duties - courts are reluctant to interfere with directors' decisions made in good faith unless they are in breach of one of the other duties described in (vii) above. Where there is no evidence of actual consideration of the best interests of the company an objective test will be applied; whether an intelligent and honest man in the position of a director of the company concerned could in the circumstances have reasonably believed that the transaction was for the benefit of the company[233];

(b) duties of care owed to some policyholders, for example those holding long term products where the amount payable depends wholly or partly on profits from investment activity (see 1.43 to 1.58 above); and

(c) in relation to certain types of life insurance policy, life insurers which distribute their own insurance products will be required to assess the suitability of that product for the relevant potential policyholder in certain circumstances;[234]; and

(d) where relevant, the terms of policyholder documentation and related marketing materials[235]. For general insurers, policyholder documentation is rarely, if ever, relevant to the exercise of the insurer's investment powers.

2.4.7 An insurer is subject to the following public (or Beneficiary) disclosure requirements (those in (c) to (e) apply to life insurers only):

(a) the narrative disclosure requirements described in 1.60 to 1.62 above, where applicable;

(b) Pillar 3 disclosures[236];

(c) to state how the main elements of its equity investment strategy are consistent with the profile and duration of its liabilities, in particular long-term liabilities, and how they contribute to the medium to long-term performance of its assets[237];

(d) regarding arrangements with its investment managers (which, for this purpose, is defined to include an AFM) and their duration and, in particular, how:

(i) the arrangement incentivises the investment manager to:

- align its investment strategy and decisions with the profile and duration of the liabilities of the insurer, in particular long-term liabilities; and
- make investment decisions based on assessments of medium- to long-term financial and non-financial performance of the portfolio company, and to engage with portfolio companies in order to improve their performance in the medium- to long-term;

(ii) the method and time horizon of the evaluation of the investment manager's performance and the remuneration for asset management services are in line with the profile and duration of the liabilities of the firm, in particular its long-term liabilities, taking into account its

UNITED KINGDOM

absolute long-term performance[238]; and

(e) under COBS21, to notify unit-linked policyholders of the risk profile and investment strategy for the linked fund at inception, before making any material changes and (in relation to conditional permitted links) at other appropriate times, taking into account a policyholder's needs[239].

2.4.8 A life insurer which distributes life policies to retail clients is likely to have to disclose publicly the nature of its commitment to the Stewardship Code or its alternative approach.[240] Although Investing with Purpose does not make any direct recommendation designed to increase the number of insurers, especially general insurers, who are signatories to the code, the report's emphasis on the need for the development and improvement of stewardship in the fixed income markets may well have this effec.[241]

2.4.9 The FCA has now published (in CP21/17) its proposals for publicly available, annual entity and product level TCFD disclosures for life insurers in relation to insurance-based investment products and DC pension products. Further details of proposed thresholds and reporting are given at 2.3.8 above, save that:

(a) the initial threshold for life insurers is proposed as £25 billion assets under management or more;

(b) the insurer's TCFD entity report must, at a minimum, explain how climate-related considerations have influenced its decisions, such as asset manager selection, judgements on the range of funds offered and how these judgements reflect the firm's overarching climate change strategy; and

(c) product level reports would apply at the level of an individual fund or pre-set investment portfolio within a particular investment or pension product;

(d) as well as being published on the website, product level disclosures would have to be included in the annual report to with-profits policyholders or the annual pension benefit statement or pension drawdown statement (as appropriate), whichever follows most closely after the 30 June annual reporting deadline.

Legal requirements to use investment powers to IFSI

Financial materiality and investment horizons

2.4.10 For some time, climate change has been high on the PRA's agenda as a potentially material financial risk for insurers (in the case of a general insurer, on both sides of its balance sheet). The PRA has given insurers plenty of guidance on what it expects its climate change-related risk management arrangements to look like - similar to those for other risks, but taking account of the unique features of climate change-related risk - and some guidance on relevant time horizons. These expectations are potentially relevant to the way an insurer should approach other sustainability risks.

2.4.11 SS3/19 explains the PRA's expectations relating to climate change risk. An insurer should:

(a) embed consideration in its governance arrangements, including taking a sufficiently long-term view of the financial risks of climate change (which can arise beyond standard business planning horizons);

(b) incorporate the financial risks from climate change into existing financial risk management practice. For example, under the 'prudent person principle' (see 2.4.6(iii) above), an insurer should consider whether there is an excessive accumulation of financial risks from climate change in its investment portfolio, and consider mitigants when this is the case;

(c) use scenario analysis to inform strategy setting and risk assessment and identification. Insurers should use scenario analysis and stress testing to inform the risk identification process and understand the short- and long-term financial risks to their business model from climate change. Insurers are also expected to go beyond using only historical data to inform their risk assessment; the PRA Insurance Stress Test 2019 climate change exploratory scenarios required participating insurers to consider climate change-related risks as far into the future as 2100.[242]

2.4.12 The CFRF 2020 Guide[243] suggests that "good practice is to treat climate risk as a cross-cutting risk type that manifests through most of the established principal/standalone risk types. Whether treated as a principal risk or a cross-cutting risk type, linkages of climate risks with established risk types (particularly the more material risks such as … credit… and financial market) should be established and understood…Undertaking a materiality assessment of climate risks will help the insurers to decide which is the best approach [for them]."

2.4.13 The PRA has now said that it expects insurers fully to have embedded a proportionate approach (that reflects their exposure to climate-related financial risk and the complexity of their operations) to

> ANNEXES

> United Kingdom

UNITED KINGDOM

managing climate-related financial risks by the end of 2021.[244]

2.4.14 Neither PRA nor FCA has given guidance on what financially material means. The CFRF 2020 Guide points out "a small firm with large exposure to climate risk due to geographic[245] or sectoral concentration may have to implement a more sophisticated climate risk approach than a much larger firm with less exposure".[246]

2.4.15 The regulator's position on time horizon, is however, much clearer - as regards shareholder funds the time horizon tends towards the expected lifetime of the insurer[247]. For life insurers, the FCA has recently provided time horizon guidance in relation to policyholders' funds[248]. This provides that the insurer should take account of material financial factors (including environmental, social and governance factors that are material to the sustainability of an investment) "over the period of time that the firm reasonably considers is needed to achieve the investment objective or investment strategy".[249]

General insurers

2.4.16 The nature of the relationship between a general insurance policyholder and the insurer is qualitatively different from that between a long-term insurance policyholder and insurer. The first is very much a debtor-creditor relationship, with prudential protection provided by the PRA and some conduct of business protection under FCA's rules. A policyholder is directly interested in the insurer's ability to pay its claim as they fall due, but is otherwise not directly interested in the investment of its assets.[250]

2.4.17 As a result, and subject to compliance with the rules described in 2.4.6 above, the key duties shaping the insurer's investment decisions are those of its directors, in particular their section 172 duties. Section 172 refers to the promotion of "the success of the company for the benefit of its members as a whole". This codifies earlier judge-made law, which referred to the "interests of the company" meaning the interests of shareholders present and future.[251] Prevailing commentary, with which we agree, suggests that section 172 requires directors to seek to balance short-term considerations (affecting the present shareholders only) against long-term considerations that involve future shareholders as well.[252]

2.4.18 So how might IFSI fit into this? Whilst an appropriately balanced financial return to shareholders, present and future,[253] for the level of risk they are taking by investing in the insurer is likely to be a key focus for directors, their primary goal must be pursuing the success of their company (so that benefits to shareholders are derived from this). In doing so, they should have regard to a wide range of considerations, including (but not limited to) those listed in section 172(1).[254] Within the framework set by the PRA, as described in 2.4.11 above, the CFRF 2020 guide gives a great deal of information as to how an insurer's directors could consider climate change (and therefore, in principle, other sustainability factors). It notes that an insurer's "risk appetite should reflect and communicate the level of climate financial risk that an institution is willing to take, tailored to the business model, and may incorporate broader considerations based on Environmental, Social and Governance (ESG), reputational risk or corporate responsibility, (e.g. following a no-harm approach) which may already be in place within the firm….Risk appetite statements tend towards a 3- to 5-year time horizon, i.e. in line with strategic planning, but the financial risks from climate change may not materialise within such a short time frame. A mature appetite should therefore consider the impacts over a longer period, e.g. a 30-year timeframe with interim milestones".[255]

2.4.19 We expect that many general insurers will conclude that they should treat climate change as a financially material risk to the asset side of their balance sheet as well as to the liability side. Directors who have reached this conclusion will then need to decide what, if any, actions to take consistent with their risk appetite. This may mean a change to the insurer's investment goal, strategic asset allocation or investment strategy, which would in turn need to be cascaded down to the detailed investment objectives and investment policies which the insurer sets for its Investment Manager.

2.4.20 Once a general insurer has decided that climate change or any other sustainability factor is a material financial risk to its investment goal or to one of its detailed investment objectives or investment policies or its success more broadly, it will then need to decide what, if any, action to take. That insurer could conclude that instrumental IFSI is the appropriate response in its particular circumstances. A general insurer that reaches this conclusion may have more scope than pension fund trustees to invest or divest (particularly the latter) as part of its IFSI strategy because it can choose a more flexible investment goal and take into account a wider range of considerations.[256]

UNITED KINGDOM

2.4.21 Although risk is likely to be the key focus in relation to sustainability factors, a general insurer will also wish to consider related investment opportunities too (see paragraph 2.2.37 below).

2.4.22 Given the intense current focus of the PRA and FCA on systemic risk, both climate change and related to the pandemic, we would expect both to be very interested in an insurer's systemic risk-related decisions, including those concerning its investments, and an insurer which does not have good answers to their likely questions should expect to be the subject of at least informal regulatory attention. In our view, regulatory intervention is a greater risk in practice than successful shareholder litigation. There are considerable hurdles for a shareholder to overcome in order to take action against a director for breach of duties which the director owes to the relevant company, including the need to obtain permission of the court.[257] Action by the PRA or FCA would not be directed at compensating shareholders.

Life insurers

2.4.23 The analysis in relation to general insurers above is also relevant to the shareholder funds of life insurers. Where the investment decisions of the insurer do not materially affect payments to policyholders (for example, where policyholders will receive a fixed amount as they do under a fixed annuity contract), the analysis for general insurers equally applies.

2.4.24 As regards policyholder funds related to policies where the investment risk is exclusively or largely with the policyholder, an insurer's duties to its policyholders must be overlaid. The purpose of the policies and the promises made in, or in connection with them, become relevant. In the 2014 Report the Law Commission asked, of insurance-based pension policies, "how far is the provider required to consider risks to the long-term sustainability of companies in which they invest? And how far may contract-based default funds apply generally prevailing ethical standards? In contract-based schemes, this is likely to be considered as part of a duty of care, rather than a more general duty to act in a beneficiary's best interests, and there is even less guidance than for trustees. Given that trust-based and contract-based default funds perform the same function, we think that the law should seek to achieve similar outcomes".

2.4.25 The purpose of a life policy is generally to provide an investment return or income in retirement for the policyholder. This could be years, or even decades, in the future.

2.4.26 There are particular considerations in relation to each of the kinds of policy referred to in 2.4.4 above, as follows:

(a) *with-profits policies* - insurers offering with-profits policies may have significant investment decision-making discretion, although insurers would need to ensure they comply with policy terms or disclosures, such as the Principles and Practices of Financial Management[258] and meet policyholders' reasonable expectations. These are based principally on what policyholders are likely to have understood from the information given to them at point of sale and are potentially relevant to determining whether policyholders are being treated fairly.[259] Policy terms and disclosures, which can be reasonably specific on investment approach (and thus set policyholders' expectations) may constrain the methods of securing the appropriate return;

(b) *unit-linked policies* - unit-linked funds are likely to have reasonably prescriptive terms regarding the investment strategy.[260] The Association of British Insurers' Guide to Good Practice for Unit-Linked Funds (2019 edition) says "the scope of the firm's discretion in managing the fund and the limits to that discretion should be documented and disclosed to policyholders and other relevant parties, where appropriate, and reviewed when required. This documentation provides a clear point of reference against which to review any decisions taken, helping to provide clarity and certainty for all parties. Again, these potentially link to fair treatment requirements";

(c) *group personal pension schemes* - as these policies are typically unit-linked, the position is likely to be as described in (b).

2.4.27 Against this somewhat complex background, an insurer should seek to identify all financially material factors and take them into account in its strategic investment decisions. This will include identifying factors that are material to its investment goal and factors that are financially material to each separate investment objective. On the assumption that it concludes that climate change or any other sustainability factor is a financially material factor in relation to one or other or both of these matters, it will then need to decide what, if any, actions to take consistent with its risk appetite. This may mean a change to the insurer's investment goal, strategic asset allocation or investment strategy, which would in turn need to be cascaded down

UNITED KINGDOM

to the detailed investment objective and investment policy which the insurer sets for relevant investment portfolios.

2.4.28 Where the identified financially material factor is a sustainability factor, the insurer could conclude that instrumental IFSI is an appropriate response in its particular circumstances. If it does so, as regards policyholder funds, it is more likely to conclude that stewardship is appropriate (supported by selective investment and disinvestment or the possibility of it where the assets concerned are not passively managed). Having said this, in the course of pursuing a wider IFSI strategy, and viewed in the context of investment market activity more broadly, it seems reasonable to suppose that there could be times when use of investment powers could become a distinct focus, so far as permitted by policy terms. Scottish Widows' recently announced policy[261] is to divest from any company that derives more than 10 per cent of its revenue from thermal coal or tar sands, manufactures controversial weapons or violates the UN Global Compact (UNGC) on human rights, labour, environmental standards and corruption. However, for some UNGC violators, which will be priority engagement targets, this is subject to a three year exception where (broadly) Scottish Widows believes that the scale of its investment means that it has the potential to influence positive change, with divestment being considered at the end of that period if there is no change. This places a good deal of emphasis on disinvestment, while still acknowledging the importance of stewardship in appropriate circumstances.

2.4.29 Even if the insurer is inclined, in principle, to set an instrumental IFSI goal for one or more investment portfolios of policyholder funds, the life insurer would still need to confirm that to pursue this goal is consistent with relevant policy terms and disclosures, in order to be permitted to pursue the relevant IFSI goal or it would need to make appropriate changes (see 5.4.3 below).

2.4.30 Any conflicts of interest arising from differing investment approaches being taken in respect of shareholder funds and policyholder funds or within policyholder funds must also be resolved. This may not be straightforward (see 1.23 above).

2.4.31 Again, risk is likely to be the key focus in relation to sustainability factors, but a life insurer will also wish to consider related investment opportunities (subject to the various constraints already described); see 2.2.37 above.

2.4.32 Again, in our view, regulatory intervention, especially in relation to an insurer which has not considered sustainability risk, is more likely than shareholder action or policyholder action. We have noted at 2.4.22 above, some hurdles to shareholder action. As regards action by a policyholder, provided the insurer has reached a careful and reasoned decision, taking into account all relevant matters and no irrelevant ones that the relevant sustainability risk is not material or that no action is required and has complied with applicable contractual terms and the requirements of PRA and FCA rules and is not acting in a manner inconsistent with any representations it has made, the insurer should currently stand a good chance of defending its position successfully. Insurers should also ensure that they keep up-to-date with evolving standards.

Legal freedom to use investment powers to IFSI

2.4.33 We have explained above that, where an insurer concludes, or ought to conclude, that a sustainability factor represents a material financial risk to shareholder or policyholder funds (or any part of them), it must take that factor into account, even if the insurer also concludes that no action can or should be taken for the time being. This section is, therefore, only concerned with sustainability factors which are not considered to be financially material.

2.4.34 It is clear from the CFRF 2020 Guide that insurers are expected to identify, and monitor non-financial risk. One example is its own reputational risk. This seems to us to provide an important indication of the potential relevance of non-financial factors.

General insurers

2.4.35 We have described at 2.4.16 and 2.4.17 above the key duties shaping the insurer's investment decision-making, in particular those arising under section 172; the primary duty of directors is to pursue the success of the company (which is not defined exclusively in financial terms) and, in doing so, they are permitted to have regard to a wide range of considerations, including those based on corporate responsibility and other matters relevant to the insurer's reputation. It seems clear that, depending on the insurer's precise circumstances, an insurer could define its purpose or develop a strategy in ways that might lead it to engage in IFSI in a manner consistent with its primary financial focus but not necessary to its achievement; in other words to set an ultimate ends IFSI objective. An example might be a general insurer which has decided that, for

> ANNEXES

> United Kingdom

UNITED KINGDOM

financial climate change-related reasons it will not insure certain kinds of business, and also chooses (for reputational, rather than financial, reasons) to exclude the relevant companies from its investment portfolio.

Life insurers

2.4.36 The analysis in relation to general insurers above is also relevant to the shareholder funds of life insurers. As regards policyholder funds, an insurer's duties to its policyholders must be overlaid, as we have explained at 2.4.24 to 2.4.26 above. It appears that Aviva's policy on cluster munitions and anti-personnel mines is based on non-financial factors, as the rationale for it is Aviva's commitment to human rights. This policy applies to its shareholder funds and, wherever possible, to its policyholder funds.[262] However, a decision to exclude a significant business sector, such as extractive industries, for non-financial reasons would be much more difficult to justify and much more likely to be subject to successful challenge.

2.4.37 There is FCA guidance[263] in relation to policy holder funds setting out its expectations on how an insurer may take into account "non-financial matters" to demonstrate compliance with specified FCA requirements. The guidance is based on the Non-financial Factors Test and appears to assume that it is legally permissible for life insurers to take into account "non-financial matters" in their investment decisions relating to policyholders' funds in certain circumstances, even where not expressly permitted under the policy terms.[264] We agree that an insurer ought not to be prevented from taking decisions based on "non-financial factors" simply because this is not expressly contemplated by the policy terms, although contrary indications in the policy terms or collateral documentation could prevent it. The existence of the guidance may also provide some comfort that taking non-financial matters into account is consistent with policyholders' reasonable expectations.[265]

2.4.38 Broadly, the guidance applies to investment decisions affecting the types of policy described in 2.4.4 above where the policyholder is an individual.[266] It provides that an insurer may take into account "non-financial matters"[267] if:

(a) the firm has good reason to consider that the policyholders in question would generally share the views on which the non-financial matters are based; and

(b) taking those matters into account would not involve a risk of a significant financial detriment to any affected investment.[268]

2.4.39 The guidance does not indicate how an insurer should determine what level of financial detriment would be "significant" or how it should ascertain the views of policyholders. As regards the latter, it is understood that the FCA's considers that views of policyholders can be established through the typical methods firms use in target market assessment, which may include surveys or consumer interviews, but that these steps are not necessarily required provided the insurer has good reason to consider policyholders, or the relevant target market, share the views in question. It is also possible, in relation to group personal pension schemes, that information represented by policyholders to IGCs or GAAs could assist.[269]

2.4.40 The FCA has made clear[270] that guidance in its rule book is not binding and need not be followed to achieve compliance with the relevant rule or requirement. Accordingly, insurers may well be able to identify other ways in which to comply with the FCA requirements to which it relates. As regards group personal pension schemes, the FCA may feel more strongly that the guidance should be complied with because it reflects the position for occupational pension schemes.

UNITED KINGDOM

3. ASSET OWNERS' USE OF POWERS OF STEWARDSHIP

3.1 The following section considers the extent to which, and on what basis, each type of Asset Owner is required or permitted to use its position to influence the activities of portfolio companies by engaging in stewardship activities to IFSI.

Overarching considerations

3.1.1 The ability of an Asset Owner to engage with a portfolio company stems from a decision to invest in that company. So its decisions regarding stewardship are also shaped by the considerations set out under "Overview of investment duties and powers" in section 2 for each Asset Owner.

3.1.2 The scope for stewardship is probably most easily understood in the context of listed equities and the legal rights that attach to them. An Asset Owner holding equities, whether listed or private, has the right to vote on shareholder resolutions and also a right to requisition such resolutions. However, stewardship is far from restricted to the use of voting rights (see 3.1.9 below), and the absence of voting rights in relation to fixed income investments does not mean investors are powerless. That said, their opportunities to influence an issuer are different and potentially more limited to particular situations (for example, when a portfolio company wishes to raise new funds or refinance an existing debt issue). There is also less institutional experience. In recognition of the shift, in practice, of Asset Owners' allocations away from equity investments, Investing with Purpose contains discussions on stewardship behaviour in relation to fixed income, private companies and real estate and infrastructure, with recommendations in each of these areas.[271]

Investing with Purpose

3.1.3 This report notes "we have seen deeper scrutiny of stewardship responsibilities in the wake of the 2008 financial crisis and in response to a number of high-profile corporate failures. Regulators and other stakeholders have recognised the important role that stewardship can play in promoting well-functioning markets and in turn increased their expectations of investors living up to their stewardship responsibilities…Following a wave of regulatory interventions focused on enhancing transparency and accountability of stewardship practices, the industry must now step forward to meet the challenge of deepening and strengthening the role of stewardship in the UK."[272]

3.1.4 The report goes on to say "stewardship has been a core feature of the UK's investment landscape for decades, with institutional investors seeking to ensure that companies are well run and well governed and taking account of their key stakeholders…Initially this role focussed on governance issues, but over the years has expanded to consider the full range of material risks to investments, including environmental and social factors… To create long-term value for clients, investment managers oversee and manage the assets they invest in to encourage, develop and support behaviour that will lead to sustainable returns. Collectively, this work of allocating, overseeing and managing capital falls under the umbrella of 'stewardship'…The central purpose of stewardship is to generate sustainable long-term value for the beneficiaries of the investment process, who are the end owners of capital…The integration of stewardship and consideration of a wide range of risks and opportunities, including environmental, social and governance (ESG) factors in the investment process leads to better investment outcomes for clients. The assessment of these factors informs investment decision making and stewardship activities - investors support and challenge companies to better manage material risks or impacts."[273]

3.1.5 The report also makes clear that addressing systemic risk is an important purpose of stewardship "the UK Stewardship Code recognises that best practice in stewardship involves…also promoting the integrity of the market, as the long-term value of investments is tied to the resilience and strength of the wider economy. Effective stewardship therefore…includes responding to systemic risks that undermine sustainable value creation."[274]

Delegation

3.1.6 In practice, many Asset Owners rely on their Investment Managers to carry out stewardship activities on their behalf.[275] Investing with Purpose makes clear that this aspect of their relationship deserves more attention; "asset owners should express demand for stewardship by communicating their investment beliefs and objectives through the signals, incentives and expectations transmitted in selection, contractual relationship and ongoing performance assessment. This demand is critical to ensuring that investment is focused on long-term sustainable value…investment managers do not always have a clear view of their client's stewardship

UNITED KINGDOM

priorities".[276] The report is critical of the fact that stewardship is not a core focus in the selection process of an Investment Manager or in the ongoing oversight and performance assessments and indicates that it is still unusual for Asset Owners to include stewardship expectations in contractual arrangements.[277]

3.1.7 As noted at 6.9 below, it is understood that, generally, Investment Managers take a firm-wide approach to stewardship. The conflicts issues to which a firm-wide approach gives rise are discussed in that paragraph. Asset Owners need to be aware of these issues, but also of others that a single approach on the part of an Investment Manager raises for them. In appointing an Investment Manager, they will be seeking a cost-effective service that is (ideally) completely and (at minimum) sufficiently aligned with their investment beliefs, risk appetite and investment goal. So, as well as communicating what they want and need in the Investment Manager selection processes, they will also need to understand in detail what the Investment Manager is offering and whether this meets their needs.[278] If the Investment Manager is not able to offer what the Asset Owner needs, the Asset Owner will need to consider whether it can cost-effectively supplement the investment management offering with its own stewardship activities or by appointing a specialist stewardship provider or whether it needs to look elsewhere.

3.1.8 As noted, an Asset Owner should satisfy itself that the Investment Manager's stewardship approach is sufficiently aligned with its investment beliefs, risk appetite and investment goal to meet its needs. If the Investment Manager's approach involves more extensive stewardship activities than the Asset Owner would itself choose to carry out (and especially if they potentially involve investments belonging to the Asset Owner), the Asset Owner will generally need to establish with reasonable confidence that the stewardship approach is unlikely to be damaging to the interests of its Beneficiaries.[279]

The Stewardship Code

3.1.9 The framework for stewardship envisaged by the code can be summarised as follows[280]:

(a) Research - not only in due diligence exercises prior to investment but on an ongoing basis to inform investment and engagement decisions;

(b) Ongoing monitoring – to assess the risks and opportunities to long-term value;

(c) Setting expectations – investors communicate their expectations to companies;

(d) Engaging - investors engage with portfolio companies to ensure that their expectations are being met. They raise issues which they think pose a material risk to the company to understand how companies are managing those risks and responding to their concerns or views;

(e) Collaborating and escalating - if a company is not listening, an investor may escalate their engagement, for example by working with other shareholders, requisitioning resolutions at general meetings, writing formally to the full board or making public statements. The Stewardship Code also gives the example of investors working together on a thematic issue;

(f) Exercising rights – investors make use of voting and other rights as shareholders to influence company behaviour. The report recommends more proactive use of the power to requisition shareholder resolutions as an engagement activity and asks the government to consider whether changes are needed in UK company law to facilitate their use[281]; and

(g) Investment choices – Active managers will buy and hold companies and assets that help them to achieve their client's investment goals and sell those that they conclude will not.

3.1.10 Recommendation 13 of Investing with Purpose is directed at improving stewardship by educating portfolio companies on the expectations arising under the Stewardship Code and its more expansive definition of stewardship. It recommends that the FRC, in collaboration with key stakeholders, develops resources for company directors to deepen their understanding of stewardship and the code and communicate the need for constructive engagement between investors and portfolio companies.

3.1.11 The framework described in 3.1.9 above anticipates that an Asset Owner (or, in practice, its Investment Manager) will identify either before investment or during the holding period factors which are material to the value of the relevant investment. These may be idiosyncratic factors or they may be thematic, such as a sustainability factor.

3.1.12 Since stewardship is inherently concerned with changing the behaviour of portfolio companies, in practice stewardship on sustainability factors may often involve activities that fall within the scope of IFSI. A number of provisions of the

UNITED KINGDOM

Stewardship Code are consistent with the use of stewardship as an IFSI tool:

(a) Principle 4 provides that signatories should identify and respond to market-wide and systemic risks to promote a well-functioning financial system and signatories should explain, among other things, how they have aligned their investment accordingly;[282]

(b) Principle 6 requires signatories to take account of client and Beneficiary needs and refers to the length of the investment time horizon considered appropriate to deliver to those needs; and

(c) Principle 9 requires signatories to engage with issuers to maintain or enhance the value of assets. Their reports should cover how engagement has been used to monitor the company and how engagement outcomes have informed investment decisions (including decisions to hold).

Duty of care

3.1.13 The 2014 Report recognises the importance of stewardship[283] and notes that trustees have discretion over how far to engage with companies and to exercise their voting rights. It goes on to say "it is clearly in the interests of pension funds as a whole to do all they can to promote the long-term success of the companies in which they invest. We think that trustees should be encouraged to consider whether and how to engage with companies to promote their long-term success, either directly or through their investment managers"[284].

3.1.14 The 2014 Report concludes that, in certain circumstances trustees' duty of care may include duties which resemble stewardship, citing the case of *Bartlett v Barclays Bank Trust Co Ltd* [1980] Ch 515, but only where a trust's shareholding confers a substantial measure of control over the company. We think that it is worth re-examining this and especially the relevance of shareholding size, particularly given the now widespread opportunities for collective stewardship activity; a group of Asset Owners with similar views may well have substantial potential influence. We note that, in the case, the court said "the bank, as trustee, was bound to act in relation to the shares and to the controlling position which they conferred, in the same manner as a prudent man of business. The prudent man of business will act in such manner as is necessary to safeguard his investment. ….If facts come to his knowledge which tell him that the company's affairs are not being conducted as they should be, or which put him on inquiry, he will take appropriate action". This seems uncontroversial. It appears to be the case that the judge considered the main significance of the *controlling* shareholding to be that (i) it should have enabled the trustee to secure the provision of more detailed and regular information than a minority shareholder would receive, thus putting it in a position to take steps earlier to safeguard its investment, and (ii) it should have enabled the trustee to prevent the company from embarking on a disastrous scheme or to halt it in its tracks. Again, neither seems controversial on the particular facts. In the context of a listed company, an Asset Owner will not generally wish to receive inside information from a portfolio company, but will have more, and more regular, information than is typically the case for a shareholder in a private company, so the second of these points seems the more relevant.

Matters to be considered

3.1.15 An Asset Owner (or its Investment Manager) does not necessarily need to be a controlling shareholder to access information allowing it to identify a risk to a portfolio company's long-term value (and thus to the investment of the Asset Owner). For example, for some sustainability risks generic information is available on their likely economic impacts. In addition, among others, UK-incorporated portfolio companies are required to produce an increasing amount of information about their approach and exposure to sustainability risks (see 1.60 and 1.61 above). An Asset Owner (or Investment Manager) may also be in a position to influence a portfolio company's behaviour with a shareholding much smaller than a controlling one. In addition, there is increasing recognition of the benefits of stewardship, including through collaboration; the opportunities for collaboration are increasing and market practice is changing. What action is appropriate (if any) in any particular situation will depend on a number of factors and, although important, the size of the Asset Owner's shareholding in the relevant portfolio company[285] is only one element of the overall picture.

3.1.16 In considering whether stewardship is an appropriate response in respect of the relevant sustainability factor, an Asset Owner's investment goal and investment strategy will be important. It will also need to consider the effort involved and the cost[286] which should not be disproportionate to the benefit expected (either in terms of enhanced value or

UNITED KINGDOM

risk mitigated).[287] Relevant further considerations include:

(a) the extent of the relevant Asset Owner's "voice" (i.e. how influential it is with the relevant portfolio company or companies) and convening power (i.e. how likely it is that other Asset Owners will follow its lead);

(b) stewardship can take place in the context of an existing portfolio (assuming the Asset Owner has decided it does not also need to change its investment strategy or strategic asset allocation in order to pursue a given goal) and may therefore help in balancing a need to maintain investment return in the short-term with pursuing a longer-term sustainability goal;

(c) a range of stewardship techniques are available (from voting on shareholder resolutions, to deeper engagement and alone or collectively);

(d) the different impact on different classes of Beneficiary and the need to treat each class fairly - this may not be an easy balancing act (see [1.23] above); and

(e) how much to do itself and how much to delegate to the Investment Manager or a specialist stewardship service provider.

3.1.17 Due consideration will also need to be given to both short term and longer-term impacts - for example, the stewardship activity under consideration could involve significant short or medium term costs for the portfolio company to realise benefits expected to accrue over a longer period (which may, in turn, have significant income or valuation implications for the Asset Owner and impact some cohorts of Beneficiaries more than others).

3.1.18 Stewardship seems a particularly appropriate tool in relation to, for example, a systemic transition risk, where one of the risks which the trustees' action is seeking to mitigate is that of rapid and unpredictable disruption to asset values and the risk of "stranded assets" where apparently valuable assets (such as oil reserves) can rapidly lose value due to climate change, regulatory change or other external factors curtailing demand.[288]

Collective action

3.1.19 As noted in 3.1.16 above and also in Investing with Purpose (see 3.1.9 above), collective stewardship alongside other investors is potentially important for a number of reasons, including increasing influence and spreading cost. In FS19/7 "Building a regulatory framework for effective stewardship" the FCA said "several respondents stressed the value of collective engagement to tackle thematic or company-specific issues of common interest across firms, especially where individual engagement is not delivering results. One respondent noted: 'Collective engagement is crucial to overcome obstacles caused by fragmented ownership, which is a particularly acute issue for UK-listed companies…' Stakeholders also said that collective engagement could be an important way of sharing expertise and sharing the cost of otherwise expensive engagements… we agree with stakeholders that collective engagement can be an important vehicle for investors to exercise effective stewardship. This is particularly the case where ownership is highly fragmented and individual investors may not have sufficient influence.[289]

3.1.20 Although these points were made in the context of stewardship generally, they have particular resonance for the challenge of tackling a sustainability risk, with its potential portfolio-wide impacts. We have not identified any express legislative or judge-made duty for Asset Owners to collaborate in this way, or judicial recognition of such a duty. However, there is scope for Asset Owners to work collectively and it may well be a cost-effective and efficient way to seek to achieve desired stewardship outcomes; the possibility of engaging collectively is therefore likely to be a significant consideration in stewardship decision-making.

3.1.21 The FCA and its predecessors have on several occasions clarified[290] that their own rules or other applicable legal restrictions should not be taken to prevent collective shareholder stewardship designed to raise legitimate concerns, but may impose some practical constraints on what is permitted. The main legal restrictions are:

(a) *Competition law* - Co-ordination between investors designed to wield collective 'shareholder' influence over the ESG strategy of a company in which they are invested is likely to fall outside the realm of competition law, assuming no competitively sensitive information is shared between investors. Co-operation between Asset Owners and/or Investment Managers beyond this is possible, but needs to be structured in a way that complies with competition law since there is no specific exemption to competition law for arrangements designed to address sustainability risks. Collaboration between competitors amounting to price fixing, collective boycotts, or the sharing of markets and customers is almost never

UNITED KINGDOM

permitted.[291] A collaborative arrangement involving the exchange of information or the coordination of commercial activities may also infringe competition law if it is anti-competitive in object or effect and is not otherwise exempt. In most competition law regimes, exempt arrangements must be necessary and proportionate in order to provide an improvement to the production or distribution process, or a promotion of technical or economic progress, while allowing consumers a fair share of the resulting benefits, and still allowing for sufficient residual competition in the market.[292] Parties are required to provide quantitative evidence of such improvements and consumer benefits if they wish to rely on such an exemption.

Like other competition authorities, the UK CMA, recognising the importance of sustainability on current and future domestic and global agendas, has produced guidance on sustainability agreements and is continuing work on the topic.[293] Moreover, to date, there are no UK examples of competition action against investors collaborating in pursuit of sustainability goals.[294] However, while there is some guidance and case law, there there are not enough past examples to give certainty around what evidence of sustainability benefits will be enough in practice. Collaborative arrangements entered into with a view to improve sustainability outcomes may not necessarily provide direct improvements and/or consumer benefits that outweigh their anti-competitive harm, or to the extent that they do, the benefits may be difficult to measure and prove in monetary terms. In addition, even encouragement by regulators or government bodies for collaborative action will not necessarily shield from competition law scrutiny,[295] or from private competition actions brought by companies whose businesses are impacted by collaboration between Asset Owners and/or Investment Managers with a view to improved sustainability outcomes.[296] Such actions may be based on breaches of UK competition law, but could equally be international cases based on breaches of EU or other applicable competition laws and brought in the UK. The UK CMA has stated that it wants to "ensure that competition policy does not create an unnecessary obstacle to sustainable development and that businesses are not deterred from taking part in lawful sustainability initiatives in the mistaken belief that they may breach competition law".[297] Additional guidance is nonetheless required from competition authorities (here, the UK CMA) to explain in more detail their attitude to investor collaboration to address sustainability risks and how sustainability outcomes can be quantified and assessed within the existing horizontal collaboration regime.

Nonetheless, there remain a wide range of collective actions that Asset Owners may take, based on existing law and guidance. These include, for example:

(i) collaboration towards non-binding and non-individualised sustainability goals (especially where parties are afforded a high level of discretion as to the means by which they attain such a goal);[298]

(ii) joint initiatives to develop standard investment classification or measurement tools (provided there are fair and equal rights to their use);

(iii) exchanging information and best practice insights on IFSI (provided the information is not competitively sensitive);

(iv) joint initiatives to enable the rise of new markets and services;[299] and

(v) joint advocacy/dialogue with policymakers and stakeholders. Most recently, competition regulators are also increasingly open to discussing sustainability initiatives and are starting to recognise the need for further and more harmonised guidance. There are a number of consultations ongoing that are expected to clarify and, to some degree, soften the past enforcement climate and provide a better framework to better account for wider society benefits.[300]

Though operating within the margins of competition authority guidance may not prevent private competition actions being taken against Asset Owners and/or Investment Managers who act collectively, it does lower the risk of such actions being brought successfully, since a court would assess whether the collaboration was in line with competition law and that jurisdiction's relevant guidance.

(b) *Securities market-related requirements* - legal rules relating to market abuse and inside information[301] and to the disclosure of ownership of shares,[302] which are mainly enforced by the FCA, may also serve to place some limits on the permitted extent of collective stewardship, as may mandatory bid and related requirements under the Takeover Code.[303]

(c) *Industry specific issues* – there are EU law-based FCA and PRA consent requirements in relation to ownership of financial

UNITED KINGDOM

services industry businesses which can be triggered by for example, shareholders "acting in concert" or adopting a "lasting common policy towards the management" of an authorised financial services firm and similar issues may arise under legislation specific to other industries.[304] Again, this may impose constraints on what is permitted.

View of regulator of financial markets

3.1.22 The FCA (which regulates financial markets, as well as individual firms) places considerable emphasis on effective stewardship; "we think it is important to acknowledge the role that effective stewardship can play in promoting better economic, environmental and societal outcomes. However, we recognise these outcomes may be indirect, flowing from pursuing sustainable financial returns for clients and beneficiaries… Related work …increasingly emphasises the role of the institutional investment community … in promoting positive and sustainable economic, environmental and societal outcomes."[305]

3.2 Pension funds

Legal requirement to steward for IFSI

Private sector schemes

3.2.1 Pension funds are under considerable pressure to play a greater role in the stewardship arena. As noted in endnote 10, one of the reasons pension fund trustees delegate management of their scheme's assets to an Investment Manager is to avoid the need for authorisation under the FSMA. Helpfully for trustees which wish to engage in stewardship activities themselves, the FCA has confirmed that for a person to be engaging in the regulated activity of managing investments they must be exercising discretion in relation to the composition of the portfolio under management and not in relation to some other function (such as proxy voting).[306] It has also specifically addressed the position of pension fund trustees elsewhere in PERG and has confirmed that a pension fund trustee may generally carry out stewardship activities without needing to be authorised under the FSMA.[307]

3.2.2 The DWP August 2020 consultation preceding the DWP Climate Risk 2021 Consultation includes a letter from the relevant minister to the 50 largest pension schemes which said "I have sought to put beyond doubt the requirement to have a policy on stewardship of the assets, including both engagement and voting, however the assets are held…I believe it is part of trustees' fiduciary duties to have a stewardship policy, even if that policy is limited to engagement and monitoring of the asset managers who engage with investee firms and vote on trustees' behalf." Feedback included in the DWP Climate Risk 2021 Consultation and related to the August 2020 consultation suggests that respondents felt that not enough emphasis was given to the importance of stewardship as a risk management tool. In this feedback the DWP says "trustees have a duty to manage climate risks which are a financially material risk to the scheme, so engagement with companies…is very important in order to help mitigate risks and drive the low carbon transition."[308] The DWP's statutory "Guidance for trustees of occupational schemes on governance and reporting of climate change risk" emphasises that stewardship has other benefits for trustees; "stewardship, including engagement and voting activities, can promote the long-term success of pension schemes by encouraging investee companies to take a long-term responsible approach to their business strategy. Through engagement with intermediaries including consultants and asset managers, as well as investee companies, trustees will be in a good position to keep their knowledge of climate change risk and opportunities up-to-date and learn about governance approaches, strategies, risk management tools, metrics and targets."[309] In connection with this the DWP has also launched the Taskforce on Pension Scheme Voting Implementation to support trustee-directed voting in pooled investment funds and promote voting based on the preferences of pension scheme trustees.

3.2.3 TPR has provided the following guidance on stewardship to both DB and DC pension schemes:

(a) "It is up to the trustees to exercise stewardship…[it] is particularly relevant for the management of macro-economic, systemic risks such as climate change, which cannot be sufficiently hedged through portfolio construction and asset allocation alone";

(b) "we would encourage you to become familiar with your managers' stewardship policies. Where you consider it appropriate, seek to influence them, and use stewardship as a criterion when shortlisting and selecting managers"; and

(c) "it is important to understand the implications of the systemic risk of climate change on investment decisions in the context of your scheme…As climate change is a systemic, macro-

UNITED KINGDOM

economic risk, you should also consider how engagement could be used to mitigate these risks by engaging with investee companies, policymakers and collaborative industry initiatives".[310]

3.2.4 As discussed in 2.2 above, trustees' investment-related decisions should always take into account matters that they have identified, or ought to have identified, as financially material. If trustees decide that a particular sustainability factor is financially material to the achievement of their investment goal, their next decision is what, if any steps, it would be appropriate to take in order to mitigate any resulting risk. With a sustainability risk using stewardship to IFSI may well be a more appropriate tool than over or under-weighing a particular portfolio company (although, as discussed in paragraph 2.3.5, it may also be appropriate to use stewardship and investment powers in combination). As Investing with Purpose says "While some asset owners and investment managers are divesting from greenhouse gas intensive assets, the modern economy is not yet set up to abandon these products and industries altogether without significant disruption to everyday life and financial stability. Accordingly, investment managers also fulfil their management and oversight responsibilities by actively engaging with the companies they are invested in to support them to manage the physical and transition risks from climate change and make progress to more sustainable business models".[311]

3.2.5 Although a sustainability factor is rarely likely to be material in relation to only one portfolio company, it is, nevertheless, possible to envisage circumstances where a trustee concludes that it should engage with only one portfolio company in order to seek to change its sustainability impact because of its systemic significance. Examples might be, where the company in question is a systemically important institution, a bellwether of a significant industry or the owner or operator of a particular critical piece of infrastructure. Further, investment strategies of the sort mentioned in paragraph 2.2.37 above might lead an investor to engage in stewardship, even if the goal is to enhance the value of the relevant portfolio companies more than address systemic risks.

3.2.6 Given the nature of the risk involved and the significant pressure on trustees to, at a minimum, consider the exercise of their powers of stewardship in the face of a systemic risk which they have identified as material to their scheme, it would seem unwise for trustees to omit to consider whether to do so. Unless stewardship is simply irrelevant to the investment style chosen for the relevant scheme, it would be surprising if a trustee did not conclude that it should, at least, engage with its Investment Manager on stewardship and monitor their stewardship approach as part of its overall monitoring process and also, where possible, build appropriate stewardship expectations into any future appointment. Beyond this, the circumstances of every trustee and its scheme are different, and, as noted at 3.1.16 above, there are various potentially relevant matters to consider on balance. A trustee that has taken a careful and reasoned decision taking into account all relevant factors and no irrelevant ones, supported by appropriate advice, that it is not appropriate to change its existing stewardship practices, should currently stand a good chance of defending its decision successfully. Nevertheless, practices change over time and the Law Commission's "rule of thumb" in 2.2.34 above is a useful one to remember.

3.2.7 Trustees must include in the SIP their policies on the exercise of rights, including voting rights, attaching to investments and on how they intend to engage with their portfolio companies, including when and how the trustees would engage with issuers, asset managers, stakeholders and co-investors on matters including the issuer's strategy, risks, social and environmental impact and corporate governance.[312]

3.2.8 By 1 October 2021, the trustees' annual report will also need to deal with stewardship and voting practices covering:

(a) the extent to which the trustees' policy on the exercise of voting rights and stewardship has been followed; and

(b) describing the voting behaviour by, or on behalf of, trustees (including the most significant votes cast during the year) and state any use of proxy voting services.[313]

3.2.9 It looks as though further changes can be expected in these disclosure provisions for private sector schemes; Investing with Purpose includes recommendations that pension schemes should be required to explain how their stewardship policies and activities are in scheme members' best interests and that TPR should issue related guidance on how trustees might evidence this.[314]

3.2.10 In addition, the TCFD-aligned disclosure proposals referred to at 2.2.12 above will include climate-related stewardship activities.

UNITED KINGDOM

LGPS

3.2.11 In our view, the position is similar for LGPS. For LGPS, the ISS must contain the LGPS authority's policy on the exercise of the rights (including voting rights) attaching to investments and the TCFD-aligned disclosure proposals referred to in 2.2.14 above will include climate-related stewardship activities.[315]

Legal freedom to steward for IFSI

3.2.12 As already noted, where a trustee concludes, or ought to conclude, that a sustainability factor represents a material financial risk to the provision of pension benefits, it must take that factor into account, even if the trustee also concludes that no action can or should be taken for the time being. This section is, therefore, only concerned with sustainability factors which are not considered to be financially material.

Private sector schemes

3.2.13 A trustee should not take action on the basis of such a sustainability factor unless it is satisfied that to do so passes the Non-Financial Factors Test. As noted at 2.2.47 above, there are practical difficulties in the application of this test. These difficulties may be less severe in the context of stewardship activities - given the range of stewardship techniques available, it may, for example, be easier to conclude that the decision does not involve a risk of significant financial detriment to the fund (for example, by way of direct cost or through negative short or medium term impacts on portfolio company distributions or market value as a result of the alteration in portfolio company activities through successful stewardship).

LGPS

3.2.14 In our view, the position for LGPS authorities wishing to use IFSI to steward on the basis of non-financial factors is similar.

3.3 Mutual Funds

Legal requirement to steward for IFSI

3.3.1 The AFM must have in place strategies for determining when and how to exercise voting rights attached to the fund's investments to the exclusive benefit of the scheme concerned,[316] which must adhere to the disclosed investment objectives and policy and must prevent or manage any conflicts of interest arising from the exercise of those voting rights.[317] These strategies must include measures and procedures for monitoring relevant corporate events.

3.3.2 An AFM must make available to unitholders:

(a) a summary description of the strategies referred to in the previous paragraph; and

(b) (on request) details of the actions taken on the basis of them.[318]

3.3.3 In addition, an AFM for a scheme which invests in equities traded on a regulated market must develop and disclose an engagement policy and make an annual public disclosure on how that policy has been implemented, including a general description of voting behaviour (the most significant votes must be mentioned)[319] and the use of the services of proxy advisors.[320]

3.3.4 The policy must describe how the AFM:

(a) integrates stewardship into its investment strategy;

(b) monitors portfolio companies on relevant matters, including:

(i) strategy;

(ii) financial and non-financial performance and risk;

(iii) capital structure; and

(iv) social and environmental impact and corporate governance;

(c) conducts dialogues with portfolio companies;

(d) exercises voting rights and other rights attached to shares;

(e) cooperates with other shareholders;

(f) communicates with relevant stakeholders of portfolio companies; and

(g) manages actual and potential conflicts of interests in relation to its stewardship activities.

3.3.5 An AFM for such a scheme is subject to the following further public (or relevant Beneficiary) disclosure requirements under COBS 2.2B.9R (see also 2.3.7 above) where scheme investors include a pension fund or life insurer:

(a) the use of proxy advisors for the purpose of engagement activities;

(b) the firm's policy on securities lending and how that policy is applied to support engagement activities;

(c) whether and, if so, which conflicts of interests have arisen in connection with engagement activities and how the AFM has dealt with these.

3.3.6 CESR's Technical Advice to the Commission CESR09/963 states "[a] decision to not exercise the voting rights in certain circumstances, or depending on the investment strategy of the relevant UCITS (for example, UCITS following a passive investment policy such as the index funds), could be

UNITED KINGDOM

considered as protecting the exclusive benefit of the unitholders." Whilst this remains technically correct (and there are circumstances in which, for example, abstaining could be designed to achieve a sustainability impact), it does not represent the direction of regulatory travel, especially in relation to sustainability risks. For example:

(a) ESMA's more recent Technical Advice on integrating sustainability risk and factors (ESMA34-45-688) acknowledges that "many…respondents highlighted that sustainability risks are not relevant in the same way for each investment or portfolio. Therefore, these respondents invited ESMA to make it more explicit that the proposed requirements should be applied in a manner that is appropriate to the investment strategy of the relevant portfolio.…some respondents outlined the importance of ESMA clarifying that in …some scenarios [such as index-based strategies where managers do not have any or only limited discretion in their portfolio management activities] investment stewardship becomes an essential tool for fund managers to engage with investee companies on sustainability-related risks." ESMA goes to express the view that the transition towards more sustainable and inclusive investment growth should also rely on the principle of stewardship; and

(b) the joint FCA/FRC discussion paper "Building a framework for effective stewardship" (DP19/1) notes "the inability [of index-tracking funds] to exit investments increases the incentive to undertake stewardship activities and the largest 'universal' holders do invest in stewardship activities. On the other hand, passive investors can compete largely on the basis of lower fees, possibly increasing incentives to free-ride on stewardship benefits provided by others rather than incur stewardship costs themselves."

3.3.7 The FCA/FRC discussion paper goes on to consider that stewardship activities may differ in nature between index-tracker and actively managed funds and draws a distinction between "routine" and "deep" engagement[321] noting that there is value in both types of engagement:

(a) index-tracker funds may be more likely to pursue 'routine' thematic engagement strategies because they conduct less detailed research on individual companies. They may set minimum expectations across all portfolio companies for particular aspects of strategy or governance, such as executive remuneration or board composition;[322]

(b) an actively-managed fund, by contrast, may be more likely to identify idiosyncratic issuer-specific matters. Where they choose to do so, therefore, they may engage with issuers on a deeper and more targeted basis.

3.3.8 The FCA's feedback statement on DP19/1 (FS19/7) records that some respondents agreed with this distinction, but some index managers strongly challenged it and emphasised that they use their scale and influence to set strong expectations for portfolio companies on issues such as climate change. These firms said their thematic campaigns could be a catalyst for market-wide change.

3.3.9 An AFM (whose stewardship decisions are, in practice, generally limited to the stewardship aspects of its choice and monitoring of the fund's Investment Manager and any stewardship provisions in the investment management agreement between them) must decide in relation to each scheme for which it is an AFM and against the background of the purpose of that scheme (see 2.3.13 and 2.3.14 above) which sustainability factors (if any) are financially material to that scheme.

3.3.10 In relation to any sustainability factors the AFM has identified as material to the relevant scheme, it will then need to decide what, if any stewardship activity is consistent with the purpose of the scheme and otherwise appropriate and act accordingly. This assessment will need to take into account the effort and cost of the relevant activity relative to the benefit expected, and balance fairly the interests of short and long term unitholders (see 3.1.16 and 3.3.17 above and 2.3.16 and 2.3.17 above). In particular, an AFM is subject to specific requirements as regards costs; it must prevent undue costs being charged to a scheme.[323] ESMA guidance indicates that costs should be "consistent with the investment objective of the fund" and assessed against the backdrop of the "best interest" requirements.[324]

Legal freedom to steward for IFSI

3.3.11 Where an AFM concludes, or ought to have concluded, that a sustainability factor is financially material to a scheme's investment objective, it must take that factor into account. This paragraph deals non-financial factors. A sustainability factor will fall within this category where it is not considered by the AFM to be a material financial factor in relation to the scheme. As noted at 2.3.20 above, regulation and regulatory guidance indicate that for a UCITS to be permitted to steward in relation to a sustainability factor that is not financially material,

UNITED KINGDOM

this activity would need to be consistent with its disclosed investment objectives and policies. As a result, if a non-financial sustainability factor is not part of the disclosed objectives or policy, the AFM will not have legal discretion to pursue that factor in the fund's stewardship activities.

3.4 **Insurance undertakings**

Legal requirement to steward for IFSI

General insurers

3.4.1 A general insurer could choose to become a signatory to the Stewardship Code, but is not required by regulatory rules to have an engagement policy or make any related disclosures. The discussion at 2.4.17 and 2.4.18 above and that at 3.1.16 and 3.1.17 above applies equally to the stewardship decision-making process of insurers and, as indicated there, depending on their particular circumstances, the directors of an insurer could conclude that it is necessary, for example, to engage with one or more portfolio companies in relation to a sustainability factor (such as climate change) or with a particular systemically important company in order to achieve their investment goal and stay within their risk appetite.

Life insurers

3.4.2 As regards shareholder funds, the position is the same as it is for a general insurer. As regards policyholder funds, as discussed at 2.4.24 to 2.4.27 above, the overlay of policy terms and related disclosures and policyholders' reasonable expectations provides an additional layer of complexity. Subject to that, the discussion at 3.1.16 and 3.1.17 above applies equally to the stewardship decision-making process of insurers as regards policyholder funds. Depending on their particular circumstances, the directors of an insurer could conclude that it is necessary to engage in stewardship activities (for example, in relation to climate change or with a particular systemically important company) in order to achieve their investment goal and stay within their risk appetite or in order to achieve the investment objective set for one or more parts of its policyholder funds.

3.4.3 Any conflicts of interest arising from differing stewardship approaches being taken in respect of shareholder funds and policyholder funds or within policyholder funds must also be resolved, which may not be straightforward (see 1.23 and 1.24 above).

3.4.4 The position for a life insurer as regards the Stewardship Code is described in 2.4.8 above. In addition, a life insurer which invests in equities traded on a regulated market must develop and disclose an engagement policy and make an annual public disclosure on how that policy has been implemented, including a general description of voting behaviour (the most significant votes must be mentioned) and the use of the services of proxy advisors.[325] More detail on this requirement can be found at 3.3.4 above.

Legal freedom to steward for IFSI

3.4.5 As already noted, where an insurer concludes, or ought to conclude, that a sustainability factor represents a material financial risk to shareholder or policyholder funds (or any part of them), it must take that factor into account, even if the insurer also concludes that no action can or should be taken for the time being. This section is, therefore, only concerned with sustainability factors which are not considered to be financially material.

General insurers

3.4.6 On the basis described at 2.4.35 above we consider it would be open to the directors of a general insurer properly to conclude that they are able to carry on stewardship with one or more portfolio companies on non-financial risks to that company's business, including as part of an IFSI strategy.

Life insurers

3.4.7 As regards a life insurer's shareholder funds, the position is similar. As regards its policyholder funds, the position is more complex because of the need to overlay the insurer's duties to its policyholders (see 2.4.24 to 2.4.27 above) and insurers may also choose to follow the FCA guidance described at 2.4.37 to 2.4.41 above.

3.4.8 Any conflicts of interest arising from differing stewardship approaches being taken in respect of shareholder funds and policyholder funds or within policyholder funds must also be resolved, which may not be straightforward (see 1.23 and 1.24 above).

UNITED KINGDOM

4. ASSET OWNER'S PUBLIC POLICY ENGAGEMENT WITH A VIEW TO SUSTAINABILITY IMPACT

4.1 The following section considers the extent to which, and on what basis, each type of Asset Owner is required or permitted to use public policy engagement with a view to IFSI.

Overarching considerations

4.1.1 An Asset Owner's power of public policy engagement is different from its dispositive or stewardship powers in that it is unconnected with its ownership or control of investments, although its level of investment ownership (or in the case of an AFM, control) may well determine how likely policymakers are to listen to it. So, for example, it is possible to envisage a situation where an Asset Owner concludes that it is appropriate to exercise its public policy engagement powers in a way that is consistent with its overall purpose, but is in pursuit of a less specific goal than its investment goal.

4.1.2 We think that the duties to which an Asset Owner is subject in exercising its public policy engagement powers in this way are rather more limited than when it is exercising a fiduciary power such as stewardship and that the matters it is able to take into account in making its decision to so engage are potentially broader. As a result, it seems to us that the scope of matters on which it can use public policy engagement is wider. The key relevant duty it will need to observe would appear to be the "no conflict rule" aspect of the duty of loyalty[326]; a fiduciary must avoid any unauthorised conflict between its duty and its interest. This would, amongst other things, require consideration of the cost[327] to Beneficiaries of the proposed activities and whether the proposed public policy-related activity is likely to result in any adverse financial consequences for them (for example, as a result of any diminution in income likely to be paid by a portfolio company, assuming those public policy-related activities are successful, or any potential fall in value of portfolio company securities).

4.1.3 However, the power of public policy engagement can also be used in a way which is much more akin to stewardship because it has a close connection with investment activity. Investing with Purpose gives an example of this; "there are key areas of public policy [in relation to real estate and infrastructure assets] such as building and utilities regulations which will impact on the long-term sustainability of these asset classes; therefore, investors will also engage with policy makers on these issues".[328] When used in this way, we would suggest that an Asset Owner is subject to similar duties to those which apply in relation to its powers of stewardship.

4.1.4 Part A.2.2.1 of the Report envisages three levels of goal that are relevant to the concept of IFSI - overarching sustainability outcomes, portfolio-level goals and more specific steps designed to realise the portfolio-level goals. If public policy engagement proposals form part of the portfolio level goals or the more specific steps, we consider that the exercise of the relevant power is akin to the exercise of stewardship powers.

4.1.5 An Asset Owner may well be part of a much larger group and, where it is, it is possible that public policy engagement will be carried out by another group member. For example, many UCITS funds and their AFMs are established by large asset management groups which will carry out more generally directed public policy engagement on their own behalf, funded from their own resources, rather than from those of the UCITS the holding company of an insurer and an Investment Manager may carry out such engagement on behalf of both, to ensure a unified approach. Public policy engagement through a trade association is also useful not just because it provides a collective voice, but also because it can be a useful way of conveying industry views on a non-attributable basis.

4.2 **Pension funds**

Private sector schemes

4.2.1 Where public policy engagement serves as a form of engagement or stewardship, a duty to undertake it may potentially arise as described in 4.1.3 above. Otherwise, we can conceive of circumstances where a trustee may conclude that it is appropriate to use public policy engagement more generally, either through industry bodies or directly. For example, the PCRIG Guide 2020 says "investor stewardship takes place within a policy and regulatory framework which is shaped by various forces including governments, political parties, membership associations, campaign groups and public opinion. If trustees feel that the legislative framework does not sufficiently support them in acting as good stewards of their assets, they should seek to influence policy and regulatory initiatives".[329]

LGPS

4.2.2 In our view, the position is similar for LGPS, although their status as part of local government may, in practice, affect the

UNITED KINGDOM

type of engagement they wish or are able to conduct.[330]

4.3 **Mutual Funds**

Similarly to pension funds, a duty to use public policy engagement may potentially arise as described in 4.1.3 above. Otherwise, although it is theoretically possible for an AFM itself to use public policy engagement (subject to conflict and costs considerations as referred to in paragraph 4.1.2 above) more generally, for practical reasons, this is likely to be very unusual. Many UCITS funds are established by large asset management groups which will use more generally directed public policy engagement on their own behalf, funded from their own resources, rather than from those of the UCITS.

4.4 **Insurance undertakings**

4.4.1 The PRA has made clear that it expects insurers to use public policy engagement where it is appropriate to do so; for example, it "expects firms to engage with wider initiatives on climate-related financial disclosures and to take into account the benefits of disclosures that are comparable" [331].

4.4.2 The ClimateWise Principles industry initiative, of which many UK insurers are members, encourages members to disclose how they "inform public policy making" on climate-related issues.

General insurers

4.4.3 On the basis described at 2.4.20 above we consider it would be open to the directors of a general insurer properly to conclude that they are able to use public policy engagement with a view to IFSI. We cannot easily identify a conflict in doing this between the interests of the insurer and the duties it owes its policyholders.

Life insurers

4.4.4 As mentioned in 4.1.3 above, there are circumstances where engaging in public policy serves as a form of stewardship and a duty to engage in it may potentially arise. Otherwise, the position for life insurers is similar to that described in 4.4.3, save that the conflicts and costs considerations outlined in 4.1.2 are potentially relevant in respect of policyholders and policyholder funds.

ANNEXES

United Kingdom

UNITED KINGDOM

5. ESTABLISHING NEW IFSI FUNDS AND AMENDING THE TERMS OF EXISTING ONES

5.1 Introduction

5.1.1 The following section considers the extent to which it is possible for an Asset Owner to set up a fund, policy or other product with an express IFSI objective or amend the objectives of an existing one. In 5.2 below, we have excluded consideration of a scheme which (i) has fewer than 100 members; or (ii) is being wound-up or which is subject to a Pension Protection Fund assessment period.[332] 5.4 below does not cover the position of a general insurer because the terms of its policies are not relevant to its investment-related decision-making.

5.1.2 Product governance rules require manufacturers of UCITS and insurance products to specify a "target market" for the product they are manufacturing. Manufacturers must ensure that the product's characteristics are consistent with that target market and must regularly review their products for consistency with the target market that was specified.[333] Manufacturers must consider financial risks and prospective clients' investment knowledge and experience when determining the appropriate target market, but consideration of preferences in relation to sustainability factors is not currently required.[334]

5.2 Pension funds

Private sector schemes: establishing a new scheme

5.2.1 This question would only be relevant to DB schemes on relatively rare occasions, as they are generally now only set up when existing DB schemes are being merged into larger schemes or alternatively split on the sale or demerger of employer sponsor businesses. Hence new schemes will typically be receiving transfers of assets and benefits from other DB schemes and would therefore mirror existing investment powers and inherit existing asset allocations. However, new DC chosen funds can be established with express objectives relating to sustainability factors.

5.2.2 Incorporating sustainability factor-related objectives into a new DC default fund would be permissible in respect of instrumental IFSI. Inclusion of a sustainability factor-related objective for other reasons - as an ultimate ends goal (e.g. to reflect beneficiaries' desires to achieve certain sustainability outcomes) may be possible, provided the financial objective retains its primacy, but the circumstances in which this can be done are less clear. The approach which appears to be encouraged by TPR is to establish chosen funds which beneficiaries can select.[335]

5.2.3 The view expressed in the 2014 Report is that the Non-Financial Factors Test is not relevant to this scenario. The Law Commission's view, with which we agree, is that trust law permits significant financial detriment to result from a trustee's decision where the decision is expressly permitted by the trust deed. DC chosen funds involve a choice by members of a specific fund based on its terms.[336] This suggests that, as well as offering chosen funds with a sustainability factor-related objective that is additional to, but does not override, the financial objective, it would be possible to offer a chosen fund that incorporates a sustainability factor-related objective, which risks some degree of financial detriment when compared with other investment strategies, provided that beneficiaries choose to invest their money on the clear understanding that the investment approach may lead to a lower return.

5.2.4 There is no TPR guidance reflecting the Law Commission's view. There would therefore appear to be a risk of challenge by TPR of a trustee which creates a fund that prioritises a sustainability factor-related objective ahead of financial return, unless the scheme rules expressly authorise this (which would be rare). It may be that the FCA's approach to group personal pension schemes (see 5.4.2 below) reflects TPR's likely attitude.

Private sector schemes: amending an existing scheme

5.2.5 For DC schemes, although theoretically possible, it is likely to be difficult in practice to amend an existing trust deed to incorporate a sustainability factor-related goal. To do so, a trustee would need to be confident that it is acting for proper purpose within the scope of its powers, which are generally for the payment of benefits. For DB schemes, balancing the interest of the employer would make amendment of the trust deed more complicated as the employer will be responsible for making-up any shortfall incurred as a result. Amendments must be agreed with a potentially reluctant employer.

5.2.6 To the extent not incompatible with the terms of the trust, IFSI objectives or policies may be incorporated into the SIP of an existing fund to the extent permitted by the general law (see 2.2 above).

> ANNEXES

> United Kingdom

UNITED KINGDOM

LGPS

5.2.7 An LGPS authority cannot set up new "funds" or amend the statutory terms of the scheme. An LGPS authority could amend its ISS (in accordance with necessary process requirements) where IFSI is included to contribute to optimising risk-balanced returns for its beneficiaries (instrumental IFSI). Amending for other reasons (e.g. to reflect beneficiaries' desires to achieve certain sustainability outcomes) is likely to be permissible only as far as compatible with applicable guidance based on the Non-Financial Factors Test.

5.3 **Mutual Funds**

Establishing a new UCITS

5.3.1 A UCITS is an undertaking with the sole object of collective investment, operating on the principle of risk-spreading, of capital raised from the public.[337] The purpose of a UCITS must be reasonably capable of being successfully carried into effect[338] and the fund's constitution must not contain any provision that is unfairly prejudicial to the interests of unitholders.[339] These requirements enable the FCA to refuse to authorise UCITS that set objectives that it considers would mislead or unfairly prejudice investors. Subject to these limitations, UCITS are permitted to have non-financial investment objectives, which could include non-financial sustainability impact objectives, provided consumer protections such as appropriate disclosures are met.[340] Current regulatory developments and proposals are intended to increase this trend.[341] The number of sustainability-related funds is increasing[342] and it appears that there are some funds on offer to UK retail investors that make disclosures under article 9 SFDR indicating that they have sustainability goals as their objective.

5.3.2 The following requirements will also be relevant:

(a) *Valuation and evaluation*. Difficulties measuring or valuing sustainability impact (see Part A.2.3) may create regulatory compliance challenges for UCITS. The AFM is required to ensure the prospectus includes "an explanation of how investors can assess the performance of the scheme" and "information which investors and their professional advisers would reasonably require… for the purpose of making an informed judgement about the merits of investing".[343] FCA rules impose detailed requirements on the financial valuation of fund assets and the calculation and publication of unit prices, to enable unitholders to assess the merits of investing and compare the UCITS against other funds and benchmarks.[344] However, the pricing and valuation requirements do not contemplate the measurement or evaluation of progress towards a sustainability factor-related objective. Given that sustainability impact is inherently difficult to value financially, it may be difficult for a UCITS to provide meaningful, comparable information about its sustainability impact. This difficulty is recognised by regulators and others as giving rise to potential risks for unitholders who may be less able to evaluate the fund's non-financial performance and less able to understand what they are being offered;[345]

(b) *Expertise*. An AFM must "ensure it has adequate knowledge and understanding of the assets in which any scheme it manages is invested"[346] and must carry out its role with due care and skill;

(c) *Operational requirements*. The AFM is subject to operational requirements intended to minimise risks to unitholders by ensuring competent management of the fund. AFMs must ensure a high level of diligence in the selection and monitoring of assets and forecast the impact of prospective investments on liquidity and risk, based on reliable information.[347] These operational requirements pose practical challenges that have been acknowledged by regulators.[348] For example, conventional assessment tools may not assist with the measurement of progress towards a sustainability factor-related objective and limited availability of quantitative information could make it difficult and costly to meet the required standards of diligence.[349]

Amending an existing UCITS

5.3.3 An existing UCITS may amend its investment objectives or policy. A change of investment objectives or policy to permit ultimate ends IFSI, even if an existing financial objective retains its primacy, is likely to amount to a "fundamental" change and require not only prior FCA approval, but also approval by an extraordinary resolution of unitholders giving a three quarters majority.[350] If an AFM concludes that it must amend the fund's disclosures to permit instrumental IFSI this may arguably be a "significant" change rather than a fundamental one, in which case the AFM need only give prior written notice to unitholders,[351] although FCA approval may nevertheless be required. There is little regulatory guidance on the distinction between fundamental and

UNITED KINGDOM

significant changes, but in both cases the effect of the change on the scheme and its unitholders is an important consideration. A mutual fund's depositary has a duty of oversight in respect of changes impacting investment powers under COLL 6.6.4R and so will also need to be involved in judgements about the classification of a proposed change. The Depositary and Trustee Association and the Investment Association have produced joint guidance for their members (dated October 2020) on the Classification of Change Events for Authorised Funds.

5.4 **Life insurance products**

Establishing a new policy

5.4.1 A life insurer may create products with sustainability factor-related objectives, provided that applicable consumer protection requirements, including with respect to product design and marketing, are satisfied. The regulatory regime for certain types of life insurance products[352] specifically contemplates products which "target specific environmental or social objectives".[353]

5.4.2 In relation to with-profits and unit-linked policies "deliberately designed to take into account non-financial matters" which policyholders have actively selected,[354] FCA guidance suggests that "non-financial matters"[355] may be prioritised over financial return as "firms may offer products that involve significant financial risk that is not necessarily compensated by the expected return, provided that consumers actively choose these products, and that firms comply with the relevant rules on distributing such products." However, it makes clear that insurers offering "workplace personal pensions" should not "offer products (including [chosen] funds) that involve a risk of significant financial harm to consumers".[356]

Amending an existing policy

5.4.3 Amendment to policy documents to incorporate an express sustainability factor-related objective typically requires policyholder consent. Gaining consent may only be practical in relation to those types of policy held by a single policyholder. However, many such policies are likely to be held by the trustees of private pension schemes which will need to comply with their own duties in agreeing any amendment. For other types of policy, the policyholder outreach required to incorporate IFSI into a significant proportion of an insurer's existing policies may make such amendment impracticable.

UNITED KINGDOM

6. INVESTMENT MANAGERS AND IFSI

6.1 The following section considers the extent to which, and in what circumstances, an Investment Manager is required or permitted to IFSI on behalf of an Asset Owner.

6.2 In making an investment decision an Investment Manager must take account of:

(a) the terms of its investment management agreement (**IMA**) with an Asset Owner. The IMA will typically include provisions authorising the Investment Manager to act on the Asset Owner's behalf and:

(i) an investment objective, investment policy and any investment restrictions (these are the main provisions which delineate the extent of the Investment Manager's decision-making discretion as regards its dispositive, stewardship[357] and other investment-related powers);[358]

(ii) benchmark against which the Investment Manager's performance will be measured and which is likely, in practice, to be relevant to portfolio construction;

(iii) provisions on conflicts of interest (including to allow the Investment Manager to act for other clients with conflicting interests and to deal with the resolution of those conflicts);

(iv) provisions on fees (these are usually based on the value of assets under management, but may also include a benchmark-related performance fee) and costs;

(v) a contractual standard of care. For example, the Investment Association's widely used model discretionary investment management agreement (**the Model Agreement**) defines the standard of care as "the standard of care that could reasonably be expected of a professional discretionary investment manager acting in good faith and with reasonable care and skill"; and

(vi) limitations of liability.[359]

Provisions designed to incentivise the Investment Manager to make decisions based on a medium to long term assessment of an investee company's performance (see 2.2.10(b)(v)(D)) for private sector schemes and 2.4.7(d) for life insurers above) and, in the case of for life insurers, some further provisions as regards performance measurement and fees (again, see 2.4.7(d) above) may well also be included;

(b) primary and delegated legislation, including:

(i) the FCA requirements discussed in 1.21, 1.31, 1.42 and 1.45 above and the FCA requirements that a firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems (PRIN 2.1.1R(3));

(ii) FCA COBS rules (see, for example, 1.45 above), including requirements on an Investment Manager aimed at ensuring the investment mandate and the investment decisions made under it are suitable for its client.[360] This requires it to obtain appropriate information from the client concerning:[361]

- the client's financial situation, including its ability to bear losses; and
- the client's investment objectives, including its risk tolerance.

Although there is currently no express requirement to solicit clients' objectives with regard to sustainability factors as part of the suitability assessment, it is considered good practice to do so, certainly as regards ESG;[362] and

(iii) where acting for a pension trustee, requirements to invest in accordance with the Private Scheme Investment Regulations and with a view to giving effect to the principles contained in the SIP so far as reasonably practicable (see 2.2.10(b)(v) above);[363]

(c) fiduciary duties owed to Asset Owners[364] see 1.17 to 1.23 above (which may be modified by the relevant IMA); and

(d) the duty of care owed to the Asset Owner see 1.43 to 1.58 above (which again may be modified by the IMA[365]).

6.3 An Investment Manager must disclose publicly the nature of its commitment to the Stewardship Code or its alternative arrangements.[366] It is also subject to the obligations described in relation to an AFM at 3.3.3 to 3.3.5 above.

6.4 The FCA has now published (in CP21/17) its proposals for publicly available, annual entity level TCFD disclosures for Investment Managers (see 2.3.8 above, including as regards thresholds and timing) and, upon request, portfolio-level disclosures. These are intended for institutional clients that are themselves subject to climate- related financial disclosure obligations. Firms would be required to provide product or portfolio-level disclosures to those clients once

> ANNEXES

> United Kingdom

UNITED KINGDOM

in each 12-month period, upon request specifying a calculation date no earlier than 1 July 2023. Where an Investment Manager does not have the information necessary to provide portfolio disclosures, they should use proxies and assumptions, and briefly explain the methodologies, context and limitations.

6.5 The PLSA/Investment Association joint steering group referred to in relation to 2.2.9(b)(v)(D) above met for the first time early in January 2021 to consider a range of issues aimed at strengthening the relationship between Asset Owners and Investment Managers, including:

(a) the proactive steps Investment Managers can take to understand and deliver their clients' stewardship priorities;

(b) the role Investment Managers' disclosures play in the information flow between Investment Managers and Asset Owners in their approach to stewardship, including how these disclosures demonstrate that the stewardship and investment approaches have been aligned with the Asset Owner's wishes;

(c) the role of Asset Owners in ensuring stewardship plays a key role in their approach to manager selection and ongoing performance and oversight assessment; and

(d) the role the contractual relationship and non-contractual arrangements can play in embedding a long-term focus and clear stewardship expectations, including a consideration of model mandates.

6.6 Further industry guidance on these points, which seems likely to have relevance to life insurer Asset Owners too[367], can therefore be expected soon.

Legal obligations with respect to Sustainability Impact

Financial materiality and investment horizons

6.7 An Investment Manager is an agent so the IMA it has with its Asset Owner provides the framework which shapes most of the other legal requirements to which it is subject.[368] Thus, the investment objective and investment policy set by that IMA provide the yardstick against which financial materiality is to be judged. The CFRF 2020 Guide is relevant to Investment Managers as well as to insurers, although investment-related risks will be clients' risks, rather than those of the Investment Manager. The FCA will nevertheless expect appropriate understanding of each client's risk appetite including time horizons.[369] The approach to risk is circumstance specific and it is difficult to generalise. It is clear, however, that climate change (by way of example of a sustainability risk) will often be a material risk to the achievement of a client's investment objective.[370]

6.8 Despite the potential incentives to focus on short term performance discussed in Part B.4, it seems clear that at least some Investment Managers are taking a long term view on value creation and that this underlies, in particular, their stewardship activities. For example:

(a) "BlackRock takes a long-term perspective in its investment stewardship programme informed by two key characteristics of our business: the majority of our clients are saving for long-term goals so we presume they are long-term shareholders, and the majority of our equity holdings are in indexed portfolios so our clients are, by definition, long-term and locked-in shareholders"[371];

(b) "the index funds [Vanguard manages] on your behalf are practically permanent—structurally long-term—owners of the companies in which they invest.....We start with the premise that our equity index funds invest in just about every public company, and every industry, practically forever. With this indefinite horizon, our funds must focus on how companies are setting themselves up for success today, next year, and well into the future".[372]

6.9 Each Investment Manager will have a number of clients; the investment objectives those clients have set for the Investment Manager will not align with each other and may even conflict (see 1.21 to 1.23 above). As regards investment and divestment, it is feasible for a manager to take different approaches - by way of example, it may decide to divest its active clients from a particular portfolio company, whilst at the same time being obliged to retain (or depending on index-weighting, even increase) its holding of shares in that portfolio company in passive portfolios it manages. As regards stewardship, a divided approach may be more difficult in practice and is obviously less effective. As noted above, it is unusual for a client to include stewardship-related provisions in its IMA and an Investment Manager is required by FCA rules to disclose its approach to stewardship. It appears common for Investment Managers to take a firm-wide approach to stewardship activity across all of the portfolios they manage. It seems reasonable to assume that this is on the basis that to do so is in the best interests of its clients generally and that the Investment Manager has satisfied itself that its stewardship approach is not

UNITED KINGDOM

inconsistent with its obligations under its IMAs, including their investment objectives.[373]

Legal requirements to use investment powers to IFSI

6.10 An Investment Manager should identify considerations relevant to its investment decision-making against the background (primarily) of the IMA it has entered into with the Asset Owner. In order to fulfil its duty of care, an Investment Manager's decisions should always take care in its identification of relevant matters and take into account any matters it has identified as financially material to those decisions. Taking climate change as an example, the CFRF 2020 Guide[374] notes that investment decisions to which climate change is relevant should factor in both current and forward-looking climate risk assessments. It goes on to indicate that it should be considered as part of company, sectorial and underlying analysis because "climate risks can be relevant to a variety of sectors and can directly impact equity values, credit spreads, commodities, interest rates, foreign exchange, bond prices and all other associated market parameters."

6.11 It also explains that, as a matter of practice, "climate metrics and evaluation are increasingly included as part of monitoring of a portfolio of assets or securities. This attempts to take a step away from asset level monitoring and provide a view on the portfolio as a whole. This evaluation tends to be quantitatively driven and raises flags for further qualitative analysis rather than assessing whether a portfolio is within a defined limit or set of parameters to invest within…The value of stewardship and voting activities are maximised once investors have first identified red flags using portfolio climate monitoring and analysis tools." In other words, Investment Managers are increasingly looking at climate risk as a sustainability risk and not simply as an idiosyncratic risk and are using their analysis, where they consider the results are material to achieving the investment objectives the Asset Owner has set for them, to inform investment and, in particular, stewardship decisions.

6.12 As noted in relation to each Asset Owner (see 2.2.35, 2.3.17, 2.4.20 and 2.4.28 above) it seems more likely that an Investment Manager will conclude that the tool (if any) which it is appropriate to deploy in relation to a sustainability impact risk is stewardship, coupled with selective investment and disinvestment, rather than purely investment and disinvestment.[375]

Legal freedom to use investment powers to IFSI

6.13 We have explained above that, where an Investment Manager concludes that a financial factor is material to a scheme's investment objective, it must take that factor into account. This section deals with non-financial factors. A sustainability factor will fall within this category where it is not considered by the Investment Manager to be a material financial factor in relation to the investment objective its Asset Owner client has set for it. The extent to which an Investment Manager will be able to take account of non-financial factors in these circumstances will be largely dependent upon the terms of the IMA. Where this permits the Investment Manager to do so, or even sets a non-financial investment objective, it will be permitted or required to do so. Where the IMA is silent, an Investment Manager would not have legal discretion to pursue a strategy of making or disposing of investments to achieve sustainability impact for a non-financial reason.

Legal requirements to steward for IFSI

6.14 As noted in 1.39 above, an Investment Manager has a duty to take into account matters which it has, or ought to have, identified as financially material to its investment-related decisions. Where it identifies a sustainability factor that is material in this way, it must then decide, what (if any) action to take in respect of it. The Investment Manager may well conclude that stewardship activities in relation to one[376] or more companies is an appropriate way to seek to minimise the relevant risk to its Asset Owners' portfolios; see for example, "a significant challenge for asset managers with index strategies invested in thousands of listed companies globally is to provide active oversight of their holdings… our stewardship program identifies a series of strategic priorities designed to enhance the quality and define the scope of our stewardship activities for the year. Identifying these priorities enables us to plan and actively focus our engagement efforts on thematic ESG and sector-specific issues that are important to our clients".[377]

6.15 It is clear from the statements quoted at 6.8 above that the relevant Investment Managers regard the ability to engage with portfolio companies as a critical tool in their armoury in achieving long term value in the passive funds they manage. The same is true of active investors. For example:

(a) "as an active investor for many years, we believe that robust engagement and voting

> ANNEXES

> United Kingdom

UNITED KINGDOM

by institutional investors is critical to the health of financial markets and long-term value creation. This is particularly so in principles-based, "comply or explain" regimes, whose effectiveness requires active involvement by investors to hold boards of listed companies to account for the fulfilment of their stewardship responsibilities…As a long-term investor, we aim to build an understanding of the fundamental factors shaping the risks and opportunities of the companies we invest in. We believe that ESG issues can have a material impact on company performance and on the economy as a whole, and that robust ESG management by companies is an integral part of good risk management"[378];

(b) "active asset managers with the deep investment resources are required to understand how sustainability issues intersect with financial performance… Our role as fiduciaries extends beyond achieving our clients' risk-return objectives. It also requires a holistic approach to stewarding our clients' capital. Our Global Governance Principles provide a framework for stewardship, clearly setting out our expectations of company management. They are founded on the belief that long-term shareholder value is enhanced through a more comprehensive assessment of stakeholder management. This includes both how a company invests in its human capital – including employees, suppliers, their customers, and the community – as well as its approach to natural capital, including its dependency and use of natural resources and its approach to managing climate change risk. Our regular dialogue with companies and sovereigns means we are well positioned to advance sustainability imperatives via purposeful engagements, outcome-oriented voting, and asset allocation"[379]; and

(c) The Investment Association has committed to developing guidance for its Investment Manager members on governance, culture and incentivisation of stewardship.[380]

Legal freedom to steward for IFSI

6.16 As explained above, this section deals with non-financial factors. A sustainability factor will fall within this category where it is not considered by the Investment Manager to be a material financial factor in relation to its investment-related decisions. See 6.13 above for our conclusions.

Public policy engagement with a view to IFSI

6.17 In 4.1.1, we have explained that unless, unusually, a person (in this case, an Investment Manager) is engaging in public policy work as a representative on behalf of one of more clients, (in which case policy work is better seen as a particular form of stewardship), the duty which is likely to be key is the "no conflicts" rule. This requires consideration of the cost (if any) to the Investment Manager's clients and whether the proposed public policy-related activity is likely to result in any adverse consequences for the portfolios which the Investment Manager manages contrary to the terms on what it has been appointed. Public policy engagement is a potentially important, and well used, tool by Investment Managers[381].

UNITED KINGDOM

7. LEGAL LIABILITY TO THIRD PARTIES FOR THE NEGATIVE SUSTAINABILITY IMPACT OF PORTFOLIO COMPANIES, DISCLOSURE-RELATED AND REPUTATIONAL RISK

7.1 This section considers the extent to which, regardless of the legal rules under which it is required to operate and its constitution, an Asset Owner could be legally liable to third parties for the negative sustainability impact of portfolio companies, and whether an Investment Manager could also be liable because of its role in assisting the Asset Owner to invest in the relevant portfolio company and steward its investment. It also looks briefly at some other kinds of sustainability factor-related litigation risk.

7.2 **Asset Owners**

7.2.1 It is possible that Asset Owners could be found to have criminal or civil liability to third parties for the negative sustainability impact of portfolio companies.

Criminal liability

7.2.2 It is unlikely that an Asset Owner would be held criminally liable for the negative sustainability impact of a portfolio company. Exceptionally, primary criminal liability might exist where an Asset Owner has direct involvement in the portfolio company's activities or operations, and where those are determined to be criminal under the relevant legislation (for example, for unauthorised or harmful deposit of waste, or illegal discharges to air, land or water), but the usually arm's length nature of relationships between an Asset Owner and the activities of portfolio companies makes such a liability highly unlikely. The risks would be slightly higher if an Asset Owner or a director nominated by it had close day-to-day involvement in, and direction over, the activities of the portfolio company. However, this is not typical of the Asset Owners considered in this Report.

7.2.3 It is possible that direct clean-up/remediation liability can be incurred where a person causes or "knowingly permits" an incident which leads to pollution, which can result in criminal liability; however, there would have to be some direct intervention at operational level in order for an Asset Owner to be so liable; once again we consider such liability unlikely.[382]

7.2.4 Secondary liability is also theoretically possible, for example, if a nominee director appointed by an Asset Owner assumed managerial responsibility over relevant activities of the portfolio company, and consented to, or connived in, an illegal act or omission (such as pollution of a waterway, or operation of a regulated facility without the appropriate environmental permit). However, only exceptionally would an Asset Owner exercise the required level of engagement in a portfolio company's operations to attract this type of liability.

Civil liability

7.2.5 It is possible that, in certain limited circumstances, an Asset Owner could be found to have a duty of care towards individuals harmed by portfolio company's actions (or inaction) which result in a negative sustainability impact, i.e. liability in negligence. The standard of care applicable to a particular scenario will depend heavily on the facts.

7.2.6 There are a number of scenarios in which a duty of care could be owed by a parent company in respect of its subsidiary's activities. These include where a parent company issues "[g]roup guidelines about minimising the environmental impact of inherently dangerous activities … contain[ing] systemic errors which, when implemented as of a matter of course by a particular subsidiary, then cause harm to third parties".[383] In such circumstances, a parent company could be held liable for harm caused by a subsidiary.

7.2.7 However, the likelihood of liability in negligence for a minority shareholder (as an Asset Owner would generally be) is fairly remote: not only must the harm caused by the negligent act or omission have been reasonably foreseeable, but there must be sufficient proximity between the parties (i.e. between the Asset Owner and the portfolio company which causes harm, which would likely require a degree of direct involvement or operation control on the part of the Asset Owner), and it must be "*fair, just and reasonable*" to impose liability to a third party on the Asset Owner.[384] We consider it unlikely that these requirements would be met in relation to the usual activities of an Asset Owner of the type described in this Annex.[385]

7.3 **Investment Managers**

7.3.1 It is even less likely that an Investment Manager, as agents of its client Asset Owners, would be found to have liability to third parties for the negative sustainability impact of portfolio companies.

UNITED KINGDOM

Criminal liability

7.3.2 As for an Asset Owner, an Investment Manager might have primary criminal liability where it has direct involvement in a portfolio company's activities or operations, and where those are determined to be criminal under the relevant legislation. However, Investment Managers would not generally have the necessary degree of direct involvement for criminal liability.

7.3.3 As an Investment Manager would not be a member of the company, it would not be possible for them to have secondary liability (as described at 7.2.4). Liability as an accessory is theoretically possible in very narrow circumstances where the Investment Manager can be demonstrated to have aided, abetted, counselled or procured the commission of an offence (e.g. through a nominee director appointed on its behalf) but is highly unlikely.

7.3.4 It is also hypothetically possible for an Investment Manager to incur direct clean-up/remediation liability for contaminated land under Part 2A Environmental Protection Act 1990, which can result in criminal and civil liability. However, the degree of required knowledge and operational involvement makes liability unlikely.

Civil liability

The civil liability position is similar to that for Asset Owners, save that the Investment Manager will be further removed from any relevant negligent conduct and therefore less likely to be found liable. It would be typical for the IMA to include indemnification provisions such that the risk of any such liability incurred in fulfilment of its duties to the Asset Owner would in practice be borne by the Asset Owner (absent fraud or similar egregious conduct by the Investment Manager).

7.4 **Disclosure-related risk**

7.4.1 Most types of Asset Owner covered in this Annex and also Investment Managers are required to make an increasing number of essentially public disclosures about their investment and stewardship activities, including potentially any sustainability-related aspects of those activities. These disclosures have at least two broad purposes – first, they force the disclosing entity to consider whether it has in place the appropriate governance and related arrangements in relation to the matters about which it is making disclosures[386] and secondly, they aim to provide the Asset Owners themselves (in the case of disclosures by Investment Managers) and the Beneficiaries of the relevant Asset Owner (in the case of disclosures by the relevant Asset Owner[387]) with decision-useful information.

7.4.2 For the disclosing entity, this gives rise to additional risk. For example, those disclosures could be inaccurate at the time they are made or the entity might subsequently slip below the standards it has set itself in its disclosures, or perhaps it could become clear that the discloser is not taking a consistent approach across its activities.[388] At minimum, these kinds of failure give rise to reputational risk for the entity in question and may, in serious cases, lead to regulatory intervention or possibly to liability for negligent misstatement.

7.4.3 Further, although disclosures of this kind do not directly impact on an Asset Owner or Investment Manager's investment-related decision-making, they do contribute to the transparency of it, thus potentially attracting increased scrutiny from regulators and Beneficiaries (or an Investment Manager's clients).

7.4.4 It is worth noting that disclosure-related claims tend to be brought by strategic claimants (such as environmental law charities and other non-governmental organisations) who are more interested in driving change than an award of damages. This can change the dynamics of the litigation. Strategic claimants are more likely to litigate to achieve settlements in which the defendant agrees to take action to decrease its negative sustainability impact, which may well go beyond what a court could order. For an example of strategic claimants in action, see the description of the settlement in *McVeigh v Rest* (at 2.2.33 above).

7.5 **Other reputational and regulatory risks**

7.5.1 There is currently a developing trend of complaints being made by NGOs to regulatory bodies, such as on the basis of alleged breaches of the OECD Guidelines.[389] Such complaints, usually allegations of non-disclosure or contribution to environmental damage, are not part of a legally binding process but have the potential to cause significant reputational damage, and the usual outcome is for the parties to reach agreement on addressing the conduct complained of, which often requires action on the portfolio company's part. It is also possible that complainants in such actions could use any information disclosed as part of those processes to commence or inform subsequent litigation.

7.5.2 We note that National Contact Points for

UNITED KINGDOM

the OECD Guidelines in other jurisdictions have already been asked to consider complaints referred in relation to alleged breaches of the Guidelines by institutional investors.[390] However, to date no such complaints have been made against institutional investors in the UK.

7.5.3 We also note that, in retail markets, mass retail claims have become a potent force in the financial sector and beyond (for example, in relation to vehicle emissions). So far this has not been the case in areas directly related to sustainability.

Edmund Barber, Olivia Carrington, Gareth Davies, Rachel Duffy, Lisa Eger, Morag Elwis, Angela Evans, Laura Feldman, Abdullah Geelah, Tom Howard, Shona Hughes-Daly, Gregory King, Priti Lancaster, Charles Magoffin, Martin McElwee, Emma Rachmaninov, Tom Rhodes, Christopher Simpson and Annabel Sykes

UNITED KINGDOM

Appendix 1: UK annex glossary

Term	Description
2014 Report	a report by the Law Commission on the "Fiduciary Duties of Investment Intermediaries" (Law Com No 350)
AFM	authorised fund manager
BEIS	Department for Business, Energy and Industrial Strategy
CJEU	Court of Justice of the Eruopean Union
CFRF 2020 Guide	a guide by the Climate Financial Risk Forum entitled "Climate Financial Risk Forum Guide 2020" (June 2020). The summary to the guide was co-produced by the FCA and PRA.
chosen fund	a pension fund within a scheme (other than a default fund) in which scheme members may choose to invest their funds
default fund	a pension fund within a scheme in which scheme members' funds are invested in the absence of any choice by the member
DWP	Department for Work and Pensions
DWP Climate Risk 2021 Consultation	A policy response and consultation by the DWP on "Taking action on climate risk: improving governance and reporting by occupational pension schemes"
EU Impact Assessment	Commission Staff Working Document Impact Assessment Accompanying the document Proposal for a Regulation of the European Parliament and of the Council on the establishment of a framework to facilitate sustainable investment and Proposal for a Regulation of the European Parliament and of the Council on disclosures relating to sustainable investments and sustainability risks and amending Directive (EU) 2016/2341 and Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) 2016/1011 on low carbon benchmarks and positive carbon impact benchmarks
FCA	Financial Conduct Authority
FRC (to become ARGA)	Financial Reporting Council (which is to be replaced by the Audit, Reporting and Governance Authority)
FSMA	Financial Services and Markets Act 2000
GAA	governance advisory arrangements, which may be entered into by pension providers operating smaller and less complex schemes instead of establishing ICGs
IGC	Independent Governance Committees, which must be established and maintained by firms operating workplace personal pension schemes
Investing with Purpose	a report by the Treasury-led Asset Management Taskforce on "Investing with Purpose: placing stewardship at the heart of sustainability growth" (November 2020)
ISS	the investment strategy statement which is required by Regulation 7 LGPS Investment Regulations
KIID	a Key Investor Information Document, required to be produced in respect of certain packaged retail investment and insurance products (e.g. UCITS)
Law Commission	a statutory independent body created by the Law Commissions Act 1965 to keep the law of England and Wales under review and to recommend reform where it is needed
LGPS Authority	the administrative authority responsible for maintaining and investing a fund within the LGPS (SI 2016/946)
LGPS Investment Regulations	Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016
PCRIG Guide 2020	"Aligning your Pension Scheme with the TFCD Recommendations" published by the Pensions Climate Risk Industry Group (January 2021)
PLSA	Pensions and Lifetime Savings Association
PRA	Prudential Regulation Authority
Private Scheme Investment Regulations	Occupational Pension Schemes (Investment) Regulations 2005 (SI 2005/3378)
OEIC	an open-ended investment company, as defined in section 236 FSMA

UNITED KINGDOM

Term	Description
Section 172	section 172(1) Companies Act 2006
SIP	the statement of investment principles required by section 35(1) Pensions Act 1995
SS3/19	supervisory statement by the PRA on "*Enhancing banks' and insurers' approaches to managing the financial risks from climate change*" published in April 2019
TPR	The Pensions Regulator

UNITED KINGDOM

1 The Pensions Schemes Act 2021 did not receive Royal Assent until 11 February 2021, but it is sufficiently important that it and relevant matters flowing from it have been included as have statutory instruments to be made under the powers its creates. The EU's Sustainable Finance Package, the FCA's CP 21/17 on enhancing climate-related disclosures by asset managers, life insurers and FCA-regulated pension providers and CP21/18 on enhancing climate-related disclosures by standard listed companies and the BEIS' March 2021 Consultation on requiring mandatory climate-related financial disclosures by publicly quoted companies, large private companies and limited liability partnerships have been mentioned for similar reasons.

2 Very broadly, with limited modifications to make it operate properly in a UK-only context, EU legislation currently of direct effect in the UK was "onshored" at 11.00pm on 31 December 2020 – section 3 European Withdrawal Act 2018 (as amended by section 25 Withdrawal Agreement Act 2019) (EUWA). The interpretation of retained EU law (that is broadly onshored EU law, plus EU law-derived domestic legislation) is dealt with in EUWA. For EU law which has been onshored without modification, for so long as it remains in force, CJEU case law and general principles of EU law (as in force immediately prior to onshoring) apply until a relevant UK court departs from them (there are rules about which courts may make this decision and they may only do so in circumstances where they would depart from UK case law). Post 31 December 2020 CJEU decisions are persuasive, but not binding. As regards non-legislative EU materials, the FCA and PRA have confirmed that generally these remain relevant unless they have indicated otherwise. TPR has made no statement in relation to the continuing status of such materials.

3 Although, even in this case, as the CFRF 2020 Guide summary acknowledges "The understanding of [climate change] risks is relatively immature and poses unique challenges, but the need to address them is pressing." Climate change risk encompasses two separate primary risk factors - physical risk and transition risk. There is also a third - liability risk - which arises from parties who have suffered loss or damage from physical or transition risk factors and seek to recover from those they hold responsible (see SS3/19 page 2).

4 SS3/19 page 3 "Financial risks from climate change will be minimised if there is an orderly market transition to a low-carbon world, but the window for an orderly transition is finite and closing."

5 See the Taskforce on Nature-related Financial Disclosures https://tnfd.info (accessed at 14 July 2021) and "the economics of diversity: the Dasgupta review" (February 2021).

6 See Part A 1.1.3(b) of the Report. Stewardship covers a number of possible activities of varying cost and intensity.

7 We have used the expression "investment goal" to denote the overall financial objective which an Asset Owner is pursuing in the exercise of its investment-related powers and investment objective to denote an objective it has set for an Investment Manager. Save in the case of a mutual fund, the two will not necessarily be the same thing; a pension fund and an insurer may well have a number of different investment portfolios with different investment objectives, which will be consistent with its investment goal.

8 Some investment consultants provide a service referred to as fiduciary management (or implemented consulting) in which their role extends beyond an advisory one to one where investment decisions are made. Some Asset Owners use a stewardship service provider.

9 In an investment decision context, this includes through use of a pooled product. The main issues a collective approach gives rise to are covered in 3.1.19 to 3.1.22 below.

10 Occupational pension scheme trustees would need to obtain appropriate authorisation under the FSMA to carry out day-to-day management of the trust's asset themselves (see Article 37 of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (SI 2001/544) and Article 4 of the Financial Services and Markets Act 2000 (Carrying on Regulated Activities by Way of Business) Order 2001 (SI 2001/1177)) and, as such, typically they do not make day-to-day decisions or obtain such authorisation. It would not be unusual for an insurer to delegate management of its assets to a member of its corporate group, but that Investment Manager will invariably be authorised so as to be permitted to manage assets for clients which are not group members. Pension scheme trustees might instead structure their investment portfolio as a unit-linked insurance policy; this is not delegation but nevertheless adds a layer of complexity. Alternatively, they might invest only in collective vehicles (mutual funds or a pension-specific pooled fund, using an over-arching balancing agreement with an Investment Manager).

11 Many mutual funds managed by UK-based Investment Managers are established in Ireland or Luxembourg. For example, "three quarters of assets in [UK managed] overseas domiciled funds are managed for funds domiciled in Ireland and Luxembourg" ("Investment Management in the UK 2019-2020" survey, page 14).

12 In its "Guide to Investment Governance for DC schemes" (July 2019) TPR refers to "investment beliefs" and says "you may find it helpful to develop and maintain a set of beliefs about how investment markets function and which factors lead to good investment outcomes. Investment beliefs, supported by research and experience, can help focus your investment decision-making and make it more effective. If you do this, your investment strategy should then reflect those beliefs." For DB schemes, see TPR Guide "Investing to Fund DB". Trustees' investment beliefs should not be confused with their personal (i.e. ethical or moral) beliefs.

13 For example, investment restrictions and risk limits.

14 The Stewardship Code was first published in 2010 to improve long-term returns to beneficiaries by enhancing the quantity and quality of engagement between investors and companies. It was introduced as a result of Sir David Walker's Review of corporate governance in UK banks and other financial industry entities. The latest version took effect in 2020.

15 According to the FRC website, first applications to become signatories to the 2020 Stewardship Code closed on 31 March 2021 for Investment Managers and on 30 April 2021 for Asset Owners. The FRC will evaluate the reports they have submitted and notify organisations of the outcome of their application shortly before the first list of signatories, which will include successful applicants, is published in late summer 2021.

16 The Asset Management Taskforce was established in 2017 to encourage greater dialogue between the government, the industry and the FCA. It is led by the Treasury and administrative support is provided by the Investment Association. The two working groups which produced the report included representatives from investment management firms, pension funds, company directors and investment advisers as well as observers from the FCA, FRC, BEIS, DWP, TPR and the Treasury.

17 TPR has power to issue Codes of Practice containing practical guidance regarding the standards of conduct and practice of those who exercise functions under the pensions legislation. They are admissible in evidence in legal proceedings and, if any provision appears to the court or tribunal concerned to be relevant to any question arising in the proceedings, it must be taken into account – section 90 Pensions Act 2004. As well as publishing its own guidance, FCA has a process for recognising industry guidance.

18 For example, page 5 of the summary to the CFRF 2020 Guide says "this...guide aims to help financial firms understand the risks and opportunities that arise from climate change, and provide support for how to integrate them into their risk, strategy and decision-making processes. As part of this, the guide considers how firms can plan for the impact of climate policies over different time horizons and assess their exposure to climate-related financial risks so that they can adapt their businesses in response."

19 For convenience, regulatory rules made by the FCA, which cover similar ground to judge-made law and which apply to certain Asset Owners and Investment Managers, are also mentioned in this section. Any breach of regulatory rules may result in action by the regulator. In relation to some regulatory rules, but notably not FCA's principles for businesses or PRA's Fundamental Rules, a "private person" (as defined in Regulation 3(1)(b) of the Financial Services and Markets Act 2000 (Rights of Action) Regulations 2001 (SI 2001/2256) has a direct right of action in respect of breach against the relevant regulated firm. A "private person" need not be a client of the regulated firm in question.

20 There are some limitations on this: see 6.2 below.

21 *Bristol and West Building Society v Mothew* [1998] Ch 1 at 16 and 18. Unfortunately, as the 2014 Report says at paragraph 3.11 "the term 'fiduciary duty' means different things to lawyers and non-lawyers, even lawyers use the term in different ways." In chapter 62 of *Pensions, Contracts and Trusts: Legal Issues on Decision Making* (2020) David Pollard discusses this further and seeks to reconcile some important, but apparently contradictory, cases.

22 Paragraph 1.17.

23 Paragraph 1.20 of the 2014 Report usefully describes them as "legal polyfilla", moulding themselves around other structures to plug the gaps. They will, for example, impact, and be impacted by, the terms of any relevant contractual relationship between the parties and, we would suggest, any applicable statutory duties.

24 FCA rulebook PRIN 2.1.1R(8). The FCA rules use "customer" as a collective term for "professional clients" and "retail clients". The expression "client" includes eligible counterparties, as well as "customers." See FCA SYSC 10 and PRIN2.1.1 R(8) for rules on conflicts of interest.

25 Where fiduciary duties arise and PRIN 2.1.1R(8) applies, the requirements of each, which are not identical, must be complied with.

26 These would include material diminution in income from, or to the market value of, one or more investee companies.

27 See S & P Global "Lights out for coal" https://www.spglobal.com/en/research-insights/featured/coal (accessed at 14 July 2021)

28 CFRF 2020 Guide, Summary chapter, page 3.

29 Paragraph 3.44 et seq. "Fiduciary powers are a class of limited powers. Ordinarily a fiduciary obligation connotes a duty of loyalty. In this context, the significance of the fiduciary obligation is that the donee of a fiduciary power owes a duty to the objects of the power to consider from time to time whether and how to exercise it and they have various remedies open to them if the donee does not or cannot do so. He is not bound to exercise it merely by virtue of its being a fiduciary power: the duty is to consider its exercise...Generally, a fiduciary power cannot be exercised, or be left unexercised, by the donee for his own benefit..." *Lewin on Trusts* (20th Edition, 2020), 28-018. "...a power may be conferred on a person in order that it should be used, if at all, to perform vicariously a task for the person who conferred the power: to achieve an end within a range of outcomes desired or anticipated by the donor of the power, but which involves making a selection or decision which at the time of the creation of the power the donor is unable or unwilling to make. This type of power will be fiduciary: the holder of the power must stay within its terms, like the holder of a non-fiduciary power, but he will also be accountable for his conduct as regards the power in other ways..." *Snell's Equity* (34th edition, 2019), 10-009. As regards public policy engagement, an Asset Owner or Investment Manager will not necessarily be exercising a fiduciary power (see further 4 et seq and 6.17 below).

30 As David Pollard notes in chapter 10 of *Pensions, Contracts and Trusts: Legal Issues on Decision Making* (2020) this test is easy

> **ANNEXES**

> **United Kingdom**

UNITED KINGDOM

to state, but can, in practice, be difficult to apply and see also its chapter 16 as regards the determination of a decision maker's purpose.

31 Paragraph 4.35.

32 [1985] Ch 270.

33 Paragraph 6.15.

34 EWHC 448 (Ch) [2015] PLR 239 page 7.

35 Regulation 4(2)(a) – reflecting article 19(1)(a) of the IORP II, which provides that "the assets shall be invested in the best long-term interests of members and beneficiaries as a whole."

36 In their March 2014 joint guide to the regulation of workplace defined contribution pensions FCA and TPR said "FCA's job to ensure that firms that provide contract-based schemes treat their customers fairly. In the same way, [TPR] expects trustees to act in the best interests of their scheme's beneficiaries. In both cases it is clear who is responsible for considering the interests of scheme members…the regulators do have the same expectations for scheme quality and member outcomes." As the court noted in *Harries v Church Commissioners* [1992] 1 WLR 1241 at 1247 trustees "must not use property held by them for investment purposes as a means for making moral statements." In "The Short-form Best Interests Duty – Mad, Bad and Dangerous to Know: Part 1 – Background, Cowan v Scargill and MNRPF" and "Part 2 – the problems and a suggested better formulation", *Trust Law International*, Vol. 32, No. 2, 2018 David Pollard suggests that a clearer formulation than "best interests" is "trustees…must, broadly, exercise their powers within the terms of the trust…and for a proper purpose and for what they consider, in good faith, to be most likely to promote the success of the trust."

37 PRIN 2.1.1R(6) and COBS 2.1.1R(1)). The latter implements article 24(1) of MiFID, article 17(1) of Directive (EU) 2016/97 of the European Parliament and of the Council of 20 January 2016 on insurance distribution (and article 14(1)(a) and (b) of the UCITS Directive. The duties under COBS 2.1.1R are owed in a client-by-client basis (contrast the position of trustees). However, an FCA regulated firm is unlikely to have only one client and PRIN 2.1.1R(6) indicates how, as a regulatory matter, they should approach situations where the "best interests" of clients are not identical.

38 Most recently, *Adams v Options SIPP UK LLP* [2020] EWHC 1229 (Ch) at paragraph 148ff. (appeal on the COBS point dismissed because argFuments advanced to Court of Appeal differed radically ([2021] EWCA Civ 474), but Newey LJ commented at paragraph 126 that "Mr Adams might anyway have struggled to overcome the judge's finding that any breach of duty was not causative of loss").

39 This requirement is obviously somewhat modified in its application where the source of the power in question is contractual because it is generally open to the parties to the contract to modify the requirement and it can, for example, be modified by a trust deed or constitutional document.

40 At paragraph 3.31 of *Pensions, Contracts and Trusts: Legal Issues on Decision Making* (2020) David Pollard suggests that a more helpful way of thinking about this requirement is that a decision-maker must take the relevant decision at the right time, see further its chapter 69.

41 Paragraph 6.81. However, in paragraph 6.83 the Law Commission does go on to say "In DC schemes, members bear both the benefits and the risks of the investment decision and should therefore be entitled to make informed ethical choices. We think that where the trustees of DC schemes are faced with members' clearly articulated views they should attempt to provide a suitable choice of funds." Principle 6 of the Stewardship Code envisages that a signatory will take account of client and beneficiary needs and communicate to them the activities and outcomes of their stewardship and investment. This includes explaining how they have sought beneficiaries' views (where they have done so) and the reason for their chosen approach and how they have taken account of those views.

42 Or, indeed, what will promote the success of the mutual fund or insurer (see 1.19 above for the conflicts of interest requirements which must also come into play in making this judgement).

43 [1948] 1 KB 223.

44 See paragraph 3.64 of the 2014 Report. Though trustees (in particular pension scheme trustees) have long been recognized as being obliged when exercising discretions to give proper consideration to relevant matters and not consider matters which are irrelevant.

45 [2015] UKSC 17.

46 Paragraph 3.33 of *Pensions, Contracts and Trusts: Legal Issues on Decision Making* (2020) David Pollard and see further chapters 48 and 49.

47 Ibid chapter 50.

48 As noted in the [EU] Impact Assessment (pages 38 and 39) "some entities…do not analyse [ESG] factors, either because they do not have the tools and the ESG-related knowledge to do it or because they confuse ESG integration with ethical investing, which implies accepting lower risk-adjusted returns, which would not be in the best interest of their clients/beneficiaries." Paragraph 6.29 of the 2014 Report says "we hope that we can finally remove any misconceptions on this issue: there is no impediment to trustees taking account of environmental, social or governance factors where they are, or may be, financially material."

49 The ministerial foreword to the DWP Climate Risk 2021 Consultation says "I feel there is still more work to be done to change mind-sets when I hear "climate risk is likely not the most immediate or critical risk for many schemes"…Failing to ensure climate risk, the most systemic risk facing financial services, is properly considered is – in my view – a failure in trustees' duty to protect members. Some trustees may think that these proposals are an overreaction – because they believe the market has delivered for them over the past decade, because they have seen it ride out "storms" before or because they wrongly think they have not yet seen any impact of climate change on their investments. To these trustees I say that the world is changing, the challenges are changing. You need to change."

50 This issue also comes at trustees of DB schemes from another angle; trustees need to be alert to any issue which may impact the strength of the employer covenant and thus the funding employer's continuing support for the scheme. The Braganza case refers to a decision being "irrational", but others have referred to a decision that is perverse, arbitrary, capricious or outrageous. The court was not referring to the economic concept of rational utility maximisation. Rather it was imposing a minimum objective standard on the decision-maker's mental processes with a view to ensuring that the decision-maker has not abused the power. The test is not the same as that imposed by the duty of care requirements discussed at 1.43 et seq below.

51 In "From rationality to proportionality in the modern law" (2014) 44 HKLJ 447 at 449 Lord Carnwath describes the these as imposing a "very high threshold" in his discussion of the judgment of Lord Diplock in *Council of Civil Service Unions v Minister for the Civil Service* [1985] AC 374, HL.

52 The guidance issued by the then Department for Communities and Local Government, "Local government pension scheme: guidance on preparing and maintaining an investment strategy statement," says "Although administering authorities are not subject to trust law, those responsible for making investment decisions must comply with general legal principles governing the administration of scheme investments. They must also act in accordance with ordinary public law principles, in particular, the ordinary public law of reasonableness. They risk challenge if a decision they make is so unreasonable that no person acting reasonably could have made it."

53 *Re Tempest* (1886) 1 Ch App 485 at 487 - 488.

54 Paragraphs 3.59 to 3.61 of the 2014 Report explain these principles further and, in particular, that this is not a mechanistic process, but a general requirement of fairness.

55 FCA rulebook PRIN 2.1.1R(6). As noted at 1.23 above, this requirement has an important role to play in relation to the resolution of conflicts between the interests of different clients/beneficiaries. Principle 6 of the Stewardship Code can be seen as having broadly similar aims.

56 Paragraph 3.70. In *Pensions, Contracts and Trusts: Legal Issues on Decision Making* (2020) at paragraph 3.29 David Pollard identifies an implied duty of due (or properly informed) consideration, which can be seen as part of the duty of care.

57 *Henderson v Merrett Syndicates* [1995] 2 AC 145 at 193.

58 PRA fundamental rule 2, which applies to insurers, is expressed in identical terms.

59 FCA rulebook PRIN 2.1.1R(2) and (9). It seems arguable that an exercise of investment powers in relation to a unit-linked insurance fund falls within the second of these requirements. PRIN 2.1.1R(6), covered at 1.42 above is also potentially relevant in this context. As already noted, FCA guidance will be relevant to assessing whether the conduct in question falls below that required by the rules (FCA EG 2.9.4R). It may also be relevant in determining the extent of a standard of care, although the courts have been careful to keep regulatory rules and tortious duties separate: see *Green and Rowley v The Royal Bank of Scotland* [2013] EWCA Civ 1197, and also the explanation in *London Executive Aviation Ltd v The Royal Bank of Scotland* [2018] EWHC 74 (Ch) at 166.

60 (1886) 33 Ch D 347 at 355 (applied most recently in *Nestle v National Westminster Bank plc* [1993] 1 WLR 1260 at 1267-1268). However, it is clear that prudence is context-specific but less clear what it means; the 2014 Report notes (at paragraph 3.72) "there has been a move away from this traditional language of 'prudence'. In 2000, trustees' duties of care were put on statutory footing in England & Wales through the Trustee Act 2000…The Act signalled a move towards 'reasonableness' as the relevant standard of conduct." The *Nestle* case also suggested that "prudence" may not be the most appropriate expression in the context of a pension fund; "this principle remains applicable however wide, or even unlimited, the scope of the investment clause in a trust instrument may be. Trustees should not be reckless with trust money. But what the prudent man should do at any time depends on the economic and financial conditions of that time—not on what judges of the past, however eminent, have held to be the prudent course in the conditions of 50 or 100 years before. It has seemed to me that Mr Nugee's submissions placed far too much weight on the actual decisions of the courts in the last century, when investment conditions were very different." *Nestle v National Westminster Bank* [1993] 1 WLR 1260 at 1268. The concept of prudence is, however, used in EU law, for example, IORP II and Solvency II and so brought back into UK law.

61 (1886) 33 Ch D 347 at 350.

62 Paragraph 5.76 which goes on to note that, when investing in long-term equities, this includes risks to the long-term sustainability of a company's performance.

63 [1993] 1 WLR 1260 at 1282.

64 Paragraph 6.72 of the 2014 Report notes that "increasing diversification is not necessarily an unmitigated good and we did not think that the courts require a portfolio to be diversified to the fullest extent possible. Instead it is a question of degree in each case, taking

UNITED KINGDOM

into account the nature of the scheme." Paragraphs 6.73 and 6.74 provide further detail.

65 There are supporting statutory duties too generally implementing requirements of EU directives. For example, Regulation 4(4) and (7) of the Occupational Pensions Schemes (Investment) Regulations 2005 (reflecting article 19 of IORP II) apply as regards private sector pension scheme trustees. AFMs are also subject to diversification requirements see (COLL 5.2.3R(1)) and (COLL 6.6.3R(3)(a)).

66 See paragraph 3.80 of the 2014 Report.

67 As to which see [Ch2C of the Report transparency about potential impact of sustainability factors] and "Moonwalking bears and underwater icebergs: Hidden risks in markets" speech by Alex Brazier, Executive Director for Financial Stability Strategy and Risk, Bank of England at the London Business School Asset Management Conference (28 April 2018).".

68 The Pensions Regulator, "Climate Change joint statement." https://www.thepensionsregulator.gov.uk/en/document-library/statements/climate-change-joint-statement (accessed at 14 June 2021).

69 See page 52 of the Risk Management chapter of the CFRF 2020 Guide.

70 SS3/19 page 1. See also box 2 page 18 HMG Green Finance Strategy (July 2019). The review of the insurance sector underlying the quoted comment was carried out in 2015, so the position is likely to have improved in response to its publication. See 2.4.11 below for a description of the strategic approach contemplated by the PRA.

71 *Bartlett v Barclays Bank Trust Co Ltd* [1980] Ch 515 is discussed further at [3.1.13 and 3.1.14] below as regards stewardship.

72 The circumstances in which ultimate ends IFSI is permissible are considered in sections 2, 3, 4 and 6 below.

73 Or where the practice does not stand up to logical scrutiny (see *Clerk and Lindsell on Torts*, 23rd edition, 2020 at 9-140; *Edward Wong Finance Co Ltd v Johnson, Stokes and Master* [1984] A.C. 296; Bolitho v City and Hackney HA [1998] A.C. 232).

74 *Nestle v National Westminster Bank Plc* [1992] EWCA Civ 12.

75 Page 3 of the Summary chapter. Similarly, paragraph 41 of "Part 1 – Introduction of the PCRIG Guidance" of the PCRIG Guide 2020 says "trustees should also recognise that market standards are evolving in this area and that what may be considered 'prudent' in relation to climate-related risks today might no longer meet that standard in the future, given developing understanding of these risks. Trustees should keep matters under review." Recognition that there is not enough credible detailed information on climate financial risk to support accurate and cost-effective risk-modelling has led the Government to fund a Centre for Greening Finance and Investment https://www.gov.uk/government/news/leeds-and-london-set-to-become-global-centres-of-green-finance (accessed at 14 July 2021).

76 Chosen because, as the letter says, "we believe that [each of the companies in question] faces material headwinds from a move onto a 2050 net zero pathway."

77 https://www.iigcc.org/resource/investor-expectations-for-paris-aligned-accounts/ (which includes the November 2020 specimen letter and a guide entitled "Investor Expectations for Paris-aligned Accounts" (accessed at 14 July 2021)). The guide explains "Financial statements that leave out material climate impacts misinform executives and shareholders and thus, result in misdirected capital. Company leaders without correct cost and return information are equivalent to pilots without a properly functioning altimeter. In extreme cases, companies on the wrong flight path – like planes – can crash."

78 Recommendation 9 and pages 46 and 47.

79 As is acknowledged by outcomes 3 and 5 of the FCA's fair treatment of customers webpage, which is explicitly linked to PRIN 2.1.1R(6) – https://www.fca.org.uk/firms/fair-treatment-customers (accessed at 14 July 2021).

80 These requirements do not, on the whole, apply to smaller companies.

81 For example, a 2019 survey of companies' annual reporting found that 92% of the FTSE 100 companies reviewed explicitly identified sustainability risks, but only 31% specifically disclosed the environmental and/or social impacts of their business (pages. 4-5, PricewaterhouseCoopers, "Purpose and impact in sustainability reporting: A review of leading UK companies," November 2019).

82 Section 414C Companies Act 2006; DTR 4.1.8R.

83 These include (broadly) the likely long-term consequences of corporate decisions, the company's impact on the community and the environment and any reputational risk to the company.

84 For example, paragraph 7A.31, FRC, Guidance on the Strategic Report, July 2018. See also International Financial Reporting Standards, Standards and climate-related disclosures briefing, November 2019.

85 Sections 414CA-B Companies Act 2006, which apply to authorised insurers, whether or not publicly traded.

86 Paragraphs 15 and 20D, Schedule 7, Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations (SI 2008/410).

87 Section 54, Modern Slavery Act 2015. By way of illustration of how these disclosures can be used by Asset Owners and Investment Managers, see the 28 January 2021 letter from the chief executive of CCLA (an Investment Manager) to the FT, which refers to the "find it, fix it, prevent it" initiative designed to improve engagement with portfolio companies, based on their annual modern slavery statements – https://www.modernslaveryccla.co.uk/problem (accessed at 14 July 2021).

88 LR 9.8.6R. See also FCA Policy Statement PS20/17, Proposals to enhance climate-related disclosures by listed issuers and clarification of existing disclosure obligations, December 2020. Many of the UK's largest insurers by assets under management are premium listed companies.

89 HM Treasury, "Interim Report of the UK's Joint Government-Regulator TCFD Taskforce," November 2020.

90 "Initial response to the IFRS Foundation Trustees Consultation," November 2020. https://www.gov.uk/government/publications/joint-statement-of-support-for-ifrs-foundation-consultation-on-sustainability-reporting/initial-response-to-ifrs-foundation-trustees-consultation (accessed at 14 July 2021). The announcement goes on to note that this will "promote much-needed integration of financial and non-financial reporting, within a common architecture". The Investing with Purpose report anticipates that, in the future, it may be appropriate to consider a wider range of sustainability disclosures from private companies and encourages large private companies to have regard to the ongoing dialogue about harmonisation of sustainability frameworks
The International Organization of Securities Commissions (IOSCO) has established a Board-level Taskforce on Sustainable Finance, with the aim of coordinating global efforts to advance the market for sustainable finance. One particular area of focus is issuers' sustainability- related disclosures (IOSCO FR04/2020 Sustainable Finance and the Role of Securities Regulators and IOSCO page 29)..

91 HM Government, "Green Finance Strategy: Transforming Finance for a Greener Future," July 2019. https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/820284/190716_BEIS_Green_Finance_Strategy_Accessible_Final.pdf (accessed at 14 July 2021). As regards timing see the Regulatory Initiatives Grid (May 2021) published by the FCA. It is unclear whether and to what extent the non-disclosure related elements of the EU Sustainable Finance Package will be implemented in the UK.

92 Many pension funds will have a corporate trustee and so the decision-makers will, in practice, be the directors of that trustee. In contrast with insurers, we have not considered the duties of these directors separately because their powers will need to be exercised to fulfil the trustee's own duties.

93 There are no statutory definitions of beneficiary although TPR has published guidance for the trustees of private sector schemes – https://www.thepensionsregulator.gov.uk/en/document-library/regulatory-guidance/trustee-guidance (accessed at 14 July 2021).

94 See 2.2.5 below for an explanation. See also the court's approach in *Edge v Pensions Ombudsman* [2000] Ch 602) *and Re Merchant Navy Ratings Pension Fund; Merchant Navy Ratings Pension Trustees Ltd v Stena Line Ltd* [2015] EWHC 448 (Ch) which confirmed that it was legitimate for the trustee to take the employer's interests into account.

95 There appears to be academic consensus that their investment duties are broadly analogous to trustees of private pension schemes and that their obligations are to beneficiaries and scheme employers (see discussion at paragraphs 4.69 – 4.74 of the Law Commission's 2014 report). Under regulation 7(1) of the LGPS Investment Regulations, an LGPS authority must formulate its ISS statements in accordance with governmental guidance. The current guidance relating to the ISS states that investment decisions should be in the "best long term interests of scheme beneficiaries and taxpayers", although the recent case of *R (on the application of Palestine Solidarity Campaign Ltd) v Secretary of State for Housing, Communities and Local Government* [2020] UKSC 16 casts some doubt on the relevance of taxpayer interests.

96 These areas of governmental intervention may increase in the future. As noted in paragraphs 23 and 24 of "Part 1 – Introduction to the PCRIG Guidance" of the PCRIG Guide 2020 "the longer the delay in climate policy action, the more forceful and urgent any regulatory policy intervention will inevitably be in order to limit global average temperature increases to a level that's more likely to allow for economic and social stability. This would have a more severe impact on companies and pension schemes as investors… companies face increased cost and uncertainty from a disorderly low-carbon transition and increased physical risks, and investors face increased risk compared to a scenario where climate policy is enacted smoothly and steadily."

97 "By 2030, significantly reduce illicit financial and arms flows, strengthen the recovery and return of stolen assets and combat all forms of organized crime." See also commentary from the UN Office on Drugs and Crime and the UN Commission on Crime Prevention and Criminal Justice (https://www.unodc.org/unodc/en/sustainable-development-goals/sdg16_-peace-and-justice.html and https://sustainabledevelopment.un.org/index.php?page=view&type=30022&nr=656&menu=3170 respectively, both accessed at 23 January 2021).

98 There are provisions in the Environment Bill currently before Parliament intended to prevent illegal deforestation in the UK's international supply chain by requiring implementation of, and reporting on, a due diligence system. The Global Resource Initiative, a UK government-convened taskforce of leaders from business and environmental organisations established to consider how the UK can reduce the climate and environmental impacts of key UK supply claims, Final Recommendations Report, March 2020 page 25 recommended a similar mandatory due diligence obligation for financial services firms to prevent lending and investment funding of deforestation, but this is not included in the proposed legislation. See also Jonathan Ford, "Britain's necessary but insufficient battle on modern slavery," *Financial Times*, 17 January 2021 . "Failure to prevent"-type offences – see for example, section 10 Bribery Act 2010 – are one way the Government has chosen to do this in other contexts.

99 Cluster Munitions (Prohibitions) Act 2010, which gives effect to the

UNITED KINGDOM

Convention on Cluster Munitions. A ministerial statement suggests that these provisions are intended to criminalise the provision of funds "directly contributing to the manufacture" of the prohibited weapons, but that "so-called indirect financing" (including providing funds generally to companies that manufacture a range of goods, including cluster munitions) is not prohibited - Written Ministerial Statements, Foreign and Commonwealth Office, Chris Bryant, Cluster Munitions Production (*Financing*) (7 Dec 2009: Column 1WS).

100 The Pension Schemes Act 2021, in force as of February 2021, also makes provision for "collective money purchase" pension schemes that are expected to provide a form of target defined benefit that is not fully guaranteed and can vary depending on funding levels (sometimes referred to as a defined ambition scheme).

101 Required by section 35 of the Pensions Act 1995, with requirements relating to the content of the SIP provided by regulation 2 of the Private Scheme Investment Regulations.

102 TPR, "DC trust: presentation of scheme return data 2018 – 2019" ((https://www.thepensionsregulator.gov.uk/en/document-library/research-and-analysis/dc-trust-scheme-return-data-2019-2020 accessed at 14 July 2021).

103 TPR, "DC trust: presentation of scheme return data 2019 – 2020" ((https://www.thepensionsregulator.gov.uk/en/document-library/research-and-analysis/dc-trust-scheme-return-data-2019-2020 accessed at 14 July 2021).

104 Unfunded public schemes are not covered in this annex because this analysis in not relevant to them; pensions are not paid out of investment proceeds.

105 The LGPS has over 5.9 million members and its funds have an estimated aggregate market value of £287.2 billion in assets. Ministry of Housing, Communities and Local Government, "Local Government Pension Scheme Funds: England and Wales 2018-19," pages 1 and 5..

106 Which have been amended to implement IORP II requirements.

107 See especially sections 33 and 36.

108 See especially section 249A.

109 See especially regulations 2 and 4.

110 Some of these requirements do not apply to schemes with under 100 members.

111 TPR is due formally to consult in 2021 on a code of practice combining the content of its 15 current codes of practice to form a single, shorter code - https://www.thepensionsregulator.gov.uk/en/document-library/statements/single-code-of-practice-statement (accessed at 14 July 2021). TPR is focussing on the effective system of governance and the code must cover (among other things) (a) how a fund provides for sound and prudent management of activities, (b) how it includes consideration of environmental, social and governance factors related to investment assets in investment decisions and (c) an own risk assessment covering (among other things) where environmental, social and governance factors are considered in investment decisions, how the trustees assess new or emerging risks, including (i) risks relating to climate change, the use of resources and the environment; (ii) social risks; and (iii) risks relating to the depreciation of assets as a result of regulatory change. The new code and the changes to the guidance relating to governance are intended to implement various IORP II requirements.

112 These sections were inserted on 31 May 2021 by section 124 Pension Schemes Act 2021 (Commencement No 1) Regulations 2021 (SI 2021/630)). The DWP Climate Risk 2021 Consultation and June 2021 Government response to this consultation explain the approach. The Occupational Pension Schemes (Climate Change Governance and Reporting) Regulations 2021 can be found at The Occupational Pension Schemes (Climate Change Governance and Reporting) Regulations 2021 (legislation.go.uk) and https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/992082/draft-misc-provisions-regs.pdf (both accessed at 14 July 2021)respectively and are expected to come into force on 1 October 2021. The final form of the statutory "Guidance for trustees of occupational schemes on governance and reporting of climate change risk" can be found at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/995679/statutory-guidance-final.pdf. (accessed at 14 July 2021). The PCRIG Guide 2020 provides additional non-statutory guidance. TPR is also expected to publish guidance on the new regulations following consultation. The draft guidance also notes that additional, separate guidance on how climate change risks should be part of a scheme's assessment of "employer covenant" (i.e. the legal extent and financial strength of the support that the employer and its corporate group provides to the scheme, considering the latter in its position as creditor) will be published in future. Broadly, trust schemes with £1 billion or more in net assets and authorised master trusts will be subject to these new governance requirements and, in consequence, to TCFD reporting requirements (the timing proposals on this, and on reporting on these new governance requirements are covered at 2.2.12 below).

113 Implementing provisions of article 19 IORP II we would suggest that this should be interpreted consistently with the judge-made law requirements described in 1.19 and 1.27 above.

114 Or explain why matters have been omitted.

115 See 2.2.15 to 2.2.18 below for an explanation of these terms.

116 Regulation 2(3)(d) Private Scheme Regulations, implementing Article 3h of SRDII.

117 Recommendation 14 of Investing with Purpose highlights a commitment by the Investment Association and the PLSA commitment to establish a new steering group to explore how to embed a focus on long-term factors in the trustee/Investment Manager relationship. Further details are given at 6.5 below.

118 Section 33 Pensions Act 1995.

119 TPR Investment Guidance for DB schemes and TPR Investment Governance for DC schemes. See also PLSA, Stewardship and Voting Guide 2020: "There is a growing body of evidence to demonstrate that active and engaged shareholders can have a positive impact on corporate performance. That is why the PLSA has long been active in helping its members engage with investee companies… to protect and enhance the value of savers' capital…Although the term 'stewardship' is often used interchangeably with 'ESG', the issues upon which schemes should act as good stewards encompass anything potentially financially material: from strategy, performance and treatment of 'traditional' financial risks to topics such as climate change, human rights or board and workforce diversity."

120 Recommendation 16, which is expected to be established by June 2021.

121 The regulation is due to come into force on 1 October 2021: (see endnote 111).

122 In response to concerns that have been raised in consultation about the difficulties pension scheme trustees may face in obtaining sufficient data to comply with their reporting obligations, the DWP has proposed that trustees are only expected to comply "as far as they are able". The draft regulations clarify that this requires trustees to take "all such steps as are reasonable and proportionate in the particular circumstances", taking into account the time and costs that will be (or are likely to be) incurred by the scheme in meeting its reporting obligations.

123 Academic consensus on this has recently been confirmed in *R (on the application of Palestine Solidarity Campaign Ltd) v Secretary of State for Housing, Communities and Local Government* [2020] UKSC 16, paragraphs 12, 30 and 42 approving statements to this effect in the 2014 Report.

124 Regulation 58 of the Local Government Pension Scheme Regulations 2013 (SI 2013/2356).

125 Department for Communities and Local Government, "Local Government Pension Scheme Guidance on Preparing and Maintaining an Investment Strategy Statement," July 2017 and page 10 of Investing with Purpose.

126 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/933783/FINAL_TCFD_ROADMAP.pdf (accessed at 14 July 2021), at paragraph 1.17. At a PLSA conference in May, senior policy adviser, Oliver Watson, indicated that the department was close to issuing its consultation and that the direction the consultation would take would be "very similar" to the DWP proposals described in this section.

127 https://www.thepensionsregulator.gov.uk/en/document-library/statements/climate-change-joint-statement (accessed at 14 July 2021). For DB schemes, the relevance of the employer covenant presents an additional complication. As TPR notes many schemes are also supported by employers whose financial positions and prospects for growth are dependent on current and future policies and developments in relation to climate change.

128 Private Scheme Investment Regulations, reg 2(4). This definition is not on all fours with the test described in 1.36 above which envisages the possibility of a financially material consideration which the trustees fail to identify in breach of the duty of care.

129 Private Scheme Investment Regulations, reg 2(4). The statutory guidance for trustees of occupational schemes on governance and reporting of climate change risk says, in Part 3 ("Climate change governance and production of a TCFD Report") paragraph 44 (when discussing the time horizons to be used in TCFD disclosures) "It is up to trustees how they determine their time horizons. However, in deciding what the relevant time horizons are, trustees must take into account the scheme's liabilities and its obligations to pay benefits. Trustees should also take account of the following…In a DB scheme… the likely time horizon over which current members' benefits will be paid. This may be the longest time horizon they will need to consider…In a DC scheme…the likely time horizon over which current members' monies will be invested to and through retirement. This may be the longest time horizon they will need to consider."

130 TPR, "Investment governance: Investment decisions and your statement of investment principles," July 2016 https://www.thepensionsregulator.gov.uk/en/trustees/managing-dc-benefits/investment-guide-for-dc-pension-schemes- and TPR, "Regulatory Guidance: DB investment, Investing to fund DB," March 2017 https://www.thepensionsregulator.gov.uk/en/document-library/regulatory-guidance/db-investment/investing-to-fund-db (both accessed at 14 July 2021). .

131 The PLSA publication "More Light, Less Heat: A Framework for Pension Fund Action on Climate Change" provides some useful examples of how particular funds have chosen to approach climate change risk.

132 See the July 2017 guidance issued by the then Department of Communities and Local Government on preparing and maintaining an Investment Strategy Statement.

133 The time horizon will be shorter for trustees of schemes approaching buy-out or wind-up.

134 Manager of the University Superannuation Scheme, one of the UK's largest private pension schemes with the California State Teachers' Retirement System (US) and the Government Pension Investment Fund of Japan.

135 *Cowan v Scargill* [1985] 1 Ch 270 which should be understood as a general requirement of fairness (see 1.42 above).

UNITED KINGDOM

136 See "Tackling poor standards of governance and risk management in pensions are priorities for TPR" https://www.thepensionsregulator.gov.uk/en/document-library/statements/climate-change-joint-statement (accessed at 14 July 2021).

137 Advice is potentially required under the Pensions Act 1995. Section 36 Pensions Act 2005.

138 2020's global pandemic, for example. Investing with Purpose includes a section on investors' role in the Covid-19 crisis and post-Covid recovery. On 1 December 2020, the UN-convened Sustainable Insurance Forum announced that Insurance supervisors from the forum are to undertake a landmark scoping study on the financial risks of biodiversity loss and analyse how insurance supervisors and insurance companies are responding to these risks.

139 See, paragraph 6.30 of the 2014 Report and paragraphs 24 and 34 of the 25 November 2016 abridged joint opinion for ClientEarth of Keith Bryant QC and James Rickards https://www.documents.clientearth.org/wp-content/uploads/library/2016-12-02-the-legal-duties-of-pension-fund-trustees-qc-opinion-ext-en.pdf (accessed at 14 July 2021).

140 TPR guide to Investment Governance for DC schemes page 12 "It is important to understand the implications of the systemic risk of climate change on investment decisions in the context of your scheme when developing your SIP". The PCRIG Guide 2020 contains the important warning for DC schemes in part I paragraph 31 that "trustees must not relegate the consideration of climate change to members via [chosen] funds. Rather, trustees must consider its relevance as part of their duty to provide both a default fund and [chosen] funds appropriate to the needs of the membership."

141 Although it is clear that the Investment Managers appointed by a Pension Fund have a critical role to play. As the March 2020 Open Letter says "asset managers that integrate ESG factors throughout their entire investment process, vote according to the mandate to which they have pledged, and are transparent with us about their level of corporate engagement, demonstrate to us that they are committed to long-term value creation in line with our interests… asset managers who commit to sustainable value creation are not injecting politics into business, nor are they "virtue signalling." They are fulfilling their duty to us, and by extension, to the millions of families depending on us."

142 Investing with Purpose notes on page 46 "The incomparability and inconsistency of ESG information and the proliferation of standards and frameworks to solve…this has resulted in a wide range of market inefficiencies, including increased costs from duplicated reporting, verifying ESG data across the investment chain and ultimately the potential mispricing of assets." Paragraph 27 PCRIG Guide 2020 says "the market pricing of assets will say little about a given investor's own attitude or tolerance to risk, or the implications of different climate scenarios. Trustees should therefore be wary about relying on marked to market pricing of assets as a measure of climate-related financial risks." .

143 Paragraphs 15 and 19.

144 As Keith Bryant QC and James Rickards note at paragraph 50 of their 25 November 2016 abridged joint opinion for ClientEarth "It is difficult (and undesirable) in our opinion to attempt to formulate any rigid approach to determining whether a particular factor, such as climate change, will or will not give rise to a financially material risk; what is and what is not financially material is likely to be highly fact sensitive." Friends of the Earth's UN Divest campaign calls on public and private institutions to divest from fossil fuels. It is foreseeable that other parties may frame claims on the basis that an Asset Owner has not fully utilised the available flexibility within the current legal regime to the extent it could have achieved a greater positive, or reduced or prevented a negative, sustainability impact.

145 Where the strategy is a passive one, it may be possible to substitute the index being tracked with one which excludes the investments the trustees would otherwise choose not to invest in.

146 Paragraph 4 Part II of the PCRIG Guide 2020 also says "trustees should consider the internal consistency of their investment beliefs. For example, trustees of defined contribution schemes who believe in the efficacy for the scheme's default fund of a pure passive market-cap weighted fund with no flexibility to reduce allocations selectively should consider how this will reconcile with strong beliefs in relation to the impact of climate change on markets during the time horizon of the scheme's members. Likewise, trustees who believe in the ability of asset managers to identify and exploit asset mispricing should consider how this reconciles with a view that climate-related risks alone have been adequately 'priced in' to company valuations."

147 Appendix 1 to the PCRIG Guide 2020 contains a list of climate change-focussed due diligence questions to consider asking an investment manager.

148 https://equitygenerationlawyers.com/cases/mcveigh-v-rest/ (accessed at 14 July 2021).

149 In June 2020, ClientEarth launched a campaign to encourage individuals to connect with their pension providers and "challenge them over their legal duties on climate change". The Make My Money Matter campaign is wider-ranging: "As soon as people discover their money is invested, most want it to do good while it's growing. In fact, 68% of UK savers want their investments to consider people and planet alongside profit. So we're going to help people find out where their money's going and demand it does better. That can be through investments in more positive industries, or by using our pension power to ensure companies transition to more sustainable practice." https://makemymoneymatter.co.uk (accessed at 14 July 2021).

150 Although see, for example, https://www.lgim.com/landg-assets/lgim/_document-library/capabilities/lgimh-controversial-weapons-policy.pdf (accessed at 14 July 2021) "Controversial weapons are those that have an indiscriminate and disproportional humanitarian impact on civilian populations; the effects of which can be felt long after military conflicts have ended…we do not deem these companies to be a good investment based on their reputational risk profile… the market for such weapons is very limited and involvement brings reputational risk. We believe it makes business and investment sense for companies to reconsider their involvement." Paragraphs 6.64 and 6.65 of the 2014 Report appear to assume that a decision to avoid investment in controversial weapons is necessarily based on a non-financial factor. This example suggests that the decision could instead be a financial one.

151 See the passage from Investing with Purpose at 3.2.4 below. The Financial Times (31 January 2021) reported that Aviva Investors has called on thirty of the world's largest oil, gas, mining and utilities companies to set net zero emission goals and integrate climate risks into their strategy (including their plans for capital expenditure) and has said that it will divest both equity and fixed income holdings of any company which fails to meet these expectations over the next one to three years. The PCRIG Guide 2020 says (at paragraph 3 of part II) that trustees may wish to consider, in the context of their investment beliefs, the balance between engagement, voting and/or divestment as appropriate tools to manage climate-related risks.

152 At a recent sustainable investment festival, the Pensions Minister, Guy Opperman is reported in Professional Pensions as saying: "I cannot state how much I oppose this [divestment]…It is a fool's errand to describe yourself as sustainably investing when you divest from all inappropriate stocks and simply invest in tech, for instance." https://www.professionalpensions.com/news/4033298/divestment-sin-stocks-fool-errand-opperman (accessed at 14 July 2021).

153 Law Com No 374.

154 See further discussion in *Report on Pension Funds and Social Investment*, 2017, Law Com No 374 2017 at paragraph 5.50. The Law Commission's views are not binding but are likely to be regarded as at least persuasive by English courts. We have not identified any examples in case law of such a duty arising in practice.

155 The PCRIG Guide 2020 notes at paragraph 3 of part I that "Sections of the guidance may be of interest to others, including managers of funded public sector schemes." The Environment Agency Pension Fund's "Getting to Net Zero and Building Resilience" Policy to Address Climate Change (March 2021) is an example of IFSI – https://www.eapf.org.uk/~/media/document-libraries/eapf2/policies/2021/eapf-policy-to-address-climate-change-publication-version.pdf?la=en&hash=4D4E12DC50B01D6E0C85706A41AEDD9A33A4D679 or https://www.eapf.org.uk/investment/policies (both accessed at 14 July 2021).

156 Private Scheme Investment Regulations, reg 2(4). Contrast the definition of "financially material considerations" as including (but not limited to) "environmental, social and governance considerations (including but not limited to climate change), which the trustees of the trust scheme consider financially material".

157 Private Scheme Investment Regulations, reg 2(4). Contrast the definition of "financially material considerations" as including (but not limited to) "environmental, social and governance considerations (including but not limited to climate change), which the trustees of the trust scheme consider financially material".

158 TPR, "Investment governance," https://www.thepensionsregulator.gov.uk/en/trustees/managing-dc-benefits/investment-guide-for-dc-pension-schemes- (accessed at 14 July 2021). See also TPR's guidance on Investment Governance for DB schemes: https://www.thepensionsregulator.gov.uk/en/document-library/regulatory-guidance/db-investment/db-investment-governance (accessed at 14 July 2021).

159 In reaching their conclusion, the Law Commission considered a number of cases, including *Cowan v Scargill* [1985] Ch 270 (see above), *Martin v City of Edinburgh District Council* [1989] Pens LR 9, 1988 SLT 329 and *Harries v Church Commissioners* [1992] 1 WLR 1241.

160 *R (Palestine Solidarity Campaign Ltd) v Secretary of State* [2020] UKSC 16 at [43], Lord Carnwath JSC stated that the Law Commission's report "may be seen as having settled a long-running debate as to the extent to which pension trustees could take account of non-financial factors…There appears now to be general acceptance that the criteria proposed by the Law Commission are lawful and appropriate. I agree."

161 TPR, "Investment governance," July 2019 https://www.thepensionsregulator.gov.uk/en/trustees/managing-dc-benefits/investment-guide-for-dc-pension-schemes (accessed at 14 July 2021)..

162 At least in part because the underpinning case-law is rooted in charitable trust cases that arguably cannot and/or should not be readily applied outside this context. See the discussion of *Harries v Church Commissioners* in Bennet, "Must an occupational pension scheme take into account ESG factors even if there is a risk of financial detriment to the pension fund?" *Trust Law International*; Vol 32 (2019). Lord Carnwath's comments referred to in endnote 159 are obiter.

163 See the discussion of *Cowan* in "Pension Scheme Investment: Is it always just about the Money? To what extent can or should trustees take account of ethical or ESG factors when Investing?" Daykin, *Trust Law International*; Vol 28, No 4 (2014).

164 At one extreme, it has been argued that consideration of "non-financial" factors is only permissible in a "tie-break" scenario, as a way of choosing between two choices which are equal from a financial return perspective. The 2014 Report considers that this is too narrow an interpretation, stating that trustees have discretion in the way that they assess financial detriment provided that they apply their minds to the question and take professional advice about

UNITED KINGDOM

it (para 6.76). As a possible further disincentive, section 107 Pension Schemes Act 2021 inserts a new section 58B into the Pensions Act 2004 containing a criminal offence of knowingly or recklessly, and without reasonable excuse, acting or engaging in a course of conduct that detrimentally affects in a material way the likelihood of accrued scheme benefits being received. This may deter some trustees from taking into account in their investment decision-making something which is not legally required although the required mental threshold is high, and if the Non-Financial Factors Test is met, the decision should not involve a risk of significant financial detriment to the fund.

165 LGPS Pension Scheme Advisory Board, England and Wales, Board Guidance on the role of non-financial considerations in LGPS investment, May 2018 and Department for Communities and Local Government, Local Government Pension Scheme Guidance on Preparing and Maintaining an Investment Strategy Statement, July 2017.

166 FCA, Authorised and recognised funds, https://www.fca.org.uk/firms/authorised-recognised-funds (accessed at 7 July 2021). We have not covered AIFs - the EU's other main form of collective investment vehicle - as these are much less commonly sold to retail investors. They are also much less tightly regulated in terms of permitted investments etc. and regulation is mainly directed at the manager, rather than the fund itself. Pooled pension vehicles are generally AIFs.

167 OEICs are established and authorised by the FCA under the Open-Ended Investment Companies Regulations 2001 (SI 2001/1228).

168 Authorised unit trusts are established under trust law (FSMA s. 237(3)) and authorised by the FCA under section 243 FSMA.

169 Exchange traded funds (ETFs) are the most popular type of exchange-traded product in the UK. ETFs that follow the performance of an index or market are commonly known as passive, or tracker, funds. https://www.fca.org.uk/consumers/exchange-traded-products (accessed at 14 July 2021).

170 In CP20/5 "open-ended investment companies: proposals for a more proportionate listing regime" at paragraphs 2.2 and 2.3, the FCA notes that, in response to an earlier discussion paper "stakeholders noted that underlying funds regulation that applies to authorised funds and their managers (for example rules which implement the UCITS Directive), offer significant protections for investors, including retail investors. The feedback suggested that the main source of investor confidence in ETFs comes from the rules for funds rather than the Listing Rules. In addition, stakeholders noted that investors relied on funds documentation such as a UCITS prospectus, rather than the listing particulars currently required under the Listing Rules. Therefore, stakeholders stated that the current Listing Rules impose an unnecessary, additional layer of regulation that does not serve any valuable purpose for investors."

171 COLL 6.2.16R. Article 1(2) UCITS Directive.

172 Article 19(6) UCITS Directive. The AFM will commonly delegate investment to an Investment Manager but will retain responsibility for the Investment Manager's decisions: COLL 6.6.15R(1) - (1A) and 6.6.15AR(3).

173 The KIID must include appropriate information about the essential characteristics of the fund so that prospective investors are reasonably able to understand the nature and risks of the investment product that is being offered to them and, therefore, to take investment decisions on an informed basis (COLL 4.7.2R(3) and article 78(2) UCITS Directive).

174 COLL 4.2.5R. The KIID may potentially provide additional, relevant information. article 78 UCITS Directive.

175 COLL 4.2.5R(3) (article 78 (3(b)) UCITS Directive) requires the prospectus to set out the investment objectives, including the fund's financial objectives; the investment policy for achieving those investment objectives, including the general nature of the portfolio and, if appropriate, any intended specialisation; and an indication of any limitations on that investment policy. COLL 4.2.6G (article 69 (2) UCITS Directive), which provides guidance on the contents of the prospectus says, by way of guidance on what should be said about the investment policy, a prospectus might include a description of any restrictions in the assets in which investment may be made, including restrictions in the extent to which the fund may invest in any category of asset, indicating (if appropriate) where the restrictions are more onerous than those imposed by COLL 5 (Annex 1 Schedule A (1.15) UCITS Directive). In the case of an umbrella fund, the investment objective of each sub-fund must be set out in the instrument of incorporation as well (see paragraph 4, Schedule 2 Open-Ended Investment Companies Regulations 2001 (SI 2001/1228). See 5.3.3 below for how the investment objective and the investment policy can be amended during the life of the fund.

176 COLL 4.2.5R(3)(ca)(ii).

177 COBS is modified in its application to an AFM by COBS 18.5B and in relation to an OEIC without a separate management company by COBS 18.9.

178 COLL 5 (limits are summarised in COLL 5.1.2G and 5.1.4G) and, in particular 5.2.3R and 5.2.7AR(1)(b).

179 COLL 6.6.3R(3)(a). COLL 6.6.14R(1) says "The [AFM] must avoid the scheme property being used or invested contrary to COLL 5, or any provision in the instrument constituting the fund or the prospectus as referred to in COLL 5.2.4 R (Investment powers: general), COLL 5.6.4 R (Investment powers: general)."

180 COLL 6.6A.2R reflecting article 14 UCITS Directive.

181 COLL 6.6A.5R reflecting article 14(1)(e) UCITS Directive.

182 COLL 6.6.5R(1) states that "the duties and powers of the [AFM] under COLL and under the instrument constituting the fund are in addition to the powers and duties under the general law."

183 COLL 4.2.2R and 4.2.4R - the liability to pay compensation under the latter rule is in addition to any other liability it may have, for example under section 90 FSMA. As regards the KIID, see COLL 4.7.2R and section 90ZA FSMA sets out potential liability for the KIID where it is misleading, inaccurate or inconsistent with relevant parts of the prospectus.

184 The relationship between the OEIC and its unitholders might well not be regarded as fiduciary, but the regulatory duty of loyalty has broadly similar content (see 1.21 above) to what we have called fiduciary duty in the Annex (see 1.19 above).

185 In the case of an OEIC, the AFM is its authorised corporate director. Some assistance as to the nature of the relationship between the OEICs directors and the OEIC itself is given in regulation 35 OEIC Regulations which provides "(1) The matters to which a director of an open-ended investment company must have regard in the performance of his functions include the interests of the company's employees in general, as well as the interests of its shareholders (2) The duty imposed by this regulation on a director is owed by him to the company (and the company alone) and is enforceable in the same way as any other fiduciary duty owed to a company by its directors."

186 It is less clear whether a court would also conclude that it owes any of these judge-made law duties described in (b)(i) directly to unitholders when exercising its investment decision-making powers.

As regard fiduciary duties, in its 2014 Report the Law Commission concluded that, in rare cases, an Investment Manager may owe fiduciary duties to the Beneficiaries of an Asset Owner. We consider a court would take a similar approach here, although T C Cornick, in *Collect Investment Schemes: the Law and Practice* (1989), expressed the views, as regards unit trusts, that "the manager of the scheme stands in a fiduciary relationship with the holders" (A1.043) and "it seems generally accepted that the manager is subject to the same fiduciary duties as the trustee" (A4.179). This may be based on rules applying to the AFM, which refers to unitholders as well as to the UCITS scheme itself, such as COLL 6.6A.2R (reflecting article 14 UCITS Directive) and 6.6A.5R (reflecting article 14(1)(e) UCITS Directive). As regards OEICs, *Palmer's Company Law* (release 170, second release for 2021, April 2021), says in chapter 5A.102: "The financial institutions…bear fiduciary duties to the investors" and 5A.232 "it is suggested that the management company, or ACD, occupies a fiduciary relationship in respect of the OEIC."

As regards a tortious duty of care, given the valuation transparency of a UCITS scheme, we think the precedent of *Robinson v Chief Constable of West Yorkshire Police* [2018] UKSC 4 is not necessarily a reliable one.

187 Unlike the DWP proposals, the FCA proposals do not include provisions on governance and risk management because the FCA considers broadly that these already apply under its existing requirements (paragraph 2.20 of CP21/17). It is also providing limited flexibility for firms to provide some disclosures on a "best efforts basis, for example where methodologies for certain metrics are not yet widely established" and to allow use of proxy data or assumptions where relevant information is not available from portfolio companies (paragraphs 3.34 and 3.36). Entity level reports may also recognise group membership (paragraphs 4.16 to 4.20)..

188 This is defined in the FCA Handbook glossary as "a documented system of internal limits concerning the measures used by the AFM to manage and control the relevant risks for the scheme, taking into account all the risks which may be material to the UCITS including, but not limited to, liquidity risk, counterparty risk, market risk and operational risk and ensuring consistency with the UCITS "risk profile". It cross-refers to articles 38(1) and 40(2)(d) UCITS Implementing Directive (the former is discussed in 2.3.10).

189 As part of the EU Sustainable Finance Package the Commission is proposing to amend article 23 of the UCITS Implementing Directive to require AFMs to take into account sustainability risks, meaning "an environmental, social or governance event or condition that, if it occurs, could cause an actual or potential material negative impact on the value of the investment" when complying with these requirements (European Commission legislative proposal of April 2021, amending Directive 2010/43/EU as regards the sustainability risks and sustainability factors to be taken into account for Undertakings for Collective Investment in Transferable Securities).

190 The Commission is also proposing in the legislative proposal referred to in the previous endnote to insert a reference to sustainability risks into this article. In the explanatory memorandum to the proposed legislation, the Commission states that this change "clarifies that the risk management policy under Article 38 of Directive 2010/43/EU must also consider exposures of UCITS to sustainability risks." This supports our view that the insertion of "sustainability" into article 38(1) of the UCITS Implementing Directive is a clarificatory amendment since the risk limit system is already required to deal with "all…risks… which may be material for each UCITS [the AFM] manages".

191 The relevant FCA Handbook Glossary definition is "the risk of loss for a UCITS…resulting from fluctuation in the market value of positions in the fund's portfolio attributable to changes in market variables, such as interest rates, foreign exchange rates, equity and commodity prices or an issuer's credit worthiness". Paragraph 4.10 of the FCA's DP18/8 "Climate Change and Green Finance" acknowledges that, for example, climate change transition risk gives risk to market risk.

192 Page 33 of the Risk Management chapter.

193 For example, there are plans to close it.

194 It appears to be common for UK UCITS to give a period of this kind, whether or not they are strictly required to by COLL 4.2.5R(3)(ca)(ii), which requires this to be stated for any fund that "has indicated in its name, investment objectives or fund literature (including in any financial promotions for the fund), through use of descriptions such as 'absolute return', 'total return' or similar, an intention to deliver

UNITED KINGDOM

positive returns in all market conditions". Some refer to returns "over the long-term".

195 The Blackrock and Vanguard Stewardship Code statements referred to in 6.8 below show how the particular characteristics of a scheme are important to this determination - "our [index fund] clients are, by definition, long-term and locked-in shareholders" and "[our] index funds…are practically permanent—structurally long-term—owners of the companies in which they invest."

196 COLL 3.2.6R(7), partly based on article 1(2) UCITS Directive.

197 FCA, Policy Statement PS19/4, "Asset Management Market Study - further remedies," 2019 Appendix 2, non-handbook guidance at paragraph 19. This is presumably intended to pick up the COLL 4.2.5R(3)(c) (reflecting Annex 1, Schedule A (1.15) UCITS Directive) requirement that the prospectus must set out an indication of any limitations on the investment policy.

198 This is somewhat borne out by a Morningstar Report "European Sustainable Fund Flows: Q2 2020 in Review" which says (emphasis added) "One would be forgiven for assuming that repurposed funds are simply greenwashed and/or there hasn't been a complete revamp of the holdings or strategy. It is true that some funds do not make many changes. This could be because ESG factors are already extensively incorporated into the investment process and *only a few exclusions are added to the strategy*."

199 FCA Policy Statement PS19/4, Asset Management Market Study - further remedies, 2019 at paragraphs 6, 11, 18, 19, 21, 29 and 30, Appendix 2. See also: PRIIPS Regulation (1286/2014), article 8(3)(c) (applicable to the UCITS KIIDs from 2022, under article 32, as amended); Joint Committee of the European Supervisory Authorities, Joint Technical Advice on the procedures used to establish whether a PRIIP targets specific environmental or social objectives, at page 11 (available here); the template Key Investor Information Document published by the Committee of European Securities Regulators (available here); and industry body guidance from the UK Investment Association ("Fund communication Guidance," February 2019) (all accessed at 14 July 2021).

200 Which make up around 3% of UK insurers' economic activity; ONS, Experimental financial statistics for insurance using Solvency II regulatory data - enhanced financial accounts (UK flow of funds), 2018.

201 Which make up approximately 6% of the UK life insurance market; Alternative Investment Report, "Business Property Relief Industry Report 2015," 2015.

202 Which make up around 9% of the UK insurance market; Association of Financial Mutuals, "Mutuals – a history," https://www.financialmutuals.org/owned-by-you/mutuals-a-history/ (accessed at 14 July 2021).

203 OECD, Global insurance market trends, 31 January 2020. The remainder of portfolios are invested in cash and deposits, land or buildings, collective investment schemes and "other".

204 Association of British Insurers, "UK Insurance and Long-Term Savings: The state of the market 2019" page 6 quotes statistics that UK general insurers managed £143 billion of investments in 2017, compared to £1.7 trillion for UK life insurers.

205 FCA Review of the fair treatment of with-profits customers (TR19/3, page 3, paragraph 1.5).

206 Unit-linked funds account for approximately £1 trillion of assets (FCA unit-linked funds' governance review (follow up to PS18/8) findings and next steps)).

207 The FCA Review of the fair treatment of with-profits customers (TR19/3) at 1.4 notes that "At the end of 2017, about £274bn was invested in with-profits funds, compared with about £1,147bn in unit-linked funds."

208 Personal Pension Schemes (as defined in Article 3, Financial Services and Markets Act 2000 (Regulated Activities) Order 2001/544) but excluding group self-invested personal pensions for the purposes of the Annex.

209 The FCA's 'Unit-linked funds' governance review (follow up to PS18/8): findings and next steps" notes that savers in "most defined contribution pension schemes" are investors in unit-linked funds.

210 74% of policyholders included in the schemes covered by this survey are in the default fund (see *The DC Future Book: in association with Columbia Threadneedle Investments* (2020 Edition), page 18). https://www.pensionspolicyinstitute.org.uk/media/3615/20200923-the-dc-future-book-in-association-with-cti-2020-edition.pdf. (accessed at 14 July 2021).

211 There is some overlap; for example, the drafting of some of the Principles for Business and Fundamental Rules is identical, but the PRA and FCA approach them from different perspectives.

212 Policyholder funds is a convenient term to describe the insurer's assets which back life policies. The assets nevertheless belong to the insurer; the policyholders do not have any proprietary rights in them. *Foskett v McKeown* [2001] 1 AC 102 at page 120.

213 [2019] EWCA Civ 718. See also *UK Acorn Finance Limited v Markel* (UK) Limited [2020] EWHC 922 (Comm).

214 PRA fundamental rule 2 imposes an identical due care, skill and diligence requirement to PRIN 2.1.1R(2). As regards conflicts, in TR13/8 the FCA looked at the governance of unit-linked funds and gave the following examples of conflicts (a) the "seeding" of new funds with shareholder funds or other policyholder funds which can lead to conflicts when seeding capital is withdrawn, as this could affect the fund value, (b) the need, or desire, to use existing policyholder funds to seed new funds could encourage firms to invest in a manner incompatible with investment mandates, fund objectives or customers' best interests and (c) an insurer making use of the with-profits fund or inherited estate to support its unit-linked business – for example, to provide liquidity or subsidise costs. If this conflict of interest is not managed it could disadvantage with-profits customers.

215 PRIN 2.1.1R(4) and Fundamental Rule 4 also address this.

216 PRA Rulebook, Solvency II, Solvency Capital Requirement chapter, Technical Provisions chapter and related chapters and guidance.

217 PRA Rulebook, Solvency II, Conditions Governing Business and related chapters and guidance.

218 In SS1/20 Solvency II: the prudent person principle, the PRA notes that insurers "must ensure that their investments do not expose them to risks that cannot be managed effectively in accordance with the requirements of the rules in the Conditions Governing Business and the Investments Parts of the PRA Rulebook. The more complex the risk and the less understood it is (e.g. climate risk), the more difficult it is for firms to manage their exposure to such risks effectively. Therefore, the PRA expects firms to be able to pay particular attention to such risks in their investment risk management policy and to avoid over-exposure to such risks."

219 Fundamental Rule 3 requires that a firm act in a prudent manner and see PRA Rulebook, Solvency II, Investments – Prudent Person Principle: General Principles.

220 PRA Rulebook, Solvency II Investments Rule 2.1(3) Investments. Although not express in the rules, we expect that a conflict for these purposes could refer to a conflict between policyholders or a conflict between a policyholders and other parties, such as the insurer. For example, PRA Consultation Paper CP 22/19, "Solvency II: Prudent Person Principle, September 2019" at 7.4 notes in relation to intra-group loans that the conflict of interests provision in the prudent person principle "applies to all asset classes but is highlighted here as the PRA considers that investment in intra-group assets is very likely to lead to a conflict of interest (for example: between shareholders and policyholders; between subsidiaries and parent companies; and between policyholders in different subsidiaries)". See also COBS 2.1.1R(1) and the discussion of "best interests" at 1.27 to 1.31 above.

221 For example, PRA Rulebook, Solvency II, Investments, Rule 5(2)-(3)). Unit-linked life insurance policies are subject to additional, more prescriptive requirements under COBS 21 regarding permitted assets.

222 The current amount the insurer would have to pay for an immediate transfer of its liabilities to a third party (PRA Rulebook; Solvency II firms; Technical Provisions 2.2).

223 PRA Solvency II Rulebook, Investment Rule 3.

224 COBS 20.2.1AR There are specific "with profits" governance arrangements referred to in COBS 20.5.

225 COBS 21.1.1AR.

226 Individually and collectively and to manage conflicts, where they arise, effectively (COBS 19.5.6G).

227 COBS 19.5.2R and COBS 19.5.5R(2B)(b)-(d), including considering and reporting on the extent to which the firm has implemented its stated policies (COBS 19.5.5R(2E)). Where the insurer has no such policy, the IGC or GAA will consider and report on the insurer's reasons for not having a policy (COBS 19.5.5R(2C).

228 These broadly mirror aspects of the judge-made law relating to the exercise of fiduciary powers set out at 1.25 to 1.42 above. The directors of an insurer do not generally owe duties directly to shareholders, but instead owe them to the insurance company itself.

229 Companies Act 2006, section 172(1).

230 Companies Act 2006, section 171. The latter requirement is not subsumed into the general purpose test described in (A), but must be considered separately – see *Eclairs Group Ltd v JXK Oil and Gas plc* [2015] UKSC 71 where the directors honestly believed that what they were doing was in the best interests of the company, but the Supreme Court concluded that their exercise of the power to suspend voting rights was nevertheless exercised for improper purposes because it was done with a view to blocking the exercise of the relevant voting rights at a forthcoming shareholders' meeting, rather than for the proper purpose of broadly, enabling the directors to obtain accurate information about ownership of the relevant shares.

231 Companies Act 2006, section 173.

232 Companies Act 2006, section 174. .

233 Re *HLC Environmental Projects Ltd (in liq.) (Hellard v Carvalho)* [2014] B.C.C. 337. This case may also provide a basis for a court to conclude that the rationality test in the *Braganza* case (see 2.4.5(b) above) also applies in respect of directors' duties. In the HLC case the judge said "I consider that it also follows that where a very material interest [in that case the interest of a creditor] is unreasonably (i.e. without objective justification) overlooked and not taken into account, the objective test must equally be applied. Failing to take into account a material factor is something which goes to the validity of the directors' decision-making process. This is not the court substituting its own judgment on the relevant facts (with the inevitable element of hindsight) for that of the directors made at the time; rather it is the court making an (objective) judgment taking into account all the relevant facts known or which ought to have been known at the time, the directors not having made such a judgment in the first place." No court has yet expressly applied *Braganza* to directors' duties.

234 See COBS 9.2.1R; COBS 9A.2R; COBS 9A.2.3AR; and COBS 19.2R. See also endnote 54, as regards the possible application of PRIN 2.1.1R(9) during the life of unit-linked policies. In the 2014 Report at paragraph 8.53 the Law Commission said "There is also a lack of a clear duty on providers to monitor ongoing suitability over time. For default funds this is partially addressed by DWP guidance, though until now this has not had regulatory force." We cannot see that the

UNITED KINGDOM

position has materially changed in the interim and, in any event, the DWP guidance referred to by the Law Commission ("Guidance for offering a default option for defined contribution automatic enrolment pension schemes", May 2011) appears to address suitability in the sense of product governance and suitability for the employees / scheme members for whom the fund is intended (see paragraphs 17, 21, 26 and 38), rather than in the sense of ongoing decision-making throughout the course of the relationship. Outcome 5 of the FCA's fair treatment of customers "consumers are provided with products that perform as firms have led them to expect..." is potentially relevant and this area may further be addressed as part of the FCA's proposals arising from its proposed new consumer duty (see (CP21/13).

235 See 1.60 above..

236 Under the PRA Solvency II Rulebook, Reporting Parts 2 to 6. SS3/19 notes in paragraph 3.19 in relation to Pillar 3 that insurers "should consider whether further disclosures are necessary to enhance transparency on their approach to managing the financial risks from climate change, in line with the expectations set out in this SS. In particular,...firms...should consider disclosing how climate-related financial risks are integrated into governance and risk management processes, including the process by which a firm has assessed whether these risks are considered material." Page 6 of the Treasury's "a Roadmap towards mandatory climate change" says "no additional regulatory requirements are proposed at this time for [general insurers]; the PRA continues, through its supervisory expectations and engagement, to embed climate-related reporting for [relevant firms] by end-2021. The PRA will review disclosures after this deadline and determine whether additional measures are required." See 2.4.9 below as regards life insurers.

237 SYSC 3.4.8R implementing article 3h(1) SRD.

238 SYSC 3.4.9R implementing article 3h(2) SRD.

239 COBS 21.2.4R.

240 COBS 2.2.3R, as applied by COBS 2.2A.5R and see 3.4.4 below, which includes some further specific commitments as regards engagement.

241 See Recommendation 3 and see also paragraph 3.28 of FS19/7, "Building a regulatory framework for effective stewardship" which says "most stakeholders felt that firms should exercise stewardship beyond listed equities. While they recognised that stewardship may be easier to achieve in listed equities, which carry voting rights, they argued that bondholders can still exercise influence. Some respondents emphasised bondholders' 'important position in the capital structure'. Accordingly, it was noted that bondholders can exert pressure before an investment is made – e.g. when setting covenants and disclosure expectations – and when debt is being rolled over."

242 Dear CEO Letter, from C. Gerken and A. Sweeney, Executive Directors, Insurance PRA, "Insurance Stress Test 2019 and Covid-19 stress testing: feedback for general and life insurers," 17 June 2020, which notes that results from the exploratory climate scenario revealed significant gaps in the industry's capability to evaluate climate-related scenarios, particularly in relation to the evaluation of climate impacts on investments.

243 Page 13 of the Summary chapter.

244 Letter from Sam Woods "Managing climate-related financial risk – thematic feedback from the PRA's review of firms' SS3/19 plans and clarifications of expectations" (1 July 2020). Regulatory work continues in this area. The Bank of England will also be issuing additional guidance and useful material such as reference scenarios prior to the launch of the 2021 climate focused Biennial Exploratory Scenario. The PRA Response to the general insurance industry - a framework for assessing financial impacts of physical climate change (20 November 2020) recognises that general insurers would appreciate a framework for assessment of climate change risk on the asset side of their balance sheets similar to one it issued for them in 2019 relating to the liabilities side.

245 The CFRF 2020 Guide, Risk Management chapter, page 52 notes that "countries will transition at different speeds. For example, it would be unreasonable to expect countries such as China and Indonesia to transition at the same rate as, say, Germany and Denmark."

246 CFRF 2020 Guide, Summary chapter, page 12.

247 Paragraphs 3.15 to 3.17 of SS19/3 say "longer term assessment of the firm's exposure, based on its current business model, of a range of different climate-related scenarios. For example: scenarios based around average global temperature increases consistent with, or in excess of 2 °C; and scenarios where the transition to a low-carbon economy occurs in an orderly manner, or not. The PRA expects the time horizon of this long-term assessment to be in the order of decades...The PRA expects firms to use these scenarios to understand the impact of the financial risks from climate change on their solvency, liquidity and...their ability to pay policyholders... For insurers, Solvency II states that consideration of the long term is essential to insurers being able to assess their ability to continue as a going concern."

248 This guidance is linked to insurers' responsibilities under relevant Principles for Businesses.

249 SYSC 3.2.23G.

250 A policyholder may nonetheless choose to take their business elsewhere if they have concerns about the investment activities of their existing insurer.

251 *Gaiman and Others v National Association for Mental Health* [1971] Ch. 317 at [330].

252 The Rt Hon the Lord Millet, Michael Todd QC, and Alistair Alcock, *Gore Browne on Companies* (Issue 155, Jordan Publishing, 2020), chapter 15, paragraph. 10. See also GC100, "Guidance On Directors' Duties Section 172 And Stakeholder Considerations," 2018.

253 Section 172(1)(f) can be read to apply as between present and future members as well as applying as between different classes of member.

254 In FS19/7 Building a regulation framework for effective stewardship, the FCA (which is also the listing authority) said on page 13 "We also note that the direction of travel in both public policy and industry practice is towards a wider view of corporate purpose."

255 Page 10 of the Risk Management chapter.

256 Although see 2.4.6(a)(vii) above and related endnote.

257 Section 260 Companies Act 2006.

258 As explained at 5.4.3 below, it is unlikely to be possible to amend restrictive policy terms. However, amendment of disclosures may be permitted by the FCA, subject to appropriate notice/publicity etc. in relation to changes to the Principles and Practices of Financial Management see COBS 20.4.

259 COBS 20.2.1.AR.

260 COBS 21.2.4.R.

261 Scottish Widows' Exclusion Policy https://adviser.scottishwidows.co.uk/assets/literature/docs/60307.pdf (accessed at 14 July 2021).

262 Aviva plc policy on cluster munitions 2015, https://www.aviva.com/content/dam/aviva-corporate/documents/socialpurpose/pdfs/policies-responses/04-2015-aviva-policy-on-cluster-munitions.pdf (accessed at 14 July 2021).

263 SYSC 3.2.23G; and similar for personal pension schemes in SYSC 4.1.15G. Both are described as guidance under relevant Principles for Businesses.

264 FCA Policy Statement PS19/30 Independent Governance Committees: extension of remit 17 December 2019 at 2.30-32.

265 Shifting social and economic contexts may also help.

266 SYSC 3.2.23G(2); and similar for personal pension schemes in SYSC 4.1.15G(2).

267 Defined as "factors which are based on the views (including ethical concerns regarding environmental, social and governance issues) of the firm's clients or relevant policyholders." As noted in relation to the similar question which arises in relation to private sector pension schemes (sese 2.2.43 above) the definition is not fully aligned with the distinction in the 2014 Report between financial factors and non-financial factors.

268 SYSC 3.2.23G(5)-(6); and similar for personal pension schemes in SYSC 4.1.15G(5)-(6). It is perhaps unfortunate that the rule is expressed on an investment-by-investment, rather than a portfolio, basis.

269 COBS 19.5.7R(4) provides that a firm must have arrangements to ensure that the views of relevant policyholders can be directly represented to the IGC.

270 FCA "Reader's Guide - an introduction to the Handbook," page 11.

271 Investing with Purpose section 2.

272 Investing with Purpose page 7.

273 Investing with Purpose pages 17 and 19.

274 ibid page 23.

275 Some may appoint a specialist stewardship service provider.

276 Investing with Purpose pages 19 and 52.

277 Page 51 and there is a specific recommendation for investment consultants "We urge consulting firms to provide more active support to clients in raising the standard of their stewardship activities, including client oversight of asset managers, client engagement with managers on stewardship performance. This should include consideration of alignment of stewardship approach of asset managers to the client's stewardship needs as a factor in the selection and recommendation of asset managers" (Investing with Purpose Recommendation 20).

278 This includes understanding, for example, what screens and investment exclusions an Investment Manager may have in place as part of its "house" policies.

279 This potentially involves balancing the interests of Beneficiaries which may be impacted differently by the relevant stewardship approach. Damage might occur, for example, because those extra activities increase the cost of the service being provided or because they may unfairly impact on investment value or income in respect of one or more cohorts of the Asset Owner's Beneficiaries.

280 Investing with Purpose pages 25 and 26.

281 Investing with Purpose recommendations 5 and 6.

282 Principle 4 is also mentioned at 1.13 above. We do not think it should be read to suggest that signatories are expected to prioritise a well-functioning financial system above the best interests of the clients and beneficiaries although their interests could well be damaged by a financial system that does not function properly (see "outcome" under Principle 1 and the passage from Reporting with Purpose quoted in 3.1.5 above, which explains the inter-relationship). Nor do we think that alignment necessarily denotes divestment, not least because divestment reduces the ability to engage in stewardship with the relevant company. See also pages 20 to 23 of the FRC's Review of Early Reporting under the Stewardship Code (September 2020) https://www.frc.org.uk/getattachment/975354b4-6056-43e7-aa1f-c76693e1c686/The-UK-Stewardship-Code-Review-of-Early-Reporting.pdf (accessed at 14 July 2021).

283 Paragraphs 5.84 to 5.96 of the 2014 Report. The view expressed in the preceding consultation document that all but the very largest schemes lacked the internal resources or the financial clout to carry

UNITED KINGDOM

out effective stewardship was subject to considerable criticism, which noted, in particular, that stewardship is often delegated.

284 Paragraph 5.98 of the 2014 Report.

285 Or, probably more accurately, the aggregated shareholding controlled by its Investment Manager.

286 Direct costs include whether an Investment Manager charges higher fees than alternative providers to cover the costs of its stewardship practices, the costs of any direct engagement the Asset Owner undertakes and costs incurred in understanding and interpreting data on the relevant issues, or engaging investment consultants to do so. However, there are also indirect costs too - see 3.1.17 below.

287 A small pension fund with small widely diversified stakes may well reach different conclusions from a large one. There are avenues of influence available even to smaller funds, including supporting collective action. For example, the Association of Member Nominated Trustees Red Line Voting initiative provides member-nominated pension trustees with a guide to direct the voting of Investments Managers on ESG issues in relation to listed shares in pooled funds http://redlinevoting.org/ (accessed at 14 July 2021). The initiative aims to make it easier for pension schemes to direct their votes and to do so consistently across all fund managers it has employed. It is also intended to make it easier for Investment Managers to act in accordance with pension schemes voting instructions by reducing the likelihood of receiving conflicting instructions from multiple investors.

288 See S & P Global "Lights out for coal" https://www.spglobal.com/en/research-insights/featured/coal (accessed at 14 July 2021).

289 Paragraphs 3.35 and 3.36. There are other statements by regulators relevant to particular Asset Owners mentioned later in this section.

290 See, for example: 1) Financial Services Authority (the predecessor to the FCA), open letter to the Institutional Shareholders' Committee, Shareholder engagement and the current regulatory regime 19 August 2009; 2) FCA, Towards more effective stewardship – "Speech by Edwin Schooling Latter, Director of Markets and Wholesale Policy at the FCA, delivered at the LSE in London 23 March 2019." 2019; 3) FCA, Feedback Statement FS19/17, "Building a regulatory framework for effective stewardship", 2019, paragraphs 1.27-8.

291 See, for example, Consumer Detergents (Case COMP/39579), Commission Decision of 13 April 2011, C(2011) 2528 final, paragraph 53. Draft guidelines by the Dutch competition authority suggest a degree of willingness to examine the sustainability impacts of certain cartel-type agreements before deciding whether these should be permitted or not https://www.acm.nl/sites/default/files/documents/2020-07/sustainability-agreements%5B1%5D.pdf (accessed at 14 July 2021).

292 See Chapter 1 section 9 of the Competition Act applicable to conduct with an impact in the UK market. Similar provisions exist in other jurisdictions that operate a competition law regime (for example, Article 101(3) TFEU).

293 Earlier in 2021, the CMA recently published an information document to help firms navigate competition law when agreeing to cooperate for the attainment of sustainability goals available here: https://www.gov.uk/government/publications/environmental-sustainability-agreements-and-competition-law/sustainability-agreements-and-competition-law (accessed at 14 July 2021).

294 More broadly, while there is some evidence of a changing enforcement climate, enforcement cases to date have often taken a very formalistic approach. See, for example, the Dutch competition authority's 2015 decision the sustainability benefits produced by the "Chicken of Tomorrow" animal welfare standards initiative did not outweigh its anti-competitive costs and was therefore irreconcilable with Dutch and EU competition law ("ACM's analysis of the sustainability arrangements concerning the 'Chicken of Tomorrow'", ACM/DM/2014/206028, 26 January 2015). See also, the Dutch competition authority's decision that the industry association Energie Nederland's plans to close down five coal power plants was irreconcilable with Dutch and EU competition law ("Analysis by the Netherlands Authority for Consumers and Markets of the planned agreement on closing down coal power plants from the 1980s as part of the Social and Economic Council of the Netherlands' SER Energieakkoord", 26 September 2013). Conversely, see CECD (Case IV.F.1/36.718) Commission Decision 2000/475/EC [2000] OJ L187/47 where the EU Commission held an agreement to discontinue less energy efficient washing machines did not infringe EU competition law as it provided greater collective environmental benefits (as quantified in monetary terms) than the increase in costs.

295 See Joined Cases C-395 and 379/95P, *Commission and France v. Ladbroke Racing* [1997] ECR I-6265, paragraph 33 and 34). See also EU Commission decision in CASE AT.39258 – Airfreight, where encouragement of coordination on fuel surcharges amongst airlines by a civil aviation regulator was not accepted as a defence. The UK CMA is unlikely to take action against companies pursuing initiatives which are required under the UK's legal commitments, but they could take action where any competitor collaborations involve anti-competitive behaviour (e.g. information exchange) which goes beyond what is strictly necessary to comply with the law.

296 For example, businesses impacted by a group of investors collaborating to limit investment in non-green energy infrastructure.

297 https://www.gov.uk/government/publications/environmental-sustainability-agreements-and-competition-law/sustainability-agreements-and-competition-law (accessed at 14 July 2021).

298 See Commission Notice 2001/C 3/02, Guidelines on the applicability of Article 81 of the EC Treaty to horizontal cooperation agreements, OJ C 003 page 2, paragraph 185. Note, however, that the subsequent iteration of these guidelines no longer separately addresses environmental agreements (Guidelines on the applicability of Article 101 of the Treaty on the Functioning of the European Union to horizontal cooperation agreements, OJ C 11, page 1, paragraph 18). These principles have been transposed into UK law following the UK's departure from the EU. The CMA provides guidance in its "Agreements and concerted practices guidance" (OFT 401).

299 See, for example, DSD (Case COMP/34493) Commission Decision 2001/837/EC [2001] OJ L319/1, paragraph 114.

300 The most progressive (draft) guidelines to date addressing the interplay of competition law and collaborations for sustainability are by the Dutch competition regulator: https://www.acm.nl/sites/default/files/documents/2020-07/sustainability-agreements%5B1%5D.pdf (accessed at 14 July 2021). The EU Commission is currently looking into the same issues as part of the review of the two Horizontal Block Exemption Regulations and the Horizontal Co-operation Guidelines. Further guidance by other major authorities, such as the US Department of Justice or the CMA, would contribute significantly to the debate. The latter notes in its annual report for 2021: "We are continuing to develop capability to ensure that when delivering our statutory functions, we act in a way which supports the transition to a low carbon economy" and "we will communicate better to ensure that businesses engaged in sustainability initiatives know how to comply with competition and consumer law and do not unnecessarily shy away from those initiatives on the basis of unfounded fears of being in breach of the law."

301 Market Abuse Regulation (EU) 596/2014 OJ L 173, page 1, onshored as UK MAR. See Part V of the Criminal Justice Act 1993 for the criminal offence of insider dealing in England and Wales. See also FCA, Feedback Statement FS19/7, "Building a regulatory framework for effective stewardship," 2019, paragraph 4.21.

302 FCA, Handbook: Disclosure Guidance and Transparency Rules sourcebook: DTR 5.2.1R.

303 See Rules 4, 8 and 9.1 of the Takeover Code, but see also the Takeover Panel, Practice Statement No 26 (Shareholder activism), 2008; and ESMA's "white list" of activities that shareholders may undertake without being deemed to be acting in concert for the purposes of Directive 2004/25/EC on Takeover Bids. (ESMA Public Statement – Information on shareholder cooperation and acting in concert under the Takeover Bids Directive, pages 5-6).

304 Sections 178, 181 and 422 FSMA.

305 Page 13 of FS19/7, "Building a regulatory framework for effective stewardship".

306 PERG 2.7.8G(1).

307 See PERG 10.3G question 16 "Am I going to be managing investments by exercising voting rights conferred by investments that I hold as trustee under my OPS? If so, will this be viewed as my taking a day-to-day decision? No, you will not be managing investments unless the exercise of the rights would result in your buying, selling, subscribing for or underwriting securities or contractually based investments. This will not usually be the case. For example, voting to support a take-over offer to be made by a company in which the scheme holds shares would not involve managing investments as it would not result in your acquiring or disposing of investments. Neither would voting on the re-appointment of company directors or auditors or on whether a company in whom the scheme holds shares should make a rights issue (although deciding to subscribe to the rights issue when it is made would amount to managing investments). Deciding to accept an offer to buy company shares held by you under the scheme, in the context of a proposed take-over of that company, would involve managing investments. But the decision you make would be viewed as strategic and not a day-to-day decision." TPR has reinforced this for DB schemes in its investment guidance and for DC schemes in its investment governance guidance.

308 Chapter 7, paragraph 2.

309 Paragraph 24.

310 TPR, "Investment governance" https://www.thepensionsregulator.gov.uk/en/trustees/managing-dc-benefits/investment-guide-for-dc-pension-schemes (accessed at 14 July 2021). The guidance goes on to provide an example of language for a SIP which sets out in relation to the consideration of climate change as a financial factor: "given the systemic nature of climate change, we will also seek to discharge our duties by robust engagement with investee companies to encourage alignment with a low carbon economy and with policy-makers and governments to advocate for the same." Similar guidance is provided in relation to DB schemes - TPR, "DB Investment".https://www.thepensionsregulator.gov.uk/en/document-library/regulatory-guidance/db-investment/investing-to-fund-db (accessed at 14 July 2021). This is reinforced by paragraph 54 of the PCRIG Guide 2020.

311 Investing with Purpose, page 23 and see also endnote 151 above.

312 Regulation 2(3)(c) Private Scheme Investment Regulations reflecting article 3h SRD II.

313 Regulation 29A(1A) The Occupational and Personal Pension Schemes (Disclosure of Information) Regulations 2013.

314 Recommendation 15.

315 LGPS Investment Regulations, reg 7(2)(f)). This is a narrower requirement than private pension schemes are subject to - stewardship goes well beyond the mere exercise of voting rights. Notwithstanding this, The Environment Agency Pension Fund's Getting to net zero and building resilience Policy to Address Climate Change states "We will…support shareholder activity to ensure that companies manage their climate risk…support selective disinvestment from holdings when engagement has not been successful and climate risks remain and pose a financial uncertainty to the

UNITED KINGDOM

investment. This includes the denial of new debt financing to such companies as well as selectively disinvestment from equity holdings."

316 COLL 6.6A.6R(1). "Exclusive benefit" may be a concept closer to a duty of loyalty (see 1.19 above), than to "best interests".

317 COLL 6.6A.6R(2)(a) and (b). COLL 6.6.3R(3)(b) provides "the authorised fund manager must:(b) instruct the depositary in writing how rights attaching to the ownership of the scheme property are to be exercised."

318 COLL 6.6A.6R(3)(a) and (b). COLL 6.6A.6 reflecting article 21 of the UCITS implementing Directive.

319 A firm is not required to disclose votes that are insignificant due to the subject matter of the vote or the size of the holding in the company.

320 SYSC 3.4.4R to 3.4.7R, implementing articles 3(g)(1)(a) and (b) and (2) SRDII. An AFM can choose not to comply with these requirements but, if it does, must publicly disclose a clear and reasoned explanation of why it has made this choice.

321 See further FCA's February 2019 research note "Does the growth of passive investing affect equity market performance? A literature review" by Kevin R. James, Daniel Mittendorf, Andrea Pirrone and Claudia Robles-Garcia.

322 However, stewardship by index funds is not necessarily thematic. LGIM's Active Ownership Report 2019 page 50 says "we engage with the companies that can set an example in their sectors."

323 See COLL 6.6A.2R(5); and COLL 6.6A.3G(2) (reflected in "Introduction (18)" - UCITS Implementation Directive).

324 ESMA, "Supervisory briefing on the supervision of costs in UCITS and AIFs," 2020 (ESMA34-39-1042). See also COLL 6.6A.3G(2) and Recital (18) of the UCITS implementing Directive (2010/43/EU). See also COLL 6.6.20R (reflected in article 9 (3)(a) UCITS Implementation Directive); and FCA, Policy Statement PS18/8, "Asset Management Market Study remedies and changes to the handbook – Feedback and final rules to CP17/18," 2018.

325 SYSC 3.4.4R to 3.4.7R, implementing articles 3(g)(1)(a) and (b) and (2) SRDII. An insurer can choose not to comply with these requirements but, if it does, must publicly disclose a clear and reasoned explanation of why it has made this choice.

326 See 1.17 to 1.24 above.

327 As noted in 3.1.16 above, if the public policy engagement is carried out in collaboration with others (as it quite commonly would be - for example through PLSA or through a special interest group, such as [Climate Action 100+] the costs will be shared with others. Where the trustee is an incorporated professional trustee, with its own resources, it may well decide that public policy engagement undertaken at its own cost is appropriate for essentially its own corporate purposes.

328 Investing with Purpose page 33.

329 Part II paragraph 48. See further, the Railpen example on page 23 of the FRC's Review of Early Reporting under the Stewardship Code (September 2020) - https://www.frc.org.uk/getattachment/975354b4-6056-43e7-aa1f-c76693e1c686/The-UK-Stewardship-Code-Review-of-Early-Reporting.pdf

330 See, for example *R (on the application of Palestine Solidarity Campaign Ltd) v Secretary of State for Housing, Communities and Local Government* [2020] UKSC 16 and ongoing debates around the appropriateness of certain LGPS fund policies in relation to investment in Israel, on which the Ministry of Housing, Communities and Local Government has stated that: "The Government is firmly opposed to local boycotts, which can damage integration and community cohesion, hinder exports, and harm foreign relations and the UK's economic and international security. Councils should not impose boycotts that could undermine foreign policy, which is a matter for the UK Government alone…We will legislate as soon as Parliamentary time allow" (quoted in Benjamin Mercer, "LGPS wades into Israel-Palestine row with UN blacklist engagements," *Pensions-Expert.com*, 2 October 2020).

331 SS3/19.

332 The latter occurs when all of the employer-sponsors of a scheme enter insolvency processes, and during this period the PPF has oversight of the scheme's investment strategy, as it will potentially assume responsibility for providing a guaranteed minimum level of benefits to members if at the end of the assessment period the scheme is not sufficiently funded to do this itself. In such a case the PPF will take direct ownership and control of the scheme's assets.

333 PROD 3.2.8R, 3.2.19R to 3.2.26R, 4.2.15R and 4.2.33R to 4.2.39EU.

334 This focus is reflected in industry guidance: UK Finance, Guidelines: MiFID II Product Governance: Guidelines on Target Market Identification, 2017; and IA, MiFID II product governance: qualitative information requirements for the regular product review, 2019. ESMA guidance, to which the PROD section of the FCA Handbook refers, states that where the product has "specific investment objectives such as…'green investment' [and] 'ethical investment'", these objectives should be included in the target market specification (ESMA, Guidelines on MiFID II product governance requirements, 2018, paragraph 18(e)). The FCA has made similar statements to the ESMA guidance, although not in formal guidance: see FCA, Feedback Statement FS16/11: Call for Input: Regulatory Barriers to Social Investments, 2016, paragraph 1.12.

335 TPR, "A guide to Investment governance," June 2019, page 14: "In determining the investment principles for your scheme, you may in certain circumstances choose to consider factors which are not financially material to your scheme. These could include offering funds that select investments according to particular religious principles or are based on environmental or social impact."

336 Law Commission, Fiduciary Duties of Investment Intermediaries, 2014, Law Com No 350, paragraph 6.36, see also at paragraph 6.85: "there are two clear exceptions where significant financial detriment is permitted: (1) Where the decision is expressly permitted by the trust deed; and (2) In DC schemes, where members may choose to invest in a specific fund."

337 Section 236A FSMA. As a matter of UK law, it must also meet the definition of a collective investment scheme. Section 235(1) FSMA defines "collective investment scheme" as "any arrangements with respect to property of any description, including money, the purpose or effect of which is to enable persons taking part in the arrangements (whether by becoming owners of the property or any part of it or otherwise) to participate in or receive profits or income arising from the acquisition, holding, management or disposal of the property or sums paid out of such profits or income." It therefore appears that it should also enable a financial return, especially as an UCITS may only invest in transferable securities or other liquid financial assets (see further section 236A). COLL 3.2.6R(7) requires a UCITS' constitution to include "a statement that the object of the scheme is to invest in property of the [relevant] kind with the aim of spreading investment risk and giving unitholders the benefits of the results of the management of that property" (based in part on article 1(2) UCITS Directive).

338 OEIC Regs 2001, reg 15(10) and section 243(9) FSMA.

339 COLL 3.2.2R(1)(c).

340 See, for example, FCA, Feedback Statement FS16/11, "Call for Input: Regulatory Barriers to Social Investments", 2016, paragraph 1.6 and FCA, Policy Statement PS19/4, "Asset Management Market Study - further remedies," 2019, paragraphs 29 and 30.

341 As confirmed by Richard Monks, Director of Strategy at the FCA, in his speech at the SRI Services and Partners "Good Money Week" Panel https://www.fca.org.uk/news/speeches/building-trust-sustainable-investments (accessed at 14 July 2021).

342 See the Investment Association "Fund communication of responsible investment".

343 COLL 4.2.5R(3)(c-a) and 4.2.5R(27)(a).

344 UCITS Directive, article 78(5); COLL 4.1.2G; COLL 4.2.5R(3)(c-a); COLL 4.7.2R(7) (article 78 (5) UCITS Directive); 6.3 (article 85 UCITS Directive); and 6.6A.2R(4) (article 8(3) UCITS Implementation Directive).

345 For example: 1) ESMA final report on integrating sustainability into UCITS Directive and AIFMD, April 2019, paragraphs 27-29 and 40; 2) Opinion of the Securities and Markets Stakeholder Group, quoted in the Annex 5 to the ESMA final report on integrating sustainability into UCITS Directive and AIFMD, April 2019; 3) European Supervisory Authorities, joint consultation paper on ESG disclosures, April 2020, page 72; 4) FCA, consultation paper on climate-related disclosures by listed issuers (CP20/3), 2020, paragraphs 2.19 and 5.3; and 5) FCA, Feedback Statement on Call for Input: Regulatory Barriers to Social Investments (FS16/11), 2016, paragraph 2.24. See discussion of similar concerns in Law Commission consultation paper no 216, Social Investment by Charities, 2014, paragraphs 6.11 to 6.13.

346 COLL 6.6A.4R (article 23(2) UCITS Implementation Directive). See also article 7(1)(b) UCITS Directive, which requires that "the persons who effectively conduct the business of a management company are sufficiently experienced also in relation to the type of UCITS managed by the management company."

347 COLL 6.6A.2R(4) (article 8(3) UCITS Implementation Directive); and 6.6A.4R (article 23 UCITS Implementation Directive).

348 For example, "Building trust in sustainable investments": speech by Richard Monks, Director of Strategy at the FCA, 21 October 2020; FCA FS16/11, feedback statement on Call for Input: Regulatory Barriers to Social Investments, paragraph 2.24.

349 OECD report, "Investment governance and the integration of environmental, social and governance factors," 2017, page 21 (accessed at 14 July 2021).

350 As regards FCA approval, see regulation 21 Open-ended Investment Company Regulations 2001 (SI 2001/1228) and section 251 FSMA. As regards unitholder approval, see COLL 4.3.4R to 4.3.7G (Article 44 UCITS Directive). A "fundamental change" includes one which (a) changes the purposes or nature of the scheme; (b) may materially prejudice a unitholder; or (c) alters the risk profile of the scheme. See also The Investment Association, "Member Guidance, Authorised Funds: A Regulatory Guide," 2017, page 14., which gives the example of a change in investment policy or objective as a fundamental change.

351 COLL 4.3.4R to 4.3.7G (Article 44 UCITS Directive).

352 Insurance-based investment products as defined in Directive (EU) 2016/97 of the European Parliament and of the Council of 20 January 2016 on insurance distribution, OJ L 26, Article 2(1)(17).

353 Regulation (EU) 1286/2014 of the European Parliament and of the Council of 26 November 2014 on key information documents for packaged retail and insurance-based investment products, OJ L 352, Article 8(3)(c).

354 SYSC 3.2.23G(6).

355 I.e. factors which may influence a firm's investment strategy or decision, and which are based on the views (including ethical concerns regarding environmental, social and governance issues) of the firm's clients or relevant policyholders. This definition, in our view, could encompass policyholders' views on sustainability impact objectives.

356 FCA, Policy Statement PS19/30: Independent Governance Committees: extension of remit, 2019, at paragraph 2.2.36. This is likely because, as the 2014 Report points out at paragraph 8.33 there is no "point of sale" in relation to these products.

357 Typically, express provisions are limited to the exercise of voting

UNITED KINGDOM

rights. Investing with Purpose says (at pages 51 and 52) "while managers are starting to see stewardship expectations feature in contractual arrangement more often, this is by no means the norm... Investment managers do not always have a clear view of their client's stewardship priorities."

358 Generally, an Investment Manager will seek to have a comprehensive statement of requirements in its IMA so that it does not need to look at underlying trust deeds, policies or regulations applying to the Asset Owner.

359 COBS 2.1.2R limits the extent to which an Investment Manager may exclude its liabilities. There are additional limits in relation to "retail clients". A local authority pension fund falls within the definition of "retail client" but, in practice, is likely to opt up to the status of "professional client".

360 COBS 9A.

361 In respect of a professional client, the Investment Manager is entitled to assume it has the requisite level of experience and knowledge it would otherwise be required to obtain appropriate information about.

362 The SFDR MiFID Implementing Directive adopted by the Commission on 21 April 2021 as part of the EU's Sustainable Finance Package amends the MiFID suitability provisions underlying this rule so as to require an Investment Manager to seek information about its clients' sustainability preferences. Although the UK will not be required to implement this directive, it is assumed that the FCA will at least consider doing so as part of its UK Green Taxonomy proposals (see the FCA's Regulatory Initiatives Grid of May 2021).

363 Section 36 Pensions Act 1995.

364 By contrast, it is unlikely that there would generally be a sufficiently close relationship of trust and confidence between an Investment Manager and the beneficiaries of a pension fund client for the Manager to owe fiduciary duties to beneficiaries directly (see paragraphs 10.21 to 10.29 of the 2014 Report for a more detailed discussion of the position of an investment manager).

365 Subject, where the Asset Owner is a private sector scheme, to section 33 Pensions Act 1995.

366 COBS 2.2.3R, as applied by COBS 2.2A.5R.

367 The investment division of the Association of British Insurers merged with the Investment Management Association to form the Investment Association in 2014.

368 Note, however, that some obligations referred to above (e.g. under the Pensions Act 1995) cannot be overridden by the IMA.

369 See PRIN 2.1.1R(3).

370 The CEO of Blackrock's 2020 letter to portfolio companies said "our investment conviction is that sustainability- and climate-integrated portfolios can provide better risk-adjusted returns to investors. And with the impact of sustainability on investment returns increasing, we believe that sustainable investing is the strongest foundation for client portfolios going forward. In a letter to our clients today, BlackRock announced a number of initiatives to place sustainability at the center of our investment approach, including: making sustainability integral to portfolio construction and risk management; exiting investments that present a high sustainability-related risk, such as thermal coal producers;...and strengthening our commitment to sustainability and transparency in our investment stewardship activities." His 2021 letter returns to this theme and ends by saying "we face a great challenge ahead. The companies that embrace this challenge – that seek to build long-term value for their stakeholders – will help deliver long-term returns to shareholders and build a brighter and more prosperous future for the world."

371 Blackrock January 2020 statement on compliance with the Stewardship Code.

372 Vanguard 2019 statement on compliance with the Stewardship Code.

373 Annex 5 of PLSA's publication "Pension scheme implementation guidance not reporting template for asset owner" includes a list of potential stewardship conflicts.

374 See page 34 of the Risk Management chapter.

375 See policy described in endnote [153] and Scottish Widows example in 2.4.28 above.

376 In its Active Ownership Report 2019, LGIM notes that it chooses to engage with portfolio companies that can set an example in their sector.

377 State Street Global Advisors 2020 Asset Stewardship Report, page 45 and policy and collaboration section of LGIM's Active Ownership Report 2020.

378 Statement of Compliance with the Stewardship Code by BMO Global Asset Management EMEA (November 2018).

379 Lazard Asset Management Annual Sustainable Investment Report 2020 (pages 46 and 47).

380 State Street Global Advisors Stewardship Report 2020 and policy advocacy and collaboration section of LGIM Active Ownership Report 2020.

381 See, for example, Blackrock's statement on compliance with the UK Stewardship Code.

382 Liability under the Environmental Protection Act 1990 exists under a bespoke regime which could be considered generally civil in nature, in attempting to ensure remediation rather than impose liability. Nonetheless, an enforcing authority can serve a notice to require remediation of contaminated land and a failure to comply with a notice can amount to a criminal offence under the Environmental Protection Act 1990, section 23(1)(c).

383 *Lungowe v Vedanta Resources Plc & another* [2019] UKSC 20 at 52.

384 *Caparo Industries PLC v Dickman* [1990] 2 AC 605.

385 We note that where an Asset Owner is involved directly in lending activity (so-called "shadow banking"), there may be a closer nexus between the Asset Owner (as lender) and the activities of the portfolio company, which may have a negative sustainability impact. This may increase the possibility of a successful claim in negligence – for example, where a loan for a particular activity which ultimately caused a negative sustainability impact was given negligently, on the basis that it was reasonably foreseeable that the activity for which the loan was granted would result in a negative sustainability impact.

386 They may also serve to highlight any shortcomings in those arrangements and motivate the Asset Owner or Investment Manager to address those shortcomings.

387 In the case of shareholders in insurers, they already receive this kind of information in the form of the insurer's annual accounts.

388 See "Aviva chief warns insurers on 'forked tongue' over climate change," Financial Times, 1 March 2021.

389 Charities, NGOs and other interested parties have also used alternative means to draw attention to ESG-related actions (or inaction) by corporates, including through references to the Advertising Standards Agency (for example, challenging airlines for making "lowest emissions" claims, although we are not aware of any such challenges having been brought against Relevant Investors to date in relation to their investment strategies) and through asking questions and proposing shareholder resolutions in fora such as annual general meetings.

390 See, for example: OECD Watch Case Database, *Milieudefensie/ Friends of the Earth Netherlands v ING Bank*, 2019.

UNITED STATES

1. INTRODUCTION

1.1 For the purposes of this annex, we have considered relevant U.S. federal or state laws and regulations in effect on March 31, 2021. Sections 2–4 discuss whether Asset Owners are required or permitted to "Invest for Sustainability Impact" ("IFSI") when the portfolio being managed by the relevant Asset Owner is not subject to an explicit IFSI investment objective. Section 5 considers whether newly offered or organized funds can be established within the current U.S. legislative framework that have an explicit IFSI investment objective. Sections 6 and 7 consider an Investment Adviser's[1] duties to IFSI and whether any legal liability may arise to third parties for negative Sustainability Impact, respectively. Section 8 considers the growing importance of taking into account environmental, social and governance ("ESG") factors where these factors have implications for an investor's duty to achieve its financial investment objective that are financially material.

1.2 As discussed in the main body of the report, the expression "Investing for Sustainability Impact" is not a precisely defined legal term. It is important to emphasize that, to the extent there are any applicable federal or state laws or regulations in the United States, these laws do not reference the IFSI concept. The expression is used in this Annex as a conceptual framework in order to describe any legal duty or authority on the part of Asset Owners or their Investment Advisers that could lead them to pursue one or more Sustainability Impact objectives of any sort, whether in order to achieve their financial objectives by protecting or enhancing the financial performance of investments ("instrumental IFSI") or in order to achieve economic, environmental or social benefits where this is motivated by a purpose other than protecting or enhancing the financial performance of investments ("ultimate ends IFSI"). An example of instrumental IFSI would be the goal of securing behavior change on the part of investee enterprises that can help to avert an aspect of the climate crisis, thereby reducing systemic/non-diversifiable risk to an entire portfolio in order to assist the investor in pursuing its legally required financial goal(s). In contrast, ultimate ends IFSI is the pursuit of a sustainability impact goal for any reason other than seeking to achieve the investor's legally required financial goal. Often under U.S. literature and administrative guidance, the activities of investors that fall within the concept of "instrumental IFSI" will be referred to as "economic return investing" (although that expression also refers to a wider range of investment activities), and activities of investors that fall within the concept of "ultimate ends IFSI" will be referred to as "collateral benefit investing." For the purposes of this annex, we have elected to use our IFSI terminology to ensure consistency across the report.

1.3 We have not found any U.S. federal or state law or regulation that would require an Asset Owner or Investment Adviser to pursue ultimate ends IFSI without regard to financial return. Although there may be some cases where ultimate ends IFSI is permissible (subject to prioritizing the achievement of financial return), the reality of the litigious environment in the United States likely means that Asset Owners and their Investment Advisers will need to determine prior to taking any action whether or not a litigator could successfully posit a causal link between such activities and any adverse impact on financial return and thereby prove a breach of their duties as a result of pursuing such activities.

1.4 The concept of this difference between actions motivated exclusively by financial return considerations and those motivated by wider-ranging considerations is present in discussions in the U.S. market, including in the form of guidance issued by the U.S. Department of Labor regarding integration of ESG factors in the investment process.[2] Very broadly (since this is discussed more fully below), the current understanding, especially in the context of pension fund management, is that where an environmental, social or governance factor has material implications for the realization of an investor's financial investment objective, then the investor will be under a duty to take it into account appropriately in the way it seeks to discharge its duties to

UNITED STATES

pursue that financial objective. However, where an ESG factor does not have material implications, then it will only be possible to take it into account in the way a portfolio is managed in limited circumstances, if ever.

1.5 In this annex, certain underlying key themes recur:

Distinction between federal and state law

1.6 The U.S. system of laws and regulations is bifurcated into a two-tier system consisting of federal and state law. Federal law, in almost all cases, supersedes state law. The laws and regulations that apply to different Asset Owners vary greatly, and it is important to determine whether the Asset Owner is regulated by federal law, state law or both. Each of the 50 U.S. states has its own laws, and the sections that apply to state laws in this annex do not purport to be a full 50-state survey. Accordingly, the discussions below on state law are for illustrative purposes only and set out some of the more high-profile state laws in order to illuminate the divide between federal and state law.

Considerations of instrumental and ultimate ends IFSI

1.7 As discussed further below, for certain types of Asset Owners, making investment decisions in any manner that is not focused on achieving their financial objectives by protecting or enhancing the financial performance of investments is either inconsistent with existing or proposed laws, regulations or interpretative guidance, or only permitted in a limited set of circumstances. For example, even when applicable laws, regulations or guidance do not explicitly regulate ultimate ends IFSI, the ability of an Asset Owner or Investment Adviser to engage in ultimate ends IFSI may be curtailed by the fiduciary duties to which they are subject requiring them to focus on and prioritize financial return.

1.8 However, the question of whether a given course of action is ultimate ends IFSI rather than instrumental IFSI may not be entirely straight-forward. In particular, the possible need for an Asset Owner or Investment Adviser to take into account different underlying investor time horizons can result in a need for complex judgements as to whether it is legally required or permitted to engage in IFSI. It is possible that pursuing a given Sustainability Impact goal might help in mitigating systemic risk to the financial performance of a portfolio in the long-term and thereby support the realization of an Asset Owner or Investment Adviser's financial investment objectives over that period. However, in considering whether to act, the Asset Owner or Investment Adviser would need to weigh various factors. These include duties to investors that could be affected by the negative effect (if any) of pursuing that impact goal on investment performance in the short-term. In addition, the Asset Owner or Investment Adviser will need to weigh whether short-term benefit foregone (if any) as a result of pursuing the impact goal would be sufficient to off-set the effect of potential future loss of value or opportunity if the relevant systemic risk is not mitigated. In either case, this necessitates an analysis of how an Asset Owner or Investment Adviser must balance potential conflicting interests of different investors in the same asset pool.

1.9 Given the litigious nature of the United States, Asset Owners and Investment Advisers will be aware that they need to be in a position to provide legally acceptable reasons for any course of action they take, whether in relation to IFSI or otherwise; this includes as to its cost and impact or potential impact on investment returns over the relevant time period or periods and by reference to, potentially, different generations of underlying beneficiaries. That said, as a practical matter, especially in the case of stewardship and policy engagement, it could be difficult for a litigious investor to prove a causal relationship between the action of the Asset Owner or Investment Adviser and any negative impact on financial performance (assuming that the costs and expenses of stewardship and policy engagement are not disproportionately material to such performance), particularly since the Asset Owner or Investment Adviser will not be responsible for implementing any change that is the subject of the action. While the possibility of claims may be more foreseeable in the event of financial underperformance, there may also be a risk of investor litigation should an Asset Owner or Investment Adviser take no action whatsoever in response to the risks posed by sustainability factors.

UNITED STATES

1.10 Because of the complex considerations involved in delineating IFSI from traditional investment practices, and the lack of explicit guidance in many aspects of the U.S. regulatory system in consideration of IFSI, we anticipate that Asset Owners or Investment Advisers may be more cautious about using their investment powers to pursue instrumental IFSI as compared to exercising their stewardship powers. We take this view because we anticipate that the use of investment powers may have more direct implications for the financial performance of a portfolio, at least in the short-term. In the meantime, especially in public markets, where Asset Owners or Investment Advisers conclude that sustainability factors represent a risk to the achievement of their financial investment objectives (or that they may present opportunities), it may be more likely that they will conclude that taking appropriate stewardship action, rather than the exercise of their investment powers, represents the best avenue for discharging their standard of care in a manner that produces verifiable results (whether as a result of changes in the composition of the board of directors or corporate strategy of entities in which fiduciaries invest or otherwise). That said, the exercise or possible exercise of investment and divestment powers in that context might provide a way of strengthening their communications with the company and its directors.

1.11 Whether using investment powers, stewardship or undertaking policy engagement, Asset Owners or Investment Advisers considering pursuing Sustainability Impact goals will need to address challenges in terms of defining those goals and assessing progress towards them and their potential financial implications (and how these can assist in seeking to achieve their financial objectives), and establishing a robust understanding of how they can best bring their influence to bear. This may lead them to focus on areas where there is greater investment community consensus and clearer policy direction on these matters.

Sole interest rule in trust fiduciary law vs. best interests rule in corporate law[3]

1.12 The trustees of retirement assets, retirement plans, pension funds, public pension plans, public pension funds and private retirement plans generally owe fiduciary duties to beneficiaries of the trust. In crafting an investment strategy, trustees must carefully evaluate their actions in light of their fiduciary duties, some of which are statutory, some of which are contained in regulatory guidance and others that result from decisional law interpreting statutes and regulations. Fiduciaries are largely unable to contract out of their fiduciary duties,[4] and accordingly are highly reluctant to pursue an investment strategy that subjects them to potential legal liability.

1.13 Under the "sole interest rule" of trust fiduciary law, which is derived from the duty of loyalty, a trustee must consider only the interests of the beneficiaries.[5] Accordingly, a trustee's use of ESG factors, if motivated by the trustee's own ethical judgment regarding the need to obtain collateral benefits for third parties or assumptions regarding the collective will of its beneficiaries without formally soliciting their views in accordance with the terms of the trust, will violate the duty of loyalty. Under the sole interest rule, a trustee violates the duty of loyalty if the trustee has any motive or rationale for undertaking an action other than the "sole interest" or "exclusive benefit" of the beneficiary. A trustee who is influenced by the trustee's own or a third party's interests is disloyal, because the trustee is no longer acting solely in the interest of the beneficiaries. The sole interest rule imposes a categorical prohibition, with "no further inquiry" into whether a conflicted transaction was fair. It has historically been applied in a context in which a conflicted transaction is unlikely to be beneficial and beneficiary monitoring of the activities of the trustee is weak. Paragraph 1.15 below discusses this rule in the context of ultimate ends IFSI.

1.14 A different rule applies in the context of corporations where management of those entities are bound by a different type of loyalty. Under this duty of loyalty, a fiduciary is not categorically prohibited from acting with a conflict of interest, but rather must act in the "best interest" of the principal. The best interest rule is satisfied if and to the extent that

ANNEXES

United States

UNITED STATES

actions by a fiduciary that are in the self-interest of the fiduciary are also, with sufficient frequency, in the best interests of the principal; accordingly, the principal is better off with an enquiry into whether self-interested transactions pass an "entire fairness" test. As discussed further in Paragraph 2.5.9 below, the "entire fairness" test considers whether a transaction is entirely fair to stockholders, considering both the process and price of a transaction. This is especially likely if the fiduciary (e.g., a corporate board of directors) was chosen for professional expertise that overlaps with the fiduciary's personal interests. Transactions that do not satisfy the entire fairness test will likely come to the attention of investors and therefore be subject to effective challenge.

1.15 In relation to trusts, as discussed in greater detail below, instrumental IFSI can be consistent with trust fiduciary law when the fiduciary's "sole" or "exclusive" motive in doing so is to seek to achieve the financial investment objective of the trust. If motivated solely by this purpose, an instrumental IFSI investing strategy satisfies the sole interest rule. In contrast, ultimate ends IFSI will not satisfy the sole interest rule under trust fiduciary law—simply because it does not prioritize achieving the financial objective of the trust.[6] Even if ultimate ends IFSI were permitted or required under applicable U.S. federal or state law, the pursuit of ultimate ends IFSI[7] could face a number of practical challenges that could inhibit Assets Owners or Investment Advisers from engaging in it. These may include the following: (a) an investor base is likely to include a diverse group of individuals with different conclusions and beliefs about appropriate collateral goals (so that the beliefs of some are likely to conflict with all or some of the ultimate ends pursued by a fiduciary), (b) at the time of writing, there is no commonly established mechanism to allow investors to express their preferences with respect to collateral goals and how to transmit them to the fiduciary and (c) the inability to demonstrate a link between investment decisions made and the achievement of applicable financial investment objectives, if such decisions produce (after fees and expenses) returns materially below those generated by other investment advisers over a selected period. Any such decisions will likely be challenged by investors on a post hoc basis in a litigious society such as the United States (making fiduciaries potentially unwilling to bear this risk).

U.S. social and political context

1.16 Although at this point it is too early for the Biden administration to have implemented significant specific regulatory changes, early indications suggest that there will be a renewed focus on climate and ESG issues across federal agencies,[8] especially in light of the Covid-19 pandemic and accelerating manifestations of the climate crisis, both of which have arguably put the relationship between ESG factors and financial returns in the spotlight.[9] There are two main ways that ESG investing may change as a result: (a) the debate over its economic value will be re-examined in light of any outperformance of ESG-oriented portfolios and companies during the crisis and thereafter and (b) the broader conversation on social inequities and systemic racism that intensified during the pandemic have arguably (i) increased investor awareness of the ways in which sustainability can affect their investments, (ii) bolstered investor support for socially responsible corporate policies and (iii) shifted investors' prioritization of Sustainability Impacts in the short-term, for example toward a greater emphasis on the treatment of employees and matters that affect health and safety.

1.17 The U.S. Securities and Exchange Commission (the "SEC" or the "Commission") has acknowledged increased investor demand for ESG products[10] and the importance of disclosing material ESG and climate-related risks to investors. On March 4, 2021, the SEC announced the creation of a "Climate and ESG Task Force" within the SEC Division of Enforcement, the initial focus of which will be to "identify any material gaps or misstatements in issuers' disclosure of climate risks under existing rules."[11] The move was followed by a number of announcements from the Commission on the SEC's renewed focus on climate and ESG-related risks, including comments from then-Acting Chair Allison Herren Lee that "climate and ESG are front and center for the SEC" given increased investor prioritization of these issues and a request for comments from market participants on climate

UNITED STATES

change disclosure.[12] In his March 2021 confirmation hearing before the Senate, the now-current chair of the SEC, Gary Gensler, responded to critics of ESG-related investing by stating that "it's the investor community that gets to decide what's material to them."[13] This recent focus on monitoring and regulating ESG-related disclosures is currently positioned within the existing framework under U.S. federal securities laws, which requires disclosure of all material risks to investors. The acknowledgement of the growing importance of ESG factors to investors and enforcement against issuers that fail to make appropriate disclosures will likely encourage Asset Owners to take these factors into account, at least where they potentially have material financial implications, when seeking to achieve their financial objectives.

UNITED STATES

2. ASSET OWNERS' USE OF POWERS OF INVESTMENT AND DIVESTMENT TO IFSI

2.1 The following section considers the extent to which and in what circumstances each type of Asset Owner is (a) legally required or (b) legally permitted or able to use its powers of investment and divestment to IFSI.

2.2 **Retirement funds**

Asset Owner: Retirement funds (including public funds and private retirement plans such as tax-efficient 401(k) and IRA plans) are the legal owners of the assets. These funds can manage assets directly or outsource management to an investment decision-maker.

Beneficiary: Current pension plan participants, as well as persons designated by a participant to receive some or all of the participant's pension benefits.

Investment decision-maker: Investment or asset manager that acts on behalf of the Asset Owner. The investment decision-maker is often a trustee of the fund, although many trustees delegate all or part of their responsibility for investment decisions to third-party Investment Managers with respect to all or a portion of the fund assets.

Types of retirement funds covered

2.2.1 A retirement fund is any employee benefit plan established or maintained by an employer or by an employee organization (e.g., a labor union), or both, that provides retirement income or defers income until termination of covered employment or a later date.[14] Retirement funds represent some of the largest investment pools in the United States and can generally be categorized as either public pension funds or private sector retirement plans, depending on whether plan participants are employed in the public or private sectors. Retirement assets or plans include:

(a) Defined benefit plans (often referred to as pension funds), where, as a general matter, the plan sponsor (or its delegate) selects the investments for the plan's assets and the beneficiaries receive a pre-determined benefit paid out of investment proceeds that is calculated in advance using a formula based on age, earnings and years of service to yield a lump sum or periodic hybrid payment schedule; and

(b) Defined contribution plans (often referred to as individual retirement plans), where, as a general matter, plan participants acting in their own discretion are permitted, through an individual's account under the plan, to select certain funds from a group of external mutual funds and other investment vehicles vetted and selected by or on behalf of the Asset Owner in which they may invest their portion of the plan's assets. Unlike defined benefit plans, there is no specific benefit participants are entitled to and returns vary based on the value of investments. The majority of defined contribution plans are funded by employee contributions out of pre-tax income, subject to an annual maximum contribution amount that is mandated by law. Beneficiaries choose how to invest their contributions from a list of mutual funds and other investment vehicles selected by the fund trustee. These defined contribution plans have tax benefits and contributions are sometimes matched by employers. Defined contribution plans may be funded through participants, their employer, or both.

2.2.2 Public pension funds are subject to state and local laws regarding administration and investment and collectively managed by or on behalf of participating employees. In the U.S., public pensions are offered at every level of government and are widely available to most public sector employees. State pension plan contributions are generally made by participating employers, which can include state and local government or governmental agencies, school districts and public universities or other local government entities. Together, we refer to these funds in this report as "public pension funds."

2.2.3 Private retirement plans take many forms and are established or maintained by private employers for the benefit of their employees. Unlike public pension funds, private retirement plans are regulated by federal law. Some employers voluntarily offer access to their own independently established pension funds, while others do so because they are required to provide access to pension funds (which may be company-specific or industry union-specific) under the terms of collective bargaining agreements that are generally entered into with organized labor

UNITED STATES

(i.e., unions such as the autoworkers). They are commonly defined benefit plans. Private retirement plans also include private defined contribution plans, as described above in Paragraph 2.2.1(b). In such plans, a framework for investing with certain tax benefits is established and maintained by employers and offered to their employees, and those who wish to save for their retirement are given the ability to set up individual retirement accounts. The employer holds back a part of the employee's salary (tax-deferred) and places it into a fund for investment that the employee can access at retirement age. Some employers are willing to match, in whole or part, contributions made by their employees. There are also private individual retirement plans that are not maintained by or affiliated with employment but are structured or otherwise incentivized by the federal government to provide tax benefits and remain in the control of the investors; these private plans are not otherwise discussed in this report.

2.2.4 Both employer and individual retirement plans generally are funded by voluntary employee contributions out of income, with certain exceptions, such as (a) defined benefit plans sponsored by governmental entities for their employees' benefit that are required under federal, state or local U.S. law, to which public employees are often required to contribute, and (b) private sector defined benefit plans, which are often funded exclusively, or matched in part, by employer contributions. Contribution amounts for each employee are generally subject to an annual maximum contribution amount that is mandated by law.

2.2.5 All retirement funds, both public and private, are held in trust. A fund's trustee holds title to the assets in the fund and is subject to fiduciary duties in managing the assets.

Overview of investment duties and powers – public pension funds

2.3 Public pension funds are subject to federal, state or local laws and regulations regarding the establishment and administration of pension funds for the relevant federal, state or local public sector employees and are collectively managed by or on behalf of participating employees.

2.3.1 Trustees of public pension funds are subject to certain rules and fiduciary duties derived from common law, which have largely been incorporated into state statutes. These obligations include the sole interest rule, the prudent investor rule and the duty of impartiality.

Sole interest rule

2.3.2 Most state laws contain language that require a trustee to act in the "sole interest" of their beneficiaries. Virtually every state has similar language mandating its pension trustees to act in the "sole interest" of their beneficiaries. "Interest" has been interpreted to mean financial interests, as discussed further below in Paragraphs 2.4.3 through 2.4.5 in the context of private retirement funds. In our view, acting in the "sole interest" would require a trustee to consider instrumental IFSI strategies to address the material sustainability risks and opportunities that may affect the financial interests of its beneficiaries. The California Constitution mandates that trustees of its pension funds "shall discharge their duties with respect to the system solely in the interest of, and for the exclusive purposes of providing benefits to, participants and their beneficiaries, minimizing employer contributions thereto, and defraying reasonable expenses of administering the system. A retirement board's duty to its participants and their beneficiaries shall take precedence over any other duty."[15] Likewise, New York law provides that the trustee of a fund has the power to make investments that "shall be for the exclusive benefit of the participants and beneficiaries."[16] Such state laws are in general silent on whether the terms "participant" and "beneficiary" should be interpreted to include future participants and beneficiaries, and in the absence of language expressly contemplating such future participants or beneficiaries, it is likely, based on general principles of judicial interpretation (which generally require courts to apply the ordinary meaning of words utilized and limit their ability to construe silence as permitting an unarticulated objective), that such terms would be construed as referring to existing participants or beneficiaries only. Existing participants may have a financial interest in the long-term success that allows multi-generational transfer of wealth to children at the end

UNITED STATES

of a participant's life, considering later generations a beneficiary of their prudent investments that reduce systemic risks to their overall portfolio.

2.3.3 As noted in Paragraph 1.13 above, under the "sole interest rule" of trust fiduciary law, a trustee must consider only the interests of the beneficiaries. Accordingly, where a trustee is influenced by sustainability factors in the way it manages the fund, if motivated by the trustee's own sense of ethics or propriety (or the trustee's own sense of the collective will of its beneficiaries) or to obtain collateral benefits for third parties, it has violated the duty of loyalty. Under the sole interest rule, a trustee violates the duty of loyalty if the trustee has any motive or rationale for undertaking an action other than the "sole interest" or "exclusive benefit" of the beneficiary. A trustee who is influenced by the trustee's own or a third party's interests is disloyal, because the trustee is no longer acting solely in the interest of the beneficiaries. The sole interest rule imposes a categorical prohibition, with "no further inquiry" into whether a conflicted transaction was fair. It has historically been applied in a context in which a conflicted transaction is unlikely to be beneficial and beneficiary monitoring of the trustee is weak.

2.3.4 When assessing whether a trustee has acted in the "sole interest" of its beneficiaries, federal and state courts will also consider whether the trustee has satisfied the "prudent investor rule," another fiduciary duty described below.

Prudent investor rule

2.3.5 A trustee is subject to a duty of care, referred to in trust law as a duty of prudence, which requires the trustee to administer the trust as "a prudent person would, in light of the purposes, terms, and other circumstances of the trust."[17] The principles of this duty, also known as the "prudent investor rule," were incorporated in the Uniform Prudent Investor Act (1992) ("UPIA"), which was promulgated by the National Conference of Commissioners on Uniform State Laws in 1994. Most states have adopted a version of the UPIA, but states are permitted to expand, restrict or eliminate provisions of the UPIA when codifying state law, including the prudent investor rule. Further, the prudent investor rule is a default that is subject to the actual terms of the trust. Under the UPIA and most of the state laws we have assessed, the prudent investor rule requires a trustee to satisfy the fiduciary duty of care by investing and managing trust assets "as a prudent person would" and "exercis[ing] reasonable care, skill and caution."[18]

2.3.6 As defined under the UPIA, the rule is a facts-and-circumstances standard that requires a trustee to invest and manage trust assets as a prudent investor would by "considering the purposes, terms, distribution requirements, and any other circumstances of the trust."[19] A trustee must employ "an overall investment strategy having risk and return objectives reasonably suited to the trust" and must "diversify the investments of the trust."[20]

2.3.7 In our view, this would require a trustee to consider whether there are any factors that create material risks or opportunities in seeking to achieve the financial investment objective of the trust, including those that could arise as a result of sustainability factors. If so, the trustee would also be required to consider properly what steps, if any, to take. Where adopting an IFSI approach can reasonably be expected to help (either individually or collectively when taken together with the actions of other parties) in mitigating the risk or realizing the opportunity, then the trustee should include that in its assessment and act accordingly. Any assessment would need to take account of all relevant circumstances including, for example, the need for impartiality (with appropriate consideration of short-term versus long-term benefits) as between different generations of beneficiaries (see Paragraph 2.3.8, below), the possible expense for the trust of the action (whether in terms of investment performance, costs or otherwise), the magnitude of the risk and its likelihood and the period within which it could crystalize. Given the litigious nature of the United States, fiduciaries may face investor challenges with respect to any judgment exercised in the course of such an assessment (including challenges as to whether any action should have been taken at all) if investors believe that any actions taken by the trustee on the basis of any such assessment did not serve to enhance or protect investment returns. Accordingly, as noted at Paragraph 1.10

UNITED STATES

above as a practical matter, these factors may lead trustees to focus particularly on stewardship and public policy engagement as a means of pursuing Sustainability Impact goals.

Duty of impartiality

2.3.8 The "duty of impartiality" acknowledges that a trustee must be loyal to all pension plan participants and beneficiaries, and that different groups covered by the plan may have different interests.[21] The duty requires that a trustee impartially consider these potentially differing interests, which can, for instance, include the time horizon to retirement of different participants and beneficiaries, but does not require that a trustee ensure absolute equality among competing interests.[22] The duty of impartiality has been incorporated in the state laws of at least 15 different states,[23] but even absent express state law on this point, it is likely that state courts will refer to general principles of trust law when interpreting the duties of a trustee of a pension fund.

Overview of investment duties and powers – private retirement plans

2.4 Private pensions and retirement plans are governed by the Employee Retirement Income Security Act of 1974 ("ERISA") and certain amendments thereto. Although ERISA is the primary federal law establishing the legal duties and legal powers of investment for private retirement plans, other federal laws may also apply to private retirement plans, depending on the circumstances, including the United States Internal Revenue Code of 1986 and certain federal bankruptcy laws. ERISA sets minimum standards for most voluntarily established retirement plans to protect participants. Additional, more stringent, standards for private retirement plans can be established under state tax and labor law, but the discussion below is limited to ERISA.

2.4.1 ERISA requires retirement plans to provide participants with plan information, sets fiduciary responsibilities for those who manage and control plan assets and gives participants the right to sue for benefits and breaches of fiduciary duty.[24] Under ERISA, or "the regulation", the exclusive purpose of the ERISA fiduciary is to provide benefits to participants and their beneficiaries and to defray reasonable expenses of administering the plan.[25] An ERISA fiduciary is liable for a breach of fiduciary responsibility if he or she (i) either participates knowingly in, or knowingly undertakes to conceal, an act or omission of another fiduciary, knowing that such act or omission is a breach; (ii) fails to comply with the fiduciary duties under ERISA in administering specific responsibilities which give rise to status as a fiduciary, and enables another fiduciary to commit a breach; or (iii) knows of a breach of duty by another fiduciary, unless there are reasonable efforts to remedy the breach.[26]

2.4.2 ERISA imposes a trust structure on most private pension funds and retirement plans to protect the interests of plan participants.[27] Accordingly, the U.S. courts commonly treat the Restatement of Trusts as authoritative on issues under ERISA relating to the obligations of those who administer such funds and plans to participants and beneficiaries therein.[28] The Restatement is an influential treatise published by the American Law Institute for practitioners of law, trustees and investment advisers. Although it is a secondary authority and thus non-binding, the Restatement is widely accepted as a persuasive source of law and is relied on by courts throughout the United States. Responsibility for the interpretation and enforcement of ERISA is divided among the Department of Labor, the Department of the Treasury and the Pension Benefit Guaranty Corporation. As a practical matter, interpretative guidance issued by any of the foregoing is effectively viewed as binding by industry participants, although courts bear the ultimate responsibility for interpreting ERISA and whether regulations promulgated thereunder are *ultra vires* or not.

Sole interest rule

2.4.3 Similar to the "sole interest" state law rules governing public pension funds described in Paragraph 2.3.2, under ERISA, a plan fiduciary must act "solely in the interest of the plan participants and beneficiaries for the exclusive purpose of: (i) providing benefits to participants and their beneficiaries; and (ii) defraying reasonable expenses of administering the plan."[29] Under this rule, also sometimes called "the sole benefit" or "exclusive benefit" rule, the trustee "has a duty to the beneficiaries not to be influenced by the interest of any third person or

UNITED STATES

motives other than the accomplishment of the purposes of the trust."[30] As such, a trustee would violate this duty if he or she acted with any motive or rationale for undertaking an action other than the "sole interest" of the beneficiary.

2.4.4 In 2014, the U.S. Supreme Court held, in the context of the purpose to which ERISA's sole interest rule applies, that the benefits to be provided to plan beneficiaries means "financial benefits." As interpreted by the U.S. Supreme Court, the "exclusive purpose" of a trustee of a fund governed by ERISA must be:

> *'providing benefits to participants and their beneficiaries' while 'defraying reasonable expenses of administrating the plan.' Read in the context of ERISA as a whole, the term 'benefits' in the [ERISA] provision just quoted must be understood to refer to the sort of financial benefits (such as retirement income) that trustees who manage investments typically seek to secure for their trust's beneficiaries. . . . The term does not cover nonpecuniary benefits[.]*[31]

Prudent investor rule

2.4.5 A trustee's conduct must satisfy the fiduciary duty of care, referred to as "prudence" in trust law. Similar to the "prudent investor rule" incorporated in the UPIA governing public pensions, as described at Paragraph 2.3.5, ERISA also codifies the duty of care and requires a private retirement plan trustee to act "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."[32]

2.4.6 Under the prudent investor rule as defined by ERISA, a trustee must employ a strategy that "diversif[ies] the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so."[33] Such an approach does not preclude a parallel strategy to address systemic risks to the entire portfolio that cannot be addressed by portfolio diversification alone.

2.4.7 Factors a trustee needs to consider when prudently exercising its powers include the likely duration of the trust and the amount and timing of its distribution requirements, along with potentially associated needs for liquidity, stability of income flow and preservation of (or growth in) the purchasing power of capital. The personal and financial circumstances of the trust beneficiaries inevitably impact decisions with respect to the foregoing, insofar as they are relevant to the trust purposes.

2.4.8 A trustee's duties under the "prudent investor" rule not only apply to the initial investment decision, but also require a trustee to continually observe and evaluate investments to ensure they are consistent with the purpose and needs of a trust. In determining whether an investment is appropriate for a trust, a trustee should look at the investment's expected return, risks, marketability, cost and any unique characteristics.[34] A trustee is expected to balance the goals of protecting a trust's principal and giving a trust a reasonable rate of return. A trustee's duties also include a duty of full disclosure of all facts that materially affect a beneficiary's rights and interests.[35] For example, if a trustee reached the view that declining systemic sustainability could damage the level of benefits available to existing long-term participants, it would be under an obligation to disclose that to them. Whether it feels obligated to do so will depend on a comparison of the expected timeframe within which existing participants and beneficiaries will seek to access their benefits under the trust and the expected timing of the adverse systemic impact on the level of benefits available to them. Certain sustainability factors could crystalize within a shorter time frame in a way that is hard to predict and it would be expected for most pension plans to include members with time horizons for investing of 20–40 years. Finally, as noted above, as a matter of judicial interpretation, it will likely be difficult for a trustee assessing the need for such disclosure to conclude that participants and beneficiaries should necessarily include future participants and beneficiaries without express statutory support for such a conclusion.

Duty of impartiality

2.4.9 The Supreme Court confirmed in a 1996 decision that the common law duty of impartiality, as described in Paragraph 2.3.8, also applies to private retirement plans under ERISA. In discussing various duties of a fiduciary under ERISA, the

› ANNEXES

› United States

UNITED STATES

Supreme Court noted, "The common law of trusts recognizes the need to preserve assets to satisfy future, as well as present, claims and requires a trustee to take impartial account of the interests of all beneficiaries."[36] Although the decision refers to future claims, because neither ERISA nor the ruling expressly refers to future beneficiaries, the reference to beneficiaries is likely better viewed as a reference to existing (not future) beneficiaries, some of whose interests are short-term and others of whose interests are long-term (and therefore may result in future claims). Accordingly, the ruling would appear to support the notion that adverse Sustainability Impacts should be taken into account when the relevant adverse impact on the level of available benefits is expected to occur within the timeframe for receipt of benefits by the youngest existing beneficiaries of the trust, such as those climate change impacts that may crystalize in a relatively short period of years. As such, the duty of impartiality clearly does not preclude an instrumental IFSI strategy and, in fact, would require the inclusion of sustainability factors that impact the achievement of overall financial goals of the fund. However, there is not yet similar support for an ultimate ends IFSI strategy that in our view would require still an explicit guidance from the beneficiaries.

U.S. Department of Labor

2.4.10 The Department of Labor, or "DOL," regulates the investment practices of private retirement plans. In recent years, DOL issued a series of interpretive and field assistance bulletins to provide guidance regarding ESG investing. We consider such DOL guidance would apply to IFSI on the basis that IFSI involves investors intentionally taking sustainability factors into account in the way they manage their assets, either in order to pursue financial return goals or goals that go beyond financial return. These DOL bulletins are designed to provide guidance with respect to enforcement positions, clarification of policies or changes in policy.[37] Given DOL's responsibility for enforcement, as a practical matter, these guidance documents are viewed as binding by industry participants who wish to avoid the costs and potential penalties resulting from any investigation.

2.4.11 An interpretive bulletin issued in 2015 (the "2015 Bulletin") states that "ERISA do[es] not permit fiduciaries to sacrifice the economic interests of plan participants in receiving their promised benefits in order to promote collateral goals."[38] A field advice bulletin issued in 2018 (the "2018 Bulletin") reaffirms that "plan fiduciaries are not permitted to sacrifice investment return or take on additional investment risk as a means of using plan investments to promote collateral social policy goals."[39] The key question arising from both of these statements appears to be whether ESG investing that is not entirely motivated by seeking to achieve the financial investment objectives of the plan trustees (whether their approach involves instrumental IFSI) will result in the "sacrifice" of economic interests of investment return and is therefore not authorized. Both the 2015 Bulletin and the 2018 Bulletin recognize that this need not necessarily be the case. DOL has expressed the view that if a pension trustee has two investment options with otherwise identical risk and return factors, the trustee may take collateral benefits into account as a tiebreaker in its decision on how to act. The 2015 Bulletin states that "fiduciaries may consider such collateral goals as tie-breakers when choosing between investment alternatives that are otherwise equal with respect to return and risk over the appropriate time horizon. ERISA does not direct an investment choice in circumstances where investment alternatives are equivalent, and the economic interests of the plan's participants and beneficiaries are protected if the selected investment is in fact, economically equivalent to competing investments."[40] The 2018 Bulletin "reiterate[s] the view that when competing investments serve the plan's economic interests equally well, plan fiduciaries can use such collateral considerations as tie-breakers for an investment choice."[41] On the face of it, this statement is difficult to reconcile with the "sole interest" rule described above. Furthermore, although there appears to be some evidence that the integration of ESG considerations into investment decisions may have only either a neutral or positive effect on the overall performance of an investment portfolio,[42] it is by no means the case that there is industry-wide consensus on this point and it remains

UNITED STATES

difficult to verify. In other words, where pension trustees are pursuing collateral goals, it may be challenging for them to be confident that the situation is genuinely a "tie-break." In this context, until pension trustees are comfortable that they will not expose themselves to potential litigation for a breach of the "sole interests" rule in a tie-break situation, they may not be comfortable relying on this statement in the 2018 Bulletin to make investment selections that are intended to achieve goals that are collateral to the goal of securing the requisite financial return (including ultimate ends IFSI).

2.4.12 That being said, with respect to investment-specific decisions relating to duties seeking to achieve the investment objectives of the relevant plan, DOL bulletins from 2015 and 2018 recognize that ESG issues may influence the financial performance of investments and accordingly investing with ESG considerations can be consistent with ERISA law when the trustee acts on "solely economic considerations."[43] As with any other decision in relation to the plan, the trustee would need to follow a proper process in reaching its decision as to whether or not to take into account such ESG considerations. A trustee will also likely want to ensure its ability to prove it indeed acted solely with economic considerations in mind based on objective criteria.

2.4.13 In October 2020, DOL finalized a rule that adopts amendments to investment duties under Title I of ERISA to confirm that ERISA requires plan fiduciaries to select investments and investment courses of action based solely on financial considerations related to the risk-adjusted economic value of a particular investment or course of action (the "2020 Final Rule").[44] Under the 2020 Final Rule, DOL notes that fiduciaries are prohibited from subordinating interests of participants and beneficiaries in their retirement income to non-pecuniary goals, and fiduciaries were cautioned that accepting reduced expected returns or greater risks to secure non-pecuniary benefits is a violation of ERISA.[45] At the same time, DOL continued to recognize what it refers to as the "all things being equal" test, or the "tie-breaker" standard, which allows a fiduciary to make investment decisions based on non-pecuniary factors if plan fiduciaries cannot "distinguish alternative investment options based on pecuniary factors alone."[46]

2.4.14 In March 2021, following the change to the Biden administration, DOL announced that it would not enforce the 2020 Final Rule after hearing from a wide variety of stakeholders that the rule had caused investor confusion and had already had a "chilling effect on appropriate integration of ESG factors in investment decisions," including in circumstances where consideration of ESG factors would be permissible.[47] DOL has been instructed by President Biden to revisit the 2020 Final Rule, which became effective on January 12, 2021 but has not been enforced under the new administration.[48] The move is in line with the Biden administration's renewed prioritization of climate and ESG issues, and may suggest that DOL intends to take a more permissive approach to ERISA rules that relate to the consideration of ESG factors by fiduciaries.

Legal requirements to use investment powers to IFSI – public pension funds

2.4.15 There is no legal requirement that expressly requires a public pension fund trustee to IFSI. There are, however, certain statutory regimes, such as U.S. sanctions laws and rules against money-laundering, the goals of which can be viewed as consistent with investing for Sustainability Impact insofar as not investing in the relevant prohibited investments may indirectly have positive Sustainability Impact consequences, for example by reducing or preventing the risk of corruption or other criminal activity.

2.4.16 As mentioned above, in most if not all states,[49] the trustee has a duty to invest solely for the financial interest of beneficiaries. The term "beneficiaries" is likely to be interpreted to refer only to existing beneficiaries. However, these existing beneficiaries may include beneficiaries with a longer time horizon insofar as they will only be entitled to make claims on the fund significantly in the future when the impact of long-term environmental and social sustainability risk on economic returns may be more material and apparent. At least one state court has recognized that a public pension fund does not breach its fiduciary duty by administering the fund to "create and maintain long-term stability and

> ANNEXES

> United States

UNITED STATES

viability."[50] In our view, therefore, if a trustee concludes (or ought to have concluded) both that (a) sustainability factors pose a material risk to its ability to achieve the economic objectives of its overall investment strategy (or create economic opportunities) and (b) it is in a position to take actions that (either individually or collectively when taken together with the actions of other parties) can help to mitigate that risk or realize the economic opportunities, then a failure to even consider, let alone act on, the potential adverse financial impact of sustainability factors on its investment objectives (or potential economic opportunities) and what it may be able to do about them would appear to represent a breach of its duties to investors. The question then becomes what actions it ought to take. As described at Paragraph 2.3.7, where adopting an IFSI approach can reasonably be expected to help (either individually or collectively when taken together with the actions of other parties) in mitigating the risk or realizing the economic opportunity, then the trustee should include that in its assessment and act accordingly. Any assessment would need to take account of all relevant circumstances, including, for example, the need for impartiality as between different generations of beneficiaries, the possible expense for the trust of the action (whether in terms of investment performance, costs or otherwise), the magnitude of the risk and its likelihood and the period within which it could crystalize. Among other things, the need for impartiality as described in Paragraph 2.4.9 will require the trustee to balance the risks to longer term beneficiaries against the possibility of lower shorter-term returns for beneficiaries who are already making claims or will be making claims in the near future. Furthermore, particularly in public markets, there may be a question as to the extent to which the individual use of investment powers by an investor is likely to have any impact on the behavior of the relevant company (whether in terms of its sustainability impact or otherwise), even if the trustee is comfortable that the immediate consequence of doing so will not be lower investment returns that adversely affect impartiality between beneficiaries. In this context, although some commentators have argued that specific investment decisions ought to be made with such longer term considerations in mind,[51] it may be easier for a trustee to reconcile these competing beneficiary interests by instead seeking to address the systemic risks presented by sustainability factors by engaging in collective sustainability-related stewardship activities. However, it is possible that the use of (or clear willingness to use) investment powers in this context to reduce or increase company holdings could provide a way of strengthening voice.

2.4.17 As the potential adverse impacts of climate change and other sustainability factors on investment returns (long-term but also materializing in the short-term) becomes increasingly apparent and supported by peer-reviewed evidence, it is reasonable to expect instrumental IFSI to become more common, given:

(a) the fact that the prudent investor rule requires the trustee to take into account the duration of the trust, so that the amount and timing of its distribution requirements may make it more likely that a trustee would conclude that long-term environmental and social sustainability risk represents a sufficiently imminent risk to future investment returns;[52]

(b) the fact that the prudent investor rule expressly contemplates the revisiting of prior investment decisions and requires a trustee to continually observe and evaluate investments (as described in Paragraph 2.4.8) so that a trustee should change its existing strategy to adapt to new circumstances and evidence; and

(c) the requirement that a trustee disclose all facts that materially affect a beneficiary's rights and interests will lead a trustee to disclose sustainability risks that could result in material damage to the financial position of the trust, potentially putting it under pressure to adopt investment strategies that can reasonably be expected to help mitigate the risks disclosed.

Legal requirements to use investment powers to IFSI – private retirement plans

2.4.18 There is no legal requirement that expressly requires private retirement plans to IFSI. As for public pension funds, there are, however, certain statutory regimes, such as U.S. sanctions laws and rules against money-laundering, that can be viewed as consistent with IFSI insofar

UNITED STATES

as the investments that they preclude may indirectly have a positive social impact, for example by mitigating the risk of corruption or other criminal activity.

2.4.19 The circumstances in which the trustees of a private retirement plan would need to consider engaging in instrumental IFSI in the way they use their investment powers are similar to those described in relation to public pension funds at Paragraphs 2.4.15 and 2.4.16 above. In that context, as noted in Paragraph 2.4.9, the common law duty of impartiality has been recognized by the Supreme Court as applicable to private retirement plans under ERISA.

2.4.20 Note DOL's guidance that investment returns cannot be sacrificed when taking ESG factors into account (see Paragraphs 2.4.10 through 2.4.14 above) does not prohibit instrumental IFSI since the aim of that is to help in generating the requisite investment returns (or preserving long-term investment value in a manner consistent with that).

2.4.21 However, the extent to which trustees feel confident about engaging in instrumental IFSI in practice may depend on whether DOL revises its existing rules, as discussed in Paragraph 2.4.14, to no longer presume that the inclusion of ESG factors in investment decisions requires a higher burden to prove that these are relevant to achieving the requisite investment return (in other words, eliminating any guidance that could be interpreted as requiring that pursuing instrumental IFSI would require greater evidence that investment returns have not been sacrificed).

Legal freedom to use investment powers to IFSI – public pension funds

2.4.22 As described at Paragraph 2.4.16, decisions on whether or not a public pension fund should engage in IFSI will be determined by an assessment of the impact of sustainability factors on achieving its financial return objectives. Such assessment cannot be carried out based on a traditional economic cost benefit analysis, particularly when engaging in IFSI to address systemic risks, because such risks and the benefits of mitigating them are difficult to quantify. Decisions will need to rely, at least in part, on an assessment of the potential adverse impact of ESG factors on portfolio value and performance. In the event of a dispute positing a causal link between engaging in instrumental IFSI and an adverse impact on financial return, a court would seek to determine whether a proper due diligence process was conducted by the fund manager that enabled it to make a reasoned determination in a manner consistent with its fiduciary duties, rather than the ultimate outcome.

2.4.23 Some states, such as Delaware, that have not adopted the UPIA have amended their trust code in a way that might allow for some element of IFSI, including ultimate ends IFSI. For example, a 2018 amendment to the Delaware trust code provides that, "when considering the needs of the beneficiaries, the fiduciary may take into account the financial needs of the beneficiaries **as well as** the beneficiaries' personal values, including the beneficiaries' desire to engage in sustainable investing strategies that align with the beneficiaries' social, environmental, governance or other values or beliefs of the beneficiaries."[53] As amended, the new Delaware trust code makes enforceable a term of a trust that prescribes a "sustainable or socially responsible investment strateg[y] . . . with **or without** regard to investment performance."[54] In states that adopted the UPIA, as described above at Paragraph 2.3.5, the prudent investor rule is a default rule, which may be expanded, restricted or eliminated or otherwise altered by the express provisions of a trust.[55] It is possible, therefore, that some states could adopt provisions similar to those adopted by Delaware. Where a state permits (but does not mandate) taking into account "sustainable or socially responsible" strategies (i.e., so that they are permitted to engage in instrumental IFSI), the fiduciaries of such pension plans would need to obtain the requisite support of the beneficiaries to alter the provisions of the trust documentation in accordance with any applicable voting requirements of their constitutive documentation A strategy that relies on provisions such as that found in the Delaware trust code does not conflict with the "sole interests" rule that requires a trustee to administer the trust in the "sole interest" of its beneficiaries.[56] In other words, unless the relevant state trust code provisions clearly supersede the "sole interests" rule, it would appear that trustees will be limited to instrumental IFSI in the theoretical "tie-break" situations such as those described in Paragraph 2.4.11.[57]

UNITED STATES

Legal freedom to use investment powers to IFSI – private retirement plans

2.4.24 The position is broadly similar to that described above in relation to public pension funds. See Paragraphs 2.4.10–2.4.14 for a discussion of DOL's interpretive and field assistance bulletins guidance and 2020 Final Rule regarding ESG integration. As noted, the guidance states that private pension funds should not take ESG factors into account in their use of investment powers unless the ERISA fiduciary can conclude that doing so will have a positive (or, in a tie-breaker situation, neutral) impact on investment returns.

2.5 **Mutual funds**

Asset Owner: The fund. Mutual funds have a two-tier decision-making structure. Mutual funds are governed by a board of directors, which, in turn, generally hires an Investment Adviser to make investment decisions and conduct the day-to-day operations of the fund. The Investment Adviser's employees may also be investors in or directors of the fund. The board of directors oversees the Investment Adviser and represents the interests of the fund's shareholders.[58]

Beneficiaries: Individual investors.

Investment decision-maker: Investment Adviser. The typical relationship between an Investment Adviser and an Asset Owner that is a fund is a principal-agent relationship, where the principal (the Asset Owner) hires an agent (the Investment Adviser) to perform investment advisory services on the principal's behalf. Investors and investment advisers, to some extent, have different interests in these arrangements. For example, while both are likely to want the mutual fund to achieve its financial objectives, the Investment Advisor also has an economic interest in generating fees. Potential issues that could emerge from this element of intermediation include the possibility that Investment Advisers could align with their own corporate positions on issues, including sustainability-related issues that are a focus of IFSI, and have different time horizons given their typical appointment for shorter time periods.[59]

Types of mutual funds covered

2.5.1 There are three main types of investment companies in the U.S. (one of which, ETFs, defined below, can be viewed as a hybrid of the other two):

(a) **Open-end mutual funds** are bodies corporate the shares of which can be acquired and redeemed by investors at any time, subject to very limited circumstances in which redemptions can be suspended. Thus, the number of shares of an open-end fund is always changing, and as the fund receives additional investment, its portfolio grows. An investor will generally purchase shares in the fund directly from the fund itself, rather than from existing shareholders. Most open-end funds are actively managed, although there has been substantial growth in Assets Under Management committed to index funds (including ETFs). The price at which shares in an open-end fund are issued or can be redeemed will vary in proportion to the net asset value of the fund and so directly reflects its performance.[60]

(b) **Unit investment trusts ("UITs")** are exchange-traded mutual funds with a fixed portfolio of stocks and/or bonds that are created for a specific length of time. A UIT is not actively managed and has no board of directors. A UIT's securities will not be sold or new ones bought except in certain limited situations (such as bankruptcy or a merger).[61]

(c) **Exchange-traded funds (or "ETFs")** are investment funds traded on public exchanges whose price changes throughout the day. Unlike open-end mutual funds, ETFs do not sell individual shares directly to, or redeem their individual shares directly from, retail investors. ETFs have traditionally been designed to track the performance of published indices or a pre-defined basket of stocks, commodities and/or bonds and are therefore generally not actively managed even though they have an Investment Adviser. Actively managed ETFs that buy or sell investments consistent with a stated investment objective are also permitted by the SEC. The popularity of ETFs has rapidly increased in recent years because of their low transaction and management costs and stock-like features. An ETF operates with an arbitrage mechanism designed to keep it trading close to its Net Asset Value ("NAV") and therefore combines the valuation feature of an open-end fund, which can be bought or sold at the end of each trading day for its net asset value,

UNITED STATES

with the tradability feature of a closed-end fund, which trades throughout the trading day at prices that may be more or less than its net asset value. Closed-end funds are not considered to be ETFs, even though they are funds and are traded on an exchange, because ETFs have the ability to redeem or issue new shares based on investor inflows and outflows and closed-end funds (unlike most ETFs) are generally actively managed.[62] A small number of ETFs are structured as UITs.[63]

Overview of investment duties and powers

2.5.2 Mutual funds are professionally managed investment funds that pool money from multiple investors to invest in securities and, at times, higher-risk investments. The fund's portfolio is managed by an Investment Adviser. Due to economies of scale, they can achieve a higher level of diversification.

2.5.3 Mutual funds are principally regulated under the Investment Company Act of 1940 (as amended, the "Investment Company Act"). The Investment Company Act regulates the organization of companies, including mutual funds, that engage primarily in investing, reinvesting and trading in securities, and whose own securities are offered to the investing public. Among other things, it is designed to minimize conflicts of interest that arise in these complex operations. Under the Securities Act of 1933 (as amended, the "Securities Act"), all mutual funds must be registered with the SEC as investment companies. Mutual fund issuers are subject to reporting requirements and regulation by the SEC under the Securities and Exchange Act of 1934 (as amended, the "Exchange Act").

2.5.4 Mutual fund Investment Advisers are principally regulated under the Investment Advisers Act of 1940 (as amended, the "Investment Advisers Act"). The Investment Advisers Act requires firms or sole practitioners that receive compensation for securities investment advice to register with the SEC and comply with regulations promulgated under the Act. Generally, only large advisers, who have at least $100 million in assets under management, must register with the SEC. States may also require registration under similar state-level legislation, and an Investment Adviser may be required to register with multiple states, depending on its operations and state requirements.[64]

2.5.5 Registration with the SEC subjects mutual funds to numerous regulatory requirements imposed for the protection of investors. Primary regulation occurs under the Investment Company Act and the rules adopted under that Act, but mutual funds are also subject to the Securities Act and the Exchange Act, which broadly regulate publicly traded securities and require disclosure of material information to investors.

2.5.6 Mutual funds must provide interested investors with a prospectus which, among other things, is required to disclose the investment objectives or goals of the mutual fund, information on the fund's past financial performance, the principal investment risks to which the mutual fund is exposed and information regarding the fund's fees and expenses (including shareholder fees and operating expenses).[65] As discussed further in Paragraph 2.5.11 below, principal investment risks would also include material ESG factors.

2.5.7 Under the SEC's regulations,[66] mutual funds are required to incorporate in their public disclosures all material risks to their investment strategy.

2.5.8 In addition to the requirements of federal law, which apply to the mutual fund vehicle itself, the directors of a mutual fund owe duties to the fund, discharge of which is potentially relevant to IFSI. Directors of mutual funds must abide by standards of care prescribed by state statutory and common law. Specifically, directors are subject to state law duties of care and loyalty. The duty of care generally requires that directors act in good faith and with that degree of diligence, care and skill that a person of ordinary prudence would exercise under similar circumstances in a like position of responsibility with respect to a mutual fund. The duty of loyalty generally requires that directors exercise their powers in the interests of the fund and not in the directors' own interests or in the interests of another person or organization.

2.5.9 Under the law of most states, the legal standard of review generally applied by courts of competent jurisdiction with respect to the duty of care and the duty of loyalty owed to a company by

UNITED STATES

its directors is the "business judgment rule." Some states have codified the business judgment rule through so-called "constituency statutes," which expressly state that directors are empowered to balance the interests of all stakeholders, employees and other stakeholders. However, Delaware, one of the most important states in the United States for corporate law (due, in part, to the number of corporations that are organized there), does not have a constituency statute, and directors must make decisions in the best interests of the corporation and its shareholders. Under the business judgment rule, a court will uphold the decisions of a director and not second-guess business judgments so long as they are made in good faith, with the care that a reasonably prudent person would use and with the reasonable belief that the director is acting in the best interests of the corporation. Under the best interest rule, an action by a fiduciary that is in the self-interest of the fiduciary will be in the best interests of the beneficiaries with sufficient frequency that the beneficiaries are better off with an inquiry into whether a transaction passes an "entire fairness" test. This is especially likely if the fiduciary (e.g., a corporate board of directors) was chosen for professional expertise that overlaps with the fiduciary's personal interests. Transactions that do not satisfy the entire fairness test will likely come to the attention of investors and therefore be subject to effective challenge.

Legal requirements to use investment powers to IFSI

2.5.10 We are not aware of any provision that expressly requires mutual funds to use investment powers to pursue an instrumental IFSI strategy, unless the mutual fund has been established with an investment objective in its prospectus that essentially requires it to engage in such an IFSI strategy, so that investors acquire fund interests with the expectation that such objective will be pursued. Under § 8(b)(3) of the Investment Company Act, a mutual fund's registration statement must include all "matters of fundamental investment policy," and the accuracy of that statement and the fund's prospectus are subject to anti-fraud rules under Rule 10b-5 of the Exchange Act and §§ 11 and 12(a)(2) of the Securities Act. Therefore, if a fund discloses in its prospectus that it will engage in an investment approach within the scope of IFSI, under federal securities law, it has a duty to do so and will be subject to enforcement action from the SEC if the SEC determines that the fund made inaccurate or fraudulent representations in the fund's registration statement. However, there is no general duty to invest a fund's portfolio in a way that secures the well-being (defined more broadly than purely in financial terms) of beneficiaries, reflects the sustainability aspirations of the beneficiaries or seeks to further wider societal goals unless such objectives are already disclosed in the fund's prospectus. In theory, the pursuit of instrumental IFSI may be needed to secure the financial objective of the fund. However, because registration statements must be tightly drafted to include all "matters of fundamental investment policy", there is usually not sufficient latitude to use investment powers to pursue an instrumental IFSI strategy unless explicitly provided. As discussed below in Paragraph 3.3, there is more latitude to use stewardship activities around instrumental IFSI that may affect fund performance.

2.5.11 As discussed in Paragraphs 2.5.6 and 2.5.7, mutual funds are required to provide investors with a prospectus that includes a description of the principal investment risks to which the mutual fund is exposed, and mutual funds are required to incorporate in their public disclosures all material risks to their investment strategy, which accordingly requires the disclosure of relevant Sustainability Impact-related risks to the extent that they are deemed to be financially material, even if the fund's investment objective does not specifically require an investment approach within the scope of IFSI.

2.5.12 Where a fund's disclosed investment objective specifically contemplates an IFSI investment approach, there is a clear requirement for the disclosure of metrics with which investors may gauge the extent to which such objective is being attained. The determination of materiality will be made within the context of the potential impact on the stated investment objective and will require disclosure of the material risks to the achievement of such objective as well as the steps (if any) that the mutual fund is taking to address those risks.

UNITED STATES

2.5.13 For mutual funds that do not include an IFSI objective, materiality, and the disclosure of material risks, must be viewed under more general standards of what is material under relevant U.S. federal laws. Information is material if there is a substantial likelihood that a reasonable investor would consider the information important in deciding how to vote or make an investment decision. As more investors indicate that enhanced Sustainability Impact-related disclosure is a significant factor in their investment decisions, there is a potentially increased risk to the fund of there being a smaller pool of new investors and outflows of existing investors that may result from a failure to include such disclosure.

2.5.14 These risks have arguably reached a point that they present a financially material risk to a fund and its strategy, including its ability to diversify its portfolio adequately. Decreased liquidity of the fund units may also adversely impact investors. In this context, it may therefore be reasonable for mutual funds to conclude that enhanced Sustainability Impact-related disclosure is material to a reasonable investor's investment decision. If this conclusion is correct, then funds that eschew such disclosure may, as an alternative approach, need to include a risk factor in the fund's prospectus disclosing that the failure to include such disclosure may make the fund less attractive as compared to other funds and result in investor outflows and lower liquidity.

2.5.15 For those mutual funds that decide to provide disclosure of Sustainability Impact-related metrics because they conclude that such information is material to the investment decisions of their investors, such metrics should be clearly defined and include an explanation of how each such metric is calculated and why it provides useful information to investors.

2.5.16 When providing Sustainability Impact-related metrics for the purpose of allowing investors to assess IFSI, as with the disclosure of financial and operating metrics, the metrics must provide a full and fair representation of the information that is purported to be conveyed, without the selective disclosure of metrics intended solely to show the fund in a better light.

2.5.17 The selection of a particular fund name that could be interpreted as implying an IFSI objective may also be relevant to the exercise of investment discretion, with the effect that it could be necessary for a mutual fund to adopt an IFSI investment approach in order to act in a manner consistent with the way the fund has been marketed to investors. In March 2020, the SEC published a request for comment on the framework for evaluating requirements for registered investment companies' names. §35(d) of the Investment Company Act prohibits a registered investment company (which includes mutual funds, closed-end funds, UITs and ETFs) from adopting a name that includes words the SEC deems materially deceptive or misleading (known as the "Names Rule"). For registered investment companies with a name that suggests a particular type of investment, the Names Rule requires the fund to adopt a policy to invest at least 80% of its assets in the type of investment, industry, country, geographic region or tax exemption suggested by its name. The SEC Staff solicited input on whether the Names Rule should apply specific requirements for ESG or sustainable registered funds and what those requirements should be, if any. The SEC Staff also asked market participants whether registered funds should be limited in characterizing investments as sustainable or ESG and whether a registered fund with ESG in its name must make investments that meet certain ESG factors or criteria. In a July 2021 speech, SEC Chair Gary Gensler stated: "When it comes to sustainability-related investing, though, there's currently a huge range of what asset managers might mean by certain terms or what criteria they use."[67] The question of what kind of disclosures are required for purported ESG funds will continue to be at the forefront of SEC regulation in this area.[68]

2.5.18 Further limiting the potential that mutual funds would be required to use investment powers to pursue instrumental IFSI, we are not aware of any general duty or requirement to manage a fund in a way that takes into account the prospect that potential future fund investors may be more materially and adversely impacted by sustainability factors, since prioritizing these potential investors would be inconsistent with the entire fairness test

> ANNEXES

> United States

UNITED STATES

described above. That said, many mutual funds are likely to have investors with a range of time-horizons, some long-term and, when it comes to any need to take account of sustainability factors in managing the assets of a fund, even given the open-ended structure of funds to facilitate ease of investor entry and exit, it will be necessary to bear in mind the potential for some sustainability and associated transition risks to crystallize in the short-term.

Legal freedom to use investment powers to IFSI

2.5.19 Mutual funds are free to organize themselves as a fund with an objective that would involve engaging in an investment approach within the scope of IFSI so long as such investment objective is properly disclosed in the fund's prospectus, along with the potential risks to investors (including, if relevant, the potential risk of lower financial returns as compared to benchmark funds that do not have an equivalent objective but invest in similar securities).

2.5.20 Separately, mutual funds may amend their prospectuses to disclose explicitly to investors that a fund's strategy to achieve its existing investment objectives includes considering ESG-related factors in its investments. In 2019, nearly 500 funds did so.[69] On February 26, 2021, the SEC issued a bulletin to investors that explained, "Funds that elect to focus on companies' ESG practices may have broad discretion in how they apply ESG Factors to their investment and governance processes. For example, some funds integrate ESG criteria alongside other factors, such as macroeconomic trends or company-specific factors like a price-to-earnings ratio, to seek to enhance performance and manage investment risks. Other funds focus on ESG practices because they believe investments with desired ESG profiles or attributes may achieve higher investment returns and/or encourage ESG-related outcomes."[70] However, absent legislation expressly permitting such a change without investor consent, it would be difficult for an existing fund to change its previously disclosed investment objective altogether to one that required it to use its investment powers to engage in instrumental or ultimate ends IFSI without majority, if not unanimous, investor consent (given that its existing investor base will have made their determination to invest based on disclosure of the fund's investment objectives prior to the relevant change), unless it is able to conclude that such engagement represents the natural evolution and continuation of such previously disclosed objective.

2.6 Insurance undertakings

Asset Owner: The insurance company is the asset owner and invests the premiums that are paid to it by its policyholders.

Beneficiaries: The insurance company's policyholders and shareholders are the beneficiaries of the company's investments. Policyholders in the sense that any payments made under policies are financed from the investment of the company's assets. Shareholders in the sense that they benefit from the insurance company's dividends and capital growth.

Investment decision maker: Insurance companies may use internal or external Investment Advisers. The largest insurance companies have sufficient economies of scale to support their own internal Investment Adviser, whether part of the insurance company, a subsidiary or other affiliate. However, many insurance companies outsource all or part of their asset management to external Investment Advisers. Many of the largest external insurance company Investment Advisers are also mutual fund Investment Advisers.

Types of insurance undertaking covered

2.6.1 In the U.S., insurance companies are regulated by the laws of each state, and so there is not one uniform law that regulates and sets standards for insurance companies.

(a) Life insurance: The insurer undertakes, in consideration of a specific premium being paid, to pay out a lump sum or fixed regular income on death or another defined event. There are three roles involved in the policy purchase: (i) the policy owner; (ii) the insured person; and (iii) the beneficiary. With respect to life insurance, a policy owner purchases insurance that provides financial coverage over a person's life, known as the insured. The insured may or may not be the policy owner. The beneficiary is the person (or multiple people) who will receive death benefits when the insured passes away. Life insurance may be term insurance, which covers a defined period of time.

UNITED STATES

If the insured person survives the term, there is no payout. Permanent life insurance provides coverage for an entire lifespan, and a payout occurs so long as the premiums on the policy continue to be paid. There are two main types of permanent life insurance: whole life insurance; and universal life insurance. Whole life insurance has a fixed coverage and premium amount and has the potential to accumulate cash value over time. Universal life insurance offers flexible premiums and the cash value earns interest at the greater of the current market rate or the minimum interest rate set by the policy.

(b) General insurance includes insurance policies that are not life insurance, including property, accident and sickness, travel and liability insurance, among others. The insurer's liability is to pay out when a valid claim is made by the relevant policyholder. Any profits of investment activity are retained by the insurer.

2.6.2 Insurers may have a range of objectives for their asset portfolio. Investments made by insurance companies in relation to products with a longer-term time horizon, such as life insurance, focus on long-term yield, while others focus on total return.

Overview of investment duties and powers

2.6.3 Under the McCarran-Ferguson Act of 1945, insurance companies are exempt from most federal regulation. They are therefore organized and regulated primarily on a state-by-state basis, with some exceptions, as described in Paragraphs 2.6.8 through 2.6.10.

2.6.4 It is necessary to distinguish between the law as it applies to the insurance company and the law as it applies to the directors of the insurer who determine what business it should undertake and on what terms (and who would also, therefore, be responsible for decisions about whether it should engage in IFSI).

2.6.5 In the case of the former, to the extent that insurance companies are publicly listed corporations, they must comply with federal SEC obligations relating to disclosures of material information reasonably expected to affect the value of the corporation. In addition to the duties that apply under legislation, insurance companies also have contractual obligations to policyholders under the terms of their policies. If and to the extent that policies contain undertakings by the insurance company as to how it will manage the insurance funds collected in order to generate returns sufficient to pay entitlements under such policies, the insurance company must comply with such provisions. Such provisions could include a requirement to engage in IFSI.

2.6.6 In the case of the latter, under the corporate law of most states, the directors of the insurer owe a duty of care and a duty of loyalty to the company. Under the law of most states, the legal standard of review for these duties is the "business judgment rule" (absent certain triggers which may result in higher levels of scrutiny, such as when a director has a potential conflict of interest that could result in a breach of the duty of loyalty).

2.6.7 As described earlier in this report in Paragraph 2.5.9, under the business judgment rule, a court will uphold the decisions of a director of a public company and not second-guess business judgments so long as they are made in good faith, with the care that a reasonably prudent person would use and with the reasonable belief that the director is acting in the best interests of the corporation—that is, acting for the benefit of the beneficiaries as a whole. Under the best interest rule, an action by a fiduciary that is in the self-interest of the fiduciary will be in the best interests of the beneficiaries with sufficient frequency that the beneficiaries are better off with an inquiry into whether a transaction passes an "entire fairness" test. This is especially likely if the fiduciary (e.g., a corporate board of directors) was chosen for professional expertise that overlaps with the fiduciary's personal interests. Transactions that do not satisfy the entire fairness test will likely come to the attention of investors and therefore be subject to effective challenge.

2.6.8 In 2010, Congress passed the Dodd–Frank Wall Street Reform and Consumer Protection Act (the "Dodd–Frank Act").[71] Significantly, Title V of the Dodd–Frank Act created the Federal Insurance Office ("FIO") in the Department of the Treasury.[72] The FIO is authorized to monitor the insurance industry and identify any gaps in the state-

> ANNEXES

> United States

UNITED STATES

based regulatory system. The FIO's authority to report on and monitor the insurance industry extends to all lines of insurance, except health insurance, certain long-term care insurance and crop insurance.[73] In particular, the Dodd-Frank Act authorizes the FIO to consult with state insurance regulators on "insurance matters of national importance and prudential insurance matters of international importance."[74] The FIO also may assist the Treasury Department in international negotiations of certain bilateral or multilateral agreements regarding prudential insurance matters and determine whether those agreements preempt state laws.[75] Accordingly, some commentators have argued that entry into an international climate change agreement that relates to prudential insurance matters could offer the FIO an opportunity to preempt the policy positions of state insurance authorities and the National Association of Insurance Commissioners.[76]

2.6.9 The Dodd–Frank Act also established the Financial Stability Oversight Council ("FSOC").[77] The FSOC is charged with monitoring the financial services markets, including the insurance industry, to identify potential risks to the financial stability of the United States.[78] It may determine that an insurance company or insurance broker (if it is a "U.S. nonbank financial company" for purposes of and as defined in the Dodd–Frank Act[79]) is systemically significant and therefore subject to prudential supervision by the Board of Governors of the Federal Reserve System (the "Federal Reserve").[80] The FSOC may make recommendations to the Federal Reserve regarding, among other things, the establishment of increased reporting and disclosure requirements and general risk management for nonbank financial companies that are supervised by the Federal Reserve ("Supervised Nonbank Financial Companies").[81]

2.6.10 The FSOC is also empowered to make recommendations to primary financial regulatory agencies regarding the application of new or heightened standards and safeguards for financial activities or practices, and certain participation in such activities, that threaten the stability of U.S. financial markets. A primary financial regulatory agency must impose standards recommended by the FSOC, or standards similar to those recommended, or must explain in writing to the FSOC why the agency has determined not to follow the recommendations.

2.6.11 Under the state-based insurance regulation system, each state operates independently to regulate its own insurance markets, typically through a state department of insurance or division of insurance. The National Association of Insurance Commissioners ("NAIC") is a standard-setting and regulatory support organization created and governed by the chief-insurance regulators from the 50 states, Washington D.C. and five U.S. territories.[82]

2.6.12 Each state decides whether to pass each NAIC model law or regulation, and each state may make changes in the enactment process, but the models are widely, albeit somewhat irregularly, adopted.

2.6.13 While laws vary from state to state, generally, investment options for insurance companies are highly controlled and limited by state regulations, which are designed to ensure that insurers will have appropriate reserves and liquidity to satisfy claims from their insured policyholders. As NAIC described in 2012, "Because investment is a large part of the insurance business, regulators pay close attention to investment risk, encouraging less risky investment when appropriate. In the 1990s, insolvencies caused by high-risk investment strategies led U.S. regulators to consider their oversight and possible restriction of insurer investments . . . ."[83]

2.6.14 The outsourcing of an insurance company's investment management does not relieve the insurer's management and its board from investment responsibilities, and oversight of external Investment Advisers will be required to ensure that the portfolio is managed appropriately.

General insurance: Legal requirements to use investment powers to IFSI

2.6.15 We are not aware of any provision that expressly requires insurers to use their investment powers to pursue instrumental IFSI. However, insurers are obligated to manage their assets with care, skill, prudence and diligence because, as with mutual funds, directors of insurers must abide by the director's duty of

UNITED STATES

care and duty of loyalty, as described in Paragraphs 2.5.8–2.5.9. Because insurance companies need to ensure that they have sufficient funds (and the appropriate level of liquidity) to satisfy claims, they will need to manage their assets in a way that would enable them to pay claims under the policies they have written, including future claims that may arise as a result of sustainability risks. Given this objective, the duty of care and duty of loyalty arguably requires a director of an insurance company to consider long-term sustainability risks (including the sort that instrumental IFSI might seek to address) and their potential adverse financial impact on the company's portfolio when selecting investments if they conclude that doing so is in the "best interests" of the insurer. The size of a large insurance company's assets under management may result in pressure from both shareholders and policyholders to apply such resources to instrumental IFSI to achieve long-term growth of assets. Of course, all such transactions will need to satisfy the entire fairness test or risk coming to the attention of shareholders or policyholders and becoming the subject of challenge.

2.6.16 Unless it is contractually provided for in the terms of the relevant policy (in the case of policyholders) or required by its constitutive documents or applicable state corporations law (in the case of shareholders), we are not aware of any requirement for directors of an insurance company to assess the views of policyholders or shareholders on IFSI or any other preference. The views of shareholders are nevertheless likely to be important to directors, particularly if they are held by a block of shareholders with sufficient votes to remove directors. However, regardless of the views of shareholders, directors remain bound to act in the "best interests" of the insurer and ensure that transactions pass the "entire fairness" test.

2.6.17 General risk reporting and disclosure requirements under applicable securities laws that are not IFSI-specific will dictate whether or not any disclosure of the potential negative impact of a failure to IFSI on the performance of an insurer's investments is necessary. If an insurance company identifies and discloses sustainability risks that may adversely impact its financial performance, its directors will be obligated under the duty of care to consider what steps, if any, ought to be taken by the company to avoid or mitigate such risks. Where approaches consistent with instrumental IFSI could provide an effective way of addressing these risks to financial return and preservation of assets, directors would need to consider them and, if they conclude that such an approach will in fact serve to address such risks, act accordingly.

General insurance: Legal freedom to use investment powers to IFSI

2.6.18 We are not aware of any law prohibiting insurers from pursuing instrumental IFSI as part of their objectives and strategy for managing portfolio assets. Insurers have the flexibility to pursue instrumental IFSI, so long as they invest in a way that (a) maintains sufficient reserves and liquidity to cover claims, (b) falls within the constraints of the business judgment rule and applicable state laws pertaining to permissible investment strategies and (c) does not conflict with the terms of any of their policies.[84]

2.6.19 As public companies, the directors of insurance companies are held accountable to their shareholders, and so it may be difficult to ignore investor demands that they exercise their powers to invest in ways that would fall within the scope of instrumental IFSI. [85] However, as noted above, this shareholder pressure cannot trump the directors' duty to act in the "best interests" of the company and engage in transactions that pass the "entire fairness" test. In order to reconcile the two, the directors will need to conclude that the failure to do so may adversely affect the financial performance of the company.

Life insurance: Legal requirements to use investment powers to IFSI

2.6.20 Analysis of the legal requirements to use investment powers to pursue instrumental IFSI in the context of life insurance is similar to that of general insurance (Paragraphs 2.6.15–2.6.19).

2.6.21 In addition, if there is consumer demand for life policies that involve the underlying funds being invested in ways that would fall within the scope of instrumental IFSI, then it is legally permissible for a life insurance company to enter into policies of that sort. Having done so, similar to a

UNITED STATES

mutual fund with an explicit instrumental IFSI investment objective as described in Paragraph 2.5.10, the life insurance company would then be required to pursue the relevant investment approach and, in the event of a delegation of investment management, to require that its Investment Adviser does the same.

Life insurance: Legal freedom to use investment powers to IFSI

2.6.22 The legal freedom to use investment powers to instrumental IFSI in the context of life insurance is similar to that of general insurance (Paragraphs 2.6.18–2.6.19), although it is more likely that a life policy could stipulate an investment objective or policy if the policy in question is more akin to an investment product than a protection product such as whole life insurance, the value of which (as determined based on a portfolio of investments for which a particular investment strategy could be stipulated) can be borrowed against in a tax-efficient manner as part of the policyholder's retirement strategy. If this is the case, the terms of the life policy may constrain, or explicitly promote, investment in pursuit of sustainability impacts that would fall within the scope of instrumental IFSI.

2.6.23 To the extent that the terms and conditions of the relevant product are silent on the issue of Sustainability Impact, a pursuit of instrumental IFSI should be possible taking into account risk-return objectives, which will likely include different time horizons depending on the product objectives. However, similar to the discussion on pension funds in Paragraph 2.4.22, due to the litigious environment in the U.S., the directors of an insurer will need to conclude that pursuing an instrumental IFSI strategy will not be likely to lead to lower financial returns unless it is marketed and approved by users as such.

UNITED STATES

3. ASSET OWNERS' USE OF THEIR POSITION TO ENGAGE IN STEWARDSHIP ACTIVITIES TO SECURE SUSTAINABILITY IMPACT

3.1 The following section considers the extent to which, and on what basis, each type of Asset Owner is (a) legally required or (b) legally permitted or able to use its position to influence enterprises in which it invests by engaging in stewardship activities designed to achieve positive sustainability impacts and minimize negative sustainability outcomes.

Overarching considerations

3.1.1 In general, when we refer to stewardship, we refer to an Asset Owner's attempt to influence the behavior of companies through direct engagement, forming coalitions to campaign for change, submitting items for a vote at company annual meetings through the shareholder proposal process under Rule 14a-8 of the Exchange Act,[86] developing and exercising voting guidelines that reflect sustainability activities and exercising votes in favor of other shareholders' proposals regarding sustainability initiatives, among others.

3.1.2 A large group of Asset Owners have actively engaged in stewardship activities to achieve positive sustainability impacts with the express purpose of improving long-term financial returns and the preservation of value.[87]

3.1.3 In many cases, there may be more flexibility for Asset Owners to pursue instrumental IFSI through stewardship, particularly where an Asset Owner is seeking to achieve Sustainability Impacts in order to discharge its duties in relation to realizing a financial return (directly or through stewardship, or the stewardship policies they set for their Investment Advisers), than through investment or divestment. Among other things, stewardship may have less direct consequences for short term financial performance measured against relevant benchmarks.

3.1.4 Where an Asset Owner considers engaging in instrumental IFSI in discharging its legal duties or in the exercise of its discretions, it will need to assess a range of factors, including whether the costs involved in addressing certain systemic risks created by some sustainability factors are justifiable, for example, where the risk concerned is systemic and there are therefore limits to what any individual actor can reasonably hope to achieve. However, this balance between costs and outcomes could change if the relevant Sustainability Impact were pursued in cooperation with other investors, since any cost is likely to be spread and the aggregate impact of the whole may be more than any individual part acting in isolation. Similarly, the assessment may well change if the investor's own planned action is considered (as it should be) in the context of the activities of other third parties (such as policymakers introducing rules, say, to reduce carbon emissions) that are relevant to the sustainability outcome sought. While we do not think the law yet imposes a general duty on Relevant Investors to collaborate to pursue instrumental IFSI, in our view Asset Owner duties are generally likely to require them to consider, among other things (a) whether to engage in stewardship to secure their financial or other stated objectives, (b) whether the stewardship needs to be focused on achieving Sustainability Impacts in order to do that, (c) whether acting in collaboration with other investors is the best way of advancing their goals and (d) to act accordingly.

3.1.5 In the United States, pension funds and mutual funds (although there is a range of practices) have historically been at the forefront of stewardship activities and have influenced the behavior of companies through direct engagement, forming coalitions to advocate for change,[88] submitting items for a vote at company annual meetings through the shareholder proposal process under the Exchange Act, and developing and exercising voting guidelines that reflect sustainability activities and exercising votes in favor of other shareholders' proposals regarding sustainability initiatives, among others. Activities such as these are within the scope of instrumental IFSI because at least some of them are likely to involve attempts to get companies to do things that directly or indirectly change their sustainability impact. Indeed, pension funds and mutual funds engaging in

UNITED STATES

these activities have offered a range of rationales for such stewardship for achieving long-term financial returns through benefitting broader societal goals, such as battling climate change.

3.1.6 On September 23, 2020, the SEC released final rules that affect an Asset Owner's ability to engage directly with companies through the submission of a shareholder proposal that is included in an issuer's proxy statement and is subject to a vote by all shareholders. As discussed in Paragraph 3.1.1, this is one means of stewardship engagement, although only one, since much engagement does not involve formal shareholder votes. Under the recently revised rules, the thresholds for submitting a shareholder proposal will increase. Previously, shareholders holding $2,000 worth of a company's equity securities for a period of one-year were eligible to submit a shareholder proposal within the parameters described therein.[89] The revised thresholds inversely correlate length of ownership to the required equity stake, raising the minimum ownership amount of a company's equity securities to $25,000 for one year, $15,000 for two years or $2,000 for three years.[90] These thresholds apply to each shareholder — the rule does not permit aggregation of holdings to meet these thresholds.[91] In addition, for a proposal that failed to receive majority support to be resubmitted, it needs to meet minimum support thresholds to be eligible for re-proposal. If a proposal does not meet the minimum support threshold, a company may exclude the proposal for three years following the meeting at which it failed to meet the applicable minimum support threshold. The SEC raised those minimum support thresholds from 3%, 6% and 10% for one, two or three or more prior votes in the last five years, respectively, to 5%, 15% and 25% for the same period.[92] Other changes will also affect eligibility. These changes may be perceived by some Asset Owners as limiting their ability to use shareholder votes to engage directly with issuers and other shareholders on sustainability matters.

3.1.7 One example of a driver of change is the Investor Stewardship Group ("ISG"), an investor-led effort that includes over 60 U.S.-based institutional investors and global asset managers, including some of the most significant pension funds and mutual funds. The ISG began as an initiative to establish a framework of basic investment stewardship and corporate governance standards for both investors and companies. The ISG put together a set of stewardship principles for institutional investors and governance principles for U.S. public companies and seeks commitments from its institutional investor members to seek to implement the ISG's stewardship principles, in a manner appropriate for the relevant investor. Although ISG is an example of how investors can collaborate, it does not have a stated IFSI approach in its governance principles. That said, where a sustainability factor presents material risks or opportunities to a company, it would clearly be a matter that would need to be properly addressed through its governance processes.

3.2 Public pension funds and private retirement plans

Legal requirements to engage for Sustainability Impact

3.2.1 Although there is not an explicit legal requirement to engage for Sustainability Impact, a trustee's duty to act in the interest of its beneficiaries would likely include stewardship activity that is designed to achieve Sustainability Impacts if the trustee concludes that doing so is necessary to secure their financial or other stated objectives. For example, the DOL has ruled that trustees must use their voting rights as an asset on behalf of the interests of a trust's beneficiaries,[93] and accordingly a trustee of a private retirement plan should consider whether the exercise of such voting rights is necessary to protect such interests against any adverse sustainability impact on the performance of their portfolio. Pension funds will need to consider stewardship activity, including the use of voting rights, if they conclude that such stewardship activity will enable the fund to:

(a) Cause a particular investee target to achieve a given sustainability impact that will serve to maintain or enhance such target's value in the fund's portfolio. This approach may be a more economically efficient means of improving the portfolio's risk-balanced return compared to a divestiture. Similar to the position discussed in Paragraph 2.4.22 for a trustee, a fund manager would need to demonstrate that it engaged in a proper due diligence process that enabled it to make a reasoned determination as to

UNITED STATES

whether or not stewardship activity could positively impact a portfolio's value or return in order to defend against a law suit that alleged a decrease in financial return due to such stewardship activity ; or

(b) Mitigate a systemic sustainability risk that could adversely impact the performance of its portfolio—either due to activity in a particular sector or the broader economy. In this case, a fund is more likely to conclude that it cannot address such risk through individual stewardship but that effective stewardship requires collective action. In assessing collective stewardship action, the fund will need to consider its general chances of success, the added costs of coordination and the need to ensure that the potential benefits across all beneficiary cohorts satisfy the duty of impartiality described in Paragraph 2.4.9.

Legal freedom to engage for Sustainability Impact

3.2.2 Public pension funds and private retirement plans have the legal freedom and duty to engage in stewardship for Sustainability Impact when such stewardship can contribute to seeking a financial return or the preservation of assets for their beneficiaries. Indeed, these funds have been increasingly vocal proponents of shareholder proposals related to sustainability.

3.2.3 For example, the Office of the New York State Comptroller, responsible for New York State Common Retirement Fund (one of the largest pension funds in the United States), has highlighted its use of shareholder proposals to bring ESG issues to the attention of a company board and announced that in 2019, it sent 832 letters to portfolio companies requesting action on ESG-related issues.[94] The California State Teachers' Retirement System ("CalSTRS"), the second largest U.S. pension fund, has rebranded its corporate governance unit as its sustainable investment and stewardship strategies unit in order to reflect a proactive action-oriented program focused on long-term sustainability.[95] In addition, the California Public Employees' Retirement System ("CalPERS"), the largest pension fund in the U.S., has supported shareholder proposals requiring greater disclosures of diversity of companies' board and workforce, as well as environmental practices and risks.[96]

3.2.4 Public pension funds and private retirement plans increasingly form coalitions, often also backed by the largest funds, to campaign for sustainability initiatives at companies. For example, Climate Action 100+ includes more than 320 investors, which includes many pension funds and represents over $32 trillion in assets under management. Climate Action 100+ engages companies to curtail greenhouse gas emissions and set targets to achieve related goals.[97] In some instances, pension funds have partnered with traditional financial shareholder activists to focus on sustainability or have actively advocated for sustainability changes themselves.[98]

3.2.5 In other instances, U.S. public pension funds and private retirement plans have formed global alliances to advocate for ESG stewardship using public platforms and open letters to advocate for changes. For example, in a letter released in March 2020, the chief executives of Japan's Government Pension Investment Fund (with $1.57 trillion under management and the world's largest pension fund), CalSTRS and UK's Universities Superannuation Scheme ("USS") declared that "[a]s asset owners . . . we strive to act as stewards of long-term capital, creating sustainable value by supporting companies with a clearly defined, long-term vision for growth" and committed to building relationships with other asset owners that pledge to integrate ESG factors in their investment process.[99]

3.2.6 In addition, on December 16, 2020, the DOL issued a final rule regarding "investment duties" under ERISA that address the ability of an ERISA fiduciary to comply with the fiduciary duties of prudence and loyalty when fiduciaries exercise proxy voting, shareholder rights and other activities that relate to stewardship.[100] The rule codifies the DOL's position that ERISA plan fiduciary duties of prudence and loyalty apply when deciding whether to vote proxies and exercise other shareholder rights. Specifically, a fiduciary would be permitted to vote proxies only when the fiduciary "prudently determines that the matter being voted upon would have an economic impact on the plan"[101] and that fiduciaries would be prohibited from voting proxies unless there was a determination that the matter voted on would have an "economic impact."[102] More

ANNEXES

United States

UNITED STATES

critically, the supplementary information published with the rule clarifies that the "use of plan assets by a plan fiduciary to further political or social causes that 'have no connection to enhancing the economic value of the plan's investment' through proxy voting or shareholder activism is a violation of ERISA's exclusive purpose and prudence requirements."[103] The proposed rules had stated that ERISA fiduciaries would have had an obligation to refrain from voting altogether *unless* the fiduciary determined that the vote would have an economic impact on the plan.[104] This duty to refrain from voting was removed from the final rule out of a concern that it could lead to fiduciaries refraining from voting altogether out of a concern of incurring liability. While the role of stewardship in relation to ESG factors in pursuing a plan's financial objectives is recognized, there is nonetheless a risk, despite the safe harbors included in the rule, that the rule could chill the willingness of an ERISA fiduciary to engage in stewardship activities and proxy voting for instrumental IFSI because of the significant review and documentation necessary to demonstrate economic benefits. However, on March 10, 2021, the DOL announced that it would not enforce the rule and instead intends to revisit this rule, after hearing from stakeholders.[105]

3.3 Mutual funds

Legal requirements to engage for Sustainability Impact

3.3.1 We are not aware of any express requirement on mutual funds to engage for Sustainability Impact. The general factors that a mutual fund will need to consider when engaging in instrumental IFSI stewardship will be similar to those applicable to pension funds in terms of the cost-benefit analysis of whether such activity will serve to maintain or enhance the value of an individual investee or help guard against systemic risks to the fund's entire portfolio. However, there is of course a very broad range of stated investment objectives that have been adopted by mutual funds, and the nature of its stated investment objective may make a particular mutual fund more or less likely to engage in such stewardship. If the terms of the fund's prospectus set out a sustainability impact objective, it is more likely that the fund will conclude that stewardship represents one of, if not the most, cost-efficient means of protecting and enhancing the performance of its portfolio in a manner that is consistent with such stated objective. However, if the fund does not have a specific sustainability objective, or is highly diversified such that its investment in a particular investee will not significantly alter the outcome of its overall performance, divestiture may be a more efficient option with respect to any particular investee if the fund concludes that the value of such investee is likely to be adversely affected by sustainability factors. With respect to a systemic sustainability risk to its entire portfolio, a mutual fund may conclude that stewardship activities are required as part of its legal duties to protect and enhance its broader portfolio financial return, after having conducted the proper process review discussed in Paragraph 3.2.1.

Legal freedom to engage for Sustainability Impact

3.3.2 The applicable legal framework described in Paragraphs 2.5.8 and 2.5.9 above, which generally sets a good faith and reasonableness standard under state law duties of care, indicates engagement for Sustainability Impact could be consistent with the duty to seek financial objectives if, in their discretion, the financial benefit analysis of such engagement outweighs its relevant cost.

3.3.3 Among companies that provide mutual fund investments, BlackRock, State Street Global Advisors and Vanguard Group are among the most significant in the U.S., both in terms of size of investments and stewardship influence. Each company releases stewardship reports, detailing its respective focus and efforts on stewardship with companies. BlackRock's report notes that it was awarded an A+ score for its stewardship and governance efforts in the most recent UN PRI assessment.[106] It also discusses in detail its efforts related to climate and environmental risk and its views on sustainability. It is worth noting, however, that these reports tend to be issued at the Investment Adviser group level rather than by or on behalf of specific mutual funds. It is nevertheless important that these Investment Advisers have concluded that as a matter of fiduciary responsibility engaging in these activities does not conflict and, in fact, is beneficial to the pursuit of the objectives of the mutual funds that they manage.

UNITED STATES

3.3.4 BlackRock has been vocal about incorporating sustainability considerations into its engagement efforts and its view that engagement efforts form part of its role as a fiduciary with respect to its clients' assets because these issues drive long-term sustainable performance. State Street has similarly stated that it believes stewardship is a fiduciary responsibility and one of the ways State Street can add value to portfolio companies and clients. Like BlackRock, State Street's annual report sets forth its views and engagements on sustainability issues. Vanguard noted in its 2019 Investment Stewardship Annual Report that it engaged directly with 258 companies in carbon-intensive industries and often discussed long-term risks with management representing nearly one-third of Vanguard's engagements with companies.

3.3.5 Furthermore, Vanguard disclosed that it raised relevant environmental and social issues at companies across a variety of sectors and regularly asks companies how the company's sustainability strategy integrates with corporate strategy. Parsing through these statements, however, it is notable that all three institutions appear to be careful to link sustainability objectives to concepts that can be construed as improved economic return (in BlackRock's case, "long-term performance,"[107] in State Street's case, "add[ed] value,"[108] and in Vanguard's case, "integ[ration] with corporate strategy"[109]). In short, promoting sustainability in pursuit of long-term performance is consistent with instrumental IFSI because economic return is the ultimate goal.[110]

3.4 Insurance undertakings

General insurance: Legal requirements to engage for Sustainability Impact

3.4.1 We are not aware of any express legal requirement on insurance companies to engage for Sustainability Impact. However, the factors that will lead directors to engage in instrumental IFSI stewardship will likely be similar to those applicable to pension funds. Directors will generally need to conduct an analysis of whether the expenses of such stewardship can be justified to protect or enhance the performance of its portfolio and meet the financial objectives of its shareholders and policyholders as part of their duty of care described in Paragraphs 2.5.8 and 2.5.9. This may include determinations with respect to specific investments as well as systemic threats to the entire portfolio. The stewardship analysis for a director will differ depending on the type of insurance company and assets involved, for example whether the insurance company (a) has a stated financial objective that expressly or implicitly requires such stewardship, (b) is investing in and managing the relevant assets in connection with (or subject to the contractual terms and conditions applicable to) particular policies issued by such insurance company or (c) is investing the proprietary assets of the company without regard to specific policies for the benefit of the company's shareholders. Different asset pools may require a different cost-benefit analysis of the stewardship expenses against the potential benefit to the pool in question, including, for example, whether such expenses are fairly allocated between the insurer's own funds and those held in connection with the administration of its policies. Finally, and unique to insurance companies, the determination to engage in instrumental IFSI stewardship for directors should also include consideration of whether (i) their company is exposed to sustainability risks because of the sort of risks it insures and (ii) the expense of stewardship is justified by its potential to mitigate such risks to its financial performance.

3.4.2 There is widespread engagement by insurance companies in stewardship activities relevant to sustainability. In March 2019, the Reinsurance Group of America ("RGA") was the first U.S. insurance firm to sign the Principles for Responsible Investment. Organizations and frameworks/initiatives such as the Principles for Sustainable Insurance ("PSI"), the Sustainable Insurance Forum ("SIF"), the International Association of Insurance Supervisors ("IAIS"), and the Network of Central Banks and Supervisors for Greening the Financial System ("NGFS") are working collaboratively to address sustainability challenges in the insurance sector.

> ANNEXES

> United States

UNITED STATES

4. ASSET OWNERS' ENGAGEMENT IN PUBLIC POLICY WORK TO SECURE SUSTAINABILITY IMPACT

4.1 The following section considers the extent to which, and on what basis, each type of Asset Owner is (a) legally required or (b) legally permitted or able to use its position to engage in public policy work designed to achieve positive sustainability impacts and minimize negative sustainability impacts for example, where these are relevant to the value of portfolio assets.

4.2 **Public pension funds and private retirement plans**

4.2.1 The position on pursuit of instrumental IFSI public policy work related to trustee duties is broadly the same as for engagement in stewardship activities described in Paragraph 3.2.1. As a general matter, trustees will need to balance the costs associated with policy engagement against the likely benefits to achieving their financial objectives. There is not an explicit legal requirement to engage in public policy work. However, funds should conduct an analysis that weighs the potential benefits against the impact of the costs involved on their ability to meet their financial goals, taking into account the likelihood of being able to bring about systemic change since public policy action will likely require collective action and not be enterprise-specific.

4.2.2 Consistent with policy work to bring about systemic change in pursuit of instrumental IFSI, many pension funds have been active in the public debate through panel forums and open letters, such as the recent open letter advocating for ESG integration for long-term value authored by the investment officers of Japan's public pension fund, CalSTRS and UK's USS.[111]

4.3 **Mutual funds**

4.3.1 The position in relation to public policy work in pursuit of instrumental IFSI is broadly the same as for stewardship as discussed in Paragraph 3.3.1. We are not aware of any explicit legal requirement on mutual funds to conduct public policy work for Sustainability Impact.

4.3.2 As discussed in Paragraph 3.3.2, the legal framework for mutual funds is flexible enough to permit them to use their position to engage in public policy work designed to achieve sustainability impact in pursuit of the objectives of their funds. Accordingly, as described in Paragraph 3.3.3, many of the largest mutual fund owners are already active in stewardship and public policy undertakings in connection with advocating for systemic change (since public policy action will likely require collective action and not be enterprise-specific).

4.4 **Insurance undertakings**

4.4.1 Similar to the position with respect to stewardship described above in Paragraph 3.4.1, Insurance companies are not legally required to use their position to engage in public policy work designed to achieve positive sustainability outcomes and minimize negative sustainability outcomes. However, some directors may conclude that such public policy activities may form a part of their duty to act in the best interests of their companies by protecting assets against systemic risks (since public policy action will likely require collective action and not be enterprise-specific). This is evidenced by the fact that many insurance companies are active in public debates through panel forums and open letters.

> ANNEXES

> United States

UNITED STATES

5. ESTABLISHING NEW FUNDS TO INVEST FOR SUSTAINABILITY IMPACT AND AMENDING THE TERMS OF EXISTING ONES

5.1 The following section considers the extent to which it is possible for an Asset Owner to set up a fund, policy or other product with the express objective of instrumental or ultimate ends IFSI.

5.2 **Public pension funds and private retirement plans**

5.2.1 Under state law, public pension funds must abide by the sole interest rule, as described in Paragraphs 2.3.2 and 2.3.3. Under the rule, the trustee may not engage in collateral benefits ESG integration for non-pecuniary objectives without violating their fiduciary duties to their beneficiaries, given that “sole interest” has been interpreted to mean financial interests; however, the rule does permit a trustee to consider ESG factors that support the trustee’s fiduciary duty to optimize risk-based investment returns.

5.2.2 As discussed in Paragraphs 2.3.2 and 2.3.3, a trustee for a private retirement plan would be prohibited from pursuing an objective for a portfolio that conflicts in any way with the objective of maximizing financial returns. The trustee must act in a way that advances the “sole” (i.e., sole *financial*) interest of the beneficiary. Accordingly, a strategy that replaces this overriding financial return objective with the objective of ultimate ends IFSI would be inconsistent with applicable law and regulations.

5.3 **Mutual funds**

5.3.1 Those who want to set up funds that incorporate IFSI into their investment objective, as either a primary or secondary objective, can do so, subject to including appropriate disclosure in the fund’s prospectus as to the fund’s strategy and attendant risks. Integrating an IFSI Impact objective into an existing fund is likely very difficult without the consent of 100% of investors (or such lesser percentage, if any, as may be permitted by the fund’s constitutive documents and disclosed in the prospectus) given that investors made their original investment decision based on the investment guidelines disclosed in the prospectus made available to them at the time of their investment.

5.3.2 To the extent that IFSI does not conflict with the investment guidelines contained in the investment advisory agreement or its fiduciary duties, such an objective could in theory be incorporated into an Investment Adviser’s strategy. However, most investment advisory agreements include a precisely articulated general standard of care that must be complied with by the Investment Adviser, and compliance with this standard and any other relevant provisions of the investment advisory agreement must be carefully considered by the Investment Adviser before any such incorporation.

5.3.3 Given the increased investor demand and interest in IFSI, there are a number of mutual funds that are designed to screen investments for ESG criteria and specifically exclude stocks of certain companies that do not meet these criteria. It would, in principle, be possible to establish new funds with specific sustainability impact goals in a similar way.[112]

5.4 **Life insurance products**

We are not aware of any prohibition on insurers from incorporating IFSI into the investment objectives of their products, as either a primary or secondary objective. Any strategy connected with such products will need to be consistent with director duties to act in the best interest of their company, as discussed in Paragraph 2.6.15, including maintaining sufficient reserves and liquidity to cover policyholder claims. In the case of life insurance, this could mean setting a Sustainability Impact objective in addition to, and even with priority over, a financial return objective for the relevant policyholder, or a unit-linked policy that is linked to a fund with an objective that would involve adopting a strategy within the scope of IFSI. In the case of general insurance, this could mean offering a policy with a guarantee to relevant policyholders that their premiums will be invested for Sustainability Impact.[113] States enact different disclosure requirements regarding life insurance policies. It is possible that under some state laws, disclosure of such objective would be required to be provided to the relevant policyholders if a life insurance product were to be created with the intention that premiums will be invested for Sustainability Impact, particularly if such objective can impact the amount payable if a claim is made under the relevant policy.

UNITED STATES

6. INVESTMENT ADVISERS' DUTIES TO INVEST FOR SUSTAINABILITY IMPACT

6.1 This section considers the extent to which, and in what circumstances, an Investment Adviser is (a) legally required or (b) legally permitted to Invest for Sustainability Impact on behalf of an Asset Owner or otherwise, in each of the three ways contemplated in sections 2–4.

Overarching considerations

6.2 Investment Advisers' obligations are generally owed to Asset Owners under their investment advisory contract, not to beneficiaries of the funds they manage. Investment advisory contracts typically include provisions preventing non-parties, such as beneficiaries, from enforcing the terms of the agreement. Further, an investment advisory contract will typically require an Investment Adviser to manage the fund portfolio in accordance with the investment guidelines disclosed in the fund's prospectus.

6.3 To the extent that an Investment Adviser breaches its contract and the investors suffer losses as a result, the Asset Owner will have a fiduciary duty to its investors to enforce its rights and remedies against the Investment Adviser and seek damages for such breach in order to recover value for its investors. Furthermore, if an Investment Adviser breaches its obligation, as part of its duty of care, to make a reasonable inquiry into, and have a reasonable understanding of, its clients' investment objectives, the Asset Owner would have recourse to the Investment Adviser for such breach and would likely view pursuing such recourse as part of its fiduciary duty to its shareholders in order to recover value for them.

6.3.1 Accordingly, in the case of a mutual fund, an Investment Adviser will likely require that any new investment objective be approved by, if applicable, the relevant requisite percentage of beneficiaries and a concomitant amendment to the investment guidelines in an updated prospectus and investment advisory agreement, thereby protecting itself from contractual liability.

6.4 **Legal obligation to IFSI**

Powers of investment and divestment

6.4.1 Investment Advisers also have fiduciary duties under Section 206 of the Investment Advisers Act.[114] Section 206 applies to both SEC and state-registered Investment Advisers, as well as other Investment Advisers that are subject to the territorial jurisdiction of the Investment Advisers Act but are not required to be registered under the Act. The duties are not explicitly defined, but the standard and definition is derived from a series of SEC interpretations and judicial precedent. Most recent among these is an interpretation of the standard of conduct for investment advisers (the "Advisers Act Release").[115]

6.4.2 The Release makes it clear that the fiduciary duty:

(a) is composed of both a duty of care and a duty of loyalty;

(b) is principles-based;

(c) applies to the entire relationship between the Investment Adviser and its client; and

(d) may not be waived.[116]

Duty of care

6.4.3 The duty of care includes: (a) the duty to provide advice that is in the best interest[117] of the client and (b) the duty to provide advice and monitoring throughout the relationship.

6.4.4 The duty of care:

(a) includes a duty to provide investment advice that is suitable for the client (which would arguably include taking account of a client's sustainability objectives);

(b) requires an Investment Adviser to make a reasonable inquiry into, and have a reasonable understanding of, its clients' investment objectives (including, in the case of an investment adviser whose client is a registered investment company or a private fund, a reasonable understanding of the fund's investment guidelines and objectives, including any sustainability objectives); and

(c) requires an Investment Adviser to have a reasonable belief that the advice it provides is in the best interest of the client based on those objectives.

6.4.5 In order to develop a reasonable understanding of its clients' investment objectives, the Advisers Act Release recommends that:

(a) In the case of retail clients, an Investment Adviser should develop an understanding of the investment profile of the client by,

> ANNEXES

> United States

UNITED STATES

at a minimum, (i) making a reasonable inquiry into the client's financial situation, level of financial sophistication, investment experience and financial goals and (ii) updating the client's investment profile in order to maintain a reasonable understanding of the client's investment objectives and adjust the advice to any changed circumstances; and

(b) In the case of institutional clients, an Investment Adviser should develop an understanding of the investment mandate by gaining a reasonable understanding of the client's objective within that portfolio, but not the client's objectives within its entire investment portfolio.

Duty of loyalty

6.4.6 The duty of loyalty requires that an Investment Adviser not subordinate its clients' interests to its own. To fulfil its duty of loyalty, an Investment Adviser must make full and fair disclosure to its clients of all material facts relating to the advisory relationship, including the capacity in which the firm is acting with respect to the advice provided and any conflicts of interest.

6.4.7 This combination of care and loyalty obligations has been characterized as requiring the investment adviser to act in the "best interest" of its client at all times and "to adopt the principal's goals, objectives, or ends."[118]

6.4.8 Whether the investment management advice provided to the client is in a client's best interest must be evaluated in the context of the portfolio that the adviser manages for the client and the client's objectives, including its tolerance for higher risk in exchange for higher expected returns. An adviser's fiduciary duty applies to all investment advice that the investment adviser provides to clients, including advice about investment strategy.

6.4.9 A reasonable belief that investment advice is in the best interest of a client also requires that an adviser conduct a reasonable investigation into the investment so as not to base its advice on materially inaccurate or incomplete information. The SEC has taken enforcement action where an investment adviser did not independently or reasonably investigate securities before recommending them to clients.[119]

6.4.10 Finally, an investment adviser's duty of care also encompasses the duty to provide advice and monitoring at a frequency that is in the best interest of the client, taking into account the scope of the agreed relationship. For example, when the adviser has an ongoing relationship with a client and is compensated with a periodic asset-based fee, the adviser's duty to provide advice and monitoring will be relatively extensive as is consistent with the nature of the relationship. Conversely, absent an express agreement regarding the adviser's monitoring obligation, when the adviser and the client have a relationship of limited duration, such as for the provision of a one-time financial plan for a one-time fee, the adviser is unlikely to have a duty to monitor. In other words, in the absence of any agreed limitation or expansion, the scope of the duty to monitor will be indicated by the duration and nature of the agreed advisory arrangement.

6.4.11 It is clear, therefore, that an Investment Adviser, as part of its duty of care, must consider the client's objectives when determining what is suitable for and in the best interests of its clients, not substituting its own preferences for those of the client. Further, an Investment Adviser cannot take actions in breach of the then-current investment guidelines in the investment advisory agreement. Under its duty of loyalty, if the client specifically mandates an instrumental or ultimate ends IFSI in its investment guidelines, the Investment Adviser would be required to follow it. However, if the guidelines are silent on this, the Investment Adviser could only pursue sustainability impact goals in the way it uses its investment powers where this is consistent with seeking to achieve the required financial investment objective (i.e. instrumental IFSI). That said, in practice Investment Advisers may feel reluctant to do so in these circumstances if it creates a risk of reduced financial performance, for example, in the short-term. Using investment powers to pursue an ultimate ends IFSI strategy would not be possible absent an explicit mandate.

Engagement to achieve Sustainability Impact

6.4.12 As noted, stewardship may involve trying to change the behavior of a company (i.e., its impact) in some way relevant to sustainability.

UNITED STATES

6.4.13 As with the use of investment powers where an investment management contract is silent on the question of sustainability impact goals, in principle an Investment Adviser would still be able to engage in stewardship intended to achieve goals of that sort where it concludes that doing so is likely to be effective in pursuing its financial investment objective. In practice, the Investment Adviser would likely need to be cautious that any activity did not damage investment performance, although in principle it should be possible to defend actions taken in pursuit of instrumental IFSI when the guidelines were silent as being consistent with its clients' financial interests.

6.4.14 As discussed above in Paragraphs 3.3.3 through 3.3.5, among companies that provide mutual fund investments, BlackRock, State Street Global Advisors, and Vanguard Group are among the most significant in the U.S. in terms of their stewardship influence. They have engaged in stewardship activities that advocate for Sustainability Impacts that judge to put long-term financial performance at risk. Each company has released stewardship reports, detailing its respective focus and efforts on stewardship with companies.

Public policy work to achieve Sustainability Impact

6.4.15 We are not aware of any requirement to undertake public policy engagement in relation to the Investment Adviser.

6.4.16 As noted above, an Investment Adviser's duties will be framed by the contractual terms of its mandate. Where the mandate is silent as to Sustainability Impact, we do not consider there to be any legal requirement for Investment Advisers to engage in public policy work to Invest for Sustainability Impact.

6.5 Legal freedom to IFSI

6.5.1 An Investment Adviser is under a duty to follow the terms of its mandate from its client and where such mandate is silent, its duty includes seeking a long-term return for its client. As discussed in Paragraph 6.4.14, many of the largest investment advisers have stated publicly that to achieve such long-term return for their client requires them to invest in and advocate for Sustainability Impacts. Of course, such duty to advocate for long-term returns for their clients cannot conflict with their other fiduciary duties, such as the duty of loyalty.

UNITED STATES

7. LEGAL LIABILITY TO THIRD PARTIES FOR THE NEGATIVE SUSTAINABILITY IMPACT OF ENTERPRISES IN WHICH PORTFOLIOS ARE INVESTED

7.1 This section considers the extent to which, regardless of the legal rules under which it is required to operate and its constitution, an Asset Owner could be legally liable to third parties for the negative Sustainability Impact of enterprises in which it invests, and whether an Investment Adviser could also be liable because of its role in assisting the Asset Owner to invest in the relevant enterprise and steward its investment.

7.2 **Asset Owners**

7.2.1 It is difficult to hold Asset Owners or Investment Advisers liable to third parties for the negative Sustainability Impact of enterprises in which investments are made. Out of more than 120 cases in the U.S. that we have identified relating to such claims, all were unsuccessful on such claims due to constitutional grounds (lack of standing, justiciability) and evidentiary grounds (difficult to prove that allege tortious behavior caused negative Sustainability Impact).

7.2.2 The bar is high to make a successful claim that an Asset Owner or the Investment Adviser should be liable for historical emissions or public statements/disclosures. Traditional notions of vicarious liability inform the litigation risk for Asset Owners and Investment Advisers with regard to claims arising from both such claims. Accordingly, if an Asset Owner or Investment Adviser does not control an entity making ESG-related statements and is not involved in making public statements about sustainability that are later challenged, it will likely not be held liable for such statements. In other words, the Asset Owners or Investment Advisers would not be held liable merely for their investment activities, but only if they step out of their traditional roles into one that is controlling the enterprises in which they invest.

7.2.3 However, they can still be held liable with regards to more localized negative Sustainability Impacts under certain federal statutes, like the Comprehensive Environmental Response, Compensation and Liability Act (“CERCLA”),[120] which facilitates environmental clean-up, and analogous state laws.

7.3 **Investment Advisers**

7.3.1 The legal liability faced by Investment Advisers to third parties is similar to that faced by Asset Owners, as described in Paragraph 7.2.

> ANNEXES

> United States

UNITED STATES

8. THE GROWING IMPORTANCE OF TAKING ACCOUNT OF ESG AND SUSTAINABILITY FACTORS WHERE THESE ARE "FINANCIALLY MATERIAL"

8.1 Building on the findings of the Freshfields Report of 2005,[121] it has become increasingly important for Asset Owners and their Investment Advisers to take ESG factors into account in managing investment portfolios because of the way in which they could be material to achieving the financial investment objectives of the relevant Asset Owner or Investment Adviser in accordance with their legal duties. The main reasons are summarized below.

8.2 A recent empirical study on the correlation between ESG criteria and corporate financial performance that combined the findings of 2,200 individual studies concluded that taking ESG factors into account when investing has a positive impact on financial performance over time, particularly in industries that can be negatively impacted by ESG issues, such as fossil fuel-related investments that can be impacted by climate change effects.[122] Another recent study back-tested ESG metrics for materiality and found that a strategy that solely based its investment decisions on these metrics outperformed a global composite of stocks.[123]

8.3 ESG proponents have pointed to an MSCI analysis which found that each of the four MSCI ESG indexes outperformed their parent indexes during the first quarter of 2020.[124] The impacts that some ESG factors can have on financial performance and long-term value creation, along with investor demand for information, will likely lead to broader financial disclosure. The recent outperformance of ESG-oriented funds may accelerate the number of Asset Owners pressing their Investment Advisers and Investment Managers to pursue ESG investment products and strategies.

8.4 Knowledge about the systemic impact of declining sustainability is becoming increasingly widespread and is supported by various studies. According to one estimate by the Intergovernmental Panel on Climate Change, as reported by Moody's Analytics, climate change alone has the potential to destroy $69 trillion in global economic wealth through 2100.[125]

8.5 Sustainability efforts surrounding human capital management ("HCM") represent one of the most significant governance themes emerging in 2020, which sits at the intersection between investors, the workforce and consumers. As we have moved to a talent-based economy, HCM has become a "mission critical asset."[126] Investors, including those focused on IFSI, are likely to focus on these issues. It is also increasingly likely that investors view these issues as financially material, as the ability to attract and retain and compensate a workforce is critical to the success of companies in a talent-based economy.

8.6 Because of this growing body of evidence and related projections, it will likely become increasingly important for Asset Owners to incorporate ESG aspects in their decision-making process, particularly where ESG factors can materially impact the investment's financial performance long-term.

8.7 While Asset Owners may increasingly incorporate ESG factors independently based on their assessment of their impact on financial performance, there is also evidence that client demand constitutes a major driving force behind incorporating ESG factors into investment decisions.[127] There has been increasing interest from consumers and investors in "sustainable" or "socially responsible" brands and investments. In response, the Deloitte Center for Financial Services (DCFS) expects client demand to drive ESG-mandated assets to constitute half of all professionally managed investments in the U.S. by 2025, with potentially 200 new ESG funds by 2023.[128]

8.8 Financial materiality

8.8.1 We believe the determination of what is financially material is a decision for each investor based on its own particular circumstances. The key legal consideration will be the investor's investment objective. A sustainability factor is likely to be material, in our view, if a reasonable investment professional would conclude that there is a reasonable prospect of it having (alone or in combination with other factors) a significant impact (within the investment time horizon) on the investor's ability to achieve its investment objective over the relevant period.

Freshfields Bruckhaus Deringer

Elizabeth Bieber, Melina E De Bona, Lori Goodman, Timothy Harkness, Lauren Kaplin, Hannah Khalifeh, Brian Lewis, Sam Lowenstein, Laurie Morgan, Travis Panneck, Jerome Ranawake, Brian Rance, Jordan Salzman, Elvira Sihvola, Altin Sila, Aaron Voloj Dessauer and Timothy Wilkins

UNITED STATES

1 Investment Advisers are often referred to as Investment Managers in other jurisdictions.

2 *See, e.g.,* Max M. Schanzenbach & Robert H. Sitkoff, *Reconciling Fiduciary Duty and Social Conscience*, 72 Stan. L. Rev. 381 (2020).

3 *See* Schanzenbach & Sitkoff, *supra* note 2.

4 Fiduciaries are able to waive the corporate opportunities doctrine, which precludes officers and directors from personally benefitting from opportunities that belong to the corporation, in certain jurisdictions. See Del. Code Ann. tit. 8, § 122(17).

5 *See, e.g.,* Cal. Const. art. XVI, § 17(b).

6 *See* Schanzenbach & Sitkoff, *supra* note 2.

7 And, similarly, instrumental IFSI.

8 *See, e.g.,* Exec. Order No. 14,030, 86 Fed. Reg. 27,967 (May 20, 2021) (directing various agencies to develop a government-wide assessment of climate-related financial risk).

9 Oliver Milman, *Biden's Clean Energy Plan Would Cut Emissions and Save 317,000 Lives*, The Guardian (July 12, 2021), https://www.theguardian.com/us-news/2021/jul/11/biden-administration-clean-energy-climate-crisis.

10 *SEC Announces Enforcement Task Force Focused on Climate and ESG Issues*, U.S. Secs. & Exch. Comm'n (Mar. 4, 2021), https://www.sec.gov/news/press-release/2021-42.

11 *Id.*

12 Allison Herren Lee, *A Climate for Change: Meeting Investor Demand for Climate and ESG Information at the SEC*, U.S. Secs. & Exch. Comm'n (Mar. 15, 2021), https://www.sec.gov/news/speech/lee-climate-change; Allison Herren Lee, *Public Input Welcomed on Climate Change Disclosures*, U.S. Secs. & Exch. Comm'n (Mar. 15, 2021), https://www.sec.gov/news/public-statement/lee-climate-change-disclosures.

13 Stacy Cowley et al., *Biden's Picks for Financial Regulator Jobs Emphasize Transparency and Fairness*, N.Y. Times (Mar. 2, 2021), https://www.nytimes.com/2021/03/02/business/sec-cfpb-gensler-chopra-hearing.html.

14 *Retirement Plans Benefits and Savings, Fiduciary Responsibilities*, U.S. Dept't of Lab., https://www.dol.gov/general/topic/retirement (last visited Mar. 24, 2021).

15 Cal. Const. art. XVI, § 17(b). California courts have upheld this provision. *See, e.g., In re Ret. Cases*, 110 Cal. App. 4th 426, 472 (2003).

16 N.Y. Retire. & Soc. Sec. § 177(9)(b) (2015).

17 Restatement (Third) of Trusts § 77(1) (Am. Law Inst. 2007).

18 Uniform Prudent Investor Act §2(a) (Unif. Law Comm'n 1994); *see, e.g.,* N.Y. Est. Powers & Trusts Law § 11-2.3(a).

19 Uniform Prudent Investor Act §2(a).

20 *Id.* §2(b), 3.

21 Restatement (Third) of Trusts § 79(1) (Am. Law Inst. 2007).

22 *Id.* § 79(1) cmt. c.

23 Id. For states that have not officially incorporated the duty of impartiality into state law, courts may still impose this duty by relying on common law (i.e., judicial precedent and other persuasive authority).

24 *ERISA*, U.S. Dep't of Lab., https://www.dol.gov/general/topic/health-plans/erisa (last visited Mar. 24, 2021).

25 29 U.S.C § 1104(a)(1)(A).

26 29 U.S.C. § 1105(a).

27 ERISA provides an exception for assets of a plan which consist of insurance contracts or policies, assets of an insurance company or plan which are held by an insurance company, and a plan which consists of retirement accounts. 29 U.S.C. § 1103(b).

28 *See, e.g., Thole v. U.S. Bank, N.A.*, 140 U.S. 1615, 1619 (2020).

29 29 U.S.C. § 1104(a)(1)(B), known as the "prudent man standard of care."

30 Restatement (Third) of Trusts § 78(1) cmt. f.

31 *Fifth Third Bancorp v. Dudenhoeffer*, 573 U.S. 409, 420-21 (2014) (quoting 29 U.S.C. §1104(a)(1)(A)(i)-(ii)).

32 29 U.S.C. §1104 (a)(1)(B).

33 29 U.S.C. § 1104(a)(1)(C); *see also* Restatement (Third) of Trusts § 90(a)-(b).

34 *See* Restatement (Second) of Trusts § 227 cmt. o.

35 Restatement (Third) of Trusts § 82.

36 *Varity Corp. v. Howe*, 516 U.S. 489, 514 (1996).

37 Under U.S. law, government agencies are granted authority to promulgate rules that have force of law. Administrative Procedure Act, 5 U.S.C. § 553 (2006). While DOL bulletins lack force of law, they are persuasive authority.

38 Interpretive Bulletin Relating to the Fiduciary Standard Under ERISA in Considering Economically Targeted Investments, 80 Fed. Reg. 65135 (Oct. 26, 2015) [hereinafter IB 2015-01].

39 Emp. Benefits Sec. Admin., U.S. Dep't of Lab., Field Assistance Bulletin No. 2018-01, at 2 (2018) [hereinafter FAB 2018-01].

40 IB 2015-01, 80 Fed. Reg. at 65136.

41 FAB 2018-1, at 2.

42 Deutsche Asset & Wealth Management, ESG & Corporate Financial Performance: Mapping the Global Landscape (2015), https://www.unepfi.org/fileadmin/events/2018/sydney/ESG-and-Corporate-Financial-Performance.pdf; Asset Mgmt. Working Grp., UN Env't Programme Fin. Initiative & Mercer, Demystifying Responsible Investment Performance: A Review of Key Academic and Broker Research on ESG Factors (2007), https://www.unepfi.org/fileadmin/documents/ Demystifying_Responsible_Investment_Performance_01.pdf; Christophe Revelli & Jean-Laurent Viviani, *Financial Performance of Socially Responsible Investing (SRI): What We Have Learned? A Meta-Analysis*, 24 Bus. Ethics, Env't & Resp. 158 (2015), https://onlinelibrary.wiley.com/doi/abs/10.1111/beer.12076; Esther Whieldon et al., *ESG Funds Outperform S&P 500 Amid COVID-19, Helped by Tech Stock Boom*, S&P Global Mkt. Intel. (Aug. 13, 2020), https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/esg-funds-outperform-s-p-500-amid-covid-19-helped-by-tech-stock-boom-59850808; Audrey Cher, *Sustainable Funds are Outperforming Their Peers During the Pandemic, BNP Paribas Says*, CNBC (June 2, 2020), https://www.cnbc.com/2020/06/02/esg-funds-outperforming-peers-during-coronavirus-pandemic-bnp-paribas.html. However, it should be acknowledged that there is and historically has been some evidence that shows the opposite.

43 The 2015 Bulletin, for example, posits that because a trustee "should appropriately consider factors that potentially influence risk and return," and because "[e]nvironmental, social, and governance issues may have a direct relationship to the economic value of the plan's investment," ESG factors "are proper components of the fiduciary's primarily analysis of the economic merits of the competing investment choices." IB 2015-01, 80 Fed Reg. at 65136. The 2018 Bulletin recognizes that "there could be instances when otherwise collateral ESG issues present material business risk or opportunities to companies that company officers and directors need to manage as part of the company's business plan and that qualified investment professionals would treat as economic considerations under generally accepted investment theories." FAB 2018-01, at 2.

44 Financial Factors in Selecting Plan Investments, 85 Fed. Reg. 72846 (Nov. 13, 2020), *available at* https://www.govinfo.gov/content/pkg/FR-2020-11-13/pdf/2020-24515.pdf.

45 The Final Rule does not explicitly define which factors are "pecuniary" and "non-pecuniary," but explicitly states that ESG factors can be pecuniary in certain situations. Id.

46 *Id.*

47 Emp. Benefits Sec. Admin., *U.S. Department of Labor Releases Statement on Enforcement of its Final Rules on ESG Investments, Proxy Voting by Employee Benefit Plans*, U.S. Dep't of Lab. (Mar. 10, 2021), https://www.dol.gov/newsroom/releases/ebsa/ebsa20210310.

48 *Id.*

49 As noted in the introduction, this survey does not purport to be a study of all applicable state law.

50 *White v. Pub. Emps. Ret. Bd.*, 268 P.3d 600, 608 (Or. 2011) (emphasis added).

51 *See, e.g.,* Susan Gary, *Best Interests in the Long Term: Fiduciary Duties and ESG Integration*, 90 Colo. L. Rev. 731 (2019), http://lawreview.colorado.edu/wp-content/uploads/2019/04/8.-Gary_revised_4.17.pdf.

52 *See* Gary, *supra* note 53, at 795.

53 S.B. 195, 149th Gen. Assemb. (Del. 2018) (enacted), https://legis.delaware.gov/BillDetail/26606.

54 Del. Code tit. 12, § 3304-3308 (Apr. 8, 2020), https://delcode.delaware.gov/title12/title12.pdf (pp. 99-101).

55 Uniform Prudent Investor Act §1(b) (Unif. Law Comm'n 1994).

56 As noted in Paragraph 2.4.9, the Supreme Court, in interpreting ERISA as applicable to private retirement funds, has interpreted the "sole interest" rule as requiring a trustee to optimize the risk-balanced return as relevant to the investment objectives of the trust.

57 DOL has recognized that in a "tie-break" circumstance, where two investment options have identical projected risks and returns, a trustee may consider non-pecuniary factors as a tie-breaker. While DOL's guidance applies only to private retirement plans, the same principle likely applies to public pension funds.

58 Interpretive Matters Concerning Independent Directors of Investment Companies, 64 Fed. Reg. 59877 (Oct. 14, 1999), https://www.sec.gov/rules/interp/ic-24083.htm.

59 *See* Lucian A. Bebchuk et al., *The Agency Problems of Institutional Investors*, 31 J. Econ. Persps. 89, 102 (2017).

60 U.S. Secs. & Exch. Comm'n, Mutual Funds and ETFs: A Guide for

UNITED STATES

Investors (2016), https://www.sec.gov/investor/pubs/sec-guide-to-mutual-funds.pdf.

61 *Unit Investment Trusts (UITs)*, U.S. Secs. & Exch. Comm'n, https://www.investor.gov/introduction-investing/investing-basics/glossary/unit-investment-trusts-units (last visited Mar. 24, 2021).

62 Closed-end funds make up a minority of mutual funds available to investors and thus have not been included here as a primary type of mutual fund.

63 *Id.*

64 *Laws and Rules*, U.S. Secs. & Exch. Comm'n, https://www.sec.gov/investment/laws-and-rules (last visited Mar. 24, 2021).

65 Mutual Fund Prospectus, U.S. Secs. & Exch. Comm'n (July 28, 2010), https://www.sec.gov/fast-answers/answersmfprospectustipshtm.html.

66 U.S. Secs. & Exch. Comm'n, Div. of Inv. Mgmt., Fund Disclosure Reflecting Risks Related to Current Market Conditions (2016), https://www.sec.gov/investment/im-guidance-2016-02.pdf.

67 Chair Gary Gensler, Prepared Remarks Before the Asset Management Advisory Committee (July 7, 2020), https://www.sec.gov/news/public-statement/gensler-amac-2021-07-07.

68 *See* U.S. Secs. & Exch. Comm'n, Rules Related to Investment Companies and Investment Advisers to Address Matters Relating to Environmental, Social and Governance Factors (2021), https://www.reginfo.gov/public/do/eAgendaViewRule?pubId=202104&RIN=3235-AM96.

69 *See* Jon Hale, *The Number of Funds Considering ESG Explodes in 2019*, Morningstar
(Mar. 30, 2020), https://www.morningstar.com/articles/973432/the-number-of-funds-considering-esg-explodes-in-2019.

70 *Environmental, Social and Governance (ESG) Funds – Investor Bulletin*, U.S. Secs. & Exch. Comm'n (Feb. 26, 2021), https://www.sec.gov/oiea/investor-alerts-and-bulletins/environmental-social-and-governance-esg-funds-investor-bulletin.

71 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203,
124 Stat. 1376 (2010).

72 *Federal Insurance Office*, U.S. Dep't of the Treasury, https://home.treasury.gov/policy-issues/financial-markets-financial-institutions-and-fiscal-service/federal-insurance-office (last visited Mar. 22, 2021).

73 *Federal Insurance Office (FIO)*, Nat'l Ass'n of Ins. Comm'rs (Feb. 12, 2020), https://content.naic.org/cipr_topics/topic_federal_insurance_office_fio.htm.

74 31 U.S.C. § 313(c)(1)(G).

75 31 U.S.C. § 313(c)(1)(E)-(F).

76 *See* Michael S. Barr, Howell E. Jackson & Margaret E. Tahyar, Financial Regulation: Law and Policy 428 (2021).

77 *Financial Stability Oversight Council*, U.S. Dep't of the Treasury, https://home.treasury.gov/policy-issues/financial-markets-financial-institutions-and-fiscal-service/fsoc (last visited Nov. 13, 2020).

78 *Id.*

79 12 U.S.C. § 5311(a)(4)(B).

80 *Designations*, U.S. Dep't of the Treasury, https://home.treasury.gov/policy-issues/financial-markets-financial-institutions-and-fiscal-service/fsoc/designations (last visited Mar. 22, 2021).

81 *See* 12 U.S.C. § 5323.

82 *About the NAIC*, Nat'l Ass'n of Ins. Comm'rs, https://content.naic.org/index_about.htm (last visited Mar. 22, 2021).

83 Kris DeFrain, *U.S. Insurance Financial Regulatory Oversight and the Role of Capital Requirements*, CIPR Newsl. (Nat'l Ass'n of Ins. Comm'rs & the Ctr. for Ins. Pol'y & Res.), Jan. 2012, https://www.naic.org/cipr_newsletter_archive/vol2_oversight.htm.

84 We note that it is unlikely that such policies specified how investment of premiums will be conducted, so this is unlikely to present a barrier in practice.

85 *See* Robert G. Eccles & Svetlana Klimenko, *The Investor Revolution*, Harv. Bus. Rev. (May-June 2019), https://hbr.org/2019/05/the-investor-revolution.

86 17 C.F.R. § 240.14a-8 (2020).

87 *See, e.g.*, *Investment Stewardship*, BlackRock, https://www.blackrock.com/corporate/about-us/investment-stewardship (last visited Mar. 22, 2021).

88 For example, in 2017, the New York State Pension Fund, the third largest public pension fund in the U.S. with $184.5 million in assets, joined the Portfolio Decarbonization Coalition, which aims to promote carbon efficiency by mobilizing institutional investors to decarbonize their portfolios. *New York Pension Fund Joins Multi-Billion-Dollar International Investors To Reduce Carbon Footprint*, UN Env't Programme (Jan. 24, 2017), https://www.unep.org/news-and-stories/press-release/new-york-pension-fund-joins-multi-billion-dollar-international.

89 17 C.F.R. § 240.14a-8 (2019).

90 Procedural Requirements and Resubmission Thresholds Under Exchange Act Rule 14a-8, Exchange Act Release No. 34-89964, 85 Fed. Reg. 70,240 (Nov. 4, 2020).

91 *Id.*

92 *Id.*

93 U.S. Dep't of Lab., Pension & Welfare Benefits Admin., Opinion Letter on Avon Products, Inc. Employees' Retirement Plan n.4 (Feb. 23, 1988), 1988 WL 897696 at *3 n.4

94 *2019 Corporate Governance Stewardship Report*, Off. of the N.Y. St. Comptroller, https://www.osc.state.ny.us/files/reports/special-topics/pdf/2019-corporate-governance-stewardship-report.pdf (last visited Apr. 2, 2021).

95 Hazel Bradford, *Public Funds Taking the Lead in Spectacular Boom of ESG*, Pensions & Invs. (Aug. 19, 2019, 12:00 AM), https://www.pionline.com/special-report/public-funds-taking-lead-spectacular-boom-esg.

96 *Corporate Engagements*, CalPERS (Jan. 11, 2021), https://www.calpers.ca.gov/page/investments/corporate-governance/corporate-engagements.

97 Eccles & Klimenko, *supra* note 94.

98 For example, CalPERS and CalSTRS are known for their shareholder activism, including by way of proxy voting to encourage environmental sustainability practices. *The Importance of Corporate Engagement on Climate Change*, CalPERS, https://www.calpers.ca.gov/docs/corporate-engagement-climate-change.pdf (last visited Mar. 22, 2021).

99 Christopher J. Ailman et al., *Our Partnership for Sustainable Capital Markets*, Gov't Pension Inv. Fund (July 6, 2020), https://www.gpif.go.jp/en/investment/Our_Partnership_for_Sustainable_Capital_Markets.pdf.

100 Fiduciary Duties Regarding Proxy Voting and Shareholder Rights, 85 Fed. Reg. 81,658 (Dec. 16, 2020).

101 *Id.* at 81,695.

102 *Id.*

103 *Id.* at 81,659 (quoting Interpretive Bulletin Relating to Exercise of Shareholder Rights, 73 Fed. Reg. 61,731, 61,734 (Oct. 17, 2008)).

104 *Id.* at 81,665.

105 Emp. Benefits Sec. Admin., *US Department of Labor Releases Statement on Enforcement of Its Final Rules on ESG Investments, Proxy Voting by Employee Benefit Plans*, U.S. Dep't of Lab. (Mar. 10, 2021), https://www.dol.gov/newsroom/releases/ebsa/ebsa20210310.

106 *BlackRock Earns Straight A's for Transparency by Principles for Responsible Investment*, BlackRock (Sept. 9, 2020), https://www.blackrock.com/corporate/newsroom/press-releases/article/corporate-one/press-releases/blackrock-earns-straight-a-for-transparency.

107 BlackRock, 2019 Investment Stewardship Annual Report 9 (2019), https://www.blackrock.com/ corporate/literature/publication/blk-annual-stewardship-report-2019.pdf.

108 State Street Global Advisors, Stewardship Report 2018-19, at 2 (2019), https://www.ssga.com/library-content/products/esg/annual-asset-stewardship-report-2018-19.pdf.

109 Vanguard, Investment Stewardship: 2019 Annual Report 12 (2019), https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/2019_investment_stewardship_annual_report.pdf

110 *See* Blackrock, *supra* note 116 ("[I]n our experience, companies with leading practices in [managing and reporting on the material environmental and social impacts of their operations] are more likely to deliver sustainable financial returns."); State Street Global Advisors, *supra* note 117 ("Our approach to proxy voting and issuer engagement is premised on the belief that companies that adopt robust and progressive governance and sustainability practices are better positioned to generate long-term value and manage risk."); Vanguard, *supra* note 118 ("We believe that good governance practices . . . are the foundation on which a company's board of directors can build enduring shareholder value.").

111 Ailman et al., *supra* note 106.

112 *See, e.g.*, *Vanguard FTSE Social Index Fund Investor Shares (VFTSX)*, Vanguard https://investor.vanguard.com/mutual-funds/profile/VFTSX (last visited Mar. 22, 2021); *BGF Sustainable Energy Fund*, BlackRock, https://www.blackrock.com/americas-offshore/products/229299/blackrock-new-energy-a2-usd-fund (last visited Mar. 22, 2021); *PARWX Parnassus Endeavor Fund Investor Shares*, Parnassus Invs., https://www.parnassus.com/parnassus-mutual-funds/endeavor/investor-shares (last visited Mar. 22, 2021).

113 For example, Lemonade, a renters and homeowners insurance company, charges policyholders a flat fee and, at the end of each year, invests unclaimed money to a nonprofit of the policyholder's choosing. *The Lemonade Giveback*, Lemonade, https://www.lemonade.com/giveback (last visited Mar. 22, 2021).

114 15 U.S.C. § 80b-6.

115 Commission Interpretation Regarding Standard of Conduct for

ANNEXES

United States

UNITED STATES

Investment Advisers, Investment Advisers Act Release No. 5248, 84 Fed. Reg. 33,669 (July 12, 2019).

116 *Id.* at 33,671–72.

117 Under SEC releases, what it means for an Investment Adviser to act in the "best interest" of a client is not clearly defined. Generally, an Investment Adviser "must, at all times, serve the best interest of its client and not subordinate its client's interest to its own. In other words, the investment adviser cannot place its own interests ahead of the interests of its client." *Id.* at 33,671.

118 Commission Interpretation Regarding Standard of Conduct for Investment Advisers, 84 Fed. Reg. at 33,671.

119 For example, on November 6, 2018, the SEC announced charges against Pennant Management, Inc., an Investment Adviser, for failing to perform adequate due diligence and monitoring of certain investments offered to clients. *SEC Charges Advisory Firm with Due Diligence and Monitoring Failures*, U.S. Secs. & Exch. Comm'n (Nov. 6, 2018), https://www.sec.gov/enforce/ia-5061-s.

120 *United States v. USX Corp.*, 68 F.3d 811, 825 (3d Cir. 1995) (holding that CERCLA liability may be imposed upon shareholders based on "a showing that the person sought to be held liable actually participated in the liability-creating conduct"); *see* also *United States v. Kayser-Roth Corp.*, 910 F.2d 24, 26 (1st Cir. 1990) (finding that an "analysis of the statute and its legislative purpose and history reveals no reason why a parent corporation cannot be held liable as an operator under CERCLA"); *United States v. A & N Cleaners & Launderers, Inc.*, 788 F. Supp. 1317, 1331 (S.D.N.Y. 1992) ("[C] ourts generally resolve ambiguities in CERCLA's language in favor of imposing the most expansive liability, citing the statute's remedial purpose.").

121 Freshfields Bruckhaus Deringer & UNEP Finance Initiative, A Legal Framework for the Integration of Environmental, Social and Governance Issues into Institutional Investment (2005).

122 Gunnar Friede et al., *ESG and Financial Performance: Aggregated Evidence from More than 2000 Empirical Studies*, 5 J. Sustainable Fin. & Inv. 210 (2015).

123 Mozaffar Khan, *Corporate Governance, ESG, and Stock Returns Around the World*, 75 J. Sustainable Fin. & Inv. 103 (2019).

124 Brian Croce, *DOL Proposal Could Chill Prospects for ESG in ERISA Plans*, Pension & Invs. (June 26, 2020), https://www.pionline.com/regulation/dol-proposal-could-chill-prospects-esg-erisa-plans.

125 Chris Lafakis et al., Moody's Analytics, The Economic Implications of Climate Change 2 (2019), https://www.moodysanalytics.com/-/media/article/2019/economic-implications-of-climate-change.pdf.

126 At the annual general membership meeting of the Investment Company Institute on May 2, 2019, former SEC Chair Jay Clayton stated in his remarks, "Forty years ago, our rules said: 'Tell us about your plant, property, and equipment. Tell us about your sort of hard capital asset and what they mean to your business[.]' . . . If I am an investor looking at businesses today, I want to know what you are doing with your human talent, how you are growing your human talent, how you are accessing new talent, how you are retaining existing talent . . . ." Thomson Reuters Tax & Accounting, *Chairman Clayton: Companies Should Provide More Disclosure on Human Capital Management*, Thomson Reuters (May 6, 2019), https://tax.thomsonreuters.com/news/chairman-clayton-companies-should-provide-more-disclosure-on-human-capital-management/. In addition, in his remarks to the SEC Investor Advisory Committee on March 28, 2019, former Chair Clayton said, "Turning to human capital, I believe that the strength of our economy and many of our public companies is due, in significant and increasing part, to human capital, and for some of those companies *human capital is a mission-critical asset*." Jay Clayton, *Remarks to the SEC Investor Advisory Committee*, U.S. Secs. & Exch. Comm'n (Mar. 28, 2019), https://www.sec.gov/news/public-statement/clayton-remarks-investor-advisory-committee-032819 (emphasis added).

127 Sean Collins & Kristen Sullivan, *Advancing Environmental, Social, and Governance Investing*, Deloitte (Feb. 20, 2020), https://www2.deloitte.com/us/en/insights/industry/financial-services/esg-investing-performance.html ("Client demand from both retail and institutional investors is now the top reason reported by money managers to incorporate ESG factors into investment decisions.").

128 *Id.*

GLOSSARY

Defined Term	Description
2005 Freshfields Report	Freshfields Bruckhaus Deringer, A legal framework for the integration of environmental, social and governance issues into institutional investment, produced for the Asset Management Working Group of the UNEP Financial Initiative, 2005
2020 UK Code	2020 UK Stewardship Code
Amendment IDD Delegated Regulation	Commission Delegated Regulation amending Delegated Regulations (EU) 2017/2358 and (EU) 2017/2359 as regards the integration of sustainability factors, risks and preferences into the product oversight and governance requirements for insurance undertakings and insurance distributors and into the rules on conduct of business and investment advice for insurance-based investment products, C(2021) 2614 final
AuM	Assets under management
Black letter law	Legal standards expressed and established in legislation or judge made law, and ascertainable from printed sources
Beneficiary	A person who derives a financial benefit from asset owners' investment activity, see Section B.1.1.4
CAPM	Capital Asset Pricing Model
CDP	CDP (formerly known as the Carbon Disclosure Project) is a global environmental impact non-profit, providing a platform, working with the CDSB, for companies, cities, states and regions to report information on their climate, deforestation and water security impacts.
CDSB	Climate Disclosure Standards Board
CESR	Committee of European Securities Regulators
EU Commission	European Commission
COP	UN Global Compact Communications on Progress
CRISA	Code for Responsible Investing in South Africa
CSA	Corporate Sustainability Assessment
DAI	Dutch Association of Insurers
DB	Defined Benefit
DC	Defined Contribution
ECJ	European Court of Justice
ELD/Environmental Liability Directive	Directive 2004/35/CE of the European Parliament and of the Council of 21 April 2004 on environmental liability with regard to the prevention and remedying of environmental damage, OJ L 143, 30 April 2004, 56–75
ELTIFs	European long-term investment funds
EMH	Efficient Markets Hypothesis
EPA	UK Environmental Protection Act 1990
ERISA	US Employee Pension Retirement Income Security Act of 1974
ESAs	The European Supervisory Authorities (EBA, EIOPA and ESMA)
ETF	Exchange Traded Funds

GLOSSARY

Defined Term	Description
EU Action Plan on Sustainable Finance	Communication from the Commission to the European Parliament, the European Council the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions, Action Plan: Financing Sustainable Growth, 8 March 2018, COM(2018) 97 final
European Green Deal	Communication from the Commission to the European Parliament, the European Council the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions, The European Green Deal, 11 December 2019, COM(2019) 640 final
EuSEF	European social entrepreneurship funds
EuVECA	European venture capital funds
Fiduciary duties	See Section B.3.3.2
Fiduciary manager	Service provider who advises clients on how to invest their assets and then makes investments on behalf of the client, see Part B.1.1.3(c).
GIIN	Global Impact Investing Network
Global AuM	the world's assets under management by institutional investors
GRI	Global Reporting Initiative
IBIP	Insurance-based investment product
IFSI	Investing for Sustainability Impact, see below
IGCC	Institutional Investor Group on Climate Change
IIRC	International Integrated Reporting Council
IMA	Investment Management Agreement
IMP	The Impact Management Project
Impact	For an explanation of the way in which this expression is used in the Report, see Part A, Box 1
Instrumental IFSI	Broadly, where achieving the relevant sustainability impact goal is 'instrumental' in realising the investor's financial return goals, see Part A.1, Box 3
Investing for Sustainability Impact	Any activity of an investor (using investment powers, stewardship, policy engagement or otherwise) with the intention of achieving an assessable positive change in the sustainability impact of a third party, including a reduction in negative sustainability impacts - see further in Part A.1.2
Investment consultant	Service provider that provides strategic advice to Asset Owners covering such matters as asset allocation and investment strategy. See Part B.1.1.3(c)
Investment manager	See Section B.1.1.3(b)
Investment decision maker	For IORPs, the occupational pension fund or Investment Manager(s) appointed by the occupational pension funds. For PEPP Providers, the personal pension fund or Investment Manager(s) appointed by the personal pension fund
IORP II	Directive (EU) 2016/2341 of the European Parliament and of the Council of 14 December 2016 on the activities and supervision of institutions for occupational retirement provision (IORPs), OJ L 354, 23 December 2016, 37–85
IORPs	Institutions for occupational retirement provision

GLOSSARY

Defined Term	Description
Joint Technical Advice	Joint Committee of the European Supervisory Authorities, Joint Technical Advice on the procedures used to establish whether a PRIIP targets specific environmental or social objectives pursuant to Article 8 (4) of Regulation (EU) No 1286/2014 on key information documents (KID) for packaged retail and insurance-based investment products (PRIIPs), JC 2017 43, 28 July 2017
Legal rules	Broadly, any legal provision (whether established in legislation or arising under judge-made law) that is intended to guide behaviour by imposing duties or discretions or conferring powers, see Section A.2.2
MAR	Regulation (EU) No 596/2014 of the European Parliament and the European Council of 16 April 2014 on market abuse (market abuse regulation) and repealing Directive 2003/6/EC of the European Parliament and the Council and Commission Directives 2003/124/EC, 2003/125/EC and 2004/72/EC, OJ L 173, 12 June 2014, 1–61
Member States	Member states of the European Union
MiFID II	Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU, OJ L 173, 12 June 2014, 349–496
MiFID II Delegated Directive	Commission Delegated Directive (EU) 2017/593 of 7 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council with regard to safeguarding of financial instruments and funds belonging to clients, product governance obligations and the rules applicable to the provision or reception of fees, commissions or any monetary or non-monetary benefits, OJ L 87, 31 March 2017, p. 500–517
MiFID II Delegated Regulation	Commission Delegated Regulation (EU) 2017/565 of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive, OJ L 87, 31 March2017, p. 1–83
MiFID II sustainability Delegated Directive	Commission Delegated Directive (EU) …/… of 21 April 2021 amending Delegated Directive (EU) 2017/593 as regards the integration of sustainability factors into the product governance obligations - C(2021) 2612 final
MiFID II sustainability Delegated Regulation	Commission Delegated Regulation (EU) …/… of 21 April 2021 amending Delegated Regulation (EU) 2017/565 as regards the integration of sustainability factors, risks and preferences into certain organisational requirements and operating conditions for investment firms, C(2021) 2616 final
Mutual fund	See Section B.1.1.3(a)
NCP	National Contact Point
NGO	Non-Governmental Organisation
Non-Financial Reporting Directive or NFR Directive	Directive 2014/95/EU of the European Parliament and of the Council of 22 October 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups, OJ L 330, 15 November 2014, p. 1–9
OECD Guidelines	OECD Guidelines for Multinational Enterprises
OPIM	Operating Principles for Impact Management
Overarching sustainability outcomes	See Section A.1.2.1
Outcome	For an explanation of the way in which this expression is used in the Report, see Part A, Box 1
Passively managed funds	Funds that seek to track the performance of a given index by replicating its constituents
Pension fund	See Section B.1.1.3(a)
PEPP	Pan-European Personal Pension Product
PEPP Providers	Providers of pan-European Personal Pension Product

GLOSSARY

Defined Term	Description
PEPP Regulation	Regulation (EU) 2019/1238 of the European Parliament and of the Council of 20 June 2019 on a pan-European Personal Pension Product (PEPP), OJ L 198, 25 July 2019, 1–63
PPP	'Prudent person' principle
PRIIPs Regulation	Regulation (EU) No 1286/2014 of the European Parliament and of the Council of 26 November 2014 on key information documents for packaged retail and insurance-based investment products, OJ L 352, 9. December 2014, 1–23
PEPP Regulatory Technical Standards	Commission Delegated Regulation (EU) 2021/473 of 18 December 2020 supplementing Regulation (EU) 2019/1238 of the European Parliament and of the Council with regard to regulatory technical standards specifying the requirements on information documents, on the costs and fees included in the cost cap and on risk-mitigation techniques for the pan-European Personal Pension Product, OJ L/99, 22 March 2021, 1-33
RTS	Regulatory Technical Standards
SASB	Sustainability Accounting Standards Board in the US
SFDR/Disclosure Regulation	Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability�related disclosures in the financial services sector, OJ L 317, 9 December 2019, 1–16
SIC	Sustainable Investing Code
Solvency II	Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance, OJ L 335, 17 December 2009, 1–155
Solvency II Delegated Regulation	Commission Delegated Regulation (EU) 2015/35 of 10 October 2014 supplementing Directive 2009/138/EC of the European Parliament and of the Council on the taking up and pursuit of the business of Insurance and Reinsurance, OJ L 12, 17 January 2015, 1–797
Amendment Solvency II Delegated Regulation	Commission Delegated Regulation amending Delegated Regulation (EU) 2015/35 as regards the integration of sustainability risks in the governance of insurance and reinsurance undertakings, C(2021) 2628 final, 21 April 2021
SRD	Directive 2007/36/EC of the European Parliament and of the Council of 11 July 2007 on the exercise of certain rights of shareholders in listed companies, OJ L 184, 14 July 2007, 17–24
SRD II	Directive (EU) 2017/828 of the European Parliament and of the Council of 17 May 2017 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement, OJ L 132, 20 May 2017, 1–25
Sustainability factors	See Section A, Box 2
Sustainability impact	See Section A.1.2
Sustainability impact goals	See Section A.1.2
Systemic risk	See Part A.1, Box 4
Taxonomy Regulation	Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088, OJ L 198, 22 June 2020, OJ L 198, 22 June 2020, p. 13–43
TCFD	Task-Force on Climate-related Financial Disclosures
Transparency Directive	Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC, OJ L 390, 31 December 2004, 38–57

GLOSSARY

GLOSSARY

Defined Term	Description
UCITS	Undertakings for collective investment in transferable securities
UCITS Delegated Directive	Commission Directive 2010/43/EU of 1 July 2010 implementing Directive 2009/65/EC of the European Parliament and the Council as regards organisational requirements, conflicts of interest, conduct of business, risk management and content of the agreement between a depositary and a management company, OJ L 176, 10 July 2010, 42–6
UCITS Directive	Directive 2009/65/EC of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities, OJ L 302, 17 November 2009, 32–96
Ultimate Ends IFSI	Broadly, where achieving a sustainability impact goalis pursued alongside the investor’s financial return goals, but not as a means to achieving them, see Part A, Box 3
UNCTAD	United Nations Conference on Trade and Development
UNFCC	UN Framework Convention on Climate Change
WBA	World Benchmarking Alliance

REFERENCES

BIBLIOGRAPHY

Abt, W., *Almost Everything You Know About Impact Investing is Wrong*, Stanford Social Review, London,18 December 2018.

Anderson, A. and Robinson, D. T. *Financial Literacy in the Age of Green Investment*, Swedish House of Finance Working Paper 19-6, 2020, available at: https://ssrn.com/abstract=3353534.

Allianz Life Insurance Company of North America, *Ethics and Investing: How Environmental, Social and Governance Issues Impact Investor Behaviour,* 2019.

Australian Government, Corporations and Markets Advisory Committee, *The Social Responsibility of Corporations Report,* 2006.

Australian Prudential Regulation *Authority, Prudential Practice Guide SPG 530 Investment Governance*, November 2013.

Australian Securities and Investments Commission, *ASIC's Regulatory Guide 128: Collective Action by Investors*, June 2015.

AXA Investment Managers UK, *Consumer Survey* 2018.

Bailard Wealth Management, *From SRI to ESG: The Origins of Socially Responsible and Sustainable Investing*, 2017, available at: https://www.bailard.com/wp-content/uploads/2017/06/Socially-Responsible-Investing-History-Bailard-White-Paper-FNL.pdf?pdf=SRI-Investing-History-White-Paper (accessed 13 July 2020).

Balp, G. and Strampelli, G., *Institutional Investor Collective Engagements: Non-Activist Cooperation vs Activist Wolf Packs*, Ohio State Business Law Journal, 2020, Vol 14(2), 135.

Bank of England, *Financial Stability Report*, August 2020.

Bank of England Prudential Regulation Authority, *Enhancing banks' and insurers' approaches to managing the financial risks from climate change*, Supervisory Statement SS3/19, April 2019.

Bank of New York Mellon, *New Frontiers of Risk: Revisiting the 360° Manager,* 2014, available at: https://fundspeople-repository.s3.amazonaws.com/system/audio_document/file/122/a8c1035313addf2d.pdf (accessed 13 July 2020).

Barko, T. et al., *Shareholder Engagement on Environmental, Social and Governance Performance*, ECGI Finance Working Paper N° 509/2017, 2017.

Basiago, A., *Methods of Defining 'Sustainability'*, Sustainable Development, 1995, Vol. 3(3), 109-119.

Bassen, A. et al., *Climate Information in Retail Investors' Decision-Making: Evidence From a Choice Experiment*, Organization & Environment, 2019, Vol. 32(1), 62-82.

Batson, D. C., *Altruism in Humans* (Oxford University Press 2010).

Bauer, R. et al., *Get Real! Individuals Prefer More Sustainable Investments*, 2021, available at: SSRN: https://ssrn.com/abstract=3287430.

Bénabou, R. and Tirole, J, *Individual and Corporate Social Responsibility*, Economica, 2010, Vol. 77, 1-19.

Berg, F. et al., *Aggregate Confusion: The Divergence of ESG Ratings*, 2020, available at: https://ssrn.com/abstract=3438533.

Berg, F. et al., *Rewriting History II: The (Un) predictable Past of ESG Ratings*, ECGI Finance Working Paper N° 708/2020, 2020.

Besley, T. and Ghatak, M. *Prosocial Motivation and Incentives*, Annual Review of Economics 2018, Vol. 10, 411-438.

Bhole, L. M. and Mahakud, J., *Financial Institutions and Markets,* 6th edn (McGraw-Hill Education , 2017).

Bioy, H., *Do Sustainable Funds Beat Their Rivals*, Morningstar, London, 16 June 2020 available at:https://www.morningstar.co.uk/uk/news/203214/do-sustainable-funds-beat-their-rivals.aspx (accessed 13 July 2020).

BlackRock, *Sustainability Goes Mainstream: 2020 Global Sustainable Investing Survey*, 2020.

BNP Paribas Asset Management, *Attitudes Towards Socially Responsible Investment in Europe,* 2019.

Bodie, Z. et al., *Investments*, 12th edn (McGraw-Hill Education 2021).

Bollen, N. P. B., *Mutual Fund Attributes and Investor Behavior*, The Journal of Financial and Quantitative Analysis, 2007, Vol. 42(3), 683-708.

Bowles, S., *The Moral Economy: Why Good Incentives Are No Substitute for Good Citizens* (Yale University Press 2016).

Bonnefin, J. F. et al., *Do Investors Care about Corporate Externalities? Experimental Evidence*, HEC Paris Research Paper N° FIN-2019-1350, 2019, available at: SSRN: https://ssrn.com/abstract=3458447.

Borgers, A. C. T. and Pownall, R. A. J. *Attitudes Towards Socially and Environmentally Responsible Investment*, Journal of Behavioral and Experimental Finance, 2014, Vol. 1, 27-44.

Boston Consulting Group, *Total Societal Impact: A New Lens for Strategy,* 2017.

Brest, P. et al., *How Investors Can (And Can't) Create Social Value*, Journal of Corporation Law, 2019, Vol. 44, 205-231.

Brière, M. and Ramelli, S., *Responsible Investing and Stock Allocation*, Amundi Working Paper, 104-2021, 2021.

Broccardo, E. et al., *Exit vs. Voice*, Working Paper, Revised, December 2020, available at https://scholar.harvard.edu/hart/publications/exit-vs-voice (accessed 16 July 2021).

Brodback, D. et al., *Altruism and Egoism in Investment Decisions*, Review of Financial Economics 2019, Vol. 37(1), 118-148.

REFERENCES

Brunen, A. C. and Laubach, O. *Do Sustainability-Conscious Individuals Prefer Socially Responsible Investments? A Study Among the Users of Robo Advice*, 2021, available at: https://ssrn.com/abstract=3778610.

Cambridge Institute for Sustainability Leadership, *Unhedgeable Risk*, 2015.

Cambridge Institute for Sustainability Leadership, *Walking the Talk: Understanding Consumer Demand for Sustainable Investing,* 2019.

Carney, M., *Building a Private Finance System for Net Zero: Priorities for Private Finance for COP26*, November 2020.

Carney, M., *Value(s): Building a Better World for All* (William Collins 2021).

Carter, P. et al., *The Elusive Quest for Additionality*, Center for Global Development, Working Paper 495, 2018.

Ceccarelli, M. et al., *Low-carbon Mutual Funds,* ECGI Finance Working Paper N° 659/2020, 2021.

China Social Investment Forum (China SIF), *China Sustainable Investment Review*, 2019.

Climate Action 100+, *Climate Action 100+ Sector Strategy: Aviation – Recommended Expectations*, January 2021.

Climate Financial Risk Forum, *CFRM 2020 Guide*, 2020.

Coates, J. C., *The Future of Corporate Governance Part I: The Problem of Twelve*, Harvard Public Law Working Paper N° 19-07, 2018, available at: https://ssrn.com/abstract=3247337.

Cundill, G. et al., *Non-financial Shareholder Activism: A Process Model For Influencing Corporate Environmental and Social Performance*, International Journal of Management Reviews, 2017, Vol. 20(2), 606-626.

Curtis, Q. et al, *Do ESG Mutual Funds Deliver on Their Promises*, ECGI Law Working Paper N° 586/2021, 2021.

Dasgupta, P., *The Economics of Biodiversity: The Dasgupta Review*, HM Treasury, 2021.

Davies, G. B., *SII Attitudinal and Behavioural Research*, Centapse, 2017.

Delsen, L. and Lehr, A., *Value Matters or Values Matter? An Analysis of Heterogeneity in Preferences for Sustainable Investment*, Journal of Sustainable Finance and Investment, 2019, Vol. 9(3) 240-261.

Dimson, E. O. Karakaşand, X. L, *Coordinated Engagements*, ECGI Finance Working Paper N° 721/2021, 2021.

Division of Examinations of the US Securities Exchange Commission, *The Division of Examinations' Review of ESG Investing Risk Alert*, April 2021.

Døskeland, T. and Pedersen, L. J. T. *Investing with the Brain or Heart? A Field Experiment on Responsible Investment*, Management Science, 2016, Vol. 62(6), 1632-1644.

Dutch Association of Insurers, *The Sustainable Investing Code,* 2011, available at: https://www.asrnl.com/-/media/files/asrnederland-nl/duurzaam-ondernemen/duurzame-belegger/sustainable-investing-code.pdf?la=en (accessed 13 July 2021).

Eccles, N. S. and Viviers, S., *The Origins and Meanings of Names Describing Investment Practices that Integrate a Consideration of ESG Issues in the Academic Literature*, Journal of Business Ethics, 2011, Vol. 104, 389-402.

Eccles, R. G and Kastrapeli, M.D., *The Investment Enlightenment*, State Street Corporation, 2017.

Edelman, *Special Report: Institutional Investors U.S. Results*, Edelman Trust Barometer 2020, 2020.

E. T. Jackson and Associates Ltd, *Final Report of the Strategic Assessment of the Rockefeller Foundation's Impact Investing Initiative*, 2012 available at: https://www.rockefellerfoundation.org/wp-content/uploads/Impact-Investing-Evaluation-Report-20121.pdf (accessed 13 July 2021).

Ethex Investment Club Ltd, *Understanding the Positive Investor,* 2017.

European Fund and Asset Management Association, *Ownership of Investment Funds in Europe*, 2019.

European Fund and Asset Management Association, *Sustainable Investment in the European Asset Management Industry: Defining and Sizing ESG Strategies*, Market Insights, Issue 3, 2020.

European Parliament's Policy Department for Citizens' Rights and Constitutional Affairs, *Environmental Liability of Companies*, 2020.

European Securities and Markets Authority, *Guidelines on certain aspects of the MiFID II suitability requirements*, 2018.

European Sustainable Investment Forum (EUROSIF), *European SRI Study,* 2018.

FCLTGlobal, *Balancing Act: Managing Risk across Multiple Time Horizons*, 2018.

Financial Conduct Authority, *Building a Regulatory Framework for Effective Stewardship: Feedback to DP 19/1,* Feedback Statement 19/7, January 2019.

Financial Conduct Authority, *Asset Management Market Study - further remedies*, Policy Statement PS19/4, February 2019.

Financial Conduct Authority, *A New Consumer Duty*, Consultation Paper CP 21/13***, 2021.

Financial Reporting Council, *The UK Stewardship Code 2020*, 2020.

Financial Sector Conduct Authority, *Guidance 4-5 regarding Principle 4 of the Stewardship Code*, 2014.

Financial Sector Conduct Authority, *Guidance Notice 1 of 2019 on Regulation 28 to the Pension Funds Act 1956*, 2019.

Financial Services Agency, *Clarification of Legal Issues Related to the Development of the Japan's Stewardship Code*, 2014.

Fink, L. *A Matter of Purpose*, Letter to CEOs, available at: https://www.blackrock.com/corporate/investor-relations/2018-larry-fink-ceo-letter (accessed 13 July 2021).

REFERENCES

Force for Good, *Capital as a Force for Good: Global Finance Industry Leaders Transforming Capitalism for a Sustainable Future,* 2020.

Freshfields Bruckhaus Deringer LLP, *A legal framework for the integration of environmental, social and governance issues into institutional investment*, 2005, available at:https://www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf (accessed 13 July 2021).

Friede, G. et al., *ESG and Financial Performance: Aggregated Evidence From More Than 2000 Empirical Studies*, Journal of Sustainable Finance and Investment, 2015, Vol. 5(4), 210-233.

Frijns, J. M. G. et al, *Looking in the Mirror*, Transparency International, 2013.

Global Compact, *Who Cares Wins – Connecting Financial Markets to a Changing World*, 2004.

Global Impact Investing Network, *Annual Impact Investor Survey 2020,* 2020.

Global Impact Investing Network, *The State of Impact Measurement and Management Practice,* 2020.

Global Sustainability Investment Alliance (GSIA), *Global Sustainable Investment Review,* 2018.

Good Money Week Public Polling, *Attitudes to Ethical and Sustainable Investment and Finance in the UK, 2017, 2,* available at: https://www.goodmoneyweek.com/sites/default/files/download/public_polling_report_2017_gmw.pdf (accessed 13 July 2021).

Gordon, J. N., *Systematic Stewardship*, European Corporate Governance Institute Law Working Paper N° 566/2021, 2021.

Government Pension Investment Fund, *Our Partnership for Sustainable Capital Markets*, 2020, available at: https://www.gpif.go.jp/en/investment/Our_Partnership_for_Sustainable_Capital_Markets.pdf (accessed 13 July 2021).

Gutsche, G. and Ziegler, A., *Are Private Investors Willing to Pay for Sustainable Investments? A Stated Choice Experiment*, MAGKS Joint Discussion Paper Series in Economics N° 40-2016, 2016.

Gutsche, G. et al., *Revisiting the Determinants of Individual Sustainable Investment – The Case of Japan*, Journal of Behavioral and Experimental Finance, June 2021, Vol. 30.

Hart, H. L. A., *The Concept of Law,* 3rd edn (Oxford University Press 2012).

Hartzmark, S. I. M. and Sussman, A. B., *Do Investors Value Sustainability? A Natural Experiment Examining Ranking and Fund Flows*, Journal of Finance, 2019, Vol. 74(6), 2789-2837.

Heeb, F. et al., *Do Investors Care About Impact?*, 2021, available at: SSRN: https://ssrn.com/abstract=3765659.

Heredia, L. et al., *BCG Global Asset Management 2020 – Protect, Adapt and Innovate,* 2020.

Hirschman, A., *Exit, Voice and Loyalty: Responses to Decline in Firms, Organizations and States* (Harvard University Press 1970).

HM Treasury, *UK Listing Review*, March 2021.

HM Treasury, *Chancellor sets out ambition for future of UK financial services*, 9 November 2020, available at https://www.gov.uk/government/news/chancellor-sets-out-ambition-for-future-of-uk-financial-services (accessed 13 July 2021).

Höchstäder, A. K. and Sheck, B., *What's in a Name: An Analysis of Impact Investing Understandings by Academics and Practitioners*, Journal of Business Ethics, 2015, Vol. 132, 449-475.

Hoepner, A. et al., *ESG Shareholder Engagement and Downside Risk*, ECGI Working Paper Series in Finance, Working Paper N° 671/2020, 2020.

Hong, H. and Kacperczyk, M., *The Price of Sin: The Effects of Social Norms on Markets*, Journal of Financial Economics, 2009, Vol. 93(1), 15-36.

Impact Frontiers Collaboration, *How Investors Can Integrate Social Impact With Financial Performance to Improve Both*, Stanford Social Innovation Review, London, 15 May 2020.

Impact Management Project, *Investor Contribution in Public and Private Markets*, Discussion Document, 2019.

Impact Management Project, *Overview of the Impact Management Project*, available at: https://29kjwb3armds2g3gi4lq2sx1-wpengine.netdna-ssl.com/wp-content/uploads/Investor_s-Perspective_-A-Shared-Convention-for-Impact-Management.pdf (accessed 13 July 2021).

Impact Management Project, World Economic Forum and Deloitte, *Statement of Intent to Work Together Towards Comprehensive Corporate Reporting, Summary of alignment discussions among leading sustainability and integrated reporting organisations CDP, CDSB, GRI, IIRC and SASB*, 2020.

Institutional Investors Group on Climate Change, *Net Zero Investment Framework: Implementation Guide*, March 2021.

Institutional Investor Services, Inc., *Survey Analysis: ESG Investing Pre- and Post-Pandemic,* 2020.

International Finance Corporation, *Creating Impact: The Promise of Impact Investing,* 2019.

International Finance Corporation, *Growing Impact: New Insights into the Practice of Impact Investing,* 2020.

International Financial Reporting Standards Foundation (IFRS), *Consultation Paper on Sustainability Reporting,* September 2020.

International Monetary Fund, *Global Financial Stability Report,* 2019.

Investment Association, *Investment Management in the UK 2019-2020,* 2020.

Investment Company Institute, *Investment Company Fact Book A Review of Trends and Activities in the Investment Company Industry,* 60th edn, 2020.

REFERENCES

REFERENCES

Investment Consultants Sustainability Working Group, *Guide for assessing the climate competency of Investment Consultants*, 2021.

Joint Committee of the European Supervisory Authorities, *Joint Technical Advice on the procedures used to establish whether a PRIIP targets specific environmental or social objectives pursuant to Article 8 (4) of Regulation (EU) No 1286/2014 on key information documents (KID) for packaged retail and insurance-based investment products (PRIIPs)*, JC 2017 43, 2017.

Katelouzou, D. and Micheler, E., *The Market for Stewardship and the Role of Government*, ECGI Working Paper N° 556/2020, 2020.

Kay, J., *Review of UK Equity Markets and Long-Term Decision Making*, Interim Report and Final Report, 2012, available at: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/31544/12-631-kay-review-of-equity-markets-interim-report.pdf and https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/253454/bis-12-917-kay-review-of-equity-markets-final-report.pdf (accessed 13 July 2021).

Kölbel, J. F. et al., *Can Sustainable Investing Save the World: Reviewing the Mechanisms of Investor Impact*, Organization and Environment, 2020, Vol. 33(4), 554-574.

Langbein, J. H. et al, *Pension and Employee Benefit Law*, St. Paul, 2015.

Legal and General Investment Management, *Active Ownership Report 2019*.

Louche, C. et al., *From Preaching to Investing: Attitudes of Religious Organisations Towards Responsible Investment*, Journal of Business Ethics, 2012, Vol. 110, 301-320.

Lydenberg, S., *Integrating Systemic Risk into Modern Portfolio Theory and Practice*, Journal of Applied Corporate Finance, 2016, Vol. 28(2), 56-61.

MacLaughlin, D. and Massa, A., 'The Hidden Dangers of the Great Index Fund Takeover,' Bloomberg, London, 9 January 2020.

Mahmoud, O. and Meyer, J, *Social Responsibility in the Time of Uncertainty: A Natural Experiment*, 2021, available at: SSRN: https://ssrn.com/abstract=3774995.

Markowitz, H., *Portfolio Selection*, Journal of Finance, 1952, Vol. 7(1), 77-91.

McCahery, J. A. et al., *Behind the Scenes: The Corporate Governance Preferences of Institutional Investors*, Journal of Finance, 2016, Vol. 71(6), 2905-2932.

McDevitt, K. and Schramm, M., *2018 U.S. Fund Flows Trends in 5 Charts - Investors shunned most of Wall Street last year,* Morningstar, London, 28 January 2019.

Monks, R., *Building trust in sustainable investments* (speech), 21 October 2020.

Morgan Stanley Institute for Sustainable Investing, *Sustainable Signals: Growth and Opportunity in Asset Management*, 2019.

Natixis Investment Managers, *Trust, Transparency and the Quest for Clarity,* 2017.

Natixis Investment Managers, *Retirement Reality Check: A Generational Look at Defined Contribution Plan Participation,* 2019.

Natixis Investment Managers, *Looking for the Best of Both Worlds*, 2019.

Netherlands Authority for Consumers and Markets, Guidelines, *Sustainability Agreements: Opportunities within Competition Law*, 2020, available at https://www.acm.nl/sites/default/files/documents/2020-07/sustainability-agreements%5B1%5D.pdf (accessed 13 July 2021).

Nilsson, J., *Investment with a Conscience: Examining the Impact of Pro-social Attitudes and Perceived Financial Performance on Socially Responsible Investment Behaviour*, Journal of Business Ethics, 2008, Vol. 83, 307-325.

Nilsson, J., *Segmenting Socially Responsible Mutual Fund Investors: The Influence of Financial Return and Social Responsibility*, International Journal of Bank Marketing, 2009, Vol. 27(1), 5-31.

Nollkaemper, A., *The Duality of Direct Effect of International Law*, The European Journal of International Law, 2014, Vol 25(1), 105-125.

Nuveen, *Fourth Annual Responsible Investing Survey*, 2018.

Nuveen, *Fifth Annual Responsible Investing Survey*, 2019.

OECD, *OECD Guidelines for Multinational Enterprises*, 11th edn, 2011.

OECD , *Social Impact Investment: Building the Evidence Base*, 2015.

OECD , *Pension Markets in Focus*, 2019.

OECD, *Recommendations on Sustainability-Related Practices, Policies, Procedures and Disclosure in Asset Management*, Consultation Report, CR 01/21, 2021.

OECD , *Social Impact Investment 2019: The Impact Imperative for Sustainable Development*, 2019.

Ondetti, G., *The Social Function of Property, Land Rights and Social Welfare in Brazil*, Land Use Policy, Vol. 50, January 2016, 29-37.

Pensions Climate Risk Industry Group, *Aligning your Pension Scheme with the TCFD Recommendations, Part II – Trustee governance, strategy and risk management: how to integrate and disclose climate related risks,* 2021.

Pensions Regulator, *Investment Governance*, 2019, available at: https://www.thepensionsregulator.gov.uk/en/trustees/managing-dc-benefits/investment-guide-for-dc-pension-schemes (accessed 13 July 2021).

Porter, M. and Kramer, M., *Creating Shared Value – How to reinvent capitalism – and unleash a wave of innovation and growth*, Harvard Business Review, 2011.

› REFERENCES

REFERENCES

Portfolio Alignment Team, *Measuring Portfolio Alignment: Assessing the Position of Companies and Portfolios on the Path to Net Zero,* available at: https://www.tcfdhub.org/wp-content/uploads/2020/10/PAT-Report-20201109-Final.pdf (accessed 13 July 2021).

PRI, *Global Guide to Responsible Investment Regulation*, 2016.

PRI, *Policy Frameworks for Long-term Responsible Investment: The Case for Investor Engagement in Public Policy,*2014.

PRI, *How ESG Engagement Creates Value for Investors and Companies,* 2018.

PRI, *Impact Investing Market Map,* 2018.

PRI, *PRI Reporting Framework: Main Definitions,* 2018.

PRI, *Taking Stock: Sustainable Finance Policy,* 2019.

PwC, *Asset and Wealth Management Revolution: The Power to Shape the Future*, 2020.

RBC Global Asset Management, *An Evolving Landscape, 2019 Responsible Investing Survey*, 2019.

Riedl. A. and Smeets, P. *Why do Investors Hold Socially Responsible Investment Funds?* Journal of Finance, 2017, Vol. 72(6), 2505-2550.

Rossi, M. et al., *Household Preferences for Socially Responsible Investments*, Journal of Banking and Finance, 2019, Vol. 105, 107-120.

Rouch, D., *The Social Licence for Financial Markets: Reaching for the End and Why it Counts* (Palgrave Macmillan 2020).

Rubinstein, M., *Markowitz's 'Portfolio Selection': A Fifty-Year Retrospective*, Journal of Finance, 2002, Vol. 57(3), 1041-1045.

S&P Global Inc., *Lights out for coal*, available at: https://www.spglobal.com/en/research-insights/featured/coal (accessed 13 July 2021).

Sandberg, J. et al., *The Heterogeneity of Socially Responsible Investment*, Journal of Business Ethics, 2009, Vol. 87, 59-533.

Sandberg, J. and Nilsson, J., *Do Ethical Investors Want Purity or Effectiveness? An Exploratory Study on the Ethical Preferences of Mutual Fund Investors*, Journal of Financial Services Marketing, 2015, Vol. 20, 34-45.

Schanzenbach, M. M and Sitkoff, R. H., *Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee*, Stanford Law Review, 2020, Vol. 72, 381-454.

Schroders Plc, *Global Investor Study*, 2018.

Schroders Plc, *Global Investor Study. Are People Compelled to Invest Sustainably?*, 2019.

Schroders Plc, *Global Investor Study - Under Pressure: Investors' Response to Crisis,* 2020.

Schoenmaker, D. and Schramade, W., *Principles of Sustainable Finance* (Oxford University Press 2019).

Schueth, S., *Socially Responsible Investing in the United States*, Journal of Business Ethics, 2003, Vol. 43, 189-194.

Schwartz, S. H., *Les Valeurs de Base de la Personne: Théorie, Mesures et Applications*, Revue Française de Sociologie, 2006, Vol. 47(4), 929-969.

Siddiqui, A.U. *The Demography of Socially Responsible Investors across Countries and Time: A Systematic Review*, Asian Journal of Managerial Science, 2018, Vol. 7(2), 7-15.

Square Mile Investment and Consulting Research Limited, *ESG Survey Results*, 2020.

Standard Chartered Private Bank, *Standard Chartered Sustainable Investing Review 2020*, 2020.

State Street Global Advisors, *Performing for the future: ESG's place in investment portfolios. Today and tomorrow,* 2018, available at: available at: https://www.ssga.com/investment-topics/environmental-social-governance/2017/esg-institutional-investor-survey-us.PDF (accessed 13 July 2021).

Stewart, S. D., Piros, C. D. and Heisler, J. C., *Portfolio Management: Theory and Practice*, (Willey 2019).

Sustainable Insurance Forum, *Biodiversity loss and associated risks to be addressed in new study by UN-convened Sustainable Insurance Forum*, 1 December 2020, available at https://www.sustainableinsuranceforum.org/biodiversity-loss-and-associated-risks-to-be-addressed-in-new-study-by-un-convened-sustainable-insurance-forum (accessed 13 July 2021).

Task Force on Climate-Related Financial Disclosures, *Implementing the Recommendations of the Task Force on Climate-related Financial Disclosures*, 2017.

Task Force on Climate-related Financial Disclosures, *Recommendations of the Task Force on Climate-related Financial Disclosures, Final Report*, June 2017.

Task Force on Climate-related Financial Disclosures, *Forward-looking Financial Metrics Consultation –Summary of Responses*, 2021.

Thinking Ahead Institute, *The World's Largest 500 Asset Managers 2020,* 2020.

Thinking Ahead Institute, *Global Pension Fund Assets Study,* 2021.

2 Degrees Investing Initiative, *A Large Majority of Retail Clients Want to Invest Sustainably: Survey of French and German Retail Investors' Sustainability Objectives,* 2020.

Tyler, T. R., *Why People Cooperate: The Role of Social Motivations* (Princeton University Press 2011).

UBS Investor Watch, *Global Insights: What's on Investors' Minds, Return on Values,* 2018.

UK Asset Management Taskforce, *Investing with Purpose: Placing Stewardship at the Heart of Sustainable Growth*, 2020.

UK Competition and Markets Authority, *Investment Consultants Market Investigation, Final Report*, 2018.

REFERENCES

REFERENCES

UK Department for International Development/Investing in a better world project, *Investing in a Better World: Understanding the UK Public's Demand for Opportunities to Invest in the Sustainable Development Goals*, 2019.

UK Government Department for Work and Pensions, *Aligning your Pension Scheme with the TCFD Recommendations*, *Part II – Trustee governance, strategy and risk management: how to integrate and disclose climate related risks*, 2021.

UK Sustainable Investment and Finance Association, *Clean Slate, Green Slate: Public and Investor Attitudes to 'Good' Money 2020*, 2020.

UN Environment Programme, *Lenders and Investors Environmental Liability – How Much is Too Much*, Inquiry Working Paper 16/07, 2016.

UN Environment Programme Finance Initiative, *The Materiality of Social, Environmental and Corporate Governance Issues to Equity Pricing: 11 Sector Studies by Brokerage House Analysts at the Request of the UNEP Finance Initiative Asset Management Working Group*, 2004.

UN Environment Programme Finance Initiative (UNEP IF), *Positive Impact Finance – A Common Vision for the Financing of the Sustainable Development Goals (SDGs)*, 2015.

UN Environment Programme Finance Initiative, *Corporate Impact Analysis Tool*, 2020, available at: https://www.unepfi.org/publications/positive-impact-publications/corporate-impact-tool/#:~:text=The%20Corporate%20Impact%20Analysis%20Tool,across%20different%20sectors%20and%20countries (accessed 13 July 2021).

UN Convened Net Zero Asset Owner Alliance, *Inaugural 2025 Target Setting Protocol*, October 2020.

United Nations, *A/RES/70/1 - Transforming our world: the 2030 Agenda for Sustainable Development, 2015.*

United Nations Global Compact, Guiding Principles on Business and Human Rights: Implementing the United Nations 'Protect, Respect and Remedy' Framework, available at: https://www.unglobalcompact.org/library/2 and https://www.business-humanrights.org/sites/default/files/media/documents/un-human-rights-council-resolution-re-human-rights-transnational-corps-eng-6-jul-2011.pdf (accessed 13 July 2021).

United Nations Global Compact, *The Ten Principles of the UN Global Compact*, available at: https://www.unglobalcompact.org/what-is-gc/mission/principles (accessed 13 July 2021).

US SIF: The Forum for Sustainable and Responsible Investment, *2020 Report on US Sustainable and Impact Investing Trends*, 2020.

US Trust Bank of America Private Wealth Management, *Insights on Wealth and Worth*, 2018.

Vigeo Eiris and Forum pour l´ Investissement Responsable (FIR), *The French and SRI: Results of the 8th National Survey* run by Ipsos for Vigeo Eiris and the FIR, 2017.

Wiesel, M. et al., *Social Preferences and Socially Responsible Investing: A Survey of US Investors*, Working Papers in Responsible Banking and Finance, N° 17-002, University of St Andrews, 2017.

Wins, A. and Zwergel, B. *Comparing Those Who Do, Might and Will Not Invest in Sustainable Funds: A Survey Among German Retail Fund Investors*, Business Research, 2016, Vol. 9, 51-99.

World Economic Forum, *Measuring Stakeholder Capitalism: Towards Common Metrics and Consistent Reporting of Sustainable Value Creation, White Paper*, 2020.

World Economic Forum Investors Industries, *From the Margins to the Mainstream: Assessment of the Impact Investment Sector and Opportunities to Engage Mainstream Investors,* September 2013.

World Economic Forum Investors Industries, *From Ideas to Practice, Pilots to Strategy: Practical Solutions and Actionable Insights on How to Do Impact Investing*, December 2013.

World Commission on Environment and Development, *Report of the World Commission on Environment and Development: Our Common Future,* 1987.

Copyright © Freshfields Bruckhaus Deringer, commissioned by The Generation Foundation, UNEP FI, and PRI Association 2021

The information contained in this report is for the purposes of general information only and is not to be taken as legal or any other advice, nor is it to be relied upon, in making any decision or otherwise. This report is provided with the understanding that the authors are not providing legal or any other kind of advice. The authors are not responsible for the content of websites and information resources that may be referenced in the report. Reference to any organisation or initiative and access provided to these sites or the provision of such information resources does not constitute an endorsement by the authors of the view of any organisation or initiative or the information contained therein. While the authors have endeavoured to ensure that the information contained in this report has been obtained from reliable and up-to-date sources, the changing nature of statistics, laws, rules and regulations may result in delays, omissions or inaccuracies in information in the report. The authors are not responsible for any errors or omissions, for any decision made or action taken based on information contained in this report or for any loss or damage arising from or caused by such decision or action. All information in this report is provided "as-is" with no guarantee of completeness, accuracy or timeliness, or of the results obtained from the use of this information, and without warranty of any kind, expressed or implied. The same applies, mutatis mutandis, to the Generation Foundation, UNEP FI and PRI (commissioning organisations) who have commissioned this report.

This publication may be reproduced in whole or in part and in any form for educational or non-profit purposes without special permission from the copyright holder, provided acknowledgement of the source is made as follows: Freshfields Bruckhaus Deringer, A legal framework for impact - sustainability impact in investor decision making, report commissioned by UNEP FI, The Generation Foundation and PRI, 2021. The authors and commissioning organisations would appreciate receiving a copy of any publication that uses this publication as a source.

No use of this publication may be made for resale or for any other commercial purpose whatsoever without prior permission in writing from the authors and commissioning organisations.

ISBN 978-1-3999-0023-2