CENTRE FOR CLIMATE ENGAGEMENT
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Summary Report: Investors’ fiduciary duties and systemic climate risks

Centre for Climate Engagement

Introduction

Climate change threatens the global economy on which investors and their beneficiaries rely. Investment strategies should, where relevant, account for how specific businesses and industries are exposed to climate change. However, the risk to investors from the potential for climate change to damage economic systems cannot be avoided in this way. It poses a more challenging question: should investors seek to address this risk at its source by contributing to wider efforts to tackle climate change and, if so, how? Where investors’ investment goals are threatened, fiduciary duties provide a legal basis for investor action in this area – but determining the best way to act is more challenging. There is also a related question of how to maximise the impact of activity of this sort by through a sector-wide transformation in investor behaviour.

This report draws on the final discussion in a series of three roundtables organised by the Centre for Climate Engagement and hosted at Clyde & Co. It gives a brief outline of some issues discussed in a conversation focused on the link between investors’ legal duties and climate risks to economic systems, key barriers to investors’ ability to navigate these issues, and potential ways forward. ‘Investor’ in the context of this report refers principally to asset owners managing portfolios to generate financial returns for their beneficiaries, with a particular focus on those with diversified portfolios. It is also relevant to their investment managers, but recognising that investment managers’ duties are derived from their relationship with their client asset owners. This report considers issues which are similar across much of the world, but differences in legal frameworks mean that applications may vary by jurisdiction.

The link between fiduciary duties and climate change

Investors generally have a legal duty to balance risk and return in pursuit of financial returns for their beneficiaries. It is increasingly clear that sustainability factors can create risks that are relevant to that goal. Consequently, investors are likely to be under a duty to consider whether their goals could be affected by risks of this sort and, if so, what they should do about it.

Very broadly, two types of climate risk could be relevant – what can be called ‘institution-specific' risks, and systemic risks. Institution-specific risks concern climate impacts on specific investments, for example potential decreases in a fossil fuel company’s financial performance from the introduction of climate regulations. It is relatively uncontroversial that investors need to take appropriate account of risks of this sort. The second

category of risks relate to broader implications of climate change. The climate crisis not only poses a challenge to sectors and businesses which are most exposed to climate impacts, but to the performance of the global economic system on which much portfolio growth depends. Investors are not able to 'diversify away' from risks of this sort, as they might in trying to manage institution-specific risks. Projections suggest global GDP losses from unmitigated climate change could amount to trillions of US dollars.[1] This suggests that investors' financial goals will be best served by societal success in addressing climate risks. Since asset management is a social activity, it also suggests that investors are likely to have role in supporting that process.

A major cross-jurisdictional legal survey commissioned by the UNEPFI and others and published by Freshfields in 2021, *A Legal Framework for Impact*, found that investors' legal duties generally give them discretion to do just that by seeking to bring about positive sustainability outcomes.[2] More recently, in the UK, The Financial Markets Law Committee has set out a similar position in the context of pension funds, arguing that funds can consider systemic risks in keeping with their duties.[3]

Investment levers for driving climate action

Broadly speaking, three avenues suggest themselves as ways in which investors may be able to have an influence on climate change.

Investment and divestment

Investors may be able to facilitate the net zero transition by investing in companies with positive environmental credentials, and divesting from companies which are not doing enough to reduce their impact on climate change. Here, it is important to distinguish between decisions which aim to address institutional risks and those which aim to address systemic risks. In divesting from a company or industry to address institutional risks, investors would consider that investment's *exposure* to climate risk or associated opportunities. Divestment to address systemic risks aims to actively address climate change by seeking to encourage improved climate performance on the part of the issuer, for example, by strengthening voice in corporate engagement (see below) or contributing to an increase in the cost of capital. Divestment on its own is unlikely to shield investors from systemic risks. Of course, these considerations may align – for example, industries with a significant impact on climate change tend to also

[1] See e.g. 'The global economic cost of climate change inaction', Oxford Economics (2022). Link.
[2] 'A Legal Framework for Impact: Sustainability Impact in Investor Decision-making, Freshfields Bruckhaus Deringer 2021, commissioned by Principles for Responsible Investment, UN Environment Programme Finance Initiative and Generation Foundation (2021). Link.
[3] 'Pension Fund Trustees and Fiduciary Duties – Decision-making in the context of Sustainability and the subject of Climate Change', Financial Markets Law Committee (2024). Link.

face the highest regulatory and policy risks. A climate-risk aware investment strategy could be expected to consider both classes of climate risk.

Shareholder engagement

Investors can use their position as investors (for example, their capacity as shareholders) to advance climate goals within companies. Shareholders may engage with company management in an informal way, but they can also engage more actively through a 'forceful stewardship' strategy.[4] This could include voting on climate-related shareholder resolutions or, more aggressively, voting against the reappointment of directors on climate grounds. In certain circumstances, shareholders can also bring litigation against corporate boards. This occurred in ClientEarth's unsuccessful derivative action brought against Shell's board of directors for breach of their duties under the Companies Act.[5] However, given significant barriers to derivative actions and the existence of less adversarial and costly governance processes, this type of litigation is unlikely to be top of mind for the vast majority of investors.

Engagement with policymakers and other change-agents

Investors can influence climate action beyond the scope of their own portfolio through public policy engagement and working with others in a position to stimulate change. Investors may aim to reform finance-focused policies but can also advocate for broader climate policies. This type of engagement can take many forms – including publicly signalling support for certain policy measures, responding to government consultations, or engaging with technical working groups. In addition to national and subnational governments, investors may engage with a diverse range of organisations including standards-setters and international organisations.

Trade-offs

Investors can utilise all of these strategies. They may need to consider using them simultaneously or to choose between them in certain circumstances. For example, they may need to decide whether to use their power as a shareholder to steward the company towards more sustainable choices or whether the time has come to divest from a company with poor environmental credentials. More practically, investors will need to decide on the most efficient use of their time and resources in order to make the largest impact on climate change.

[4] 'Universal Ownership in Practice: a practical investment framework for asset owners', Ellen Quigley (2020). Link.
[5] *ClientEarth v Shell's Board of Directors* [2023] EWHC 1897 (Ch). Link.

The optimal lever will likely vary based on context. For example, evidence suggests that the use of investment powers may be more effective in bringing about positive change in primary markets when compared to secondary markets, where shareholder engagement may be more effective.[6] In some circumstances, evidence has also indicated that public policy engagement may be more effective than engaging directly with companies.[7]

The law does not provide a simple roadmap for what an investor should do in every situation – the decisions facing them will be complex and situation-dependent. However, legal duties do give investors reason to grapple with them.

Barriers to action

Despite the financial grounds for addressing climate change in seeking to discharge legal duties, there is still a sense that the response of many investors and their investment managers has been muted. Numerous factors may be at play – investors may simply not have appreciated how their duties could apply in the context of the kind of risks outlined above, for example because they are more focused on nearer-term financial returns. That could reflect a narrow understanding of the relevant legal duties and the financial impacts of climate change. Another factor could be (actual or perceived) failures in the regulatory environment to facilitate this approach. However, even assuming a broad consensus on the importance to financial returns of addressing systemic climate risks, practical barriers to action remain. Three key challenges are listed below.

Aligning climate ambitions with current realities

Most climate ambitions – for example the UNFCCC's goal of limiting warming to 1.5C° above pre-industrial levels, or national targets to reach net zero greenhouse gas emissions by a certain year – aspire towards a future in which the world has tackled, or at least significantly mitigated the damage caused by, climate change. However, it is clear that the world is not on track to meet many, and possibly even most, of these shared ambitions.[8] This poses a challenge to investors. In an ideal world, investors' strategies might align with what is necessary to achieve climate targets of this sort to the extent they coincide with investors' financial interests over the relevant timeframe. Yet, investors also have to operate in the world 'as it is': their decision making must also account for the current environment, where day-to-day market activity is not necessarily aligned with many climate goals.

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[6] Quigley (n 4).
[7] Ibid.
[8] See e.g. 'Climate Plans Remain Insufficient: More Ambitious Action Needed Now', UNFCCC (2022). Link.

There is therefore a potential disconnect between investing to create the world investors need and investing in the context of the world we have today.

This is a difficult balancing exercise for investors but is not unfamiliar – meeting the needs of the present without compromising the ability of the future is, after all, the definition of sustainable development.[9]

Failure to connect individual action with systemic change

Financial institutions wield significant power, but even the actions of large and influential financial actors may not measurably move the needle in terms of reducing systemic risks from climate change. Investors may therefore fail to see how their actions are a necessary part of achieving that goal. Of course, in the aggregate the activities of those in financial markets *can* make a difference that is not only significant, but necessary to the net zero transition.

Collective action problems are not novel – it may seem obvious that investment professionals should, in unison, leverage their power to tackle the systemic threats to them from climate change despite the relatively small impact of individual acts. However, there are also pressures to prioritise decisions with discrete, more easily measurable financial outcomes. The law may prompt investors to address systemic climate risks, but it is clear that other factors, such as incentives and culture, will be important to shifting investor behaviour in this area.

Difficulty in deciding between specific actions

Acknowledging that legal duties may lead investors to address the systemic threats from climate change is much simpler than determining how they should do this. What steps are the most appropriate, are the necessary frameworks and methodologies available, how can investors best measure the climate impact of those they wish to influence and how it is changing, and how are investors to understand whether their activities are making any difference? Do investors have the information they need?

Even in retrospect, understanding the impact of decisions to act may be difficult given the often complex causal link between investor behaviour and emissions-reducing activity. These issues do not justify inaction, but underline the importance of considered, evidence-based investment strategies.

[9] Sustainable development was defined this way in 1987 by the United Nations Brundtland Commission.

Charting a path forward – key areas for change

The issues outlined above are not easy to navigate. However, investors may need more if they are to grasp how their activities have the potential to assist in tackling systemic threats that are relevant to them, and to understand how best to act. The section below highlights a few broad examples of possible ways forward. However, developing a set of priority actions would require a deeper and more expansive analysis.

Creating and leveraging cultural change

Revisiting the mental frames that investors apply in deciding how to discharge their duties is a good place to start - socialising the idea that investors have an interest in reducing systemic climate risks where these impinge on their financial goals, and that their duties do not present a barrier to appropriate action. Many credible institutions and individuals have already highlighted the link between investors' legal duties and the need to tackle climate change risk, though there may be further scope for investor groups, including net zero coalitions, to emphasise the connection.

Investors who recognise how climate change impacts their core duties may be more likely to utilise and contribute to relevant resources and collaborations. Nongovernmental organisations have published guidance on which investors can draw when creating a climate strategy. Pooling of know-how between investors may also be important to identifying and sharing best practice and cultivating the necessary change. The Transition Plan Taskforce, for example, has gathered expertise from asset owners and others to publish reports, methodologies, and tools which can support investors in their climate transition. Investors that understand the importance of mitigating systemic risks, and have the knowledge and tools to consider how these risks may impact difficult decisions, will be better equipped to shift their investment and engagement practices.

Law and policy reform

Although there is a strong case that existing legal obligations do not present a barrier to investors looking to address systemic climate risks that impact on their financial goals, in some jurisdictions law and policy reform may help facilitate change at the necessary scale and pace. There may be scope to go further in recognising the link between environmental factors and fiduciary duties in some legal frameworks, as is the case with regards to directors' fiduciary duties the UK's Companies Act.[10] Alternatively, financial regulators may publish guidance explaining this legal position, which is generally a quicker process than reforming legislation. Such policy

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[10] Section 172(1)(d)

developments could be informed by the expertise and experience of investors, who could be encouraged to engage in relevant policy processes such as government consultations.

Policy attention to areas relevant to the outworking of investors' duties in tackling climate risks is also important. For example, sustainability reporting and disclosure requirements imposed on companies can provide better climate-related information to support investment decisions and corporate engagement, though some have questioned the efficacy of such measures.[11] Similarly, competition regulators have a role – the European Commission[12] and the UK's Competition and Markets Authority[13] have introduced guidance that affirms the scope for collective action on climate risk, an approach which could be adopted in other jurisdictions. Broader climate policies such as carbon pricing and subsidies for green technologies can, of course, also incentivise investors to make decisions that address climate risks by aligning financial considerations with the green transition. A large number of other policies might have some relevance to the issues discussed in this report, and this number is likely to grow as governments continue to introduce measures which aim to reduce emissions.

Litigation

Investors can be both claimants and defendants in climate-related litigation, including claims focused on fiduciary duties. As shareholders, investors may be able to bring claims against company directors for breach of their fiduciary duties – however, as described above, these claims are unlikely to be the first option for most investors seeking to create change.

In terms of investors' own exposure to litigation, rather than a sword used by potential claimants, fiduciary duties may instead be more powerful as a shield. Demonstrating the link between systemic climate risks and the long-term performance of a portfolio could deter those advocating for a more short-term focus.

It is possible, though, that investors face litigation from their beneficiaries. This was the case in *McVeigh v Rest*,[14] an Australian case in which a beneficiary claimed that a superannuation fund had breached its legal obligations by failing to provide information on climate risks and plans to address them. The parties in *McVeigh* reached a settlement, though this case rested on specific statutory obligations rather than fiduciary duties. In the UK, *McGaughey v USS* was an unsuccessful attempt to bring a derivative action by the beneficiary of a pension

[11] 'Revisiting the Relation between Environmental Performance and Environmental Disclosure: An Empirical Analysis', Peter Clarkson, Yue Li, Gordon Richardson and Florin Vasvari (2008).
[12] 'Guidelines on the Applicability of Article 101 of the Treaty on the Functioning of the European Union to Horizontal Co-operation Agreements', European Commission (2023). Link.
[13] 'Guidance on Environmental Sustainability Agreements', Competition and Markets Authority (2023). Link.
[14] *McVeigh v Retail Employees Superannuation Trust* NSD1333/2018

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scheme against its trustee directors, rather than a claim for breach of common law fiduciary duties.[15] Nonetheless, the claim was unsuccessful and indicates barriers to successful litigation on these grounds.[16]

Stronger evidence bases

To make difficult decisions in the face of systemic climate risk, investors need to draw on relevant and accurate evidence. As outlined, there is already a significant evidence base on the financial impacts of climate change, but more granular studies, including into impacts on particular types of portfolios, may bolster the case for investors to address these risks. Research into the impact of steps that investors take to address climate change may be more important. Existing evidence has, for example, shown that voting against the election of directors can be a particularly powerful way of effecting change within companies.[17] Further research on key levers for change could give investors greater confidence to navigate these problems. Investors may not only draw from research but can also play a key role in socialising these outcomes and even contribute to the evidence base themselves.

Conclusion

Even where the financial benefit from successfully addressing climate risks to economic systems and associated legal duties are clear, aligning investor behaviour with that, individually and across markets, is no small task. The issues discussed in this report indicate both the complexity of the challenge and the diversity in potential solutions. It is clear that this transformation will require widespread and collaborative efforts not only from investors, but also from governments, researchers, companies, and many other stakeholders.

[15] *McGaughey & Davies v Universities Superannuation Scheme Limited* [2023] EWCA Civ 873
[16] There is some evidence to suggest that climate litigation may have an impact on defendants upon filing even if ultimately unsuccessful, but this effect has only been observed on the value of oil and gas majors. 'Impacts of Climate Litigation on Firm Value', Misato Sato, Glen Gostlow and Catherine Higham (2023). Link.
[17] 'Climate Votes: The Great Deception: an assessment of asset managers' climate votes in 2023', Agathe Masson (2023). Link.