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ESG and Fiduciary Duties of Investment Managers

Theoretical and practical bases for a modern interpretation of fiduciary duty under Swiss law

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I. Introduction

Organizations or individuals, known as fiduciaries, manage assets on behalf of beneficiaries and investors in the modern investment system. Beneficiaries and investors rely on these fiduciaries to act in their best interests, typically defined in financial terms[1].

The relationship between sustainability and fiduciary duty has been debated for many years and in various countries[2]. For a long time, the fiduciary duty of investment managers was interpreted as commanding the exclusive pursuit of financial profit for the investors[3]. This was seen as a significant obstacle for investment managers to integrate sustainability criteria[4], known as environmental, social, and governance aspects («**ESG**»)[5] in their investment decisions.

In the last few years, along with various initiatives to promote ESG, several economic and market developments like the financial crises of 2008, the Paris Agreement, and the COVID-19 pandemic accelerated fast-growing global ESG investing. This led to a dramatic change in the investment landscape, not only globally but also in Switzerland. In line with this transformation, there have also been growing changes in the expectations of fiduciaries by investors and beneficiaries. This raises the question of whether the traditional concept of fiduciary duty must be reinterpreted in a modern way, to be aligned with recent economic and market developments.

The objective of this article is to analyze the transposition of the concept of fiduciary duty under Swiss law and

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[1] United Nations Environment Program Finance Initiative (UNEP FI) et al., Fiduciary Duty in the 21st century, Final Report, 6 November 2020 (hereafter «**UNEP FI, Final Report**»), 10.

[2] Freshfields Bruckhaus Deringer, A Legal Framework for the Integration of Environmental, Social and Governance Issues into Institutional Investment, 2005, 109, https://www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf (last visited 18 October 2021) (hereinafter: «**Freshfields Report**»); UNEP FI et al., Fiduciary Duty in the 21st Century, 2015, 9, https://www.unepfi.org/fileadmin/documents/fiduciary_duty_21st_century.pdf (last visited 18 October 2021) (hereinafter: «**UNEP FI, Original Report**»); Joakim Sandberg, (Re-)Interpreting Fiduciary Duty to Justify Socially Responsible Investment for Pension Funds?, Corporate Governance: An International Review 21(5), 436 et seq., Hoboken (U.S.) 2013, 438.

[3] UNEP FI, Original Report (FN 2), 11 and 15.

[4] UNEP FI, Original Report, 78.

[5] PRI, What is Responsible Investment, https://www.unpri.org/pri/an-introduction-to-responsible-investment/what-is-responsible-investment (last visited 18 October 2021).

explain what a modern interpretation would mean. It assesses whether such modern interpretation of Swiss law concepts is possible, needed, and based on which legal grounds.

II. Concepts and distinctions

1. Fiduciary duty

Fiduciary duty's definition contains two aspects: a duty of loyalty (or fidelity) and a duty of care (or prudence)[6]. It is applicable in certain principal-agent relationships[7]. In the asset management industry, the primary fiduciary duty of the investment manager[8] to its client is to act for the client's benefit, which is in most cases financial[9]. Except for the agreed remuneration of the manager, which is frequently a percentage of the managed assets (management fee) and in some cases an additional percentage of the performance realized (performance fee), the fiduciary duty imposes managers a selfless exercise[10]: they must put the interests of their clients ahead of their own interest[11].

The principal-agent relationship is characterized by a high level of trust[12], as the client gives discretionary powers to the manager to invest his assets within certain parameters, which can be precise, vague, or even inexistent. As a rule, an investment manager who fulfills his fiduciary duties is not responsible for losses incurred[13].

In *common law jurisdictions*, trustees, fund managers, advisors, and a certain type of decision-makers may have a fiduciary status and owe corresponding duties to beneficiaries[14]. *Civil law countries* do not recognize the concept of fiduciary duty as such, but laws in these jurisdictions provide for equivalent duties (some forms of a duty of prudence, care, and loyalty). They often include a specific duty to seek profitability and manage investment conscientiously in the interest of beneficiaries[15]. Fiduciary duties vary among jurisdictions and depend on the special status of the fiduciaries. Mutual fund managers, occupational pension funds managers, or private investment advisors have different duties.

We can observe various common features between *civil* and *common law jurisdictions*, where most essential duties owed by fiduciaries to investors and beneficiaries are *«the duty to act prudently and the duty to act in accordance with the purpose for which investment powers are granted (also known as the duty of loyalty).»*[16]

2. ESG Criteria

There is no exhaustive list of ESG criteria, and a definitive list is neither possible nor desirable[17] as the criteria have an open and dynamic character. Their primary drivers are societal and environmental change; making a definitive list would be fragmentary and rapidly outdated[18]. In a nutshell, environmental issues include climate change, biodiversity, protection of air and water resources[19]. Social issues include human rights, labor standards, health and safety, diversity, relation with local communities[20]. Governance issues refer to the governance of companies such as board structure, size, diversity, independence, executive pay, anti-bribery, disclosure of information, business ethics[21].

While socially responsible investing («**SRI**») relates to investments based on values that the investor wants his investment portfolio to reflect for ethical or moral reasons independent from the financial performance, it must not be confused with ESG investing[22]. Since their formalization, ESG criteria inherently assume an impact on the financial performance of the target company. This means they must be considered as financially material is-

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6 Arthur Laby, Fiduciary Principles in Investment Advice, in: Criddle/Miller/Sitkoff (eds.), The Oxford Handbook of Fiduciary Law, Oxford (U.K.) 2019, 8–11.

7 For detailed overview of the concept and comparisons between common law and civil law jurisdictions, see Xenia Karametaxas, L'engagement des investisseurs institutionnels: enjeux et perspectives de la prise de décisions collectives, Collection genevoise 2019, 200 et seq.

8 The term «investment manager» is used in this paper in its generic meaning. It refers indistinctly to any person or entity qualifying as a fiduciary as a result of being in charge of investing the assets of a beneficiary (a company or a private client, a mutual fund, pension fund, pension fund's beneficiaries, trusts, etc.), including certain investment advisors, management companies, pension fund trustees and other trustees.

9 Benjamin Richardson, Do the Fiduciary Duties of Pension Funds Hinder Socially Responsible Investment?, Banking and Finance Law Review (22/2), 145 et seq., Toronto (Canada) 2007, 158 (hereinafter: «**Richardson, Pension Funds**»): Richardson claims however that benefits are not always financial, for example in the case of charitable trusts where interest includes moral aspects as well.

10 Matthew Hardin, Fiduciary Law and Social Norms, in: Criddle/Miller/Sitkoff (eds.), The Oxford Handbook of Fiduciary Law, Oxford (U.K.) 2019, 8–11, 11.

11 Richardson, Pension Funds (FN 9), 150.

12 *Ibid.*

13 Richardson, Pension Funds, 152.

14 Richardson, Multinational Perspective (FN 9, 598.

15 Freshfields Report (FN 2) 10.

16 United Nations Environment Program Finance Initiative (UNEP FI) et al., Fiduciary Duty in the 21st Century, 2019, https://www.unepfi.org/wordpress/wp-content/uploads/2019/10/Fiduciary-duty-21st-century-final-report.pdf (last visited 18 October 2021) (hereinafter: «**UNEP FI, Final Report**»).

17 Principles for Responsible Investment (PRI), Reporting Framework Main definitions *2018*, https://www.unpri.org/Uploads/x/l/q/maindefinitionstoprireportingframework_971173.pdf (last visited 18 October 2021).

18 *Ibid.*

19 *Ibid.*

20 *Ibid.*

21 *Ibid.*

22 Christopher Merker/Sarah Peck, Farewell to Uncle Milt, in: Merker/Peck, The Trustee Governance Guide (eds.), Cham 2019, 126.

sues on a *long-term* investment horizon[23]. The integration of ESG criteria aims, therefore, at identifying the impact of ESG factors in terms of risks and returns in the target companies rather than pursuing moral or ethical values.

ESG criteria are designed as a combination of traditional financial metrics with information concerning a company's environmental, social, or governance behaviors or risks that plays a role in analyzing a company's potential as an investment[24]. ESG presupposes that those criteria must be considered in any investment decision, even when the sole focus is financial performance[25].

Although ESG criteria are widely recognized as a concept, they also have been criticized as being a disguised SRI strategy resulting in confusing use in the market[26]. For example, certain authors claim that the term «ESG investing» is inherently ambiguous and is used on purpose to designate both SRI (investments for ethical or moral reasons) and pure ESG (risk-adjusted returns based on financially material ESG criteria)[27]. An author further suggests that we cannot conceal that, when companies engage in socially responsible investments, there are «*at least to some extent* […] *direct social or ethical reasons*» that are separate from the motivation to seek maximum profits[28].

The confusion derives from the fact that SRI generally has a bad reputation in the traditional financial sector. It bears the stigma of an old belief that SRI results necessarily in sacrificing financial performance for the sake of ethical or moral reasons. Even if the idea that ethics have a place in finance started to be accepted since the financial crisis of 2008–2009[29], it was far from being the case when the concept of ESG was created.

Therefore, although the following view may be considered cynical, the creation of the concept of ESG as a replacement of SRI corresponds to transforming a moral case into a business case. It allows the financial sector to be consistent with its primary goal (financial profits) while investing agnostically in sustainable investments.

These elements have since then evolved. Research seems to have shown that there is not only correlation but also causality between considering ESG criteria and financial performance[30]. Those historical reasons questioning the core of the concept of ESG should, in our view, not undermine the fact that ignoring ESG criteria in today's world amounts to either a risk management mistake or, at worst, a breach of fiduciary duty.

III. International Developments

1. The 2005 Freshfields Report

In 2005, a group of investment managers conveyed under the Asset Management Working Group of the United Nations Environment Program, Finance Initiative[31] («**UNEP FI**») asked the law firm Freshfields Bruckhaus Deringer («**Freshfields**») to analyze and issue a legal report on *whether the integration of ESG issues into investment policy was voluntarily permitted, legally required or hampered by law and regulation*[32]. Their purpose was to understand whether a portfolio manager had a fiduciary duty to pursue profit maximization solely or whether it could also include other objectives, such as ESG issues[33].

Freshfields analyzed the laws of various jurisdictions, including *common law countries* (the U.S., the U.K., Australia, and Canada) and *civil law countries* (Germany, France, Italy, Japan, Spain). In its landmark report, Freshfields concluded that in all analyzed jurisdictions, both *civil* and *common law*, «*integrating ESG considerations into an investment analysis so as to more reliably predict financial performance is clearly permissible and is arguably required in all jurisdictions.*»[34]

The impact of the Freshfields Report seems to have been striking, and it has been praised in the literature[35]. Although the report confirmed the traditional interpretation of fiduciary duty in respect of financial materiality, the statement about the mandatory integration of financially relevant ESG issues is seen as substantial progress

23 The Global Compact, *Who Cares Wins. Connecting Financial Markets to a Changing World,* 2004. https://www.unepfi.org/fileadmin/events/2004/stocks/who_cares_wins_global_compact_2004.pdf (last visited 18 October 2021), 18.

24 Susan Gary, Best Interests in the Long Term: Fiduciary Duties and ESG Integration, 90 University of Colorado Law Review (90), 731 et seq., Colorado 2019, 801.

25 Principles for Responsible Investments (PRI), What is Responsible Investment?, https://www.unpri.org/pri/an-introduction-to-responsible-investment/what-is-responsible-investment (last visited 18 October 2021).

26 Max Schanzenbach/Robert Sitkoff, Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee, 72 Stan. L. Rev. 381, 388–389 (2020) Stanford Law Review (72), 381 et seq., Stanford 2020, 388–389: *«In the late 1990s and early 2000s, however, proponents of SRI rebranded the concept as ESG by adding corporate governance factors (the G in ESG), and they asserted that ESG investing could improve risk-adjusted returns, thereby providing a direct benefit to investors».*

27 Schanzenbach/Sitkoff (FN 26), 396.

28 Sandberg (FN 2), 439.

29 William Blair/Clara Barbiani, Ethics and standards in financial regulation, Research Handbook on Law and Ethics in Banking and Finance, Research Handbooks in Financial Law Series (53), London 2019, 25 et seq.

30 See below III.3.1 *(Materiality).*

31 UNEP FI is a partnership between the United Nations Environment Programme (UNEP) and the global financial sector, based within the United Nations in Geneva.

32 Freshfields Report, 6.

33 *Ibid.*; Sandberg, 439.

34 Freshfields Report, 13.

35 Sandberg, 438; Richardson, Multinational Perspective, 638 (*«Pioneering Freshfields Report»*).

because ESG issues often have a role to play in the financial analysis of an investment's value[36]. Back in 2005, that argument was quite original as compared to prevailing views in the prominent literature[37].

2. Fiduciary Duty in the 21st Century Report

Based on the Freshfields Report, the UNEP FI, together with the Principles for Responsible Investment[38] («**PRI**») and the *Generation Foundation*[39], *then launched a project to «end the debate»* on whether fiduciary duty was a legitimate barrier to the integration of environmental, social, and governance criteria in investment management[40].

The Project issued an initial report in 2015[41] followed by a final report in 2019 (the «**Report**»). The reports contain an update on the progress made worldwide since the Freshfields Report and various policy arguments in favor of a modern definition of fiduciary duty in the light of ESG criteria. The Report provides legal explanations on fiduciary duty and its evolution and proposes a modern definition of that concept. It gives data in support of its modern definition, such as global growth in responsible investment regulation and policy[42], evidence of financial correlations between ESG and corporate performance[43], and examples of investors who integrate ESG issues in their investment process[44]. The Project includes country roadmaps containing, for each analyzed jurisdiction, the steps required to advance the modern interpretation proposed in the Report and to promote ESG integration, as well as special reports, but does not include Switzerland.

The Report concludes that «[t]*he conceptual debate around whether ESG issues are a requirement of investor duties and obligations is now over*»[45]. However, it acknowledges that further work is required in:

(i) filling the gaps that remain in the policy framework;
(ii) ensuring that policy and regulation are implemented effectively and concretely;
(iii) recognizing that other actors should play a role, such as consultants and lawyers; and most importantly
(iv) extending further the fiduciary duty *beyond financial performance.*[46]

The rationale for a modern definition of fiduciary duty can be summarized as follows:

(i) the concept of fiduciary duty is dynamic and evolves along with societal changes,
(ii) societal changes have occurred,
(iii) therefore, a new interpretation is warranted.

According to the Report, the modern definition of fiduciary duty should include adaptations in duties of loyalty and prudence for fiduciaries under both common law and civil law jurisdictions[47]:

(1) **Loyalty**: the duty to understand and incorporate the sustainability preferences of beneficiaries and clients into their decision-making, *whether or not these preferences are financially material*; and

(2) **Prudence**: incorporating *financially material* ESG factors into their investment decision-making, consistent with the *timeframe* of the obligation.

3. Financial Materiality and Timeframe

The prudence aspect of the modern definition proposed in the Report includes a duty to incorporate ESG issues without the client asking for it. This situation arises when (a) the client has not elected any ESG preference in his instructions, or (b) the fiduciary did not allow the client to express its preferences. Even in such cases, the integration of ESG is mandatory, subject to two conditions: (1) the ESG issue is financially material, and (2) it is consistent with the timeframe of the investment goals.

3.1 Materiality

The question of the materiality of ESG criteria is an essential one. Since the inception of the concept of ESG as opposed to SRI[48], the main empirical claim was that ESG criteria are «always» somehow material to the financial performance of companies, and hence of investment portfolios. Various authors have conducted financial research on this question since the beginning of the 2000s[49]. The first meaningful research was a meta-analysis conducted in 2007[50] that concluded that social and

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[36] Sandberg, 438.
[37] Sandberg, 438 (*«As Langbein and Posner put it, ‹both the duty of loyalty and the prudent man rule would be violated if a fiduciary were to make an [. . .] investment decision based on other objectives, such as to promote [job security or social welfare]› [Langbein and Posner, 1980:98]»*).
[38] The PRI is an independent network of large institutional investors created at the initiative of Kofi Annan, and partner of the United Nations.
[39] The *Generation Foundation* is the advocacy initiative funded by the profits of *Generation Investment Management* (whose Chairman is former Vice President of the United States Al Gore), see UNEP FI, Final Report, 58.
[40] The Fiduciary Duty in the 21st Century Project (see UNEP FI, Final Report, 52).
[41] The original Fiduciary Duty in the 21st Century Report (FN 2).
[42] UNEP FI, Final Report 13–14.
[43] UNEP FI, Final Report, 17–18.
[44] UNEP FI, Final Report, 19.
[45] UNEP FI, Final Report, 22.
[46] UNEP FI, Final Report, 23.
[47] UNEP FI, Final Report, 21.
[48] See above II.2.
[49] Sandberg, 438.
[50] Joshua Margolis/Hillary Elfenbein/James Walsh, Does it pay to be good? A meta-analysis and redirection of research on the relationship between corporate social and financial performance, 2007, https://www.researchgate.net/publication/237455609_Does_it_pay_to_be_good_A_meta-analysis_and_redirection_of_research_

environmental considerations most often have financial relevance for individual companies or investments[51]. In 2018 the PRI conducted a study that concluded that ESG integration offers investment outperformance advantages across all regions[52]. Bank of America Merrill Lynch Global Research led to the same results for the U.S.[53].

These studies show that ESG criteria are relevant from a statistical point of view most of the time. However, the mere fact that a company does perform poorly in terms of ESG criteria does not mean that it cannot have outstanding financial returns even in the long term. There is, for example, evidence that «vice» stocks (such as tobacco, alcohol, and gambling) often outperform on a risk-adjusted basis precisely because of investors' «moral aversion»[54]. However, the main takeaway of these studies leads, in our view, to the conclusion that ESG criteria cannot be simply ignored by a reasonable asset manager.

3.2 Timeframe

The additional element of the revised prudence definition is the timeframe aspects, as the integration of ESG criteria must be «consistent» with *long-term* investment goals (and hence with *long-term* obligations of the fiduciary). This also means that ESG issues – by nature, long-term objectives – are increasingly important given the investments' expected duration.

This is particularly obvious for environmental aspects, where climate change is expected to materialize in the *long term*, including its inherent effects on companies and our economy, but also in terms of increasing environmental regulation that presents additional risks and costs for environmentally sensitive sectors. Social aspects produce as well *long-term* effects, although arguably in a shorter timescale than climate issues. A company that does not respect human rights, for example, will eventually experience additional liability and reputational risks that would hinder its profits.

By contrast, the need to include ESG criteria when investing in *short-term* strategies either as part of a diversification strategy, or because the client requires so, is generally less material[55].

IV. Possibility of a modern interpretation

1. Organic concept of fiduciary duty

The Report states that «[t]*he concept of fiduciary duty is organic, not static. It will continue to evolve as society changes* […]»[56] and that this concept *«evolves and adjusts in response to changes in knowledge, market practices and conventions, regulations and policies, and social norms»*[57].

The concept of fiduciary duty is ancient and has evolved over time to reflect modern investment practices[58]. For example, at the beginning of the 20th century, in some states in the United States, investments in publicly traded stocks was seen as risky assets and forbidden under the prudent investor rule[59]. As portfolio diversification and risk management techniques evolved, fiduciary duties evolved with them and expanded the scope of eligible assets[60].

There is, therefore, no doubt that the interpretation of fiduciary duty is a moving definition that can change regularly. Moreover, claims are that fiduciary duties are evolving again to reflect the impacts of ESG issues on financial performance[61].

It is a truism to say that law is not static but in constant evolution. The critical question in that context is who decides that the law has changed. In democratic jurisdictions, change of law usually occurs through the relevant official authorities, such as the legislative or judicial branch. Regarding the judicial branch, this is especially true in common law countries where the judge has certain lawmaking prerogatives. It is also applicable to a more limited extent in civil law countries such as Switzerland, where judges do not, as a rule, have the power to create new law, but may have extensive interpretative power that can result in new interpretations of positive law.

In our view, we are precisely at this point in time where a modern interpretation is needed, as all conditions are fulfilled. From a Swiss law perspective, achieving *general acceptance* of a new definition of such a central legal concept should only be possible with some sort of *for-*

on_the_relationship_between_corporate_social_and_financial_performance (last visited 18 October 2021), passim.

51 Sandberg, 439.

52 Kim Nguyen-Taylor/Will Martindale (PRI), Financial Performance of ESG Integration in US Investing, 2018, https://www.unpri.org/download?ac=4218 (last visited 18 October 2021), 7; UNEP FI, Final Report 18.

53 Savita Subramanian et al. (Bank of America Global Research), ESG Part II: A Deeper Dive, 2017, https://www.iccr.org/sites/default/files/page_attachments/esg_part_2_deeper_dive_bof_of_a_june_2017.pdf (last visited 18 October 2021), passim; UNEP FI, Final Report, 18.

54 Schanzenbach/Sitkoff, 444; Harrison Hong/Marcin Kacperczyk, The Price of Sin: The Effects of Social Norms on Markets, Journal of Financial Economics (93), 15 et seq., Amsterdam 2009, 16–18 (2009).

55 Schanzenbach/Sitkoff, 397–398.

56 UNEP FI, Final Report, 13 (quoting Hon. Prof. Paul Watchman, School of Law, University of Glasgow).

57 UNEP FI, Final Report, 12.

58 Richardson, Pension Funds, 199.

59 Gary (FN 24), 800.

60 *Ibid.*

61 Richardson, Pension Funds, 199.

malization by public authorities, either in regulation or in a binding court ruling. Without a proper formalization of such change, there will always be discrepancies in the application of such standards, leading to significant differences of protection of investors and a fragmented market. Such *formalization* will certainly take place in the near future (either by the legislator, regulators, or courts).

2. Evolutive interpretation of Swiss law

According to the Supreme Court, the interpretation of a norm cannot stop at the intentions of the historical legislator. Norms also gain their meaning from the context in which they are placed, which is why their legal meaning can change with it[62].

2.1 Private law (Art. 398 para. 2 CO)

Art. 398 para. 2 CO[63] contains the core obligation which corresponds to fiduciary duties: the duty of loyalty and the duty of prudence/diligence. Such duties, which are not further defined in the text of the law, have been interpreted on many occasions by the Federal Supreme Court.

According to Swiss case law, the duties of an investment manager must be interpreted by means of objective criteria, which are, by essence, dynamic and evolutive. In any specific contractual liability case, the diligence of the investment manager is compared to the diligence of an objective «reasonable agent» placed in the same situation. The court considers not only the nature of the mandate but also particularities, such as whether there are any *«customs or rules generally followed in a profession or in a sector of the economy»*[64]. All these concepts are objective, and more importantly, they are evolutive, depending therefore on the market standard, which can obviously change significantly.

Consequently, if most investment managers consider, on the Swiss market or in a specific segment, that ESG criteria must be integrated into an investment management process, the investment manager who does not might breach Art. 398 para. 2 CO and therefore incur a liability (to the extent that the other liability criteria are fulfilled). This presupposed wide integration of such practice in the market, to become a true market standard, which is, however, difficult to measure.

2.2 Financial Market laws

Financial market laws, such as the Financial Services Act («**FinSA**»), the Banking Act («**BA**»), the Collective Investment Schemes Act («**CISA**»), and also the Occupational Pension Schemes Act («**BVG**»)[65] contain public law provisions. Compliance of entities subject to these laws is monitored by an authority (FINMA, and respectively the Occupational Pension Supervisory Commission).

Similar to private law, the interpretation of financial market laws is in constant change. The difference, however, consists in the existence of an authority, which can «specify the application of the legislation on financial markets» (Art. 7 FINMASA). Although the competence of FINMA to «specify» financial market laws has been subject to certain controversies and litigation, new practices and new interpretation of existing legal provisions are common, especially in respect of legal concepts which are formulated in broad terms, leaving much interpretation leeway to the supervisory authority.

For example, FINMA reinterpreted Art. 3g BA (which provides that FINMA can edict provisions regarding capital adequacy, liquidity, risk distribution, intra-group risk positions, and accounting for financial groups), Art. 12 of the Banking Ordinance (on risk management), and Art. 16 of the Capital Adequacy Ordinance[66] (on risks disclosure obligations), to mean that certain banks are required to publish disclosures regarding climate risks according to the recommendations of the Task Force on Climate-related Financial Disclosures («**TCFD**»)[67].

FINMA is also well-placed, due to its access to large data, to assess whether a market standard has been imposed among holders of licenses. It is clear that a modern interpretation of fiduciary duty by the regulator, from an organizational and rules of conduct perspective, would accelerate the re-interpretation of related obligations under private law[68].

It is, in our view, possible, according to such principles, for regulators to propose a modern interpretation of fiduciary duty, limited however to the specific obligations according to the existing legal frameworks, which will be analyzed below.

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[62] Federal Court decision BGE 125 II 192 E. 3g; Federal Court decision BGE 122 I 222 E. 1b/aa p. 224.

[63] Swiss Code of Obligations (220).

[64] Federal Court decision 4A_556/2019 of September 29, 2020, para. 4.3.1.

[65] The BVG is not, per se, a financial markets law as defined in Art. 1 para. 1 FINMASA.

[66] Capital Adequacy Ordinance (952.03).

[67] FINMA Circular 2016/01, as amended on 6 May 2021.

[68] Regarding the effects of public law on private law in relation to FinSA, see Thomas Jutzi/Fabian Eisenberger, Das Verhältnis von Aufsichts- und Privatrecht im Finanzmarktrecht, PJA 2019, 6–28.

V. Need for a modern interpretation

1. Recent economic and market development

Over the past decade, many developments have led to a dramatic change in the investment landscape. The list below is a summary of some key developments:

According to the *Recommendations of the Task Force on Climate-related Financial Disclosure (TCFD),* there is a growing consensus in the wake of the 2008 financial crisis that *«seeking immediate high returns without accounting for long-term implications may lead to underperformance of the economy as a whole.»*[69] As pointed out by these recommendations, negative shareholder value will be a result of weak corporate governance. Thus, the focus of investors shifted increasingly on those aspects. Additionally, more and more investors request transparency on climate change aspects and risk management approaches from organizations all over the world, resulting in an increased demand of *«risk information that is consistent, comparable, reliable and clear»*[70].

The *Paris Agreement,* adopted by nearly 200 governments in December 2015, is a landmark instrument in the climate change process. It is a fact, backed by numerous scientific studies, that continued greenhouse gas emissions will result in further and irreversible global warming. Compared to the pre-industrial period, warming of + 2° Celsius can cause disastrous social and economic consequences[71]. Switzerland ratified the Paris Agreement on 6 October 2017[72]. Economic decision-making is uniquely challenging due to the long-lasting nature of climate change and its global impact[73]. The Paris Agreement includes the objective of developing sustainable finance (*«making finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development»*)[74].

Regulatory factors: On international and national levels, the current legal framework can be considered as an evolving patchwork of legal requirements. According to the Swiss Federal Council, Switzerland's financial center plays a major role on the road to sustainable development[75]. In Europe, new disclosure regulations[76] led to increased awareness of the subject by investors. This affected Swiss investment managers with activities within the EU as well. These regulatory factors, as well as the demands of institutional and private investors, helped to shift sustainable investments higher on the priorities list of Swiss financial players. For the Federal Council, there are significant opportunities for a successful sustainable Swiss financial center. On 18 August 2021, the Federal Council *«decided on parameters for the future mandatory climate reporting by large Swiss companies. The Federal Department of Finance is to prepare a consultation draft by summer 2022»*[77].

In December 2020, and in order to prevent so-called *greenwashing* (i.e., a pretended sustainable business activity in terms of environmental impact), the State Secretariat for International Finance (**SIF**) and the Federal Office for the Environment (**FOEN**) were mandated by the Federal Council, to define necessary amendments to existing financial market legislation until autumn 2021[78]. Keeping in mind that Swiss financial products must remain exportable, the Federal Council recognized that international developments, especially those in the E.U., must be taken into consideration[79]. In November 2021, the Federal Council mandated the Federal Department of Finance (FDF), in cooperation with the Federal Department of the Environment, Transport, Energy and Communications (DETEC) and FINMA, to come with a proposal by the end of 2022 on possible amendments of the financial market legislation to address in particular greenwashing concerns. Such a proposal is expected by the end of 2022.[80]

The organizations developing voluntary reporting standards and frameworks have a key role to play in the development of sustainable markets: TCFD, Global Reporting Initiative («**GRI**»), Sustainability, Accounting Standards Board («**SASB**»), Carbon Disclosure Project («**CDP**»), Climate Disclosure Standards Board («**CDSB**») and the

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69 Task Force on Climate-related Financial Disclosure («**TCFD**»), Recommendations of the Task Force on Climate-related Financial Disclosure, June 2017, (hereafter: «**TCFD, Recommendations**»), 1.

70 *Ibid.*

71 Intergovernmental Panel on Climate Change (IPCC), Fifth Assessment Report, Cambridge 2014, https://www.ipcc.ch/assessment-report/ar5/ (last visited 18 October 2021).

72 Federal Office of the Environment (FOEN), https://www.bafu.admin.ch/bafu/en/home/topics/climate/info-specialists/climate--international-affairs/the-paris-agreement.html (last visited 10 October 2021).

73 TCFD, Recommendations (FN 69), 1.

74 Art. 2(1)(c) Paris Agreement, U.N. Doc. FCCC/CP/2015/L.9/Rev/1 (Dec. 12, 2015).

75 Swiss Federal Council, Nachhaltigkeit im Finanzsektor Schweiz Eine Auslegeordnung und Positionierung mit Fokus auf Umweltaspekte Bericht des Bundesrates, June 2020, https://www.newsd.admin.ch/newsd/message/attachments/61902.pdf (last visited 18 October 2021).

76 For example: Regulation (EU) 2019/2088 of 27 November 2019 on sustainability-related disclosures in the financial sector (SFDR); Regulation (EU) 2020/852 of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088 (Taxonomy-Regulation).

77 Press release of the Federal Council of 18 August 2021, https://www.sif.admin.ch/sif/en/home/dokumentation/medienmitteilungen/medienmitteilungen.msg-id-84741.html, and press release of 11 December 2020, https://www.sif.admin.ch/sif/en/home/dokumentation/medienmitteilungen/medienmitteilungen.msg-id-81571.html (last visited 17 October 2021).

78 *Ibid.*

79 *Ibid.*

80 https://www.sif.admin.ch/sif/en/home/dokumentation/medienmitteilungen/medienmitteilungen.msg-id-85925.html (last visited 20 November 2021).

International Integrated Reporting Council («**IIRC**») have developed important voluntary reporting standards and frameworks to guide investors and firms. Investors gradually accept and acknowledge these standards and frameworks. In September 2020, in order to establish a global standard, the above-mentioned institutions of GRI, SASB, CDP, CDSB, and IIRC committed to working closely with IOSCO and the IFRS Foundation in establishing a global standard along with the TCFD recommendations for the first time[81].

The urgent need to consider resilience in both the financial system itself and in the role played by capital and investors financial industry has been brought up by an unconventional situation: the current *COVID-19 pandemic.* By adhering to sustainable investments, capital and investors are evolving the existing economic and social systems, making them more dynamic and capable of withstanding unexpected external crises. The pandemic showed existing systems and resources *«woefully ill-prepared and insufficient to protect communities and markets from health, socio-economic and political shocks»*[82]. The coronavirus, the handling of the current situation, and the work done by governments and businesses should be seen as an opportunity to build a stronger, healthier in terms of resilience, adaptable, and thus more sustainable economy. Transparency and disclosure play an important role in that respect[83].

2. ESG Investing in OECD countries, including Switzerland

As reported by the OECD[84] on 25 September 2020[85], *«ESG Investing has grown rapidly over the past decade, and the amount of professionally managed portfolios that have integrated key elements of ESG assessments exceeds USD 17.5 trillion globally»*[86]. The amount of available ESG-related investment products is continuously increasing. According to the report, it can be said that investors understood the impact on the long-term investment performance of ESG and corporate governance factors – including risk and opportunities – as shown by their growing interest in the subject.

The report recommends that this investor interest should therefore be given appropriate consideration in investment decisions to generate sustainable, long-term financial returns.

In its report of 4 September 2021[87], the OECD pointed out that ESG investing has become a *«leading form of sustainable finance»*[88]. After its early stages of development, it has become a topic of *«mainstream finance in a number of OECD jurisdictions»*[89] through the integration of ESG factors in investment decisions. ESG ratings, which apply to companies that account for around 80 % of market capitalization in 2020, have developed over the past few years. They now incorporate long-term financial risks and opportunities in the decision-making processes.

Additionally, ESG rating is increasingly used to align investments with a low-carbon transition. Several investment products and metrics have been developed to help investors align their portfolios with corresponding specific climate objectives and strategies.

According to the *Swiss Sustainable Investment Market Study 2020*[90], the total volume of sustainable investments reached CHF 1,163.3 billion in Switzerland. The sustainable investment market is growing rapidly. The study points out that global discussion on investor responsibilities has *«further shifted away from a risk-return profile to focus more on impact generation*[91]». One interesting observation of the study is «*that asset managers perceive the lack of standards as the main barrier for the further growth of the sustainable investment market»*[92]. The study also found that investors monitor such develop-

[81] Value Reporting Foundation, https://www.integratedreporting.org/resource/statement-of-intent-to-work-together-towards-comprehensive-corporate-reporting/ (last visited 16 October 2021).

[82] ESG Investing in the time of COVID-19 was part of the Davos Agenda of the World Economic Forum in January 2021, https://www.weforum.org/agenda/2021/01/esg-investing-covid19/; https://www.weforum.org/about/media-programme (last visited 10 October 2021).

[83] Michael R. Bloomberg, Chair of the Task Force and Founder of Bloomberg LP and Bloomberg Philanthropies in the press release of the third TCFD Status Report of 29 October 2020. The Status Report shows progress and highlights need for greater climate-related disclosures and transparency, https://www.fsb-tcfd.org/publications/ (last visited 18 October 2021).

[84] Organisation for Economic Co-operation and Development (OECD); 38 countries are Member countries, including Switzerland, https://www.oecd.org/about/document/ratification-oecd-convention.htm (last visited 12 October 2021).

[85] Organisation for Economic Co-operation and Development (OECD), ESG Investing: Practices, Progress and Challenges, OECD Paris, 25 September 2020, 6, https://www.oecd.org/finance/ESG-Investing-Practices-Progress-Challenges.pdf (last visited 18 October 2021).

[86] Global Sustainable Investment Alliance (2018), Global Sustainable Investment Review, http://www.gsi-alliance.org/wp-content/uploads/2019/03/GSIR_Review2018.3.28.pdf (last visited 18 October 2021), passim.

[87] OECD, ESG Investing and Climate Transition: Market Practices, Issues and Policy Considerations, OECD Paris, 4 September 2021, https://www.oecd.org/finance/ESG-investing-and-climate-transition-market-practices-issues-and-policy-considerations.pdf (last visited 10 October 2021).

[88] *Id.*, 3.

[89] *Id.*, 3.

[90] Swiss Sustainable Investment Market Study 2020 of Swiss Sustainable Finance («**SSF**») and the Center for Sustainable Finance & Private Wealth (CSP) of the University of Zurich in June 2020 (hereafter: «**Swiss SI Market Study 2020**»), https://www.sustainablefinance.ch/upload/cms/user/2020_06_08_SSF_Swiss_Sustainable_Investment_Market_Study_2020_E_final_Screen.pdf (last visited 10 October 2021).

[91] *Id.*, 3.

[92] *Id.*, 54.

ments and assess them more and more in a systematic way[93]. The *Swiss Sustainable Investment Market Study of 2021*[94] confirms that sustainable investments in Switzerland continue to become mainstream.

3. Conclusion

These developments show that environmental, social, and governance issues are important drivers of investment value and have reached wide acceptance. The integration of ESG criteria into investment practices and processes is increasingly seen as an established practice[95].

This means that the economic and market environment in which the fiduciary duty is applied has changed thoroughly. In line with this transformation, there have also been *«fundamental changes in the expectations of fiduciaries, investors, and beneficiaries»*[96]. This is necessarily changing the standards of conduct required of fiduciaries to satisfy their duties under applicable law. In other words, the more the market practices changes, the more the modern interpretation of fiduciary duty becomes required under Swiss law.

VI. Consequences of a modern interpretation

1. Modern Interpretation

According to the Report, the modern definition of fiduciary duty should include adaptations in duties of loyalty and prudence for fiduciaries under both *common law* and *civil law jurisdictions*[97].

We will focus in this article on the core propositions of the modern definitions, namely whether, in Switzerland:

(i) the **prudence/diligence duty** includes the obligation for fiduciaries to incorporate *financially material* ESG factors into their investment decision making, consistent with the timeframe of the obligation, and whether
(ii) the **loyalty/fidelity duty** includes the obligation for fiduciaries to incorporate preferences of the clients/beneficiaries, *whether or not these preferences are financially material*.

Under Swiss law, considering that the fiduciary duties are to be reinterpreted can have two sets of consequences.

The *first consequence arises under private law*. A breach of fiduciary duty would mean that the client has a claim for damages against its fiduciary (assuming the client is able to prove the other conditions under Swiss law, namely a loss, a causation link, and the fiduciary's fault, which is presumed in case of breach of contract). As fiduciaries act under a mandate under Swiss law (Art. 394 et seq. CO), which can be terminated at all times, proving a breach of fiduciary duty does not have, as a rule, consequences on termination rights.

The *second consequence is a regulatory one*. Although repeated breaches of civil law obligation can already incur regulatory sanctions from FINMA[98], independent regulatory obligations can also apply in this context, even in the absence of changes in the text of the law itself. We will analyze below which provisions under current law could already contain obligations to include ESG factors in the investment decision making (*obligation of diligence*), as well as possible obligations to require fiduciary to enquire on their clients' sustainability preferences (*obligation of loyalty*).

2. Financial Services Providers

2.1 Civil law

The provision of financial operations to a client is generally subject to the provisions of the agency contract (Art. 394 et seq. CO), which regulates the rights and obligations arising from the contractual relationship between the investment manager and its client. The investment manager is liable to its client for the diligent and loyal performance of its mandate (Art. 398 para. 2 CO).

The *duty of loyalty/fidelity* includes the obligation of the fiduciary to *«act honestly and in good faith»*[99] in the sole interests of his client. According to the *duty of prudence/diligence* the fiduciary has an obligation to act with *«due care, skill and diligence»*[100] compared to the diligence of an objectivized *«reasonable agent»* placed in the same situation.

Generally, the investment manager also has an obligation to *render accounts* of its activities to a client (see Art. 400 para. 1 CO). According to Swiss case law, the extent of the duty to *inform* a client depends on the knowledge and the state of experience of said client[101]. Swiss case law also provides that the *extent of the duty of loyalty*

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93 *Id.*, 5, 54.
94 Swiss Sustainable Investment Market Study 2021, https://marketstudy2021.sustainablefinance.ch/ (last visited 18 October 2021), 52.
95 See above V.1.
96 See above V.1.
97 UNEP FI, Final Report, 21.
98 FINMA, Communication 41 (2012) of 26 November 2012, 5: *«l'exigence prudentielle de la garantie d'une activité irréprochable, à laquelle les assujettis doivent satisfaire, passe par le respect rigoureux des obligations civiles determinantes»* (translation: *«the prudential requirement of an irreproachable activity, which must be fulfilled by the licensed entities, requires the strict compliance with relevant civil law obligations.»*).
99 UNEP FI, Original Report, 21.
100 *Id.*, 21.
101 Federal Court decision BGE 133 III para. 7.1.1.

and the duty of prudence/diligence depends on the contractual nature of the service, i.e., an execution-only, investment advice, or a portfolio management mandate[102].

According to Swiss case law[103] (see Section IV.2.1), the duties of an investment manager must be interpreted by means of objective criteria and by considering if there are any rules generally followed in a profession or in a sector of the economy.

As outlined in Section V, national and international studies show that the sustainable investment market has grown rapidly in the last few years. The practice of integrating ESG factors in the decision-making process is rapidly becoming a part of mainstream finance[104].

Investors understand the impact on the *long-term* investment performance of ESG and corporate governance factors – including risk and opportunities – as shown by their growing interest in the subject. In line with this transformation, there have also been *«fundamental changes in the expectations of fiduciaries, investors, and beneficiaries»*[105]. As climate change unfolds, it is a fact that financial exposure to transitional challenges as well as physical and liability risks is intensifying. At the same time, new investment opportunities arise.

As ESG criteria are rapidly becoming a part of mainstream finance, changes in the investment management market call for a modern interpretation of the duty of loyalty and *the duty of prudence/diligence* of Art. 398 para. 2 CO.

On the one hand, a modern interpretation of the *duty of prudence/diligence* means under Swiss law that an investment manager must incorporate financially material ESG factors in his investment decision-making, consistent with the timeframe of the investment goal[106]. Although investment managers can choose how they wish to implement such obligations in accordance with accepted market practices, the integration of ESG criteria implies constant forward-looking assessments, an understanding of risk and opportunities, adequate investment strategies, and their financial implications. Such integration must be tailored to each specific case, depending in particular on the risk profile of the client and the time horizon of its investments.

Asset managers have, at this stage of market development in respect of the ESG concept and its acceptance as part of their fiduciary duty, many different possibilities to implement ESG factors into their decision-making process. Examples of sustainability approaches common in the market include exclusions (negative screening), best-in-class, voting and engagement, sustainable thematic investments, and impact investment[107]. It is important to note that these approaches have *«different effects and serve different motivations»*[108]. An asset manager must choose one of the approaches, or a combination of approaches, depending on various criteria such as the clients' needs or the type of assets managed[109].

The main change *for all investment managers*, which is already an important step, is to consider that the modern interpretation of fiduciary duty imposes to all fiduciaries the obligation to incorporate ESG factors in their decision-making process. Although the scope of the obligation would differ depending on the size of the investment managers, their expressed or perceived sustainability investing strategy, the mandates given by their clients, assets under their control, and various other factors, a modern interpretation of fiduciary duty under Swiss law would mean that *no investment manager can simply ignore ESG criteria when taking an investment decision for a client*. Including ESG criteria does not mean that sustainable investments shall be preferred in all scenarios or that all investment managers shall pursue sustainable strategies or offer ESG products, but only that ESG criteria shall be integrated in the decision-making process.

The consequences of ignoring ESG criteria in an investment management mandate would mean a breach of contract and a possible liability of the manager if an ESG risk materializes and that the client is able to prove its damage.

On the other hand, a modern interpretation of *duty of loyalty* would lead to requiring investment managers to allow clients to express their sustainability preferences, *whether or not these preferences are financially material*[110]. The consequences of not asking for such preferences would also amount to a breach of contract, although the consequences in terms of liability would be more difficult to ascertain where the preferences are not financially material (due to the challenges in practice to prove a damage in such cases). Therefore, such obligations could be more effective at a regulatory level, as the

[102] Federal Court decisions BGE 133 III para. 7.1 and 7.1.1; 4A_449/2018 of 25 March 2019, para 3.2 and 3.3; see also Mirjam Eggen/Cornelia Stengel, Berücksichtigung von Klimarisiken und -wirkungen auf dem Finanzmarkt, October 2019, 33 et seq., https://www.bafu.admin.ch/bafu/de/home/themen/klima/recht/rechtsgutachten.html (last visited 18 October 2021).

[103] Federal Court decision 4A_556/2019 of September 29, 2020, para. 4.3.1.

[104] OECD (2020), OECD Business and Finance Outlook 2020: Sustainable and Resilient Finance, OECD Publishing, Paris, https://doi.org/10.1787/eb61fd29-en (last visited 18 October 2021), 3.

[105] UNEP FI, Final Report, 21.

[106] *Ibid.*

[107] For definitions see AMAS/SSF, Sustainable Asset Management: Key Messages and Recommendations of SFAMA and SSF, 16 June 2020, section 1.6. Certain approaches are also used by the market to generate «impact» (not only to cover material financial risks).

[108] *Ibid*, para. 56.

[109] *Ibid*, para. 11, para.13 et seq., para 56, see also exemples in Appendix 3.

[110] *Ibid.*

regulated entities would have to apply them regardless of whether the damage can be proven by the client.

2.2 Supervisory law

In addition, if the investment manager is a financial service provider[111], the Federal Act on Financial Services (FinSA)[112] applies. According to Art. 1 para. 1 FinSA, its goal is to protect the clients of financial service providers and to establish comparable conditions for the provision of financial services by financial service providers, and thus contributes to enhancing the reputation and competitiveness of Switzerland's financial center, in line with Art. 4 FINMASA[113]. This article provides that financial market supervision laws follow the objective of protecting creditors, investors, and insured persons as well as ensuring the proper functioning of the financial market. FinSA thus contributes to sustaining the reputation, competitiveness, and sustainability of Switzerland's financial center. FinSA contains public law requirements for financial services providers in the form of rules of conduct and organizational requirements.

When providing financial services[114], financial service providers must comply with the rules of conduct according to Art. 7 to 20 FinSA.

These rules of conduct contain the duty to:

(i) provide information to clients (Art. 7 et seq. FinSA);
(ii) perform an appropriateness or suitability review in case of providing investment advice or portfolio management (Art. 10 et seq. FinSA);
(iii) document in an appropriate manner and render accounts (Art. 15–16 FinSA); and
(iv) provide transparency and care in client orders (Art. 17 et seq. FinSA).

Financial services providers must also take organizational measures and prevent conflicts of interest (Art. 25 ff. FinSA). Further organizational requirements are provided for under the FinIA[115] as well, namely risk management obligations applicable to licensed investment managers (either as managers of collective portfolios or as individual asset managers). Integration of ESG criteria in the investment process corresponds to a risk management obligation (see below VI.2.3d).

In the parliamentary debates on the FinSA in 2017, motions to embed specific sustainability criteria, in particular in the investment advice and discretionary investment management provisions of FinSA, were clearly rejected[116]. One of the reasons given for the rejection was that it should be left to the financial service providers to decide how they want to structure their investment policy[117]. As discussed in the debates, sustainable products and services could be used as positive differentiating features in a competitive market and should therefore not be prescribed by regulation[118]. The importance of this rejection at the parliamentary level should be mitigated. Indeed, FinSA provisions were heavily debated, and a political consensus was difficult to reach on various fundamental questions. Adding a new layer of complexity through sustainability provisions was, at that time, very challenging politically. In its Guidance 05/2021, FINMA stressed the fact, that FinSA does not contain specific provisions on how to take into account sustainability preferences at the point of sale, although this might change in the future.

In any event, contractual obligations have an effect on supervisory law, and repeated breaches of civil law obligations can lead to regulatory sanctions under the general principle of the guarantee of irreproachable business conduct[119].

Another meaningful sign that the market standard is evolving is the publication by the Swiss Bankers Association of the *Guideline for the integration of ESG considerations into the advisory process for private clients*[120]. Such guideline (although not binding) provides that (i) ESG considerations can be fitted into the existing regulatory framework[121], (ii) ESG preferences form part of the documentation framework under FinSA requirements[122], (iii) ESG criteria, if financially material, should be still taken into account even if the client has expressed

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[111] According to Art. 3 para. c FinSA financial services are any of the following activities carried out for clients: acquisition or disposal of financial instruments, receipt and transmission of orders in relation to financial instruments, administration of financial instruments (portfolio management), provision of personal recommendations on transactions with financial instruments (investment advice) and granting of loans to finance transactions with financial instruments.

[112] Financial Services Act (950.1)

[113] Financial Market Supervision Act (956.1).

[114] According to Art. 3 para. c FinSA financial services are any of the following activities carried out for clients: acquisition or disposal of financial instruments, receipt, and transmission of orders in relation to financial instruments, administration of financial instruments (portfolio management), provision of personal recommendations on transactions with financial instruments (investment advice) and granting of loans to finance transactions with financial instruments.

[115] Financial Institutions Act (954.1).

[116] Official bulletin of parliamentary business, https://www.parlament.ch/en/ratsbetrieb/amtliches-bulletin/amtliches-bulletin-die-verhandlungen?SubjectId=40908, NR HS 2017, third session (last visited 18 October 2021); Eggen/Stengel (FN 101), p. 31.

[117] Maurer, Official bulletin of parliamentary business AB 2017 N. 1208; see also Eggen/Stengel, p. 31.

[118] Gössi, Official bulletin of parliamentary business AB 2017 N. 1308; see also Eggen/Stengel, p. 31.

[119] See footnote 97.

[120] Swiss Bankers Association, Guideline for the integration of ESG considerations into the advisory process for private clients, June 2020, https://www.swissbanking.ch/_Resources/Persistent/5/9/3/b/593b75d1d479ddc70fff20a76991deffd9ca4bab/SBA_Guidelines_for_the_integration_of_ESG_considerations_into_the_advisory_process_for_private_clientsEN.pdf (last visited 18 October 2021).

[121] *Id*, p. 4.

[122] *Id*, p. 8.

no interest in applying ESG criteria to its investments[123], (iv) ESG preferences apply to both discretionary investment management and investment advisory mandates[124], and (v) suitability and appropriateness also apply to ESG investment solutions, with similar considerations from financial advisors[125].

FINMA in its Guidance 05/2021, indicated that the Guideline of the Swiss Bankers Association could help reduce the risk of greenwashing at the point of sale. FINMA noted that greenwashing risks exist at the point-of-sale level and that financial service providers shall manage them. One of the risks identified by FINMA is the civil liability risk, although the possibility for clients to prove damage in such a context may be challenging (see above VI. 2.1).

Point of sale recommendations apply in respect of both Swiss and foreign financial products (not limited to funds).

Similar to the private law obligations, market practices tend, therefore, to consider that implementation of ESG criteria is required for any prudent manager. The conditions are, in our view, already fulfilled for FINMA to consider that all investment managers must include ESG criteria in their investments and risk process due to their inherent financial materiality.

As regards the duty to allow clients to express sustainability preferences that are *not financially material,* such obligation would be more effective if embodied in the regulatory framework rather than exclusively in the civil one, although the conditions for such a regulatory framework are, in our view, not met yet, for the following reasons.

From a practical point of view, if a client expresses *non financially material preferences* that require, especially, *impact investing*[126] or *engagement approaches*[127], not all investment managers have the capabilities to scale up their internal processes and organize the implementation of such client preferences. The implementation of such approaches can be very challenging, as it requires in particular specific data as well as resources and specialized knowledge of data handling. As of today, numerous investment managers are still not able to offer a product range corresponding to a client's non-financially material preferences (e.g., due to costs reasons, size, lack of specialized knowledge, investment strategy). Requiring investment managers to ask clients' preferences where they do not have the capabilities to implement impact investing or engagement approaches would produce counter-productive effects and false expectations. Against this background, a general obligation to ask clients' for non-financially material preferences at a regulatory level that require impact investing or engagement approaches would be, in our view, premature.

In any event, a one-size-fits-all approach could not be realistically implemented in the short term. The regulation would have to take into account the capabilities of the investment managers and, for example apply first to larger investment managers. One could also consider various degrees of granularity when asking for non-financially material client preferences, depending on the size and capabilities and/or the sustainable investment strategy of the investment managers.

2.3 Investment Funds

a. Fiduciary Duties

In the investment funds area, Art. 20 CISA provides that all persons who act as administrator, custodian or representative of collective investment schemes, as well as their agents, are considered fiduciaries, subject to obligations of loyalty (acting independently and *exclusively* in the interest of investors), diligence/prudence (organizational measures for irreproachable business conduct) and information (towards investors).

The duties described in Art. 20 CISA are very broad but are namely specified in Art. 31 to 34 CISO, as well as in the self-regulation of the AMAS[128]. None of these provisions, however, contain specific ESG-related obligations.

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123 *Id*, p. 8.

124 *Id*, p. 6.

125 *Id*., p. 10.

126 AMAS/SSF, Sustainable Asset Management: Key Messages and Recommendations of SFAMA and SSF, 16 June 2020, para. 54: *«Impact investments intend to generate a measurable, beneficial social and / or environmental impact alongside a financial return. Important differentiating factors to other forms of sustainable investments (namely thematic investing) are the intentionality of an investment in a sector or activity that has such a positive impact, the management process that allows for a direct impact, and the measurability of the impact through relevant Key Performance Indicators (KPIs). Impact investments can be made in both emerging and developed markets and target a range of returns from below-market to above-market rates, depending upon the circumstances. If an asset manager claims to provide impact investment products, regular reporting is crucial for the intention, the respective management processes and the achieved impact, based on relevant KPIs.»*, https://www.sustainablefinance.ch/upload/cms/user/EN_2020_06_16_SFAMA_SSF_key_messages_and_recommendations_final.pdf (last visited 18 October 2021)

127 AMAS/SSF, Sustainable Asset Management: Key Messages and Recommendations of SFAMA and SSF, 16 June 2020, para. 50: *«Engagement refers to an active dialogue between shareholders and management teams of investee companies or other relevant stakeholders with the goal of convincing them to take account of environmental, social and governance criteria within their sphere of influence. A structured engagement process defines clear engagement targets with a clear timeframe and reports on outcomes such as changes in a company's strategy and processes so as to improve ESG performance and reduce financial risks.»*, https://www.sustainablefinance.ch/upload/cms/user/EN_2020_06_16_SFAMA_SSF_key_messages_and_recommendations_final.pdf (last visited 18 October 2021).

128 Asset Management Association Switzerland, https://www.am-switzerland.ch/association/en/selbstregulierung-standard/guidelines-valid-as-of-1-january-2022 (last visited 18 October 2021).

b. Sustainability Preferences

From a loyalty perspective, it is obviously not possible to impose to a fund to consider the preference of investors, since the management of the assets is not tailored to a specific investor, but to the fund itself (with a multitude of investors) with its existing investment objectives and criteria detailed in the fund documents. As regards single investor funds, such investors (generally large professional or institutional investors) can generally impose their own conditions, and protection in that regard is not required.

c. Transparency and Reporting

FINMA recently provided more clarity on its practice regarding fund-level requirements for Swiss collective investment schemes in its Guidance 05/2021 on the prevention and combating of greenwashing[129]. The scope of such regulation is limited to sustainability-related funds, meaning funds which (i) refer to sustainability in their name (e.g, sustainable, green, ESG, environment-friendly), (ii) are described as sustainability-related in the product documentation, or (iii) otherwise provide for a link to sustainability, typically through advertisement. The legal basis for such practice is based, in our view, on Art. 12 CISA, protecting the public against deceptive and confusing names.

Sustainability-related funds have since September 2021 two sets of anti-greenwashing obligation, regarding *transparency* and *reporting.*

On *transparency,* information to be provided must (i) avoid references to sustainability where no sustainable investment strategy/policy is pursued, (ii) include details about the sustainability approach and its implementation, (iii) ensure consistency between the approach chosen and the investments allowed, (iv) provide for approaches other than widespread exclusion criteria (which would not be sufficient as such), (v) include reference to «impact investments» or «zero-carbon» only where such impacts or carbon reductions can be measured and verified, and (vi) provide details about the investment strategy/policy, the selection of permitted investments, and details on how sustainability considerations are integrated into the investment decision process; in such context, general information is not sufficient.

In its presentation held on November 9, 2021, FINMA gave interesting examples encountered in its practice, where the measures implemented were not sufficient. Among various examples given, allowing 1/3 of investments that do not follow a sustainability approach is typically not admissible. FINMA also explicitly recommended to asset managers to apply the key messages and recommendations of AMAS and SSF of 16 june 2021, especially regarding the sustainability approaches.

The main novelty introduced by the FINMA Guidance 05/2021 consists of retrospective *reporting* requirements regarding the extent to which a sustainability-related fund has achieved its sustainability goals. Although FINMA does not mention which standards the reporting should follow, it recommends a «high degree of transparency».

According to FINMA's developing practice, the ex-post ESG reporting shall be (i) publicly available, (ii) consistent (in terms of form and content), (iii) highly transparent, and (iv) avoid extensive disclaimers (e.g., regarding ESG ratings).

d. Information Duty about Risks

According to Art. 84 para. 2 CISA, investors are entitled to obtain certain information from the fund management company or the SICAV. Among such information, investors shall be informed about *«risk management»*, and the fund management company or the SICAV shall *«inform the investors at all times upon request.»*

Such information duty can be limited by the general principle requiring fund management companies to treat investors equally. It shall make sure not to give certain investors information that the others do not have or cannot obtain[130]. Business secrets are also protected and do not fall within the extended information duty of the fund management company. The same goes for confidential or sensitive information, which may have an impact on the NAV price. Information, which, if granted to an investor, would put such investor in a more favorable position as compared to other investors, is generally not disclosable[131].

Regarding information rights, one shall distinguish between (i) information about the fund management company itself (for example, whether it takes into account ESG criteria generally for all its funds, or imposes such requirement to asset managers to which it delegates the asset management of its funds), and (ii) information about a specific fund.

In respect of the first category, such information does usually not raise any issues, and such information can be provided. Investors do, however, not have a right to obtain such information, as it is not related to the specific fund where the investor has invested[132].

Information about a specific fund in which the investor has invested (either currently or in the past) must be

[129] https://www.finma.ch/en/documentation/finma-guidance/ (last visited 13 November 2021).

[130] BSK KAG-du Pasquier/Rayroux, Art. 84 N 2.

[131] *Ibid.*

[132] See also Guidelines of the Asset Management Association Switzerland on Duties Regarding the Charging and Use of Fees and Costs (Transparency Guidelines) of 22 May 2014, para. 15.

provided. A modern interpretation of fiduciary duty in such context results in considering that ESG aspects are a risk management question within the meaning of Art. 84 para. 2 CISA. They give rise to the right of the investor to obtain such information. Although not referring to Art. 84 CISA, and limited to sustainability-related funds, the reporting obligations introduced recently by FINMA in its Guidance 05/2021 (see above), are in line with a modern interpretation of fiduciary duty. Due to Art. 84 para. 3 CISA (which provides that the investor can request orders from a court), such obligation is not only a regulatory one for the fund management company but also creates a civil law claim of the investor against it.

e. Integration of ESG

It is important to emphasize that financial materiality remains a *sine qua non* condition of mandatory ESG integration. As a result, identifying ESG criteria consists in identifying risks and benefits, which is not conceptually different[133] from other risks such as litigation or regulatory risk[134].

From this concept, all entities which are subject, regulatory-wise, to risk monitoring, should be required to include ESG criteria in their processes. This approach is in line with FINMA's interpretation of the materiality of climate risks, as well as with the recommendation of the AMAS dated 16 June 2020[135].

Fund management companies and asset managers of collective assets (of investments funds or pension funds) are required, according to Art. 26 FinIA, to manage risks regarding the assets entrusted to them. Such obligations are specified in Art. 41 FinIO, and by Art. 8 to 14 FinIO-FINMA[136].

While such obligations do not specifically mention climate risks, the risks that must be managed according to Art. 10 para. 1 FinIO-FINMA are the «main risks» of the collective investment scheme. Art. 11 para. 3 let. c FinIO-FINMA provides that the market, liquidity, and counterparty risks must be managed.

Although the analysis of the risks must necessarily be tailored to the type of investments and the size of the collective investment scheme, applied according to the principle of proportionality, it is in our view clear that an ESG risk analysis is required for all asset managers of collective assets, fund management companies, and SICAVs.

In its Guidance 05/2021, and based on Art. 9 FinIA, as well as Art. 14 para. 1 let. c, and Art. 20 para. 1 CISA, FINMA clarified the organizational requirements applicable to all entities based in Switzerland managing sustainability-related funds (both Swiss and foreign):

- The investment decision process must consider sustainability factors, which shall then be reviewed as part of the investment controlling and risk management monitoring.
- Sustainability-related knowledge and expertise shall be available within the governance, supervision and control function, and at the operational level.
- The body for governance, supervision, and control shall set out the sustainability strategy.
- The entity shall assess, monitor, and validate information provided by external data providers (analysis, data, tools, and rating).

The obligations include complying with the sustainability strategy of each product, and the identification of sustainability risks within the risk management process, in addition to traditional investment risks.

According to FINMA's presentation on November 9, 2021, examples of inappropriate measures include:

- changes introduced based on customer pressure;
- unclear exclusion criteria;
- insufficient awareness of greenwashing risks;
- insufficient control framework for data delivery from external rating and benchmark providers;
- inadequate performance targets for ESG team members; and
- incomplete integration of ESG risks in the risk reporting/control framework.

FINMA considers for now that these risks «affect all the traditional risk categories, such as credit, market or operational risks»[137]. It is only a question of time before specific risk obligations are included in the mandatory risk management frameworks of asset managers (not only those managing sustainability-related funds), and this without needing a new legal basis.

[133] Schanzenbach/Sitkoff, 448.
[134] This is also FINMA's understanding: see FINMA Commentary on the Partial Revision of Circulars 2016/1 and 2016/2: https://www.finma.ch/de/~/media/finma/dokumente/dokumentencenter/anhoerungen/laufende-anhoerungen/20201110-klimabezogene-finanzrisiken/erl_rs16_01_16_02_20210506_de.pdf?la=de (last visited 18 October 2021): *«These climate-related risks can be described and captured in the classic categories of risk, such as credit, market, insurance, or operational risks. They therefore do not form a new risk category, but a new risk factor. In principle, financial institutions can build on their existing risk management. However, new developments in the environment and new risk factors must also be effectively recognized and managed and manage them appropriately.»* (translation).
[135] AMAS/SSF, Sustainable Asset Management: Key Messages and Recommendations of SFAMA and SSF, 16 June 2020, https://www.sustainablefinance.ch/upload/cms/user/EN_2020_06_16_SFAMA_SSF_key_messages_and_recommendations_final.pdf (last visited 18 October 2021).
[136] Art. 8 to 14 FinIO-FINMA are applicable to fund management companies by virtue of Art. 18 para. 1 FinIO-FINMA and to SICAVs according to Art. 67 CISO-FINMA.
[137] *Ibid.*

2.4 Pension Funds

The only textual reference under Swiss law to «fiduciary duty» (*devoir de diligence fiduciaire/treuhänderischen Sorgfaltspflicht*) is set out in Art. 51b para. 2 BVG. Such fiduciary duty is applicable to all persons or entities in charge of the administration or management of a Swiss pension fund.

A core aspect of fiduciary duty and of the obligations deriving from a mandate under Swiss law is the duty to act in the interest of the client or beneficiary and take into account its instructions.

For pension funds, especially, the investment horizon is usually expressed in the long term, as they use their proceeds to provide returns to employees' retirement benefits across several generations[138]. Various authors have emphasized the relation between sustainable investments and the long-term goals of pension funds[139], although other authors have mitigated this argument because, in practice, pension funds often have rolling investments focused on *short-term* investments, making them *«perpetual investors making short-term investments, forever.»*[140]

a. Integrating ESG criteria (prudence)

The BVG does not set out textual obligations to include ESG criteria in the investment process. Under Swiss law, scholars do not agree on the scope or effects of the inclusion of ESG criteria and whether such obligation can be inferred from current law[141].

Similar to asset managers regulated under FinIA, all fiduciaries that have risk identification and monitoring duties are required, in our view, to include ESG criteria in their processes.

We concur with the authors who consider that the relevant material risks deriving from ESG criteria must already be taken into account by all persons in charge with pension funds pursuant to Art. 51b para. 2 BVG, Art. 71 para. 1 BVG, as well as Art. 50 para. 1 and 3 BVV2.

The rationale is that ESG criteria are, by definition, financially material, and are therefore to be transposed in a prudent asset management activity by taking them into account. This approach is agnostic on the final choices made by the relevant fiduciary, and it is more a question of organization and proper processes.

b. Preferences of pension fund beneficiaries (loyalty)

Regarding sustainability preferences (*loyalty aspect*), the situation regarding beneficiaries for pension funds (such as the employees contributing to an occupational pension fund) is complex. The beneficiaries cannot easily express their preferences or reach a consensus on the investment approach[142]. While the beneficiaries of collective investment schemes are voluntary investors that can walk away, the beneficiaries of pension funds (or trust schemes, or even insurance policyholders) usually result in a captive pool of investors with very different views.

Under Swiss law, Yvar Mentha interestingly suggests that the pension funds should regularly consult with the pension fund's beneficiaries and then operate investments according to the majority (simple or qualified) of beneficiaries, such orientation becoming mandatory for the pension fund, based on Art. 71 BVG[143].

Assuming that beneficiaries can give investment instructions to their pension fund, which is not necessarily the case under Swiss law[144], the question on how such decisions would be made by the beneficiaries would be challenging to overcome in practice (majority rule, granularity of questions, type of implementation). So even assuming that pension funds can act according to the beneficiaries' instructions, there are legal and practical difficulties that are complicated to overcome[145].

One of the difficulties of such an approach is that beneficiaries of a pension fund have different values and ethical opinions, and it is generally impossible in practice to determine what beneficiaries want[146]. The heterogeneity of beneficiaries would, in practice, make it impossible to define what investments would be permissible or not[147]. For specific issues, however, the outcome seems however clear: Freshfields in their Report assumed that some characteristics are so repugnant, such as child labor, that a fiduciary could assume that all beneficiaries would have

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[138] For a detailed argumentation on the specificities of pension fund fiduciaries see Karametaxas, The Role of Pension Funds in the Low-carbon Transition, in: Trigo Trindade/Bahar/Neri-Castrane (eds), Vers les sommets du droit: Liber amicorum pour Henry Peter. Geneva, 370–371.

[139] Sandberg, 439.

[140] Lydenberg, *Reason, Rationality and Fiduciary Duty*, 2013, http://iri.hks.harvard.edu/files/iri/files/lydenberg_-_reason_rationality_and_fiduciary_duty.pdf (last visited 18 October 2021).

[141] For a detailed overviews of the literature on this topic see Rolf H. Weber/Andreas Hösli, Der Klimawandel und die Finanzmärkte, GesKR 4/2019, 544 et seqq., 574, and the referred quotations from Mentha and Spillmann; Sandro Abegglen, Rechtsgutachten Klimarisiken in der Vermögensverwaltung bei Pensionskassen, 12. Oktober 2018, https://www.klima-allianz.ch/wp-content/uploads/181012-Rechtsgutachten-NKF-an-Klima-Allianz-Schweiz-betr.-Klimarisiken-Original.pdf (last visited 18 October 2021).

[142] On the possibility under trust law to authorize or ratify socially responsible investments, see William Sanders, Resolving the Conflict Between Fiduciary Duties and Socially Responsible Investing, 35 Pace Law Review (35/2), 535 et seq., 2014, 573–574 (2014).

[143] SHK BVG-Mentha, Art. 71 N 119.

[144] This is precisely the reason why the pension fund has a «fiduciary duty» by law, as it decides for beneficiaries' investments.

[145] For a detailed analysis of the trustee/beneficiary relationship in this precise context, see Richardson, *Multinational Perspective*, 621.

[146] Sandberg, 441.

[147] Sandberg, 442.

the same views[148]. Following such approach, it would be possible, in the future, that new criteria, typically known as key ESG factors, reach the same level of «repugnance» to investors, as to become impossible to place in a reasonable pension fund's portfolio.

In our view, we must assume, even by way of legal fiction, that a pension fund acts in the interest of all its beneficiaries and must therefore determine independently what it deems best for them – in other words, as a fiduciary. It must consider the broadest set of beneficiaries on a long-term basis (at an intergenerational level), and not according to a simple majority rule following a vote at a fixed point in time. The pension funds shall make sure that external investment managers to which the pension fund delegate the investment of part of the assets comply with sustainability preferences of the pension funds' beneficiaries, as determined by the pension fund itself as a fiduciary.

VII. Summary

The concept of fiduciary duty is organic and evolves along with societal changes. Growing views among asset managers internationally tend to consider that a modern interpretation of fiduciary duty is now needed. Such modern interpretation would include an obligation for investment managers to (i) *incorporate financially material ESG factors into their investment decision-making, consistent with the timeframe of the obligation* (**prudence**) and (ii) to *incorporate sustainability preferences of clients into their decision-making, whether or not such preferences are financially material* (**loyalty**).

Under Swiss law, such a modern interpretation would be possible, both under civil law and regulatory law. The modern interpretation of **loyalty** is in view required under both civil and regulatory law, mainly due to market developments and new understandings of the ESG criteria impacts on risks and performance. On a regulatory level, all investment managers subject to risk management obligations (banks, financial institutions under FinIA and CISA, as well as pension funds under the BVG) should include ESG criteria in their decision-making processes. They have flexibility on the implementation approaches of such obligation but cannot simply ignore ESG criteria without breaching their fiduciary duty and corresponding regulatory obligations. In line with FINMA Guidance 05/2021, such obligations apply extensively to Swiss asset managers of sustainability-related funds (both Swiss and non-Swiss).

Regarding the **prudence** aspects, a modern interpretation of fiduciary duty under civil law would produce in practice only limited effects due to challenges for the client to prove the damage due to a breach of non-material preferences. On the regulatory side, regulation could be effective but might be premature to be applied broadly among all investment managers due to implementation challenges regarding impact investing or engagement approaches. A regulation should, in any case, not follow a one-size-fits-all approach. A solution could consist in asking for client preferences based on different granularity levels depending on the size, the investment strategies and capabilities of the investment managers.

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[148] Freshfields Report, 12. Sandberg, 441 says that even on those issues, one could always find beneficiaries that have different opinions. This argument, although valid, does not undermine the fact that a very large consensus could be assumed in those cases case, and marginal views could be ignored, which should be the case at least under Swiss law.