PRI Principles for Responsible Investment

generation foundation

UN environment programme finance initiative

A LEGAL FRAMEWORK FOR IMPACT

EUROPEAN UNION

INTEGRATING SUSTAINABILITY GOALS ACROSS THE INVESTMENT INDUSTRY

CONTENTS

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EXECUTIVE SUMMARY

A wave of policy actions by the European Union in recent years has given investors a major role to play in the bloc's transition to a sustainable economy. Emerging policies, laws and tools pave the way for a wider pursuit of sustainability impact goals by investors – but they are still not sufficient to bring the EU significantly closer to its environmental and social goals, be it through increased capital flows towards sustainable activities or stewardship driven by sustainability concerns.

Additional measures are needed to enable more asset owners and managers to pursue environmental and social impact goals – an approach called "investing for sustainability impact" (IFSI) in [A Legal Framework for Impact] (LFI), a report authored by Freshfields Bruckhaus Deringer and commissioned by the PRI, the United Nations Environment Programme Finance Initiative and the Generation Foundation.

The report, published in July 2021, surveyed 11 jurisdictions around the world, including the EU, aiming to answer the following question: are investors permitted or required to target positive sustainability impacts in the way they invest and manage their portfolios, including through stewardship? In other words, are they allowed or required to engage in IFSI?

The authors found that investors are likely to have a legal obligation to consider engaging in IFSI[1] where it can help pursue their financial objectives (instrumental IFSI[2]) and that, in some circumstances, investors can pursue sustainability goals for reasons other than achieving financial goals and in parallel with them (ultimate ends IFSI[3]).

Building on the findings of the LFI report relating to the EU, this paper sets out why legal changes are needed to enable mainstream investors to work towards sustainability impact goals.

EU law still limits investors' ability to invest or exercise stewardship in alignment with social and environmental goals, except where it is also financially beneficial to do so. In addition, existing duties may be understood in ways that result in investors not considering pursuing sustainability impact goals even where those align with discharging their duties to pursue financial return (i.e., instrumental IFSI).

As a result, there is a potential inconsistency between EU financial regulation and wider EU sustainability goals. It may therefore be necessary to (1) clarify that existing duties may require or permit the pursuit of positive sustainability impacts by investors, especially in the case of instrumental IFSI; (2) remove legal barriers that impede investors from pursuing positive sustainability impacts more broadly; and (3) provide clarity on the appropriate mechanisms for investors to consider pursuing such impacts.

To create greater alignment across the EU framework in a number of these key areas, this paper presents the following recommendations developed by the PRI[4]:

Policy recommendations: measures to embed the pursuit of positive sustainability impacts in fiduciary duties and other rules

- Clarify, within the "prudent person" principle, when sustainability impact goals must or can be considered and develop implementation guidance
- Clarify beneficiaries' "best interest" to take into account sustainability impact goals
- Gather and reflect beneficiaries' and clients' preferences as to whether their money should be used to achieve positive sustainability impacts
- Clarify the relationship between financial and sustainability objectives

Other areas to explore: barriers to investing for sustainability impact and potential tools for removing them

- Directors' duties
- Barriers to stewardship
- Sustainability impact-focused investment products
- Due diligence

The appendix contains detailed analysis of relevant EU rules for pension funds, the management companies of Undertakings for the Collective Investment in Transferable Securities (UCITS), insurance undertakings and investment managers.

1 See the full definition in the key terms section.
2 Ibid
3 Ibid
4 Further work would need to be undertaken by the European Commission to determine how these options should be implemented.

KEY TERMS

This paper uses the term "sustainability impacts" to refer to any effects investment activities have on sustainability outcomes – for example, environmental or social outcomes. The impacts can be positive or negative.

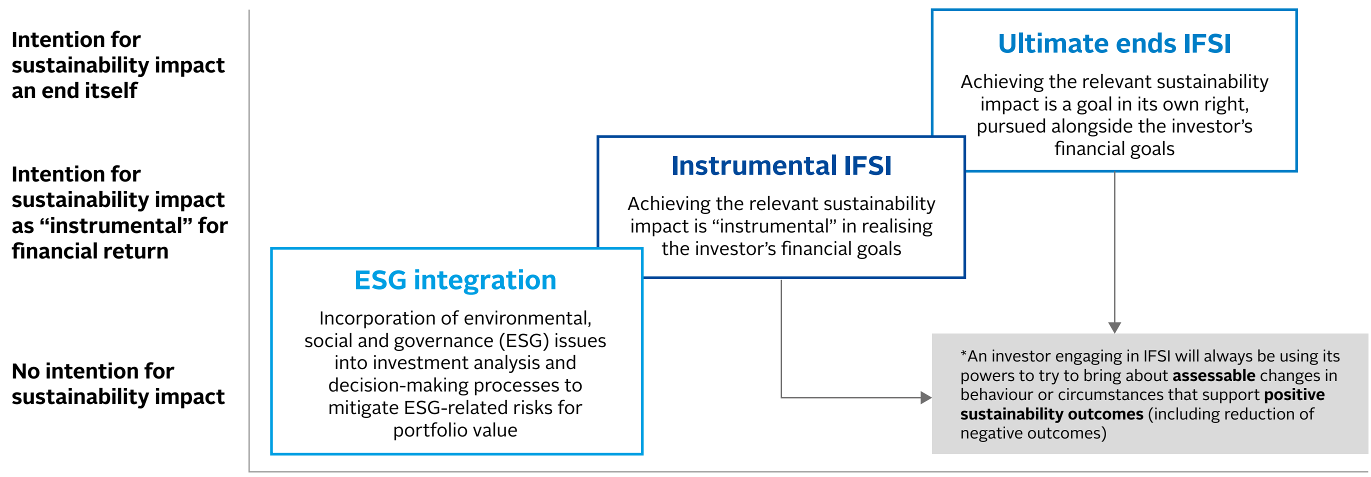
In the European Commission's [strategy for financing the transition to a sustainable economy], published in July 2021, sustainability impacts are partly covered by the notion of "inside-out" risks. Sustainability impacts (inside-out risks), on the one hand, and financially material sustainability risks ("outside-in" risks), on the other, are the two aspects of the "double materiality" concept.

This paper also refers to "investing for sustainability impact", or IFSI, a concept developed in the LFI report. IFSI is not a legally defined expression and is not used as a term of legal art. Instead, it serves as a "conceptual net" to catch, broadly, any activities that involve an investor intentionally attempting (through its investment powers, stewardship or otherwise) to influence the behaviour of investee enterprises and other third parties in assessable ways that can help achieve overarching sustainability outcomes. These are 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[5]. Contributions to these sustainability outcomes targeted by investors are called "sustainability impact goals".

The LFI report presents two types of IFSI based on the objectives[6] pursued by the investor:

- "instrumental IFSI", where achieving the relevant sustainability goal is "instrumental" in realising the investor's financial return objectives;
- "ultimate ends IFSI", where achieving the relevant sustainability goal – and the associated overarching sustainability outcome it supports – is a distinct goal, pursued alongside the investor's financial return objectives, but not wholly as a means of achieving them.

Figure 1: Investing for sustainability impact (IFSI). Source: Adapted from the LFI report.



The concept of IFSI covers impact investing but is not limited to that practice. Impact investing has to date tended to be the preserve of certain types of investors (e.g., development finance institutions, specialist investment funds) and focused on certain types of investments (e.g., private market investments in enterprises aiming for particular positive social or environmental impacts)[7].

IFSI is relevant to understanding all investing that includes the deliberate pursuit of positive sustainability impacts irrespective of the type of investor or investment.

Lastly, in this paper, "beneficiaries" refers to the people who derive a financial benefit from asset owners' investment activity.

5 In other words, IFSI involves two levels of impact: (1) the impact of investee enterprises and other third parties on sustainability factors and (2) investors' ability to have a positive influence on that impact.

6 The distinction between the different objectives that investors may have in pursuing positive sustainability impacts is key to understanding the policy options discussed in this paper, especially options that concern investors' core investment duties.

7 See pages 30-31 of the LFI report for more details.

THE CASE FOR SUSTAINABILITY IMPACT

The world is experiencing multiple social and environmental crises, while failing to adequately address the risk of further crises – for example, the crossing of planetary boundaries. The current EU legal framework for investment, at least the way it is often understood and applied, responds to historical risks and crises, such as the 2008 financial crisis. The major financial reforms implemented in Europe after 2008 were necessary and important for the stability of the financial system and to reduce risks to the real economy. However, they are not a panacea for a future crisis driven by the failure of the environmental or social systems that our prosperity and way of life depend on.

We can see this in the way markets operate. Capital markets continue to finance and support economic activities that are inconsistent with, or undermine, the EU's progress towards its key environmental and social objectives. These activities contribute to the build-up, over the medium-to-long term, of systemic risks and negative externalities[8] ultimately borne by taxpayers, communities or national governments. Recognising this, an increasing number of governments around the world are establishing legally binding climate targets. The EU's commitment to cut its emissions by 55% by 2030 compared with 1990, coupled with the European Green Deal, is a clear example of an ambitious whole-economy transition plan with legal underpinning.

Currently, investors tend to see themselves as being required to consider environmental and social issues only in so far as they are likely to affect financial return on an investment. This mode of operating – which rarely includes consideration of the social and environmental impacts of the businesses financed by investors – will fall short of minimising harm, nor will it substantially contribute to the realisation of environmental and social goals. Ultimately, it is likely to undermine capital markets themselves. Aligning investor behaviour and capital markets with the EU's sustainability goals calls for a new model of investing whereby decisions are made according to three key considerations: risk, return and sustainability impact. It is also essential to ensure that relevant policies address the importance of stewardship as a way to tackle sustainability issues.

The EU is paying increasing attention to the sustainability impacts of investments, with the following notable policy and regulatory developments:

- The European Commission's 2018 action plan on financing sustainable growth includes an objective directly linked to sustainability impacts: to increase capital flows towards sustainable activities. The EU strategy for financing the transition to a sustainable economy published in July 2021 builds on that initial action plan and aims to integrate sustainability impact throughout the investment value chain.
- The 2019 regulation on sustainability-related disclosures in the financial services sector (SFDR) sets wide-reaching disclosure obligations relating to the adverse impacts of investments at entity and product level[9]. The SFDR creates a disclosure framework based on established environmental and social due diligence guidelines. As such, it establishes a framework for financial market participants requiring identification and "prioritisation" of adverse impacts, as well as disclosure of actions planned or taken to avoid or reduce adverse impacts identified over time.
- The 2020 regulation on the establishment of a framework to facilitate sustainable investment (the EU Taxonomy Regulation), provides a practical tool to bridge the gap between international sustainability goals, like the Paris Agreement, and investment practice. The technical screening criteria set up at level 2 provide performance thresholds, helping investors assess whether the economic activities in which they invest meet robust environmental sustainability standards and are aligned with high-level policy commitments, such as the European Green Deal and EU climate law[10]. Under Article 20 of the Taxonomy Regulation, the Platform on Sustainable Finance (PSF) was mandated to advise the Commission on addressing other sustainability objectives, including social goals. The PSF published its final report on a possible social taxonomy on 28 February 2022.

8 The World Economic Forum identifies the top 10 global risks over the next 10 years in its Global Risks Report 2022. They include failure to address climate change and erosion of social cohesion.

9 Some obligations are on a comply-or-explain basis for financial market participants with 500 or fewer employees.

10 The Taxonomy Regulation applies to undertakings that are already required to disclose non-financial information pursuant to Article 19a or Article 29a of the Non-Financial Reporting Directive (NFRD) and to financial market participants marketing products that fall under Article 8 or 9 of the SFDR. They must disclose how and to what extent the EU taxonomy has been used in determining the sustainability of the underlying investments, the environmental objective(s) to which the fund contributes and the proportion of the underlying investments that is taxonomy-aligned, expressed as a percentage (Article 5 of the Taxonomy Regulation).

- In April 2021, the European Commission published six amending delegated acts as part of a broader package of sustainable finance measures[11]. Among other obligations, the delegated acts require financial firms, such as asset managers, advisers and insurers, to include sustainability factors in their procedures and to consider the sustainability preferences of their clients. These amendments aim to help investors make informed investment decisions aligned with global sustainability objectives, as part of their fiduciary duties.
- The April 2021 proposal for a Corporate Sustainability Reporting Directive mandates the creation of EU sustainability reporting standards. The standards are aimed at increasing the consistency and comparability of reported company information relating to the six environmental objectives of the Taxonomy Regulation, social factors (such as equal opportunities, working conditions and respect for human rights) and governance factors (such as business ethics and political engagements)[12]. This is a prime example of policy coherence between investor and corporate disclosure obligations, building an end-to-end disclosure framework that will enable investors to scale up their contribution to the European Green Deal and wider sustainability goals[13].
- On 23 February 2022, the European Commission proposed a directive on corporate sustainability due diligence (CSDD). The CSDD directive aims to "foster sustainable and responsible corporate behaviour and to anchor human rights and environmental considerations in companies' operations and corporate governance". Under the proposal, companies in scope will be required to conduct environmental and social due diligence throughout their entire value chains. Certain large companies must also adopt Paris Agreement-aligned transition plans, and directors will have a duty to take into account the consequences of their decisions on sustainability matters and to set up and oversee the implementation of the due diligence processes.
- The proposed European Climate Law is binding on the EU and its member states. It requires the EU to review all existing and future EU legislation to make it consistent with the bloc's climate targets and could provide a way forward to better align private capital flows with the EU's goals. The "Fit for 55" package presented in July 2021 contains legislative proposals to revise the EU climate and energy framework to help the bloc cut its emissions by at least 55% by 2030. The package includes legislation on the emissions trading system, effort sharing, land use and forestry, renewable energy, energy efficiency, emission standards for new cars and vans, as well as the Energy Taxation Directive.

11 The package aims to improve the flow of capital towards sustainable activities across the EU. It contains three measures: the EU taxonomy Climate Delegated Act, a proposal for a Corporate Sustainability Reporting Directive (CSRD) and six amending delegated acts on sustainability preferences, fiduciary duties and product governance. The delegated acts relate to UCITS, alternative investment fund managers (AIFMs), insurance undertakings and distributors, and investment firms.

12 See Article 19b (paragraph 2) inserted into the Accounting Directive by the Commission's CSRD proposal.

13 The key changes under the CSRD proposal, which revises the NFRD, are to extend the scope to all large companies and all companies listed on regulated markets (except listed micro-enterprises); require the audit (assurance) of reported information; introduce more detailed reporting requirements and a requirement to report according to mandatory EU sustainability reporting standards; and require companies to digitally "tag" the reported information, so it is machine-readable and feeds into the European Single Access Point.

BRIEF LEGAL ANALYSIS

This section summarises the LFI report's findings on EU laws. The report focuses on rules applicable to pension funds, mutual funds and insurance companies – the three largest sub-categories of asset owners by global assets under management – as well as investment managers. The following laws were covered in the EU analysis:

- **For pension funds:**
  - Directive on institutions for occupational retirement provision (IORP II)
  - Regulation on a pan-European personal pension product (PEPP)
- **For insurers and insurance distributors:**
  - Directive on the business of insurance and reinsurance (Solvency II)
  - Insurance Distribution Directive (IDD)
- **For mutual funds, typically targeted at retail investors:**
  - Directive on undertakings for collective investment in transferable securities (UCITS Directive)
- **For investment managers:**
  - Revised Directive on markets in financial instruments (MiFID II)

Funds operated and managed under the above legal frameworks may be set up with the specific purpose of investing or engaging for positive sustainability impact. However, the LFI report focuses on the extent to which the pursuit of sustainability impact objectives is possible, under current laws, where the fund mandate is "silent" on that pursuit. The report also covers, to a certain extent, amendments proposed via April 2021 delegated acts. Broadly, the analysis finds the following:

- **Pension funds** are not under an explicit general duty to invest or engage for sustainability impact in current EU law. But in discharging their investment duties they are allowed to engage in IFSI and are likely to have an obligation to consider IFSI in some cases. They may consider the sustainability impact of their investments where consistent with the prudent person principle (PPP)[14], which focuses on financial interests. In other words, pension funds may be required or permitted to consider pursuing positive sustainability impacts in their investment and engagement activity where that is instrumental to achieving the beneficiaries' financial best interest (i.e., instrumental IFSI), but the position in relation to ultimate ends IFSI is more restricted.
- **Insurance companies** are not under an explicit general duty to invest or engage for sustainability impact, but directors may need to consider pursuing positive sustainability impacts in order to discharge their general duties. Their situation is similar to that of pension funds, although they may have greater scope to engage in ultimate ends IFSI in some cases. The integration of sustainability risks in the PPP in April 2021 opens up a pathway for insurers to invest for sustainability impact under certain conditions[15]. Note that the PPP requires, in particular, that the integration of sustainability factors in investment decisions does not conflict with the "best interest" of policy holders[16].
- **UCITS management companies** are not under an explicit general duty to invest or engage for sustainability impact. However, they may need to consider steps to achieve positive sustainability impacts in pursuing their financial objectives (i.e., instrumental IFSI). Similarly to pension funds and insurers, any investment or costs incurred (including for engagement) for the purposes of achieving a positive sustainability impact must be justified in line with the financial best interest of the end-investors. UCITS management companies may also be subject to MiFID II rules on suitability (see the annex for more details).
- **Investment managers** authorised under MiFID II are not under an explicit general duty to invest or engage for sustainability impact. However, they may be required or permitted to consider taking steps to achieve positive sustainability impacts where consistent with clients' "best interest". The best interest of clients refers to individual clients' investment objectives as stipulated in the investment mandate they give to the manager and, where relevant, the clients' investment duties. As such, the determination of clients' best interest is granular and tailored (i.e., it is not applied in a general way across all of an investment firm's clients).

14 Solvency II and IORP II both include a requirement to invest in accordance with the prudent person principle, called the prudent person rule in IORP II. Guidelines on applying the principle are issued by the European Insurance and Occupational Pensions Authority (EIOPA) – see, for example, here for Solvency II guidelines.

15 See Delegated Regulation (EU) 2021/1256 of 21 April 2021 amending Delegated Regulation (EU) 2015/35 as regards the integration of sustainability risks in the governance of insurance and reinsurance undertakings.

16 The PRI supports the requirement to take sustainability impacts into account when assessing risks under the prudent person principle as this will better support insurers and reinsurers seeking to integrate sustainability impact goals into investment activities. However, practical challenges may remain in the absence of clear guidance on resolving potential conflicts between sustainability impact goals and financial return as part of investors' fiduciary duties.

- Moreover, the April 2021 amendments to MiFID II delegated regulation[17] will require firms to ask for a client's sustainability preferences and reflect these in the investment objectives and suitability assessment. However, it is questionable how far this extends to establishing a client's desire to pursue particular positive sustainability impacts (including, for example, through stewardship of investees in their portfolio) and this does not constitute an explicit duty to invest for sustainability impact. When clients do express such preferences, steps taken to reflect those preferences must also be consistent with other investment objectives agreed with clients, including their financial objectives.

17 Delegated Regulation (EU) 2021/1253 amends Delegated Regulation (EU) 2017/565 in two ways: (1) it introduces a client's sustainability preferences as a top-up to the suitability assessment and (2) it integrates sustainability risks into organisational requirements.

THE CASE FOR POLICY REFORMS

Emerging policies, laws and tools developed by the EU support a trajectory towards the pursuit of sustainability impact goals by investors. However, EU law – including amendments put forward by the Commission on fiduciary duties in April 2021 – still limits investors' ability to invest or exercise stewardship in alignment with social and environmental goals, except where it is also financially beneficial to do so. In addition, existing duties may be understood in ways that result in investors not considering pursuing sustainability impact goals even where those goals align with discharging their duties to pursue financial return (i.e., instrumental IFSI).

As a result, there is a potential inconsistency between EU financial regulation and wider EU sustainability goals. For greater alignment, it may be necessary to (1) clarify that existing duties may require or permit the pursuit of positive sustainability impacts by investors, especially in the case of instrumental IFSI; (2) remove legal barriers that impede investors from pursuing positive sustainability impacts more broadly than that; and (3) provide clarity on the appropriate mechanisms for investors to consider pursuing such impacts. This paper presents options for reforms to create greater alignment across the EU framework in a number of these key areas.

The application of essential concepts such as the inside-out perspective of double materiality[18] could also be further clarified to account for both (1) positive sustainability impacts intentionally pursued by investors, whether through the use of investment powers, stewardship or otherwise (i.e., the sort of activity covered by the idea of IFSI), and (2) positive and negative sustainability impacts that otherwise result from their activities[19]. Note that this issue is not directly covered in this paper and should be explored in further work.

The LFI report identifies various barriers for investors seeking to achieve sustainability impact goals. Essentially, these are linked to:

- investors' duties (e.g., a lack of clarity over whether investors can or should consider pursuing sustainability impact goals when assessing what they need to do to act in beneficiaries' best interests and when setting investment objectives, as well as over the role of collective action in pursuing positive sustainability impacts);
- processes (e.g., questions over how investors can or should gather and include beneficiaries' sustainability references in the investment decision-making process);
- disclosures (e.g., insufficient data from investee companies, which may reduce the effectiveness of disclosure obligations in increasing capital flow towards sustainable activities).

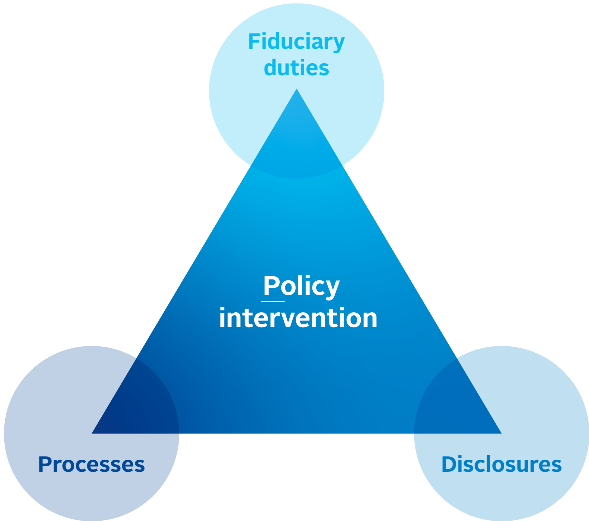
Much of the focus of the EU sustainable finance regulatory framework has been on disclosure requirements. Disclosure is important, but it also has its limits. For example, the SFDR does not cover the full range of ways in which investors may achieve positive sustainability impacts, it does not fully distinguish between the sustainability impact of an investee and the investor's positive influence on that impact, and it has introduced disclosure requirements for principal adverse impacts without addressing investors' core investment and process duties. Moreover, several EU member states have developed minimum requirements for sustainable or ESG investment funds in the absence of EU requirements, which creates a risk of fragmentation[20]. There is a need to balance the current focus on disclosures with other obligations – for example, those related to investors' duties and processes – in order to provide the appropriate regulatory framework for pursuing sustainability impact goals.

18 We note the EU's intention to apply double materiality comprehensively to financial sector policy, stated in the July 2021 sustainable finance strategy: "To align with the European Green Deal, the financial sector itself will need to be more resilient to the risks posed by climate change and environmental degradation and also improve its contribution to sustainability. This requires a comprehensive approach which consists of the systematic integration of both financially material sustainability risks (outside-in) and sustainability impacts (inside-out) in financial decision-making processes. It is crucial that both angles of the materiality concept are duly integrated for the financial sector to contribute proactively and fully to the success of the European Green Deal."

19 There is an additional question about the nature of any responsibility an investor may have for the sustainability impacts of an investee entity simply because it holds, for example, shares issued by that entity, especially where the entity is large and the shares are listed and highly liquid.

20 In the sustainable finance strategy set out in July 2021, the Commission announced that it would consider labels for ESG benchmarks and minimum sustainability criteria for financial products that promote environmental or social characteristics.

Figure 2: Areas for policy intervention to align capital markets with sustainability goals



Mutually reinforcing policy interventions in the areas of investors' fiduciary duties, processes and disclosure requirements would help align capital markets with sustainability goals. The following pages present a menu of options for policy reforms. These reforms are designed to better embed investors' right – and, in some cases, obligation – to pursue positive sustainability impacts in fiduciary duties. This would give investors greater confidence in striving for sustainability impact goals in pursuing their financial objectives and enable them to consider pursuing positive sustainability impacts through their investment decisions and stewardship activities more broadly.

The options propose possible solutions to barriers linked to investor duties and processes and, where possible, build upon the actions announced in the Commission's strategy for financing the transition to a sustainable economy unveiled in July 2021. Further legal analysis would need to be undertaken by the Commission to determine how these options should be implemented, as well as to assess their potential impact and relative merits.

POLICY RECOMMENDATIONS TO EMBED SUSTAINABILITY IMPACT GOALS IN FIDUCIARY DUTIES

The four broad recommendations below concern two key, closely related elements of fiduciary duties: the “prudent person” principle (PPP) and beneficiaries’ best interest. IFSI is already permitted or required within the limits of the prudent person principle (see recommendation 1) and the concept of beneficiaries’ best interest[21] (recommendation 2) – but there is a question as to what extent investors understand this. Investors are also uncertain as to the scope of what is permitted. Beneficiaries’ sustainability preferences (recommendation 3) and the relationship between financial and sustainability objectives (recommendation 4) also have a potential role in shaping fiduciary duties.

1. CLARIFY, WITHIN PPP, WHEN SUSTAINABILITY IMPACT GOALS MUST OR CAN BE CONSIDERED AND DEVELOP IMPLEMENTATION GUIDANCE

The overall objective of the following recommendations is to clarify that, in applying the PPP, insurers and occupational pension funds (1) have an obligation to consider pursuing social and environmental impact goals where this would help achieve their financial objectives and (2) may in some cases pursue environmental and social impact goals as a distinct goal, alongside financial objectives. This might require amending the wording of Article 132 in Solvency II and accompanying guidance from the European Insurance and Occupational Pensions Authority (EIOPA), and Article 19 in IORP II, or issuing supplementary guidance to clarify when IFSI is permitted or required.

DETAILED RECOMMENDATIONS

Further clarify the PPP in Solvency II

Inside-out risks were added in the PPP through Article 275a[22] in Commission Delegated Regulation (EU) 2021/1256. Starting from August 2022, insurers will not only need to assess sustainability risks as they affect their investment performance but will also be required to take into account the potential long-term impact of their investment strategy and decisions on sustainability factors[23].

Although the amendment is welcome, more guidance is needed as to what taking sustainability impacts into account means in practice as it may be interpreted in different ways due to its high-level nature.

- Clarify that investors should consider not only long-term inside-out impacts but also short- and medium-term impacts, since sustainability impacts may materialise in the short-to-medium term as well[24].

21 The prudent person principle in Solvency II and the equivalent prudent person rule in IORP II describe how investors should exercise their duties and powers and to what ends. The concept of beneficiaries’ best interest is key to identifying those goals.

22 Article 275a states: “1. When identifying, measuring, monitoring, managing, controlling, reporting and assessing risks arising from investments, as referred to in the first subparagraph of Article 132(2) of Directive 2009/138/EC, insurance and reinsurance undertakings shall take into account sustainability risks. 2. 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.”

23 The focus on the impact of investment strategy and decisions is necessary but not sufficient as it neglects other actions that can be more effective in changing the sustainability impacts of investees, such as stewardship and engagement with policy makers.

24 Essentially, as a minimum, it should be clear that any inside-out impact that could be relevant to achieving the goals of the insurer (financial or otherwise) that are relevant to the portfolio concerned should be appropriately addressed by the insurer in running the portfolio.

- Clarify that this requirement extends to taking active steps to pursue positive sustainability impacts when that is necessary to address sustainability risks, and that it goes beyond simply not investing in assets that carry sustainability risks or reducing exposure to them. In many cases, active steps may best be taken collectively with other investors and third parties.
- In order to consistently integrate double materiality across the EU financial system, clarify that the PPP in Solvency II requires the consideration of double materiality (but noting the comments above on the need to further clarify the concept of inside-out risks).

Include mandatory consideration of inside-out risks in IORP II

Article 19(1)(b) of IORP II states that, within the prudent person rule, pension schemes shall be allowed to take into account the potential long-term impact of investment decisions on environmental, social and governance matters. Moreover, EIOPA pointed out in an opinion in 2019 that taking into account ESG factors "to reduce the risk exposure of IORPs toward ESG risks is also likely to help IORPs in the pursuit of sustainability goals [and] conversely, considering the long-term impact of investment decisions on ESG factors can contribute to mitigating IORPs' exposures to ESG risks". However, in contrast to Solvency II, consideration of inside-out risks is not mandatory for occupational pension schemes.

- Amend Article 19(1)(b) of IORP II to make it mandatory for IORPs to consider inside-out risks as part of the prudent person rule. As with Solvency II, this requirement should extend to taking active steps to pursue positive sustainability impacts when that is necessary to address sustainability risks. This requirement should also follow the proportionality principle, i.e., it should not be too burdensome for small and medium-sized IORPs. The language from Article 275a of the Solvency II amendment could be replicated, as appropriate.
- In order to consistently integrate double materiality across the EU financial system, clarify that the prudent person rule requires the consideration of double materiality (but noting the comments above on the need to further clarify the concept of inside-out risks).
- Make clear that pension schemes should consider not only long-term inside-out impacts but also short- and medium-term impacts, as appropriate, since sustainability impacts may materialise in the short-to-medium term as well.

Provide implementation guidance for insurers and occupational pension schemes

- EIOPA should develop further guidance on the application of the PPP/prudent person rule in insurance and occupational pension frameworks. As pointed out by the supervisor in a 2019 document about Solvency II and the IDD, the requirement for firms to take into account the impact of their investments 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" – one implication of this is that the obligation would not establish a duty to pursue sustainability impact goals as the ultimate end. Therefore, it would be helpful to clarify:
  - whether the requirement to take account of inside-out risks is limited to investment decisions (i.e., concerning the acquisition or disposal of investments) or extends to all decisions by investors (i.e., including stewardship);
  - how insurers and pension schemes should assess sustainability risks and impacts; how they may set and pursue sustainability impact goals, either when those are in support of financial goals (instrumental IFSI) or pursued in their own right (ultimate ends IFSI)[25];
  - how sustainability impact goals relate to financial goals and duties.

25 Since there is an interplay between industry practice and evolving regulatory technical standards, which are likely to remain a work in progress, this might also involve identifying good industry practice and good regulatory standards – for example, on impact assessment – and facilitating fora in which these can develop.

2. CLARIFY BENEFICIARIES' "BEST INTEREST" TO TAKE INTO ACCOUNT SUSTAINABILITY IMPACT GOALS

The notion of best interest is key to understanding the type of objectives that investors are allowed to pursu[26]. So far, many lawyers and investors have interpreted this concept rather narrowly as mainly financial interest. Moreover, even the concept of financial interest may have been narrowly applied with insufficient consideration of systemic risks that, were they to materialise, would damage at least some beneficiaries' best financial interests. Beneficiaries have both a financial and non-financial interest in the sustainability of their social and natural environment, and the goal of investing for sustainability impact is to help ensure that sustainability, recognising that beneficiaries' financial and non-financial interests may not always align. Therefore, further work is needed to embed sustainability impact goals in the concept of best interest[27] where they are relevant to achieving financial goals, and where they are relevant to serving beneficiaries' wider interests. Below we suggest ways to do that.

DETAILED RECOMMENDATIONS

Clarify what the concept of beneficiaries' long-term best interest means. This should include highlighting the risks that declining sustainability outcomes pose to the systems on which investment return relies (i.e., one of the reasons for engaging in instrumental IFSI). In addition, explore options to allow ultimate ends IFSI on the basis that it may help serve beneficiaries' broader interests.

- For instance, we welcome the Commission's initiative to ask EIOPA to assess the potential need to broaden the concept of the long-term best interest of pension fund members and beneficiaries and introduce the obligation to consider sustainability impacts in the pension investment framewor[28]. EIOPA should also clarify in which cases existing duties already require or permit investors to consider and, where appropriate, engage in IFSI. Moreover, EIOPA guidance or IORP II could include a clarification that pension funds must take sustainability risks into account even where these could not be classified as financially material from a current perspective. This suggestion is based on the following in the LFI report: "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."[29]
- It may be worthwhile to clarify or amend the duty to invest in the "best long-term interests" of beneficiaries, set out in IORP II, to explicitly include the interests of future beneficiarie[30]. This could be done by replacing the phrase "members and beneficiaries as a whole" in Article 19(1)(a) of IORP II with "present and future members and beneficiaries"[31] and possibly highlighting the need for equity between different generations and constituent groups. A similar change could be made in the frameworks for insurance and other financial sectors. The insurance framework could be amended to clarify whether and to what extent the long-term interests of shareholders and policy holders must be considered as part of the forthcoming duty to take into account the potential long-term sustainability impacts of firms' investment strategy and decisions. As part of this option, it may also be worthwhile to include the interests of future beneficiaries as appropriate[32].

Explore ways of integrating sustainability impact goals in the concept of beneficiaries' best interest

- One option to explicitly allow for the pursuit of positive sustainability impacts where this is not solely financially motivated is to introduce a "beneficiary presumption". In this scenario, in addition to pursuing beneficiaries' financial best interest, investors would be permitted or required to presume that beneficiaries want their money to be managed in ways that support certain sustainability outcomes and that these are consistent with their best interests, unless the beneficiaries indicate otherwise. Acting on this presumption would involve ultimate ends IFSI, and the presumption

26 For example, the LFI report says: "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... The PPP requires, in particular, that the integration of sustainability factors in investment decisions does not conflict with the 'best interest' of policy holders. Such a conflict might arise where an investment decision would affect the insurer's profitability and liquidity in a way that could endanger its ability to duly meet its policy holders' valid claims."

27 Notably, IORP II implies that the best interest of beneficiaries must not be assessed in relation to the individual investment but, rather, with regard to the portfolio as a whole (see Article 19(1)(c) and (f)).

28 The plan was announced in the strategy for financing the transition to a sustainable economy in July 2021. The Commission went on to say: "The aim would be to ensure that the framework better reflects members' and beneficiaries' sustainability preferences and broader societal and environmental goals. In collaboration with the European supervisory authorities, the Commission will consider and assess further measures to enable all relevant financial market participants and advisers to consider positive and negative sustainability impacts of their investment decisions and of the products they advise on [on] a systematic basis."

29 See page 279 in the LFI report.

30 In addition to such a clarification/amendment, it would be useful to introduce further guidance on how to solve potential conflicts between the interests of different generations of beneficiaries or to foster fora where investors can come to a consensus on such matters.

31 According to Article 19(1)(a) of IORP II, the assets shall be invested in the best long-term interests of members and beneficiaries as a whole.

32 This option may be more relevant to life insurers as they generally operate with longer-term time horizons.

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[33]. However, various questions would need to be addressed, such as how to establish which sustainability objectives to presume and how much weight the sustainability objectives should be given – in particular, compared with financial return. One way of establishing which sustainability objectives to presume could be for supervisory authorities to draw up a list of sustainability impact goals they consider significant, such as those linked to systemic risks or to sustainability goals that are set in law – for example, the EU's legal commitment to reduce its net emissions to zero by 2050. Investors could also cooperate on research to establish beneficiaries' likely attitudes towards sustainability goals generally. As noted in the LFI report, the research currently available appears to suggest that end-investors do want their money to "do good" as well as earn a good return.

- Another option could be to set in law a presumption that beneficiaries' best interest is pursued only if minimum sustainability safeguards (to be defined) are respected.

The options above also support the integration of sustainability impact goals in the concepts of short- and medium-term interests[34].

33 The presumption approach is suggested in the LFI report in the section on reform options.

34 The LFI report notes, for instance, that ESMA has explicitly refused to amend the general principle of "best interest" for UCITS since ESMA is not persuaded that this would "provide more benefits compared to making the requested legislative clarifications directly in the due diligence requirements" (see this ESMA report). The LFI report states: "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." For the full discussion, see pages 285-286 of the LFI report.

3. GATHER AND REFLECT BENEFICIARIES'[35] AND CLIENTS'[36] PREFERENCES AS TO WHETHER THEIR MONEY SHOULD BE USED TO ACHIEVE POSITIVE SUSTAINABILITY IMPACTS

The authors of the LFI report found that the levels of assets committed to sustainability impact investment approaches are lower than what might be expected based on preferences expressed by individual investors in a significant portion of studies. There may be various reasons for this, including a common difference between what people say and do. However, there is also a possibility that beneficiaries and clients are not prompted to consider in initial conversations with investment managers whether their money could be managed in ways that achieve positive sustainability impacts. There is another possibility – that investment decision-makers are not given adequate information about end-investors' sustainability impact preferences or prompted to consider end-investors' sustainability aspirations when selecting investments. Research for the LFI report suggested that the difference between sustainability aspirations and investment practice could be at least partly explained by structural factors of this sort[37].

If borne out by further work, these findings could lend support to policies to encourage investment decision-makers to reflect end-investors' views on the extent to which they want their money to be managed in a way that achieves positive sustainability impacts. Below we explore how beneficiaries' and clients' sustainability preferences could be gathered and reflected in investment decisions.

DETAILED RECOMMENDATIONS

Clarify that beneficiaries' sustainability preferences can be taken into account and encourage such investment behaviours

- Clarify that investors may take beneficiaries' sustainability preferences into account[38] when considering pursuing sustainability impact objectives and encourage them to do so. For example, Article 19(1)(b) of IORP II allows investors to consider the impact of investment decisions on ESG factors as part of the PP[39]. This might be taken to suggest that IORPs should also be entitled to consider *their beneficiaries' views* on sustainability factors or risks[40]. This clarification could be made in IORP II or EIOPA guidance.
- Make clear, through guidance or otherwise, that one sort of "sustainability preference" that beneficiaries or clients may have is for their money to be managed in ways that result in assessable positive sustainability impacts, including through the use of stewardship by the investment manager.
- Explore ways to address market impediments, such as any challenges pension funds may face in establishing the sustainability aspirations of beneficiaries. Explore whether and how technology-based solutions and financial literacy[41] can help ensure beneficiary preferences are taken into account by investors.

35 The LFI report makes a relevant observation on IORPs: "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."

36 The April 2021 amendment to MiFID II introduced an obligation for investment firms to ask for and reflect clients' "sustainability preferences" in the suitability assessment that guides investment decisions. This could nudge clients to consider the sustainability impacts of their investments, affecting the selection of products. However, the MiFID amendment places no obligation on asset owners to ensure preferences communicated by them reflect beneficiaries' preferences.

37 For more details, see the section entitled "Why the difference between positive sustainability attitudes and investment practice?" on pages 61-62 of the LFI report.

38 Fiduciary duties will dictate asset owners' ability to act upon beneficiaries' preferences.

39 As part of its sustainable finance strategy, the Commission said in July 2021 that it "will ask EIOPA to assess the potential need to broaden the concept of the 'long-term best interest of members and beneficiaries' and introduce the obligation to consider sustainability impacts in the pension investment framework". The aim would be "to ensure that the framework better reflects members' and beneficiaries' sustainability preferences and broader societal and environmental goals".

40 In practice, it might be difficult to establish the prevailing views of beneficiaries and members "as a whole" as views on the sustainability impacts of investments are likely to be diverse.

41 See, for example, the financial competence framework for adults in the EU, published in January 2022 by the European Commission and the International Network on Financial Education run by the Organisation for Economic Co-operation and Development (OECD).

One option might be for governments to conduct surveys (thereby socialising the cost and possible risks involved) and to allow for certain sustainability goals to be presumed (see the discussion of the "beneficiary presumption" higher up). Alternatively, or in addition, regulators should:

- develop processes that investors could use to establish beneficiaries' preferences – for example, surveys, focus groups and interviews[42];
- clarify the scope of the information to be obtained;
- develop guidance to help investors take account of the sustainability preferences expressed[43];
- clarify how investors' obligation or discretion to consider pursuing beneficiaries' sustainability impact preferences interacts with the duty to achieve financial returns.

Establish investment strategies that involve pursuing positive sustainability impacts as one of the default options for clients

The April 2021 delegated regulation amending MiFID II requires investment managers to recommend sustainable financial instruments to clients and potential clients only if the client expresses sustainability preferences. Retail investors should be systematically offered sustainable investment products as one of the default options when the provider has them available, at a comparable cost and if those products meet the suitability test[44]. This may increase the likelihood that clients choose the more sustainable investment. See also the recommendation above on clarifying the concept of "sustainability preferences" to make clear that they include a preference for the pursuit of positive sustainability impacts by the money manager, through investment decisions, stewardship and otherwise.

42 A 2021 PRI report sets out approaches taken by investors to understand their beneficiaries' sustainability preferences and integrate them into investment practices.

4. CLARIFY RELATIONSHIP BETWEEN FINANCIAL AND SUSTAINABILITY OBJECTIVES

The legal analysis in the LFI report finds that some investors are likely to be required to consider pursuing sustainability goals in support of *their financial objectives* and that in certain circumstances investors are permitted – and in limited cases required – to consider *pursuing sustainability impact goals* alongside financial objectives (i.e., engaging in ultimate ends IFSI).

The extent to which investors can work towards sustainability impact goals in practice will depend on the relationship between financial and sustainability objectives: in particular, whether sustainability impact goals are pursued in support of financial objectives or, rather, sustainability objectives are pursued as ends in themselves, in parallel to any financial objectives. In the latter case, there may be questions as to which objectives should take precedence – the LFI report finds that at present pursuing sustainability impact goals is generally only permitted as long as it does not have a negative effect on the achievement of financial objectives.

Further guidance could be provided on how investors should determine and disclose the relationship between their sustainability goals and financial objectives. As highlighted in the above policy recommendations, it is important that policy makers explore ways to enable mainstream investors to pursue sustainability goals in parallel to financial objectives.

OTHER AREAS TO EXPLORE

What follows is a non-exhaustive list of barriers to investing for sustainability impact identified in the LFI report and examples of potential tools that could help remove those barriers. Further legal work would need to be undertaken by the Commission to understand the extent of these barriers and develop the tools for addressing them.

1. DIRECTORS' DUTIES

The duties of directors of insurers and other financial companies might be perceived to impede the integration of sustainability factors and the pursuit of sustainability impact objectives in their investment policy and otherwise. The duties of company directors should better balance corporate and investment goals with the long-term interests of the society and the environment[45]. This should be explored further under Articles 15, 25 and 26 of the Commission's proposed directive on corporate sustainability due diligence (the CSDD directive).

2. BARRIERS TO STEWARDSHIP

The issues below were highlighted in the LFI report as barriers to pursuing sustainability goals in the stewardship framework. We note the Commission's announcement in the July sustainable economy strategy that it would clarify stewardship rules for investors to reflect the financial sector's contribution to EU sustainability goals. This should be a key priority for the EU's sustainable finance framework as evidence suggests that stewardship has so far been the most reliable way for investors to have a positive sustainability impact.

A PRI paper on strengthening stewardship in the EU, published in June 2021, provides policy options relevant to some of the issues below.

A. SRD II[46]

Under Article 3g(1) of the Shareholder Rights Directive II, asset owners and asset managers must develop and publicly disclose a policy describing how they integrate stewardship in their investment strategy, or publicly disclose a clear and reasoned explanation why they have chosen not to develop such a policy. However, even if an asset owner or manager bound by these requirements decides to exercise its powers of stewardship, these rules are not explicitly designed to deliver positive sustainability impacts as such[47]. Therefore, while the SRD II clearly aims at improving companies' sustainability impacts, it does not oblige asset owners and asset managers to pursue this aim actively. It also neglects (1) the role for investor influence beyond engagement and voting, such as engagement with policy makers and standard setters, and (2) stewardship in asset classes beyond listed equity.

B. INVESTOR COLLABORATION

The LFI report highlights that investor collaboration is an essential tool for achieving positive sustainability impacts. Additional guidance could make clear that investors should consider collective action in pursuing their financial and sustainability objectives, and that this can be an effective means for investors to discharge their duties, even if the investor's contribution and the financial and wider benefits to the portfolio cannot be precisely measured. As an alternative, there could be a *prima facie* legal presumption in favour of cooperation unless there are solid reasons against[48].

Also, from a competition law perspective, additional guidance is required from competition authorities to explain in more detail how investors may collaborate to address sustainability issues and how such actions may be assessed within the existing horizontal collaboration regime[49].

C. STEWARDSHIP COSTS

An asset owner would need to be satisfied that incurring stewardship costs is consistent with its duties under EU law. Therefore, the European Commission should clarify that a financial market participant has a duty to consider undertaking stewardship – to address sustainability risks or pursue sustainability impact goals – *in ways that are consistent with* achieving financial objectives and serving beneficiaries' "best interests". The Commission should also clarify that they may incur reasonable costs in doing so. Such a clarification could encourage greater collaboration between investors on stewardship activities as a way to reduce overall costs and enhance the effectiveness of stewardship.

43 For instance, according to the UK Law Commission's 2017 report on pension funds and social investment, UK trustees can take non-financial factors into account provided that: (1) they have good reason to think that scheme members share the concern and (2) there is no risk of significant financial detriment to the fund. However, this leaves investors with various questions, which may discourage them from acting. For example, what would be a "good reason" and how many scheme members would need to share the relevant sustainability concern, and how should the risk of significant financial detriment be assessed?

44 The PACTE law in France, for example, has introduced systematic offering of ESG-labelled funds for new unit-linked life insurance contracts, starting from 2022.

45 The PACTE law in France explicitly obliges directors to consider social and environmental issues when operating the company.

46 A summary of SRD II is available here.

47 See paragraph 3.1.5 on page 291 of the LFI report, which argues this in relation to asset owners.

48 See the section entitled "Collective action to secure sustainability goals" on page 17 of the LFI report.

49 See recommendation 5.1 from the PRI's Strengthening stewardship in the EU paper: "The PRI recommends that the EU develops regulatory guidance clarifying how investors can collaboratively engage on ESG issues without being deemed to be acting in concert. The EU should further work with national regulators to ensure acting in concert and antitrust regulations do not impede collaborative engagement by investors around common sustainability goals."

3. SUSTAINABILITY IMPACT-FOCUSED INVESTMENT PRODUCTS

In order to avoid greenwashing and enforce market discipline and transparency, regulators should distinguish between labels such as "sustainable", "responsible" and "impact" and make their use dependent on satisfying minimum operating and disclosure standards[50]. In the case of products labelled "impact", these standards should include requirements on credible intentional pursuit of sustainability impact goals and assessment of progress[51]. At present, there is still a potential for confusion between products and investment approaches that may in some way take account of sustainability-related financial risks or opportunities and those that specifically involve pursuing assessable sustainability impact goals, for financial reasons or otherwise.

4. DUE DILIGENCE

Although not explored in the LFI report, due diligence is a tool that could potentially facilitate IFSI as it focuses on identifying and managing negative impacts. This paper uses the term "due diligence" in a broader sense similar to the OECD's usage of the term in its 2018 due diligence guidance for responsible business conduct[52]. Mandatory due diligence on negative sustainability impacts, and management of those impacts through mandatory target-setting are two complementary reform options that could be explored in future work.

POTENTIAL POLICY OPTIONS TO EXPLORE

- **Mandatory due diligence on negative impacts**
  This policy option involves requiring investors to prevent or mitigate principal adverse impacts (PAIs), going some steps further than current SFDR requirements[53]. These impacts include, among others, any that might hamper the realisation of the investor's objectives (financial or otherwise). Investors could also be mandated to follow specific steps to reduce those PAIs and to disclose the steps through which negative impacts were reduced.

  This option would require amending investor duties and introducing new process and disclosure requirements for any investor that directly manages assets. The new requirements should cover (1) due diligence on the potential sustainability impacts of the investee companies under consideration, including impacts that would hinder the realisation of the investor's financial or other objectives, and (2) the investor's actions to address those (negative) impacts in support of the financial or other objectives of the portfolio/product. The Commission could consider introducing some of these changes and requirements through the SFDR and/or the CSDD directive, ensuring coherence between the two and alignment with international standards such as the UN Guiding Principles on Business and Human Rights and the OECD Guidelines for Multinational Enterprises.

- **Mandatory target- and trajectory-setting**
  Investors could also be required to set targets for reducing the negative sustainability impacts of investees, as well as to provide a forward-looking trajectory for positive sustainability impacts, with thresholds, and to report on progress.

  As an example, these requirements could apply both to asset owners and managers[54]. The obligations should be built on existing disclosure requirements such as those contained in the EU taxonomy and Article 8, Article 9 and the PAI provisions of the SFDR[55]. Such requirements could reduce negative sustainability impacts while steering financial market participants towards investing for sustainability impact based on their own ambitions in terms of trajectory. These requirements could be met through investors' stewardship activities or, potentially, by increasing/reducing capital allocation to the relevant investee[56].

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50 In its sustainable economy strategy set out in July 2021, the Commission announced that it would consider labels for ESG benchmarks and minimum sustainability criteria for financial products that promote environmental or social characteristics.

51 See the section entitled "Sustainability impact-focused investment products" on page 18 of the LFI report.

52 The OECD guidance says: "Business activities may result in adverse impacts related to corporate governance, workers, human rights, the environment, bribery and consumers. Due diligence is the process enterprises should carry out to identify, prevent, mitigate and account for how they address these actual and potential adverse impacts in their own operations, their supply chain and other business relationships."

53 The draft Regulatory Technical Standards (RTS) require a description of the actions taken during the reference period and actions planned or targets set by the financial market participant for the next reference period to avoid or reduce the PAIs identified (see Article 6 of the RTS).

54 Since it may be challenging in some cases for individual investors to reduce negative impacts and achieve positive impacts in assessable ways, provisions of this sort may need to take account of activities undertaken in cooperation with other investors and third parties.

55 See the PAI due diligence and outcomes indicators proposed by the PRI in response to the European supervisory authorities' consultation on the SFDR RTS: "3a. for each issue identified as a PAI, a description of the actions taken during the reference period and planned for the next reference period; 3b. targets set in relation to these issues, at what level they are set and how they derive from global goals such as those listed in 1a".

56 Changing capital allocation is unlikely to result in negative impact reduction at investee level, although it could involve removing negative impact investments from the portfolio so that the portfolio does not hold them (but that would not necessarily affect the negative impact of the investee).

To implement these reform options, the Corporate Sustainability Reporting Directive (CSRD) – and potentially the CSDD directive – would likely have to include a requirement for companies to disclose targets and achievements related to sustainability impact objectives. The Commission's CSRD proposal does already require an undertaking in scope to disclose its plans to ensure that its business model and strategy are compatible with the transition to a sustainable economy and with limiting global warming to 1.5°C, in line with the Paris Agreement. Similarly, under Article 15 of the CSDD proposal, larger companies must do the same and, in particular, the plan must identify – on the basis of information reasonably available to the company – the extent to which climate change is a risk for, or an impact of, the company's operations. In addition, in case climate change is or should have been identified as a principal risk for, or a principal impact of, the company's operations, the company must include emission reduction objectives in its plan. Therefore, much groundwork has already been laid for mandating target-setting by companies. Policy makers should ensure these requirements under the CSRD and the CSDD directive are aligned and consider introducing the same requirements for other sustainability impact objectives.

It may also be necessary to develop sector-specific transition pathways and technology roadmaps aligned with the EU's sustainability goals in order to measure progress. In addition, these options should be combined with policy reforms that support investor stewardship activities as this tool will often be the most effective way to minimise negative sustainability impacts. Moreover, development of tailored guidelines on how to act on specific issues such as human rights[57] would be needed.

57 Institutional investors have the following responsibilities with respect to human rights: (1) publicly committing to respect human rights; (2) identifying actual and potential negative outcomes for people, arising from investees; (3) preventing and mitigating the actual and potential negative outcomes identified; (4) tracking investees' management of human rights outcomes; (5) communicating to clients, beneficiaries, affected stakeholders and publicly about outcomes and the actions taken; and (6) enabling or providing access to remedy. While the SFDR PAI requirements encourage identifying actual and potential negative outcomes, there is no obligation to act on these outcomes and minimise them. See the PRI's paper Why and how investors should act on human rights.

APPENDIX: DETAILED ANALYSIS OF EXISTING EU RULES

PENSION FUNDS

This section covers Institutions for Occupational Retirement Provision (IORPs) and providers of Pan-European Personal Pension Products (PEPPs)[58].

IORP II infers the following key **duties and powers**:

- The prudent person rule: Article 19 of IORP II was clarified in 2016 to state that "within the prudent person rule, member states shall allow IORPs to take into account the potential long-term impact of investment decisions on environmental, social and governance factors".
- Requirements relating to portfolio characteristics (security, liquidity, diversification).
- Member states may not require IORPs to invest in specific categories of assets.

IORP II also establishes the following **processes** relating to ESG factors:

- IORPs must have an effective system of governance, which includes consideration of ESG factors relating to investment assets in investment decisions.
- IORPs must maintain and document an effective risk management system, which must consider ESG risks relating to the investment portfolio.

These processes do not supersede the duties set out above.

Pension funds may also be subject to various **disclosure** rules[59]:

- IORPs must publish a Statement of Investment Policy Principles setting out elements of their approach.
- Pension funds are subject to disclosure obligations on ESG risks and adverse impacts under the regulation on sustainability-related disclosures in the financial services sector (SFDR).
- Pension funds are in the scope of the Taxonomy Regulation.
- Pension funds may fall into the scope of the Non-Financial Reporting Directive where designated a public interest entity by the member state[60].

IORPs also fall in the scope of the revised Shareholder Rights Directive (SRD II). SRD II is the principal piece of EU law relating to the exercise of engagement and voting rights. Under SRD II, institutional investors including pension funds[61] must either develop an engagement strategy or explain why they have not done so. SRD II does not explicitly mention sustainability and is generally limited to listed equity portfolios.

ANALYSIS

As a general rule, pension funds have some (limited) flexibility to invest for sustainability impact under certain conditions but are not obliged to do so.

The disclosure obligations introduced under the SFDR and the Taxonomy Regulation may encourage pension funds to consider sustainability impacts more deeply, but they do not modify the core duties set out in Article 19 of IORP II and in the PEPP regulation.

Article 19 of IORP II was clarified in 2016 to state that pension funds may consider ESG factors within the existing prudent person rule. In practice, this does not modify the meaning of the prudent person rule or the notion of acting in the best (financial) interests of beneficiaries. We interpret this to mean that investing for sustainability impact is only allowed where there is no negative impact on returns. IFSI may be permitted as a "tie-break", i.e., as a distinctive element when choosing between several otherwise similar options, but there is no obligation to select the more sustainable option.

Pension funds discharge their duties to serve the best interests of beneficiaries in relation to the entire portfolio of investments, so some flexibility may be permissible within the construction of an investment portfolio as long as the "best" financial return of the portfolio as a whole is not negatively affected.

PEPP providers' ability to consider investing for sustainability impact is broadly the same. They have additional duties relating to the suitability of products to the target market, but there is no assumption that beneficiaries in the identified target market have particular sustainability preferences.

58 The key investment duties of PEPP providers and IORPs are broadly analogous, although the PEPP regulation is slightly stronger on sustainability impacts. Given that processes do not supersede duties, the LFI report does not consider the process obligations of PEPP providers in detail. PEPP providers must also define a target market and ensure that the PEPPs they provide are consistent with the needs of the target market.

59 SRD II disclosure requirements are excluded as they do not contain an explicit reference to sustainability.

60 Analysis published in 2017 indicates that pension funds may be designated a public interest entity in Bulgaria, Croatia, Czech Republic, Iceland, Italy, Latvia, Lithuania, Poland, Portugal, Romania, Slovakia and Spain.

61 IORPs are in scope. SRD II pre-dates the PEPP regulation.

The existence of certain stewardship obligations on IORPs in SRD II suggests that engagement and voting may be broadly consistent with the duties of occupational pension funds. However, these activities must be pursued in line with the "best interest" of beneficiaries. In particular, costs incurred in the exercise of stewardship activities (engagement and voting) would need to be justified.

There is no explicit barrier in EU law to the creation of new pension funds with a specific objective of investing for sustainability impact, or to the inclusion of freely selectable sustainable options within existing schemes. Amending the terms of an existing pension scheme is theoretically possible but would likely rely on member state law and the consent of the scheme's members and beneficiaries.

UCITS MANAGEMENT COMPANIES

The **duties and powers** of UCITS fund management companies are shaped by UCITS investment objectives and policies (constitutional documents) and the UCITS Directive.

The UCITS Directive sets out the following duties for a management company:

- act honestly and fairly in conducting its business activities in the best interests of the UCITS it manages and the integrity of the market;
- act with due skill, care and diligence, in the best interests of the UCITS it manages and the integrity of the market.

Further detail on "best interests" is set out in Delegated Directive 2010/43/EU. The LFI report finds that, in general, the best interests of the UCITS are served where financial return is maximised in line with the stated investment objectives of the UCITS (set out in constitutional documents).

The duty to act in the interests of the integrity of the market is a targeted obligation aimed at avoiding specific instances of malpractice, rather than at capturing systemic risks in the broader sense.

Delegated Directive 2010/43/EU also includes rules on due diligence **processes**, inducements and best execution. The amendments in the April 2021 delegated directive[62] clarified that, as part of due diligence, managers should consider sustainability risks and, where they already consider principal adverse impacts on sustainability factors consistent with the SFDR obligations, managers should disclose how their due diligence policies take those PAIs into account.

The UCITS Directive itself contains no obligation to assess beneficiary views nor would they be considered relevant to understanding the best interests of the UCITS. However, UCITS manufacturers may be subject to MiFID II rules regarding suitability and identification of the target market. The April 2021 amendments to MiFID II require the assessment of sustainability preferences when evaluating the suitability of products for a client. Further, manufacturers should ensure the product meets the identified target market's needs in relation to sustainability, which includes ongoing review obligations.

Regarding stewardship, UCITS funds are in the scope of the revised Shareholder Rights Directive, and the UCITS Directive requires firms to develop strategies for the deployment of voting rights, to the exclusive benefit of the UCITS concerned (typically understood to be the best financial interests, as above).

UCITS funds are also subject to various **disclosure** rules:

- Obligations on ESG risks and adverse impacts at product and entity level under the regulation on sustainability-related disclosures in the financial services sector (SFDR).
- Certain types of UCITS are in the scope of the Taxonomy Regulation.
- Funds run by UCITS management companies may fall into the scope of the NFRD (soon to be revised by the proposed Corporate Sustainability Reporting Directive) where designated a public interest entity by the member state[63].

ANALYSIS

UCITS funds may be set up with the specific intent of investing for sustainability impact and may therefore pursue sustainability objectives consistent with the constitutional documents and the UCITS Directive. These documents may be amended subject to approval by the national competent authority and, under some circumstances, existing unit holders.

62 Delegated Directive (EU) 2021/1270 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). The final draft was published on 21 April 2021 as part of the EU sustainable finance package.

63 The analysis mentioned higher up indicates that these funds may be designated a public interest entity in Croatia, Czech Republic, Italy, Latvia, Lithuania, Poland, Portugal, Romania and Spain.

However, if a UCITS is not set up for the specific purpose of investing for sustainability impact, any conflict between financial return and positive sustainability impact would need to be resolved in favour of financial return. In a "tie-break" scenario, a UCITS may – but is not obliged to – select the more sustainable option[64].

UCITS must also avoid undue costs. This could limit the ability of UCITS management companies to incur costs associated with investment, stewardship or other activities where the action does not clearly lead to increased financial return over the time horizon of the fund.

The April amendments provide greater clarity on sustainability risks but do not amend the principle of acting in the "best interests" of the UCITS and therefore do not increase the flexibility to invest for sustainability impact, nor establish a duty to do so.

Both the UCITS Directive and SRD II encourage stewardship activities but neither can be considered to establish a general duty to engage in order to deliver positive sustainability impacts. In both cases, choosing not to pursue stewardship activities is a permitted route where justified in line with the respective directive[65]. SRD II does not explicitly mention sustainability impact goals for investors. As such, stewardship can be undertaken where it is consistent with the interpretation of key investment duties (see the section on SRD II higher up).

INSURANCE UNDERTAKINGS (LIFE AND GENERAL/NON-LIFE)

The key investment **duties and powers** of insurance undertakings are set out in Solvency II, the Insurance Distribution Directive (IDD) and the regulation on key information documents for packaged retail and insurance-based investment products, or PRIIPs. These need to be considered alongside guidance issued by the European Insurance and Occupational Pensions Authority (EIOPA) regarding sustainability in Solvency II. Insurers must invest in accordance with the prudent person principle (PPP); the current level 1 text of Solvency II specifies that insurers must ensure the "security, liquidity and profitability of the portfolio as a whole" and only invest in assets for which they can properly identify, measure, monitor, manage, control and report any relevant risks.

Within the PPP, it may be prudent for an insurer, under certain conditions, to consider sustainability risks that could impact profitability or which could affect the underwriting risk. We note that for life insurance the time horizon is typically longer, leading to greater potential for issues such as climate change risks to be considered material.

The April 2021 amendments to Delegated Regulation (EU) 2015/35 state that insurers must take into account sustainability risks, as well as the potential long-term impact of their investment strategy and decisions on sustainability factors. Where relevant, the strategy and those decisions must reflect the sustainability preferences of customers identified through the product approval process.

As with pension funds, member states do not have the power to require insurance undertakings to invest in certain categories of assets.

In relation to the calculation of the "best estimate" relevant for the calculation of the value of technical provisions[66], insurers are required to take into account expected future developments – including social and environmental developments – that will have a material impact on the cash in- and out-flows required to settle their insurance obligations.

Under the IDD, insurance distributors have a duty to act "honestly, fairly and professionally in accordance with the best interests of their customers".

Also under the IDD, insurance undertakings must identify a target market for each product and may only market insurance products that are compatible with the needs of the target market. They are also required to regularly review the offering to ensure this compatibility is maintained. Amendments to the IDD made in April 2021 require these **processes** to take into account the sustainability preferences of the target audience.

Insurers may be subject to another form of fiduciary duty: the directors' duty of care under corporate law. Where such a duty of care exists under national corporate law, it might allow for the consideration of long-term or sustainability factors that could affect the company as a whole when taking business decisions (including investment decisions). There is currently no EU-wide provision for a directors' duty of care, although this is under consideration as part of the initiative on sustainable corporate governance.

64 The April 2021 amendments in the UCITS Delegated Directive could increase the pressure to select the option with positive sustainability impacts, but it is not totally clear that this is the case.

65 Under SRD II, firms deciding against stewardship choose the "explain" option. Under the UCITS Directive, managers may decide against stewardship where they can demonstrate that it is not in the exclusive benefit of the UCITS to cast votes – for example, when offering a very low-cost passive product.

66 Solvency II requires these to be "a best estimate of the current liabilities relating to insurance contracts plus a risk margin", as explained here.

EU law does not directly regulate **stewardship** for general insurers, and they do not fall into the scope of SRD II. However, life insurance firms are in scope and the same rules on stewardship apply to them as those that apply to IORPs.

Insurers are subject to various **disclosure** rules:

- Disclosure obligations regarding ESG risks and adverse impacts under the regulation on sustainability-related disclosures in the financial services sector (SFDR).
- Insurers fall under the scope of the NFRD, either by virtue of being listed companies and meeting the threshold for employee numbers, or where designated a public interest entity by the member state[67].
- The Taxonomy Regulation as part of the SFDR disclosure requirements.

ANALYSIS

The "best interest" in the context of Solvency II is generally understood to be financial, as it refers to the interest of an insurance company's beneficiaries in the fulfilment of their valid claims. The April 2021 amendments require insurers to take into account sustainability risks and the potential long-term impact of their investment strategy and decisions on sustainability factors. However, this does not confer a duty to invest for sustainability impact or to select the more sustainable option from several investment objectives. This is reflected in EIOPA's 2019 technical advice on the integration of sustainability risks and factors in delegated acts under Solvency II and the IDD, which clarifies that investors are not required to "make sustainable investments, to invest with impact or to accept lower risk-adjusted returns"[68].

As with pension funds, the objectives of "security", "quality", "liquidity" and "profitability" in Solvency II refer to the portfolio as a whole, so some flexibility to pursue sustainability impact objectives may be possible within the construction of an overall portfolio.

The April 2021 amendments also set an expectation for insurers to respond to customers' sustainability preferences – taken into account in the product approval process – in their strategy and investment decision-making. However, this duty is limited by use of the caveat "where relevant", reflecting the fact that only certain types of products are likely to offer the opportunity to pursue positive sustainability impacts. The amendments do not create a general duty to invest for sustainability impact.

As with IORPs, stewardship for positive investment impact is permitted where it does not conflict with insurers' overall legal duties (set out above).

There is no barrier in EU law preventing life insurers from creating new products that aim for a positive sustainability impact among other objectives. It is possible for an existing insurance contract to be amended subject to the consent of the policy holder and the applicable member state law.

INVESTMENT MANAGERS

An investment manager's investment **duties and powers** are shaped by:

- the terms of its contractual agreement with an asset owner (Investment Management Agreement, hereafter "IMA")[69];
- EU legislation;
- national law.[70]

Under Article 24(1) of MiFID II, an investment manager must:

- act honestly, fairly and professionally in accordance with the best interest of its clients;
- 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 (the "suitability test").

67 See the 2017 analysis.

68 See paragraph 115 of the EIOPA document.

69 This analysis is limited in its treatment of IMAs.

70 This analysis does not consider national law.

It is important to note that the "best interest" of clients will vary depending on the investment objectives and circumstances of the individual client. A particular action may be in the best interest of one client, but not another. This presents conceptual challenges because there is no general notion of acting in the best interest of a collective client base and "best interest" is determined on a client-by-client basis.

The April 2021 amendments[71] to MiFID II delegated regulation[72] will require investment firms to ask for a client's sustainability preferences and reflect these in investment objectives and the suitability assessment. However, any instrument meeting the client's sustainability preferences must also be consistent with the client's other investment objectives, including financial objectives. Fund managers may offer sustainability-focused funds even where no sustainability preference has been stated, as long as the product meets the overall suitability test.

Regarding stewardship, investment firms authorised under MiFID II are also in the scope of SRD II. Stewardship activities must be carried out in line with the broader investment duties set out above.

Investment firms are subject to various **disclosure** rules:

- Obligations on ESG risks and adverse impacts under the regulation on sustainability-related disclosures in the financial services sector (SFDR).
- Some investment firms fall under the scope of the NFRD, either by virtue of being listed companies and meeting the threshold for employee numbers, or where designated a public interest entity by the member state[73].
- The Taxonomy Regulation, as part of SFDR disclosure requirements[74].

ANALYSIS

There is no specific duty to invest for sustainability impact that applies to investment managers. Similarly, there is no explicit obligation to pursue stewardship. Engagement or voting activity must be carried out consistent with the overall duties and the terms of the IMA, which may vary depending on the fund.

Some flexibility may be possible regarding investors taking such actions in pursuit of sustainability impact goals, but this must be understood in relation to the client (asset owner) that the fund manager is serving.

The investment manager's freedom to pursue sustainability impact objectives is limited by the terms of the IMA. Where the IMA does not contain specific sustainability impact objectives, the reference point for the fund manager is the duties of the asset owner – if the asset owner has more flexibility, the fund manager can reflect this.

As above, it is important to note that the "best interest" of clients will vary depending on the investment objectives and circumstances of the individual client. A particular action may be in the best interest of one client, but not another.

As with other types of investors, the SFDR disclosure obligations do not modify the core duties. The SFDR introduces a requirement (on a comply-or-explain basis, moving to mandatory for larger firms) to document a due diligence process regarding adverse sustainability impacts, as well to make disclosures against key performance indicators.

The interaction between the SFDR and fund managers' duties is somewhat contradictory:

- The SFDR is a disclosure framework, although some of the elements do infer a behavioural obligation. By setting an expectation for firms to document a due diligence process, the SFDR may infer that this is broadly consistent with an investment manager's duties. However, it does not require any firm to modify its investment decisions or stewardship behaviour to mitigate adverse sustainability impacts. As such, changes in investment behaviour would need to be justified in line with the "best interest" of clients.
- As noted above, the "best interest" is determined on a client-by-client basis. An action may be consistent with the duties owed to one set of clients, but not to another, leading to a situation where adverse impacts are managed in one fund but not another.

71 Commission Delegated Regulation (EU) 2021/1253 modifies Delegated Regulation (EU) 2017/565 in two ways: (1) it introduces a client's sustainability preferences as a top-up to the suitability assessment and (2) it integrates sustainability risks into organisational requirements.

72 Commission Delegated Regulation (EU) 2017/565 supplements Directive 2014/65/EU of the European Parliament and of the Council (MiFID II) by further specifying organisational requirements and operating conditions for investment firms.

73 See the 2017 analysis.

74 The Taxonomy Regulation complements the SFDR. See the PRI's SFDR investor briefing updated in February 2022.

Finally, the amended suitability assessment can be used to encourage greater adoption of sustainable products. The amended assessment will increase the amount of information investment managers hold regarding clients' sustainability preferences[75] and strengthen the consideration of sustainability in investment management and advice. However, this does not constitute a duty to invest for sustainability impact. Clients are not required to hold or express a sustainability preference – where they do not hold a preference, suitability will be determined with reference to the asset owner's general duties (i.e., a product that violates the prudent person principle cannot be considered "suitable"). As such, the evolution of asset owners' duties is important to investment managers.

75 Commission Delegated Regulation (EU) 2021/1253 amended 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. The client's sustainability preferences were included in the suitability assessment. "Sustainability preferences" covers financial instruments that are invested, at least to some extent, in taxonomy-compliant activities under the Taxonomy Regulation or in sustainable investments – as defined in Article 2, point (17), of the SFDR – which also encompass taxonomy-compliant activities, and instruments that consider principal adverse sustainability impacts of investments.

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ABOUT THE PROJECT

A Legal Framework for Impact is a flagship project of the Principles for Responsible Investment, the United Nations Environment Programme Finance Initiative and the Generation Foundation. The project is part of the Investment Leadership Programme, a joint initiative between the Principles for Responsible Investment and the United Nations Environment Programme Finance Initiative, created to accelerate collaboration among leading investors and boost action on achieving key global sustainability objectives. The project aims to identify and overcome the barriers to a financial system that is consistent with achieving the Sustainable Development Goals and limiting global warming to 1.5°C. Freshfields Bruckhaus Deringer were commissioned to produce a report on the extent to which legal frameworks in 11 jurisdictions enable investors to consider the sustainability impacts of their activities. The report provided the first comprehensive analysis of how far the law requires or permits investors to tackle sustainability challenges in discharging their duties – a practice called "investing for sustainability impact" or IFSI. The project is a multi-year work programme and is now focused on five key markets: Australia, Canada, Japan, the European Union and the UK.

ABOUT THE PROJECT PARTNERS

The Principles for Responsible Investment (PRI) works with its international network of signatories to put the six Principles for Responsible Investment into practice. Its goals are to understand the investment implications of environmental, social and governance (ESG) issues and to support signatories in integrating these issues into investment and ownership decisions. The PRI acts in the long-term interests of its signatories, of the financial markets and economies in which they operate and ultimately of the environment and society as a whole. The six Principles for Responsible Investment are a voluntary and aspirational set of investment principles that offer a menu of possible actions for incorporating ESG issues into investment practice. The Principles were developed by investors, for investors. In implementing them, signatories contribute to developing a more sustainable global financial system. More information: www.unpri.org

The Generation Foundation is a UK registered charity and was established alongside Generation Investment Management LLP, the sustainable investment firm founded in 2004. Its vision is an equitable society in which global temperature rises do not exceed 1.5°C. In pursuit of this, the Foundation operates a proactive grant-making and research programme that focuses on four priority areas: investor climate action; carbon pricing; gender inclusion and empowerment; and action on economic inequality. For further information, please visit www.genfound.org

United Nations Environment Programme Finance Initiative (UNEP FI) is a partnership between UNEP and the global financial sector to mobilise private sector finance for sustainable development. UNEP FI works with more than 400 members – banks, insurers and investors – and over 100 supporting institutions – to help create a financial sector that serves people and the planet while delivering positive impacts. UNEP FI aims to inspire, inform and enable financial institutions to improve people's quality of life without compromising that of future generations. By leveraging the UN's role, UNEP FI accelerates sustainable finance. https://www.unepfi.org/about/