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LEGAL FRAMEWORK FOR IMPACT: BRIEFING FOR POLICY MAKERS

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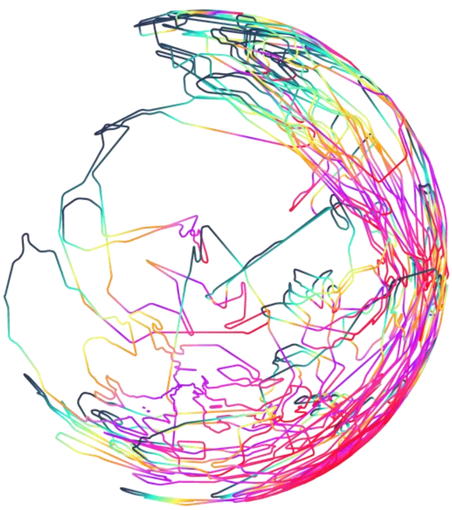

WHY DOES INVESTING FOR SUSTAINABILITY IMPACT MATTER?

Financial investments drive real-world outcomes on issues such as climate change, sustainable development and human rights – whether the impacts are intended or not. Investors increasingly recognise that financial returns depend on the stability of social and environmental systems, especially in the long term. This is driving investors to increasingly focus on what they can do to improve sustainability outcomes and contribute to global and national sustainability goals.

Investments are not sufficiently aligned with global sustainability goals – including those set out in international treaties such as the Paris Agreement and the Sustainable Development Goals (SDGs) – for targets to be met. Consequently, investment portfolios remain exposed to sustainability risks – including system-level risks.

Investors sometimes need to address sustainability impacts in order to manage ESG risks and opportunities that affect financial returns for clients and beneficiaries – particularly when sustainability impacts cause system-level risks. However this is often overlooked in mainstream investment practice.

To address this, investors need to increase the positive impacts, and decrease or eliminate the negative impacts, of their investments.

WHAT IS THE LEGAL FRAMEWORK FOR IMPACT PROJECT?

A Legal Framework for Impact, authored by Freshfields Bruckhaus Deringer and commissioned by the PRI, UNEP FI and the Generation Foundation, is a ground-breaking legal study on whether the law in 11 jurisdictions around the world **permits** or even **requires** investors to tackle some of the world's most urgent sustainability challenges, by setting and pursuing sustainability impact goals.

Building on the findings of the initial study, the broader *Legal Framework for Impact* project is now working on tailored policy recommendations and investor action in five jurisdictions: Australia, Canada, EU, Japan, and UK to support investors to invest for sustainability impact.

WHAT IS INVESTING FOR SUSTAINABILITY IMPACT?

While ESG incorporation focuses on how investors manage the effect of ESG risks and opportunities on their portfolios, investing for sustainability impact (IFSI) goes beyond this to deliberately target sustainability outcomes in the real world. The concept is used in *A Legal Framework for Impact* to describe any activities that involve an investor intentionally attempting (through investment decisions, stewardship or engagement with policy makers) to bring about assessable behavioural changes – among investee companies, policy makers or other third parties – that are aligned with positive sustainability outcomes.

A Legal Framework for Impact distinguishes between two types of investing for sustainability impact, based on the investor's objectives:

- *instrumental IFSI* – where achieving the relevant sustainability impact goal is part of realising the investor's financial return objectives;
- *ultimate ends IFSI* – where achieving the relevant sustainability impact goal is a distinct goal, pursued alongside the investor's financial return objectives.

WHAT ARE THE KEY FINDINGS OF *A LEGAL FRAMEWORK FOR IMPACT*?

- While financial return is generally regarded as the primary purpose and goal of investors, investors are likely to have a legal obligation to consider pursuing sustainability impact goals where doing so can contribute to achieving their investment objectives.
- In some circumstances, investors can pursue sustainability goals for reasons other than achieving financial return goals – i.e. in parallel to them. Investors are legally required to pursue sustainability impacts if they have committed to in the stated objectives of the financial product.
- Pursuing sustainability impact goals does not mean deprioritising an investor's financial purpose and objectives. On the contrary, in some cases investors *need* to address sustainability impacts in order to protect or enhance financial returns.
- Stewardship, asset allocation and policy engagement by investors are vital tools for investors seeking to improve sustainability impacts, and collaboration between investors is likely to make pursuing sustainability impact goals through stewardship activities both more efficient and more likely to succeed.

WHY DO WE NEED POLICY REFORMS?

Mitigating system-level risks and delivering on sustainability goals committed to by governments, such as Paris Agreement goals on climate change and the SDG's, relies on improving the sustainability outcomes of investments. Investors are increasingly seeking to understand and improve sustainability impacts, but they cannot do so without support from policy makers.

Investors face a range of impediments to accelerating action on sustainability goals:

- Investors are discouraged by uncertainty about what the law requires or permits. They need greater clarity, consistency and guidance.
- Backward-looking interpretations of legal standards exacerbate inertia, are out of step with trends in leading investment practice and impede innovative approaches to investing for sustainability impact.
- Most sustainable finance policy regimes (including disclosure rules, product standards, sustainable taxonomies and stewardship codes) don't sufficiently facilitate investing for sustainability impact.

Policy reforms are essential to facilitate investing for sustainability impact and to overcome barriers to action, while ensuring a level playing field for market participants.

RECOMMENDATIONS FOR POLICY MAKERS

The solutions proposed by the *Legal Framework for Impact* project provide the robust foundations required for investors and policy makers to enable investing for sustainability impact to become a core part of mainstream investment activity. Policy reforms should address both the legal duties investors are subject to and the circumstances in which those duties are applied, which includes sustainable finance policy frameworks and standards.

CLARIFY INVESTORS' EXISTING LEGAL DUTIES

1. Update standards and guidance to clarify when investors' legal duties enable or require them to considering pursuing sustainability impact goals.
2. Update standards and guidance to clarify that purpose-related requirements (sometimes described as a duty to act in the "best interests" of clients or beneficiaries) may entail consideration of sustainability impact goals.

ENSURE SUSTAINABLE FINANCE POLICIES FACILITATE INVESTING FOR SUSTAINABILITY IMPACT

3. Adopt comprehensive corporate sustainability disclosure frameworks which meet the needs of investors seeking to understand material sustainability risks, opportunities and impacts.
4. Ensure that sustainability disclosure and labelling regulations address not only integration of ESG risks, but also how investment entities and products assess sustainability outcomes, set sustainability impact goals and take steps to contribute to positive sustainability impacts.
5. Create and implement sustainable taxonomies to help investors understand and promote economic activities that are environmentally and socially sustainable.
6. Strengthen regulatory support for effective and accountable stewardship, including for using stewardship powers to address sustainability risks and sustainability impacts.
7. Support collaborative action by investors seeking to improve sustainability outcomes. Provide regulatory guidance to ensure that sustainability-related collective action by investors does not fall foul of anti-trust rules, including considering establishing a safe harbour where required.
8. Explore ways to enable investors to take client and beneficiary sustainability preferences into account in their asset allocation and stewardship activities.
9. Establish corporate due diligence requirements to ensure that negative sustainability impacts are identified and addressed, ensuring coherence with international standards including the UN Guiding Principles on Business and Human Rights and the OECD Guidelines for Multinational Enterprises.

GET IN TOUCH WITH US

The ***Legal Framework for Impact*** **project is regularly engaging with policymakers and regulators.** To understand how you can support investors to invest for sustainability impact and help meet societal goals, take a look at the resources below and get in touch with a member of the team.

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RESOURCES

KEY RESOURCES

A Legal Framework for Impact report, authored by Freshfields Bruckhaus Deringer

JURISDICTION-SPECIFIC POLICY REPORTS

- European Union
- Australia
- UK
- Canada
- Japan [coming, May 2023]

FURTHER RESOURCES

- A toolkit for sustainable investment policy and regulation
- Active Ownership - Active Ownership 2.0 is a framework for the more ambitious stewardship needed to deliver against beneficiaries' interests and improve the sustainability and resilience of the financial system.
- Review of trends in ESG reporting requirements for investors
- Advance – a stewardship initiative where institutional investors work together to take action on human rights and social issues.
- Sustainability outcomes: what does our reporting data reveal about emerging signatory practices?
- The investor case for responsible political engagement
- Why and how investors should act on human rights
- Closing the loop: responsible investment and the circular economy

CONTACT US TO LEARN MORE

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