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Can investors save the planet? NZAMI and fiduciary duty

Tom Gosling and Iain MacNeil*

Key points

- Asset manager signatories of the Net Zero Asset Manager Initiative, part of the Glasgow Financial Alliance for Net Zero, have committed to investing in line with the Race to Zero goal of limiting global warming to 1.5°C with limited or no overshoot.
- Given that a recent report from United Nations Environment Programme says that there is ‘no credible pathway’ in place to 1.5°C, we explore the implications for asset managers, as fiduciaries, of investing in line with a climate scenario that might now be considered an unlikely future outcome.
- We assess common ‘net zero aligned’ investment strategies such as portfolio decarbonization, tilting, active ownership, ESG integration and impact investing by reference to considerations of fiduciary duty and real-world efficacy at combatting climate change.
- We find that the more likely a strategy is to deliver real-world change in carbon emissions in line with the 1.5°C goal, the more likely it is to give rise to fiduciary concerns. Although these fiduciary concerns are unlikely in most cases to give rise to enforceable legal liability, it is likely that many asset managers, when applying an expected standard of fiduciary duty, will conclude that such strategies are not consistent with that duty in the absence of an explicit authorizing mandate from clients. As a result, the strategies most likely to be adopted are also the least likely to contribute meaningfully to addressing climate change.
- We set out ways in which the commitments could be reframed so as to maximize real-world impact of the initiative in the fight against climate change while avoiding conflicts with the fiduciary duties of signatories. Key to this is aligning commitments to a more realistic climate scenario than 1.5°C with limited or no overshoot.

1. Introduction

The battle against climate change is widely recognized as being amongst the most important challenges facing society. All of us are being asked to play our part, and that includes business and the financial sector. In a show of dedication to the cause, a group of banks, asset owners, asset managers and insurers famously came together at COP26, convened by Mark Carney, to announce the formation of the Glasgow Financial Alliance for Net Zero (GFANZ). The boldness of the claim made at its launch was striking:¹

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1 ‘Amount of finance committed to achieving 1.5°C now at scale needed to deliver the transition’ <<https://www.gfanzero.com/press/amount-of-finance-committed-to-achieving-1-5c-now-at-scale-needed-to-deliver-the-transition/>> accessed 7 February 2023.

Today, through the Glasgow Financial Alliance for Net Zero (GFANZ), over \$130 trillion of private capital is committed to transforming the economy for net zero. These commitments, from over 450 firms across 45 countries, can deliver the estimated \$100 trillion of finance needed for net zero over the next three decades.

The commitment was in fact even more ambitious than this because the commitment was not just to align finance with net zero in 2050. Through their alignment with Race to Zero, signatories pledged to 'align their investments' with the much more challenging goal of limiting global warming to 1.5°C with limited or no overshoot.

One of us has written elsewhere² that this commitment presents a potential conflict with the fiduciary duty financial institutions owe to their clients, for the following reasons. There is now only a remote possibility of limiting global warming to 1.5°C with limited or no overshoot, with warming of 2°C or more now much more likely.³ How, then, can an investment strategy targeted at the former scenario also be optimal for the latter? Surely such a strategy would result in either: capital allocation that over-invests in companies that will benefit from a rapid decarbonization and under-invests in companies benefiting from a slower transition (in particular fossil fuel-dependent industries); or engagement strategies that push investee companies to change their business models to a degree and at a pace that is not commercially optimal for them if, as expected, the 1.5°C pathway is not met.

The economic differences between the scenarios are not small. As a simple example, a 2°C pathway allows an estimated two-thirds greater consumption of oil and gas before hitting net zero than is the case under 1.5°C.⁴ As a result, many industries, including energy, industrial processes, construction and food, will require much more dramatic change in the more ambitious scenario.

We have recently seen tensions play out in the banking sector. Quite reasonably, given the science, Race to Zero confirmed in the summer that a rapid phase-out of coal financing was required to have any chance of meeting the 1.5°C goal. Banks, in particular US banks, demurred, refusing to pass up on profitable financing opportunities in a world where governments are largely allowing coal to remain part of the energy mix for years to come.

It should be said that GFANZ signatories have been clear that their commitments are contingent on government action to introduce policies consistent with the 1.5°C goal.⁵ These have not been forthcoming so arguably signatories are off the hook. This may be the technical reality, but at the very least this creates a perception problem for the industry, as it suggests that the commitment was not quite as radical as it was made out to be. It also leaves open the question of the status of the GFANZ commitments in these circumstances. Clients deserve clarity on these issues, whatever their views on the appropriate response to

2 'Trouble ahead for GFANZ' <<https://www.tom-gosling.com/blog/trouble-ahead-for-gfanz>> accessed 7 February 2023.

3 See, for example, 'Climate change: No 'credible pathway' to 1.5C limit, UNEP warns' <<https://news.un.org/en/story/2022/10/1129912>> accessed 7 February 2023.

4 Dan Welsby, James Price, Steve Pye, and Paul Ekins, 'Unextractable fossil fuels in a 1.5°C world' (2021) 597 Nature 230–4 <<https://www.nature.com/articles/s41586-021-03821-8>> accessed 7 February 2023.

5 See GFANZ commitments in Section 4 of this article.

climate change. And it still leaves open the question of whether a GFANZ signatory is in breach of their fiduciary duties if, without explicit client consent, they do authentically pursue the 1.5°C goal that, on the face of it, they signed up to.

In this article, we dig into the considerations of fiduciary duty a little more deeply, looking at how the duties of investors and corporate boards interact when addressing the issue of climate change. The considerations vary depending on what type of financial activity is being considered. To bound the discussion, we focus here on asset managers. These have their own GFANZ-affiliated subgroup: the Net Zero Asset Managers Initiative (NZAMI) with its own set of commitments specific to that industry. At the end of the article, we consider briefly how our findings may translate or differ for asset owners, banks and insurers.

In summary, we find that asset managers are likely caught between a rock and a hard place. They will either follow through with vigour on the commitments that, on a face value basis, they have made, but at the very real risk of being in breach of their fiduciary duties to clients. Or they will act consistently with their fiduciary duties but at the risk of achieving very little in the fight against climate change and so being accused of greenwashing. In practice, the former risk may be uppermost in the minds of asset managers, but the latter may be the most likely to lead to successful legal action. We conclude that NZAMI either needs to reframe its objectives in a way that aligns with the business models of many of its members or needs to accept an inevitable decline in its signatory base.

2. Arguments made in favour of investing in line with 1.5°C

A number of arguments have been advanced as to why investment action to align with 1.5°C is in fact consistent with an asset manager's fiduciary duty. We do not cover them in detail here because they have been extensively discussed by one of us elsewhere.⁶ The arguments can be summarized as follows:

- Governments could accelerate action to hit 1.5°C with no or limited overshoot. But based on evidence to date, this seems more an article of faith than a view that is consistent with the prudent person rule.
- Climate is a systemic risk and mitigating it improves risk-adjusted returns at the portfolio level. True, but the optimal trade-off for *financial* risk-adjusted returns is likely to be considerably higher warming than 1.5°C, as this target incorporated many factors that are inevitably ignored by financial markets, including just transition and non-financial aspects of our environment and lifestyle.
- Clients are interested in factors beyond financial returns, including the liveability of the planet. True, but collective action problems mean that clients do not get to choose a clear trade-off between financial returns and climate outcomes. Moreover, the interests of rich world clients and beneficiaries are not necessarily aligned with the global interests taken into account in setting the 1.5°C goal.
- Governments around the world have signed up for the Paris agreement, which creates a democratic mandate for action. True, but governments are interpreting Paris in different ways and generally not as 1.5°C with no or limited overshoot. Moreover, fiduciary duty is owed to specific clients and beneficiaries and not the electorate in general (unless the law is changed).

⁶ 'Trouble ahead for GFANZ' <<https://www.tom-gosling.com/blog/trouble-ahead-for-gfanz>> accessed 7 February 2023.

That article concluded that: ‘In summary, none of these arguments seems to resolve signatories’ emerging problems with fiduciary duty. The only fiduciary duty cover seems to be extremely clear and informed client mandates that support investment aligned with a 1.5°C scenario, regardless of the likely trajectory towards 2°C, and regardless of the costs of this approach for clients. It seems implausible that asset managers will be able to get this clarity for anything other than a minority of the assets they manage.’

In this article, we explore the arguments relating to fiduciary duty by reference to particular investment strategies that could be considered to be ‘aligned with 1.5°C’. We take as a starting point the fact that investors cannot through their actions inevitably force the world onto a 1.5°C path. To a significant degree, investors will have to take the scenario they get rather than defining it themselves, and investment risk needs to be seen in that context. On the other hand, NZAMI commitments imply that investment activity can have at least some impact on real-world outcomes. So, that is also important when considering whether asset managers are meeting their obligations to clients.

3. Fiduciary duty context

It is not the purpose of this article to undertake an extensive or fundamental review of the basis of fiduciary duty as it applies to the investment industry or companies. Excellent reviews exist elsewhere, which we draw upon here.⁷ Our aim is to articulate the key issues for practitioners and policymakers in a comprehensible way with particular reference to the question of whether being a signatory of NZAMI creates fiduciary complications.

Asset managers

Starting with asset managers, in very high-level summary the duties required can be set out under three headings:

- *The purpose of the investing activity*: This will be set out in the asset manager’s fund prospectus or their mandate from an asset owner client.⁸ In most jurisdictions, unless explicitly stated to the contrary, the primary purpose of investing activity is understood as optimizing financial returns, within acceptable risk levels, over the appropriate investment timeframe of the portfolio. This does not mean that non-financial, and in particular climate, objectives can never be pursued. This may of course be permissible *instrumentally* if pursuing such goals contributes to increasing the financial return or reducing risk. Indeed, in such cases, it could be considered mandatory.⁹ But in certain jurisdictions, it may also be permissible *alongside* the

7 For a comprehensive review of fiduciary duties of investors around the world, see ‘A legal framework for impact’ by Freshfields Bruckhaus Deringer: <<https://www.unpri.org/download?ac=13902>> and for reviews of the fiduciary duties of directors in various jurisdictions see The Commonwealth Climate and Law Initiative <<https://commonwealthclimatelaw.org/>> accessed 7 February 2023.

8 In some instances, the purpose will be implicit in the relevant investment guidelines rather than being explicit in the mandate. For example, see the ‘Model Discretionary Investment Management Agreement’ published by the Investment Association at <<https://www.theia.org/sites/default/files/2021-11/Model%20IMA%202021.pdf>> accessed 7 February 2023.

9 See ‘Impact investing for pension funds: fiduciary duty—the legal context’, by the Impact Investing Institute <<https://www.impactinvest.org.uk/wp-content/uploads/2020/11/Impact-investing-by-pension-funds-Fiduciary-duty---the-legal-context.pdf>> accessed 7 February 2023.

pursuit of financial objectives as long as financial returns are not harmed. And non-financial goals may be pursued if they are part of explicit objectives set by the asset owner.

- The *duty of loyalty*: This requires asset managers to act in the interests of their clients and to use their investment powers for the purpose of the investing activity for which they were conferred. This means that asset managers cannot use their investment discretion to pursue climate goals unless either: the pursuit of the climate goals contributes to the risk and return objectives of the investment, or those goals are an express objective of the asset owner and thereby part of the purpose of the investing activity. Note that the *proper purpose* and *best interests* duties implicit in the duty of loyalty mean that an asset manager could be on shaky ground if they pursued climate goals that were not explicitly mandated by the asset owner *even if* the pursuit of those goals was in parallel to, and not in opposition to, delivery of the financial return. That issue would turn on the financial materiality of the climate risk that is addressed by the relevant investing activity (including stewardship and public policy engagement).
- The *duty of care*: This requires the asset manager to act with appropriate skill and diligence in carrying out their investing activities on behalf of the asset owner. This duty includes concepts such as the *prudent person rule* and also requires minimum levels of diligence and an effective investment process.¹⁰

A final observation, linked to the duty of loyalty, is that an asset manager should act *in good faith* in pursuit of the investment objective. Therefore, the fact that someone *could believe* that investing in a way that addresses climate change improves risk-adjusted financial returns is insufficient. The asset manager themselves *must in fact* believe it if they are to be acting in line with their fiduciary duties. This distinction matters. We shall see later that the link between various investment strategies and real-world climate impacts and risk-adjusted return consequences is highly contested. Therefore, an asset manager's good faith belief, supported and evidenced by a systematic process for investment decision making, will matter in the analysis of whether a given strategy is appropriate.

Company directors and other types of investor

The same broad headings can be used to categorize the duties of company directors. However, there are two very important differences as compared with the case of an asset manager. First, a company director owes their duties to the company, rather than to the client or beneficiary. Secondly, through the business judgement rule, directors in practice have very wide discretion to interpret how best to interpret and pursue the purpose of the company or, in a UK context, the 'benefit of members as a whole'.¹¹

In practice, asset managers, and other financial intermediaries, tend to have a purpose that in legal terms defaults to maximization of financial returns (in the absence of contrary explicit purposes) to a much greater degree than is the case for company directors. So, whereas optimizing financial returns is a quite strong *legal* presumption for asset managers, for company directors, it is much more a *practical matter*, arising from the reality that in most jurisdictions shareholders have wide-ranging powers to appoint and remove

¹⁰ In some instances, there are more detailed regulatory requirements: see, for example, regulations made under the Pensions Act 1995.

¹¹ Companies Act 2006, s 172.

directors: a director who ignores the financial interests of a company's shareholders is not likely to last long in their position. This distinction will be important when we come later to consider what actions climate-concerned asset managers can take, consistent with their fiduciary duties, to accelerate the transition to net zero.

On the investor side, we have focused on the case of a typical asset management intermediary. The considerations for an asset owner are similar, with their beneficiaries taking on the role that an asset owner themselves plays for an investment manager. However, it is worth noting that in some jurisdictions, pension funds are subject to specific statutory duties, albeit that these typically relate to optimizing the financial position of the beneficiaries in the specific context of the pension scheme. However, certain types of corporate investors can be different.¹² So, for example, directors in insurance companies or investment companies owe their duty of care directly to the company rather than, as in the case of a typical asset manager, to the ultimate beneficiaries. In practice, as we shall revisit later, this means that investors structured as a corporate entity may have a greater ability to invest in ways that seek to achieve climate goals if considered to be in the interests of the company.

Legal standard versus expected standard

As a final comment, successful legal actions for breach of the duties outlined above are rare. Courts have generally been reluctant to second guess decision making by fiduciaries unless it has been plainly reckless or negligent. This is particularly the case with the business judgement rule for corporate directors in the USA, which applies a fairly low standard for good faith decision making by fiduciaries. There is so much noise in investment markets that the counterfactual is always difficult to establish. The chances of an asset manager being successfully sued in courts for breach of duties for pursuing climate goals (or ignoring them) may be quite low within a reasonable spectrum of behaviour, although of course, this may change over time as more test cases are brought on either side of the argument. However, fiduciaries, advised by internal and external counsel, tend to focus on the 'expected standard' of good faith execution of responsibilities rather than the minimum legal standard. Moreover, adherence to minimum legal standards does not necessarily protect fiduciaries from litigation, which may be time consuming and require settlement regardless of the likelihood of ultimate legal success.

¹² It is increasingly common for a corporate trustee to be set up in connection with pension funds. In those instances, it is the company as a separate legal person that bears the duties of the trustee to beneficiaries, albeit that it is possible for directors also to become liable for any breach of duty. Ultimately, however, beneficiaries benefit from the same legal duties whether the trustee is a corporate entity or a group of individuals. In that sense, corporate trustees differ from other corporate investors such as insurance companies.

4. The NZAMI

Members of the NZAMI sign up to a commitment statement (see box).¹³

The NZAMI commitment

In line with the best available science on the impacts of climate change, we acknowledge that there is an urgent need to accelerate the transition towards global net zero emissions and for asset managers to play our part to help deliver the goals of the Paris Agreement and ensure a just transition.

In this context, my organization commits to support the goal of net zero greenhouse gas (GHG) emissions by 2050, in line with global efforts to limit warming to 1.5°C ('net zero emissions by 2050 or sooner'). It also commits to support investing aligned with net zero emissions by 2050 or sooner.

Specifically, my organization commits to:

- a. Work in partnership with asset owner clients on decarbonization goals, consistent with an ambition to reach net zero emissions by 2050 or sooner across all assets under management (AUM)
- b. Set an interim target for the proportion of assets to be managed in line with the attainment of net zero emissions by 2050 or sooner
- c. Review our interim target at least every 5 years, with a view to ratcheting up the proportion of AUM covered until 100 per cent of the assets are included

These headline commitments are reinforced by 10 additional requirements, 5 of which are particularly relevant to our analysis. Two of these emphasize that the overarching goal is aligned with Race to Zero's objective,¹⁴ which is to limit global warming to 1.5°C with limited or no overshoot:

- [For assets to be managed under commitment b above] Set interim targets for 2030, consistent with a fair share of the 50 per cent global reduction in CO₂ identified as a requirement in the IPCC special report on global warming of 1.5°C.
- Publish Taskforce on Climate-related Financial Disclosures (TCFD), including a climate action plan, annually, and submit them to the Investor Agenda via its partner organizations for review to ensure the approach applied is based on a robust methodology, consistent with the UN Race to Zero criteria, and action is being taken in line with the commitments made here.

Three of the additional requirements emphasize the expectation that signatories' investment strategies will have a real-world impact on aggregate carbon emissions, individual company transition plans, and capital available for investment in climate solutions:

- [For assets to be managed under commitment b above] Prioritize the achievement of real economy emissions reductions within the sectors and companies in which we invest.
- [For assets to be managed under commitment b above] As required, create investment products aligned with net zero emissions by 2050 and facilitate increased investment in climate solutions.

¹³ See 'The net zero asset managers commitment': <<https://www.netzeroassetmanagers.org/commitment/>> accessed 7 February 2023.

¹⁴ 'Race to zero criteria' <<https://racetozero.unfccc.int/system/criteria/>> accessed 7 February 2023.

- [Across all assets under management] Implement a stewardship and engagement strategy, with a clear escalation and voting policy, that is consistent with our ambition for all AUM to achieve net zero emissions by 2050 or sooner.

The other commitments relate to the need to: take account of material scope 3 emissions as well as scopes 1 and 2; focus any use of offsets on long-term carbon removal; create investment products aligned with net zero and facilitate transition investment; provide relevant climate analytics to clients; engage with other actors in the market to ensure the development of products and services aligned with net zero; and ensure that the asset manager's policy advocacy is consistent with net zero 2050 or sooner.

It should be noted that the commitment does not require asset managers to invest all assets in line with net zero but rather to set a target for the proportion of assets so invested, with a view to ratcheting up to 100 per cent over time. Furthermore, the commitment contains a caveat in the final paragraph:

We also acknowledge that the scope for asset managers to invest for net zero and to meet the commitments set forth above depends on the mandates agreed with clients and clients' and managers' regulatory environments. These commitments are made in the expectation that governments will follow through on their own commitments to ensure the objectives of the Paris Agreement are met, including increasing the ambition of their Nationally Determined Contributions, and in the context of our legal duties to clients and unless otherwise prohibited by applicable law.

This is clearly an attempt to ensure that, by construction, the commitment is aligned with the fiduciary duty asset managers owe to clients. Moreover, it is an attempt to put the responsibility for developing net zero policies where it should be: with governments. This final paragraph in effect says: 'we will invest in net zero aligned strategies so long as our clients ask us to do so or governments set the economic incentives that make net zero the most likely outcome'. This is not quite the strength of commitment implied by the GFANZ press release.

So, it can be argued that the NZAMI commitment is pretty thin. A target could be set for a very small proportion of assets. Carbon-heavy industries may naturally decline as a percentage of portfolios. The letter of commitment could be met while changing little. And if all else fails the get-out-of-jail-free card of the final paragraph could be relied upon. We are left with a dilemma. Either we take the commitments at face value as having some meaningful intent and set aside the caveats. Or we focus on the caveats and deem the commitment to be meaningless in substance. For the next part of this article, we will take the former position, and will return later to the implications of the latter view.

5. What is net zero-aligned investment?

Key to the interpretation of the statement is to answer the question 'what is net zero-aligned investment?'. NZAMI recognizes three methodologies for setting net zero-aligned targets:

- Paris Aligned Investment Initiative Net Zero Investment Framework;¹⁵

¹⁵ 'Paris aligned investing initiative: investing for a net zero future' <<https://www.parisalignedinvestment.org>> accessed 7 February 2023.

- Science Based Target Initiative for Financial Institutions,¹⁶ and
- Net Zero Asset Owner Alliance Target Setting Protocol.¹⁷

These methodologies all require target setting around some combination of:

- Portfolio emissions, calculated as the aggregated share of emissions of portfolio companies, weighted according to the holding of each security by the asset manager. This can be measured either as aggregate emissions or emissions intensity (e.g. CO₂e per \$ of invested assets).
- Engagement targets to move portfolio companies, especially amongst higher emitters, to net zero alignment.
- Share of portfolio companies that are themselves net zero aligned.¹⁸
- Commitments to fund companies and technologies essential to the transition and to produce net zero-aligned products, including engagement with other market participants to bring this about.
- Engagement with policymakers and, in some cases, commitments on ensuring net zero-aligned lobbying practices.

In this section, we focus on the first four of these, which relate directly to the investment and engagement strategy and look at commonly adopted investment strategies designed to meet these goals. We consider the case of a generalized investment mandate, without specific climate objectives. If an asset owner requires certain climate objectives in the investment strategy, or if a retail fund prospectus sets out that such objectives will be pursued, then concerns about fiduciary duty fall away.

We assess the strategies through the lens of an asset manager adopting these to meet their NZAMI commitments to invest in line with net zero, including the requirement to increase the proportion of assets so invested to 100 per cent over time. We assume that it will not be possible to get all clients to sign up for net zero mandates voluntarily and so we consider, in particular, the case of adopting these strategies as part of a general non-ESG mandate.

Approach 1: portfolio decarbonization strategy

In this approach, a target is set for reduction in the portfolio's carbon footprint in line with the overall carbon trajectory for 1.5°C. To meet the 1.5°C goal, the carbon intensity of GDP needs to reduce by around 15 per cent pa to 2030,¹⁹ so portfolio decarbonization needs to meet this path (equivalent to absolute reductions of c 10 per cent pa). This is achieved by progressive divestment from higher emitting assets. This approach has been proposed by Bolton, Kacperczyk and Samama, whose research suggests that a portfolio with such a declining carbon footprint can be constructed with a tracking error that is

16 'Science based targets: financial institutions' <<https://sciencebasedtargets.org/sectors/financial-institutions>> accessed 7 February 2023.

17 'Net zero asset owner alliance target setting protocol second edition' <<https://www.unepfi.org/net-zero-alliance/resources/target-setting-protocol-second-edition/>> accessed 7 February 2023.

18 Note that, consistent with the overarching commitment, the alignment requirements are with the Race to Zero goal of 1.5°C with limited or no overshoot. For brevity, we henceforth use the term 'net zero' to mean this more stringent goal unless made clear otherwise.

19 'PwC net zero economy index 2022' <<https://www.pwc.co.uk/services/sustainability-climate-change/insights/net-zero-economy-index.html>> accessed 7 February 2023.

extremely small.²⁰ This can be explained by the fact that carbon emissions exhibit a strong sector concentration, with relatively low weighting in the market index. This means that the calculated footprint of the portfolio can be reduced significantly, at least in the early years, by excluding a relatively small number of companies.

This approach is not merely theoretical. A new set of net zero indices produced by S&P follows almost precisely this approach.²¹ More generally, a number of ‘sustainable’ funds exhibit a very low carbon footprint to exclusion of high-emitting sectors.

Would this approach cause a fiduciary duty problem? There are several reasons why it most likely would not.

First of all, the asset manager may present the strategy as a risk-management approach. A common narrative relating to climate change is that it is not adequately priced in investment markets and that investors face a significant risk of stranded assets in future if they continue to invest in high-emitting companies. Reducing exposure to these companies, therefore, reduces the losses that the investor would suffer when what the Principles for Responsible Investment calls ‘the inevitable policy response’²² comes to pass. If the approach is pursued with the intent of managing risk, then it arguably immediately fulfils the requirements of proper purpose and duty of loyalty.

The question then arises, under the duty of care, as to whether the risk-management approach is effective and well executed. This is more questionable. Indeed, it can be argued that a portfolio decarbonization approach as set out above is more akin to an active investment bet than a risk-management approach. Why do we make this apparently controversial statement? For three reasons.

First, experience suggests that the ‘inevitable policy response’ is far from inevitable. Indeed, a policy response that puts the world on track to 1.5°C with limited or no overshoot would need to be so internationally coherent and so far-reaching as to be virtually inconceivable. This has now been reinforced by the latest report from the UN Environment Programme referenced earlier.²³ Sound risk management should not equate the most desirable scenario with the most likely but instead should consider clients’ interests in the event of a range of climate scenarios, more and less favourable. Research at the sector and security level based on climate scenario analysis by Abrdn²⁴ shows that the valuations of highly impacted sectors often move in the opposite direction in Paris-aligned scenarios as compared with scenarios where the policy response is weak and global warming higher. For

20 Patrick Bolton, Marcin T Kacperczyk and Frederic Samama, ‘Net-Zero Carbon Portfolio Alignment’ (2022) working paper, available at SSRN <<https://ssrn.com/abstract=3922686>> accessed 7 February 2023.

21 See ‘S&P Dow Jones Indices and S&P Global Sustainable1 Launch S&P Net Zero 2050 Carbon Budget Index Series’ <<https://www.spglobal.com/spdji/en/index-launches/article/sp-dow-jones-indices-and-sp-global-sustainable1-launch-sp-net-zero-2050-carbon-budget-index-series/>> accessed 7 February 2023.

22 See ‘The inevitable policy response to climate change’ <<https://www.unpri.org/sustainability-issues/climate-change/inevitable-policy-response>> accessed 7 February 2023.

23 See n 3.

24 ‘Climate Scenario Analysis: A Rigorous Framework for Managing Climate Financial Risks and Opportunities’, Abrdn, February 2021 <<https://www.abrdn.com/en-gb/institutional/sustainable-investing/climate-change/climate-scenario-analysis>> accessed 7 February 2023.

example, high-carbon industries suffer in an assertive decarbonization environment, because that is not currently expected by the market. But in contrast, an unexpectedly loose policy environment causes those same asset values to appreciate. The reverse applies to certain industries expected to benefit from a rapid transition.

Alternatively, the path to net zero may be achieved by technology rather than regulation. A cheap version of carbon capture and storage may emerge that enables the world to carry on much as today. Although this seems highly unlikely, and overoptimistic, at present, it is probably no more so than a scenario that assumes that governments do all they need to do to limit warming to 1.5°C with limited or no overshoot.

The point is that a sound risk-management approach for clients should consider a range of scenarios, not just one. In particular, it may be argued that in a world where climate change is worse, beneficiaries may have a greater need for financial assets to enable their own personal adaptation to adverse climate impacts. Therefore, having a strategy that results in lower returns in scenarios where climate change, and its associated impact, is more extreme may not be optimal for all clients.

Secondly, current carbon emissions are an imprecise measure of a firm's ability to adapt. The Abrdn research shows that valuation impacts of different scenarios vary more within sectors than between sectors. In part, this reflects the ability of the firm itself to adapt. In others, it reflects the fact that the firm is undervalued regardless of transition risks. As an example, energy utilities are amongst the highest current emitters but are shown by Abrdn to benefit in almost all scenarios because of their ability to pivot to different energy sources as the world decarbonizes. Therefore, even on its own terms, a naive portfolio decarbonization approach is therefore very unlikely to be an optimal risk-management strategy.

An investor that in good faith believed that portfolio decarbonization is a good risk-management strategy probably faces a low risk of being sued for failure to meet the duty of care. But that good faith belief is critical, and there are good reasons to believe that many investors may not be able to hold that belief. Indeed, the strategy is more akin to an active investment bet on a single (arguably unlikely) scenario of overwhelming government intervention and severe (explicit or implicit) carbon pricing to limit warming to 1.5°C.

But what about the implications? Even if a simplistic portfolio decarbonization approach may not be a very credible risk-management strategy, does this really matter if the impact on returns is limited? Abrdn's research suggests that the impact of different climate scenarios on diversified portfolio returns is likely to be small over even quite long time horizons. From their work, we can estimate the impact, relative to holding the market portfolio, of a slow transition scenario on a portfolio that excludes the heaviest emitting sectors. The impact is less than 5 per cent of the portfolio value.

There are four main reasons for this small difference: the long time horizons for the most material climate impacts have limited impact on valuations because of discount rates; the most strongly affected sectors (positive or negative) have a relatively small weighting in the market index; many companies have adaptation capability, which mitigates the impact of changes in policy direction; and markets are already pricing in some element of policy

progression, which limits the policy gap compared with realistic upside or downside scenarios. The research of Bolton *et al.* reinforces this, suggesting that decarbonization can be achieved with a well-diversified portfolio that shows relatively limited tracking error even all the way out to 2050.

However, there is a caveat to the Bolton *et al.* conclusion. They adopt a partial equilibrium model in the sense that the decarbonization strategy is assumed itself not to impact market pricing. For this reason, for the tracking error to remain as low as they have modelled, only around €1trn of assets could be invested in the strategy. If the approach became widespread across the assets of NZAMI signatories then there could be significant risk of underperformance over time as funds under management crowded into a declining pool of assets consistent with the decarbonization goal.

The final consideration relates to real-world impact. The decarbonization strategy is in effect a progressive divestment strategy. The evidence for the efficacy of divestment as a strategy is decidedly mixed and on balance not persuasive.²⁵ Indeed, the carbon intensity of institutional portfolios has been declining markedly for over a decade even as emissions continue to rise.²⁶ It seems that heavy emissions are increasingly the preserve of private, closely held or state-owned entities.

One potential argument in favour of this strategy is that it could support a progressive engagement strategy. Bolton *et al.* highlight that their approach would create a predictable timeline of divestments unless companies reduced emissions. This type of conditional engagement and divestment could support real-world emissions reductions if well executed, but brings its own risks, as discussed in relation to Approach 4 below.

So, in summary, how does the portfolio decarbonization approach stack up?

Unless taken to extremes, the implications for portfolio returns are limited, probably amounting to less than 5 per cent in valuation terms compared with holding the market in a slow transition scenario. Over time, if more investors adopted this strategy, the crowding into a declining pool of 1.5°C-aligned investments could itself distort valuations and reduce returns. However, in the short-term this risk seems quite low. Given the noise in investment markets, it would be difficult to say this was a manifestly unreasonable investment strategy and so the legal risk from following this approach must be considered low from that point of view.

Of more concern would be the misrepresentation of what the fund does. First, there is little reason to believe that the approach will have a material impact on emissions in the global economy. This seems inconsistent with the NZAMI commitment to focus on real-world emissions reductions. Secondly, firms should be cautious about presenting the strategy as a risk-management approach. It is more akin to an active bet on an aggressive (and relatively unlikely) transition scenario.

25 See discussion and references contained in 'Investing for good' <<https://www.tom-gosling.com/blog/investing-for-good>> and 'Does divestment work?' <<https://www.tom-gosling.com/blog/does-divestment-work>> accessed 7 February 2023.

26 Vaska Atta-Darkua, Simon Glossner, Philipp Krueger and Pedro Matos, 'Decarbonizing Institutional Investor Portfolios', 2022, working paper, available at SSRN <<https://ssrn.com/abstract=4212568>> accessed 7 February 2023.

In many ways, the legal risks associated with misrepresentation are greater than those associated with breaches of fiduciary duty, as has been reflected in many of the climate-related claims made to date. Nonetheless, if care is taken not to overclaim on the strategy or its risk-management properties, then the strategy would likely qualify as Article 8 under the European Union (EU) Sustainable Financial Disclosure Regulation,²⁷ which could provide some safe harbour, at least within the EU. In practice, the risks are more reputational than legal: presenting a fund as contributing to the battle against climate change and managing an investor's climate risk, when really it does neither. Although it should be noted that such an approach would most likely not qualify for sustainable labelling under the Financial Conduct Authority's recently proposed approach in the UK,²⁸ which sets quite a high bar for expected real-world impact.

In this context, the linkage of the portfolio decarbonization rate to the global reduction in greenhouse gases needed to limit warming to 1.5°C with limited or no overshoot creates a strong presumption of a meaningful connection between the two. However, there is no such connection. Portfolio decarbonization has little or no connection with real-world emission reductions. And if the risk-management rationale is adopted, there is absolutely no reason to think that aligning the portfolio decarbonization rate with this global goal is meaningful. The approach therefore looks rather like one designed to maximize the investor's feeling of 'warm glow' related to the strategy, regardless of its limited impact.²⁹

Approach 2: sector tilting approach

This approach focuses on minimizing risks to a portfolio associated with a 1.5°C transition by underweighting sectors that are most likely to be impaired in a 1.5°C transition. This approach generally takes a single-materiality view, focusing on the risks to the portfolio rather than the impact on emissions. There is likely to be some correlation with Approach 1 on the basis that the major risk in a 1.5°C pathway is transition risk strongly linked to aggressive carbon pricing. Abrdn's analysis³⁰ suggests that the main exposed sectors in a 1.5°C scenario were consumer discretionary, consumer staples, energy, materials and real estate. Note, however, that this is a dynamic picture based on current sector pricing.

At the point that analysis was done, avoiding these sectors would avoid just over 2 per cent of the portfolio impairment in a 1.5°C scenario. However, in the event of a current policy continuation scenario, these sector exclusions would cost around 2 per cent relative to a neutral index position.

The concerns about this approach somewhat mirror those of the progressive portfolio approach above. First of all, it is a somewhat one-sided risk-management strategy, focused

27 Regulation 2020/852 L198/3, commonly referred to as The Sustainable Finance Disclosure Regulation. Art 8 references so-called 'Light Green' products and art 9 'Dark Green' products.

28 See 'FCA proposes new rules to tackle green washing' and FCA Consultation Paper 22/20 (October 2022) <<https://www.fca.org.uk/news/press-releases/fca-proposes-new-rules-tackle-greenwashing>> accessed 7 February 2023.

29 Florian Heeb, Julian F. Kölbel, Falko Paetzold and Stefan Zeisberger, 'Do Investors Care About Impact?' (2022) *The Review of Financial Studies*, forthcoming, available at SSRN <<https://ssrn.com/abstract=3765659>> accessed 7 February 2023.

30 See n 24.

on minimizing risk in the particular scenario of 1.5°C, but potentially at the cost of returns in slow transition scenarios. In other words, it is more of an active bet on a 1.5°C scenario than a balanced risk-management approach. Secondly, there is little evidence that sector exclusions will drive any change in real-world emissions. It is therefore not clear how much this approach really contributes to the NZAMI goal of limiting warming to 1.5°C with limited or no overshoot.

Nonetheless, by avoiding the spurious linkage with the global decarbonization rate required to achieve that goal, it is at least potentially less at risk of accusations of being misleading than Approach 1. And the probably limited impact on portfolio returns of adopting this strategy means that in practice the fiduciary concerns are relatively low.

Approach 3: tilting strategy within sectors

This is subtly different from Approach 2, in that the strategy maintains neutral sector weightings but divests from companies most exposed in the event of a 1.5°C transition and retains those best able to benefit from such a transition. This could be assessed using carbon emissions or more sophisticated measures of transition readiness. This is often referred to as a 'best in class' strategy.

This approach has two immediate advantages over and above the previous two approaches. First of all, Edmans *et al.*³¹ have shown that tilting within sectors creates stronger incentives to change than divestment. This is because blanket sector divestments do not create any pathway for companies to reverse the divestment (short of the unlikely and extreme step of changing sectors). In contrast, there may well be an executable pathway to move into the highest performing segment within each sector, on whatever climate metric is chosen.

But although the real-world impact of this approach is, at least theoretically, more meaningful, the corresponding scenario risks are higher. This is because, as Abridn has shown, the dispersion of impacts of different climate scenarios within sectors is much greater than they are across sectors. We described in relation to Approach 1 how the valuation impact of climate scenario bets based on overall sectors is relatively small, most likely less than 5 per cent in the case of a low carbon portfolio in a delayed transition scenario.

However, differences *within* sectors based on the two scenarios can be much, much greater, easily exceeding a 10 per cent swing in most sectors. Therefore, the adoption of this tilting approach, depending on the degree to which it is adopted, becomes very much more risky in terms of scenario sensitivity and deviation from the market. It is difficult to quantify this impact as it would depend strongly on the precise nature and extent of the tilting. Nonetheless, it demonstrates an important principle that emerges from this analysis: the more impactful a strategy is in terms of reducing emissions in the real world, the riskier that strategy is likely to be in the event that the world does not, in fact, reduce emissions.

31 Alex Edmans, Doron Levit and Jan Schneemeier, 'Socially Responsible Divestment' (2022) Working Paper, available at SSRN <<https://ssrn.com/abstract=4093518>> accessed 7 February 2023.

Approach 4: active ownership

In the purest form of this approach, all companies are owned in line with the market portfolio, but with active engagement used to drive portfolio companies onto a 1.5°C-aligned path. This is overlaid with policy engagement and aligned lobbying requirements, which demand that portfolio companies align their own lobbying with 1.5°C-supportive regulation.

Note that at the portfolio level, the Abrdn analysis suggests that the difference between index outcomes in Paris aligned and current policy scenarios differs by only around 5 percentage points. The Paris-aligned outcome is found to be more costly, but given the noise in investment indices (this is around one-third of a standard deviation in index performance), even if fully successful, policy alignment can be considered to have a relatively small impact, which would be below the tolerance that would cause manifest fiduciary duty concerns, especially given the inherent uncertainty in estimating and measuring the impact.

The impact of driving transition at the individual company level is much less certain as it is very difficult to know exactly how that pathway would affect company performance in different scenarios. The risk is that engagement succeeds in changing strategy at the company but without delivering the desired government policy change. Listed companies only form a portion of the total corporate universe and so business may flow from them to private companies owned by less environmentally aware owners or even to state actors.

To get a sense of the impact, suppose that engagement focuses on those companies most prone to impairment in a 1.5°C world. In essence, the engagement approach would seek to internalize the carbon costs on that company. In other words, the impairment arising in a 1.5°C world would be *voluntarily imposed* on the company by investors. However, this voluntary impairment would also prevent the company from benefiting from any upside in the event of a less favourable policy response.

Again, the Abrdn analysis can be used to show that these valuation swings are potentially very significant and could have a material impact on portfolio returns. The NZAMI commitments refer to the fact that engagement can occur at the individual company or sector level. The impact on portfolio returns is likely to be less if the engagement is sectoral rather than focused on individual companies.

It is worth noting that, despite these observations of potentially large portfolio impacts, this risk is very unlikely to manifest as a legal risk in practice. Company strategic and operational decisions are the duty of the board of directors. Establishing direct causality from the asset manager engagement to the corporate action would likely be difficult unless extremely directive shareholder resolutions were adopted (itself an unlikely scenario). Any legal risks would more likely be faced by the directors (in the case of extreme action) than the asset managers.

However, this does illustrate a practical limitation of the engagement approach. As the Net Zero Asset Owners' Alliance has noted, it is not realistic for engagement to drive corporate action on climate beyond the point that is economically rational.³²

In summary, engagement at the policy level is unlikely to give rise to risks of fiduciary duty. But engagement at the company level, if extreme, may do so. The risks are limited if engagement is pursued on a sector-wide basis. However, the duties of directors are likely to prevent action to meet 1.5°C goals with limited or no overshoot in cases where that is economically very damaging to the company. So, it is more likely that the approach will fall short of meeting the NZAMI goal of real-world impact in line with 1.5°C than it will cause a legal liability in relation to fiduciary duty. Nonetheless, very aggressive engagement could nonetheless be problematic for asset managers without a specific mandate.

Approach 5: investment in sustainable companies

Under this approach, the asset manager invests in companies that are ready for a net zero world. The Abrdn analysis³³ indicates that over half of the MSCI World Index by market capitalization is relatively unaffected by the decarbonization scenario followed. This includes sectors such as Financials, Healthcare and Information Technology. Such companies either have high adaptation potential, regardless of what scenario emerges, or will simply follow the transition in primary energy sources as power is decarbonized (or not) with few strategic implications.

A portfolio made up of such companies could be said to be net zero aligned, as the underlying investments are not exposed to large transition risks. And the number of available investee companies is sufficiently large for an asset manager to be able to put together a well-diversified portfolio offering attractive risk-adjusted returns. The manager of, say, a healthcare fund could quite readily say that their portfolio was 1.5°C aligned. Indeed, as a risk-management approach, investing in companies where returns are *largely unaffected* by the transition scenario, does have the benefit of being a genuine climate risk-management approach, through hedging against the risks of both positive and negative climate outcomes. Therefore, this approach avoids some of the potential fiduciary concerns of Approaches 1 and 2. Nonetheless, this approach is 1.5°C aligned in the limited sense of the fund not being exposed to significant transition risks, rather than in the sense of the fund making any *positive contribution* to decarbonization.

A refinement of this approach could be to assess, within sectors, which companies had effective net zero transition plans and to invest only in those. This could be considered a risk-management approach, but as with the portfolio decarbonization approach, this manages just one particular risk—the transition risk arising from a robust transition to net zero—which is arguably a one-sided view of risk. Instead, the rationale for this approach might be to send pricing signals in favour of companies that have effective net zero

32 Net-Zero Asset Owner Alliance, 'The future of investor engagement' <https://www.unepfi.org/wordpress/wp-content/uploads/2022/03/NZAOA_The-future-of-investor-engagement.pdf> accessed 7 February 2023.

33 See n 24.

transition plans, thereby lowering their cost of capital. There are two concerns with this rationale. First, as with divestment, there is very mixed evidence about whether this type of selective investment approach has any meaningful impact on the cost of capital for firms, to the extent that would affect investment decisions.³⁴ Secondly, if it does have the effect of lowering the cost of capital, the unavoidable counterpoint to this is that expected future returns will be lower. Therefore, if effective in changing real-world investment decisions, the approach will potentially have a negative impact on returns.

Approach 6: impact investment

Impact investment would involve investing in climate solutions in a way that has an additional impact on climate action. This could involve, for example, investing in high-risk technologies linked to carbon capture or sustainable agriculture. Or it could involve investing in blended finance projects to encourage renewable energy adoption in the developing world.

If such investments do indeed have the additional impact that would not otherwise have occurred, then by definition they meet the NZAMI objective of reducing real-world carbon emissions. However, if such projects offer attractive risk-adjusted returns there is no reason why they would not be happening anyway and the NZAMI initiative would be adding nothing. There must therefore be some problem that stops these projects from being funded. Typically, this is a level of risk or return that is not consistent with investors' market expectations. Therefore, truly impactful investments, in the sense of real-world additionality, must inevitably create a significant probability of reduced risk-adjusted returns. There may well be clients prepared to accept this, as the price to pay for the impact they achieve. But this cannot be assumed and would require an explicit client mandate.

Approach 7—ESG integration

Environment Social and Governance (ESG) integration involves incorporating material ESG information, including on climate, into the investment process in a way that maximizes risk-adjusted returns. If more investors adopt an approach of ESG integration, then this will help markets function by ensuring that relevant climate information is appropriately priced into security valuations. This itself should help ensure that the market incentives exist for firms to take notice of material climate factors.

This might, if such climate factors are currently unpriced, lead to incentives for some additional climate change mitigation in the real world. However, the primary objective of ESG integration is returns maximization, and so such an approach cannot accelerate climate action beyond what is incentivized by current or likely future economic signals. As such it cannot be considered an accelerant of climate policy beyond what is being pursued by governments. However, it could be viewed as being an approach that would facilitate the propagation of price signals set by governments through the market, and thereby be an aid to economic efficiency.

34 See n 25.

Because ESG integration focuses on maximizing risk-adjusted financial returns there is no concern raised in respect of fiduciary duty. However, the additional real-world impact of ESG integration is questionable, even if the investment strategy may be desirable from a client perspective. Indeed, we note that in their proposed labelling rules, the Financial Conduct Authority in the UK has excluded ESG integration approaches from qualifying for a sustainable fund label.³⁵

6. Other types of investors

The analysis in this article has focused on asset managers. In this section, we provide some brief comments, not intended to be comprehensive, on how the considerations may translate to other types of investors, in particular asset owners such as pension funds and corporate entities such as insurance companies and banks.

Asset owners

The considerations are comparable as for asset managers. Most asset owners, such as pension funds, will have a default expectation of maximizing returns, at appropriate risk (relative to beneficiary liabilities), over the investment horizon. There is general agreement that non-financial and ESG factors can be taken into account where they are financially material to the investments from a risk or opportunity perspective. This is nothing more than enabling sound investment practices. Moreover, in many jurisdictions, it is possible for asset owners to consider non-financial and ESG factors alongside financial returns, provided that the former does not impair the latter. However, to meet the proper purpose test, an asset owner should have reasonable belief that those factors are important to the beneficiaries. In practice, this is likely to require some kind of beneficiary engagement.

Whether asset owners can pursue non-financial or ESG goals at the cost of financial returns is more contested. To the extent that they can, it would require a correspondingly more explicit mandate from beneficiaries, which may in practice be hard to achieve. In this respect, the position of asset owners is arguably even more constrained than that of asset managers, who as a matter of contract can take into account whatever objectives are mandated to them by the asset owner client.

An asset owner seeking to rely on the ‘ultimate benefit of members’ argument to pursue an investment strategy aligned to 1.5°C with limited or no overshoot should be aware of the nuances that make that position quite difficult to argue.³⁶

Corporate entities

For corporate entities such as insurance companies, the duty is to the interests of the company rather than of a specific set of beneficiaries. Given the disinclination of courts to

35 See n 28, para 4.24.

36 ‘Trouble ahead for GFANZ’ <<https://www.tom-gosling.com/blog/trouble-ahead-for-gfanz>> accessed 7 February 2023.

second guess company board decision making, this may in practice give much greater leeway for a corporate entity to pursue an investment strategy aligned with 1.5°C.

For example, an insurance company may face very clear threats to its business model from the increased physical risks arising from climate change. Setting a clear leadership position through its investments on climate may be viewed as a way to catalyse a change that is beneficial to the business even if it comes at some cost to investment returns.

Banks have been at the heart of the GFANZ controversy. Indeed, it has been reported that some banks threatened to leave the Net Zero Banking Alliance (the banking subsector group affiliated to GFANZ) after Race to Zero attempted to strengthen the requirements on coal financing.³⁷

As with insurance companies, the directors of banks owe fiduciary duties to the firm, which in theory provides greater leeway of action on climate than is the case for asset managers and asset owners. However, debt financing is a major commercial activity of banks, and debt financing is disproportionately raised by capital-intensive industries, which tend to be more dependent on fossil fuels. Moreover, since bank lending is often made for 'general corporate purposes', it may be difficult to track the use of loan proceeds. The direct commercial implications of restricting relationships to companies aligned with a 1.5°C path will therefore typically be much greater for a banking loan book than a typical institutional investor portfolio, hence creating greater fiduciary duty concerns, even within the more flexible corporate legal framework.

7. Conclusions

In this article, we have explored the fiduciary duty implications for asset managers following a range of plausible investment strategies in order to meet the NZAMI commitment to 'invest in line with net zero'.

Undeniable tensions

First, we find that in practical terms, the risks of being found by a court to be in breach of fiduciary duty for following such strategies are likely to be small. This is because the adoption of such strategies is, in most practical cases, likely to lead to relatively small differences in investment return compared with investment in the market portfolio. Given the noise in markets and the range of potential investment strategies, it would be difficult to prove that one of these strategies was manifestly unreasonable.

However, secondly, the counterpoint of this finding is that the likelihood of such strategies achieving significant change in carbon emissions in the real economy—a key objective of the NZAMI project—is low. Moreover, those strategies most likely to achieve such reductions (aggressive tilting, engagement or impact strategies) are the most likely to deliver impaired returns in a scenario, which must surely be likely, in which governments do

37 'US banks threaten to leave Mark Carney's green alliance over legal risks' *Financial Times*, London (21 September 2022) <<https://www.ft.com/content/0affe8aa-c62a-49d1-9b44-b9d27f0b5600>> accessed 7 February 2023.

not impose the regulation required for global warming to be limited to 1.5°C with limited or no overshoot.

Thirdly, we contend that low-carbon strategies, which are sometimes presented as risk-management strategies, are more akin to active bets on an ‘inevitable policy response’ that introduces carbon pricing to drive the world towards a 1.5°C scenario. The risk-management rationale, if believed in good faith, is a potential route through the fiduciary duty concerns that might apply. However, we contend that thoughtful asset managers may be cautious about adopting that language.

Fourthly, there appears to be a tension between meeting the stated commitments of NZAMI to ‘invest in line with 1.5°C’ and fiduciary duty considerations. The more likely a strategy is to deliver real-world change in carbon emissions, the more likely it is to give rise to fiduciary concerns. Although these fiduciary concerns are unlikely in most cases to give rise to enforceable legal liability, for the reasons outlined above, it is likely that many asset managers, when applying an expected standard of fiduciary duty, will conclude that the strategies that are more impactful in the real world are not consistent with that duty in the absence of an explicit authorizing mandate from clients. As a result, the investment strategies most likely to be adopted by NZAMI signatories are ones that do meet fiduciary duties to clients but have a low likelihood of making a meaningful contribution to fighting climate change.

Fifthly, given that the asset management industry has the concept of fiduciary duty embedded in it, the greater risk for NZAMI signatories is going to be the reputational or legal risks of not living up to commitments made. Given the latitude within NZAMI and the various disclaimers, it is in our view unlikely that an NZAMI member could be successfully sued on the basis of its generalized NZAMI commitments. However, claims made in relation to particular fund documentation are potentially more serious. In particular, we believe that asset managers should be extremely careful about the claims they make for portfolio decarbonization approaches, whether in relation to their real-world emissions impacts or risk-management properties, given our assessment that they generally do not exhibit much of either.

Such claims would move from the difficult-to-prove area of fiduciary duty breaches to the potentially more fruitful (from a claimant’s point of view) areas of common law misrepresentation and fraud, prospectus rules, conduct of business and consumer protection rules for financial firms and competition rules. Courts, or advertising standards regulators, have shown a greater willingness to rule on these issues than they have to rule on matters of fiduciary duty. In particular, it seems that asset managers should be cautious about claiming that NZAMI membership is a meaningful reinforcement of their sustainable credentials.

Where next for NZAMI

These issues are not just theoretical. There has clearly been extensive discussion within sections of the finance community about the viability of GFANZ and its affiliated initiatives in light of concerns about fiduciary duty conflicts. As a result, GFANZ has recently clarified that:

...the Alliances within GFANZ are independent initiatives subject only to their individual governance structures. Signatories' adherence to the criteria of the Alliances is supported by the distinct governance and accountability frameworks of each alliance. The Alliances have the sole responsibility for managing these, as well as for any changes to their membership criteria.³⁸

This clearly leaves open the door for individual initiatives to decouple from Race to Zero and to set modified participation criteria. Nonetheless, it has been reported that NZAMI intends to remain aligned to Race to Zero.³⁹ Arguably asset managers are less exposed than banks because heavy emitters are a smaller proportion of global equity markets than they are of loan and debt financing. But the tensions seem sure to increase over time.

This analysis is somewhat pessimistic for NZAMI but does not mean that nothing can be done. Indeed, the main problem for NZAMI members is the linkage to the Race to Zero goal of 1.5°C with limited or no overshoot. This, on the face of it, commits members to investing towards a scenario that is both unlikely, being misaligned with the practical interpretation of the Paris agreement by the world's governments (with Nationally Determined Contributions falling far short of the 1.5°C aspiration), and economically very different *even over the short term* from more plausible scenarios. So, first of all, a commitment to aligning investment with a more plausible 2050 net zero goal and 2°C warming would be immediately less problematic. NZAMI should take the opportunity presented to it by the latest GFANZ announcement. We note that it is precisely this commitment that has been made by Norges Bank Investment Management, an asset owner with a strong responsible investing record but not an NZAMI signatory.

But many of the investment strategies discussed here, if recalibrated to 2°C rather than 1.5°C of warming would still face the criticism of limited real-world impact. So, what else could be done, within the constraints of fiduciary duty set out in this article, in cases where an asset manager does not have an explicit mandate from clients to invest in a way that accelerates climate action?

First, our analysis of fiduciary duty has shown that while asset managers are in practice quite constrained by considerations of mandate or risk-adjusted return maximization, boards in practice have considerable leeway in terms of the strategies they adopt in response to the decarbonizing economy. BP and Exxon have taken a very different stance on the pace of transition. While there may be disagreement on which strategy will ultimately prove more successful for shareholders, there currently appears to be no serious question that either BP's or Exxon's *board* faces a legal challenge relating to the fulfilment of their fiduciary duties.⁴⁰ Therefore, climate-concerned investors could, through engagement, make

38 The Glasgow Financial Alliance for Net Zero 2022 Progress Report <<https://assets.bbhub.io/company/sites/63/2022/10/GFANZ-2022-Progress-Report.pdf>> accessed 7 February 2023.

39 'Net Zero Asset Managers Initiative Keeps UN Criteria' *Ignites*, London (31 October 2022).

40 This will be jurisdiction specific. We note that Shell was successfully sued under Dutch law in a ruling that requires it to reduce its carbon emissions quicker than planned. See *Vereniging Milieudéfensie et al vs Royal Dutch Shell plc*, The Hague District Court, Judgment of 26 May 2021 <<https://uitspraken.rechtspraak.nl/inziendocument?id=ECLI:NL:RBDHA:2021:5339>> accessed 7 February 2023. The decision was not, however, based on fiduciary duty but on an unwritten standard of care laid down in Book 6 s 162 of the Dutch Civil Code. The case is currently subject to appeal.

clear to boards that they would be happy for them to lean into, rather than to resist, the energy transition. Given that it is boards that ultimately are responsible for company actions, it is very unlikely that such an approach would create fiduciary concerns for investors.

Secondly, we would note that action on policy engagement and lobbying is a fruitful area. Ensuring that policy engagement and lobbying are aligned with stated 2050 net zero commitments both for the asset manager and its investee companies is an area where asset managers could have significant potential impact. The costs of such engagement are quite low, and at the portfolio level, there are plausible reasons to believe that an orderly policy pathway towards 2050 net zero is indeed beneficial for clients, the economy, and returns. Moreover, such a policy would simply be ensuring consistency between actions and stated commitments. Any aggregate costs compared with a no-policy scenario are shown by most economic models to be extremely small. Finally, because the impacts of the action, if successful, will apply across the sector or market, arguments about disadvantaging individual companies are less applicable.

Consistent with the arguments made in this article, the Net Zero Asset Owners' Alliance has recently emphasized these two dimensions.

But thirdly, there is an urgent need to develop mechanisms to direct much-needed transition finance, particularly to developing markets. Firms can devote resources to working with governments, development banks, asset owners and non-governmental organizations to work out how to get blended finance off the ground in a scalable way. This use of expertise commits the asset manager's own resources rather than that of their clients.

So, there is much the asset management industry can do. But the claims made at the launch of GFANZ and NZAMI probably cannot be fulfilled in a manner consistent with the expected standard of fiduciary duty to clients. It would be better to accept this and to reframe these initiatives so that financial market participants can play their proper role in society's efforts to reach net zero.