

# Sustainability integration in investment management in the UK

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## Abstract

There is little doubt that conventional investment management takes into account material sustainability and ESG (environmental, governance, and social) matters. The more pertinent legal risk for investment managers is whether they would incur legal risk for failing to carry out certain ESG-related actions, such as engagement or divestment. As none of these actions are prescribed in the Stewardship Code to which investment managers may be voluntary signatories, challenges against asset owners (eg *McGaughey & Davies v USS*) would unlikely succeed as courts are arguably deferential to how investment management is carried out. The Financial Conduct Authority's (FCA) requirement for most fund managers to produce Taskforce for Climate-related Financial Disclosures entity-level and product-level reports arguably supports the assumption that climate risk is material to investment management. Specifically labelled sustainability funds, which may be opted into under new FCA regulation, entail specific disclosure and conduct duties to maintain the integrity of the labels, and seem robust in combating greenwashing. Such regulation is not, however, about steering allocation or necessarily mandating the achievement of non-financial objectives directed by public policy.

## 1. Introduction

The UK is home to a large and significant asset management industry, managing assets estimated at £9 trillion,<sup>1</sup> comprising global and domestic assets. Since the turn of the millennium, it has been observed that<sup>2</sup> investment management practices increasingly integrate material 'environmental, social and governance' (ESG) concerns, a mainstream evolution distinguished from concerns based on 'values' in relation to socially responsible investing<sup>3</sup> (which is based on faith or convictions). The nomenclature for ESG investing has more recently morphed into 'sustainable' finance more broadly.<sup>4</sup>

The mainstream evolution of sustainability integration in investment management covers a broad scope, from occupational pension schemes to self-invested pension schemes, as well as collective investment fund products such as mutual funds and alternative investment funds (hedge or private equity funds) and insurance products with investment elements. As collective

<sup>1</sup> The Investment Association, 'UK Investment Management Industry Assets under Management Grow to £9.1 trillion' (1 August 2024) <[https://www.theia.org/news/press-releases/uk-investment-management-industry-assets-under-management-grow-ps91-trillion#:~:text=The%20UK%20investment%20management%20industry,the%20Investment%20Association%20\(IA\)>](https://www.theia.org/news/press-releases/uk-investment-management-industry-assets-under-management-grow-ps91-trillion#:~:text=The%20UK%20investment%20management%20industry,the%20Investment%20Association%20(IA)>) accessed 27 Oct 2025.

<sup>2</sup> R Boffo and R Patalano, 'ESG Investing: Practices, Progress and Challenges' (OECD Paris, 2020) <[https://www.oecd.org/content/dam/oecd/en/publications/reports/2020/09/esg-investing-practices-progress-and-challenges\\_8a73d683/b4f71091-en.pdf](https://www.oecd.org/content/dam/oecd/en/publications/reports/2020/09/esg-investing-practices-progress-and-challenges_8a73d683/b4f71091-en.pdf)> accessed 27 Oct 2025.

<sup>3</sup> Julia Puaschunder, 'Socio-Psychological Motives of Socially Responsible Investors' in Sabri Boubaker, Douglas Cumming and Duc Khuong Nguyen (eds), *Research Handbook of Investing in the Triple Bottom Line* (Edward Elgar 2018). The gradual mainstreamization of SRI from the 1980s to the 2000s, into concern for general public good issues such as the environment and human rights, had broad commentator support, see Cary Kronsinsky, 'The Long And Necessary Death of Socially Responsible Investing' (2014) 4 *Journal of Sustainable Finance & Investment* 297; Benjamin J Richardson, *Socially Responsible Investment Law* (OUP 2008).

<sup>4</sup> See EU High Level Expert Group, *Report on Sustainable Finance* (2016).

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investing, whether saving through a pension scheme or a more liquid scheme such as a mutual fund, has become a significant vehicle for investment,<sup>5</sup> whether at the institutional or retail level, due to the benefits of portfolio diversification, competitive forces in the market for investment management have largely shaped sustainability integration into its practices. Empirical literature refers to increased demand,<sup>6</sup> whether by institutional clients or retail investors, especially younger millennial investors,<sup>7</sup> as a driving factor. This is also reinforced by empirical research that finds some support for sustainability integration in fund management correlating with positive fund performance,<sup>8</sup> supporting the case that some ESG factors are financially material. Nevertheless, investors' appetites for sustainability integration into investment management may take various shades of pro-social concern,<sup>9</sup> which are not homogeneous. Investment managers continue to navigate their market directions in terms of what such sustainability integration means for their practices, whether confined to financial materiality or beyond.

In this dynamic space, the legal and regulatory framework in the UK has undergone profound change by way of regulatory reform. Although private law in fiduciary duties and contractual obligations provides the foundation for investment management conduct,<sup>10</sup> legal risks have become increasingly uncertain for investment management, a context preceding the Law Commission's report in 2014.<sup>11</sup> The industry was largely self-regulating in terms of the manufacture and marketing of its collective investment products and the strategic orientations of such products (such as whether actively managed or passively managed by adhering to a stock market index). Shifts in this landscape now feature the predominance of regulatory law that attempts to clarify legal risk in investment management as well as to address market failures and broader public interest goals.

Regulatory law responds prominently to the complaints regarding greenwashing<sup>12</sup> or disingenuously labelled investment fund products whose 'ESG' or sustainable label may be attractive for inflows<sup>13</sup> but whose management practices or broader outcomes could be almost inscrutable. In this manner, regulatory law responds to the need for market confidence, avoiding a market for lemons, protecting investors' reasonable expectations against mis-selling or disingenuous management. Although the UK regulator has freedom after Brexit to deviate from European regulations,<sup>14</sup> the Financial Conduct Authority (FCA) has opted to design regulatory law safeguarding high levels of investor expectations for credibility and market confidence. As will be discussed shortly, regulatory law provides extensively for investment managers' disclosures and accountability, embedding a form of conduct regulation for investment management. The regulatory design also bears some connection to investors' discernment of sustainable outcomes, and therefore addresses a broader public interest objective of directing private financial flows

<sup>5</sup> See ch 1, Roger M Barker and Iris H-Y Chiu, *Corporate Governance and Investment Management: The Promise and Limitations of the New Financial Economy* (Edward Elgar 2017).

<sup>6</sup> Riikka Sievänen, Hannu Rita and Bert Scholtens, 'European Pension Funds and Sustainable Development: Trade-Offs between Finance and Responsibility' (2017) 26 *Business Strategy and the Environment* 912.

<sup>7</sup> Dorothy S Lund, 'Asset Managers as Regulators' (2022) 171 *University of Pennsylvania Law Review* 79.

<sup>8</sup> Mixed evidence from empirical research and meta-reviews, but there seems an overall slight outperformance advantage, see Maïke van Dijk-de Groot and Andre HJ Nijhof, 'Socially Responsible Investment Funds: A Review of Research Priorities and Strategic Options' (2015) 5 *Journal of Sustainable Finance & Investment* 178; Gunnar Friede, Timo Busch and Alexander Bassen, 'ESG and Financial Performance: Aggregated Evidence from More Than 2000 Empirical Studies' (2015) 5 *Journal of Sustainable Finance & Investment* 210; Tensie Whelan and others, 'ESG and Financial Performance: Uncovering the Relationship by Aggregating Evidence from 1,000 Plus Studies Published between 2015–2020' (NYU Stern Working Paper, 2021).

<sup>9</sup> Rajna Gibson Brandon and Philipp Krüger, 'The Sustainability Footprint of Institutional Investors' (ECGI Working Paper 2018) at <<https://ssrn.com/abstract=2918926>>; Lei Delsen and Alex Lehr, 'Value Matters or Values Matter? An Analysis of Heterogeneity in Preferences for Sustainable Investments' (2019) 9 *Journal of Sustainable Finance & Investment* 240.

<sup>10</sup> See an excellent succinct account in UNEPFI and Generation Foundation, *A Legal Framework for Impact* (2021), Annex: United Kingdom <<https://www.unepfi.org/legal-framework-for-impact/>> accessed 27 Oct 2025.

<sup>11</sup> Law Commission of England and Wales, *Fiduciary Duties of Investment Intermediaries* (2014).

<sup>12</sup> Eg see Christin Nitsche and Michael Schröder, 'Are SRI Funds Conventional Funds in Disguise Or Do They Live Up to Their Name?' in Sabri Boubaker, Douglas Cumming and Duc Khuong Nguyen (eds), *Research Handbook of Investing in the Triple Bottom Line* (Edward Elgar, 2018), ch19.

<sup>13</sup> Sofia Brito-Ramos and others, 'In Labels We Trust? The Influence of Sustainability Labels in Mutual Fund Flows' (2024) <[https://www.efmaefm.org/OEFMAMEETINGS/EFMA%20ANNUAL%20MEETINGS/2024-Lisbon/papers/479%20In%20labels%20we%20trust%20The%20influence%20of%20sustainability%20labels%20in%20mutual%20fund%20flows\\_28may2024%20EFMA.pdf](https://www.efmaefm.org/OEFMAMEETINGS/EFMA%20ANNUAL%20MEETINGS/2024-Lisbon/papers/479%20In%20labels%20we%20trust%20The%20influence%20of%20sustainability%20labels%20in%20mutual%20fund%20flows_28may2024%20EFMA.pdf)> accessed 27 Oct 2025.

<sup>14</sup> Iris H-Y Chiu, 'Sustainable Finance Regulation- Authoritative Governance or Market-Based Governance for Fund Management?' (2023) 57 *Journal of Financial Transformation* 48; Anne Lafarre and Eline Verhoeff, 'European Regulation of Sustainable Finance and Investor Sustainability Duties: Measuring is Knowing?' (2023) 39 *Banking and Finance Law Review* 255.

towards important common goods. It has been articulated in policy<sup>15</sup> that private financial flows are important for incentivizing private economic and corporate activity to align with common goals such as maintaining the 1.5°C trajectory for climate change. Although financial regulation does not assume a function of steering allocations in the UK, it fosters an incentive-based framework supportive of policy aims.

Section 2 discusses the legal and regulatory framework for gradually embedding materially sustainable factors into fundamentally, financially focused investment management. This section shows how regulatory law has enriched the private fiduciary law foundations, clarifying legal risk but also introducing new demands. Section 3 turns to the legal and regulatory framework for investment management that holds out a form of association with non-financial factors in the ESG or sustainable realms. Such representations are now regulated to be more accountable, shaping ongoing investment management conduct as well. Finally, Section 4 turns to the UK's opt-in sustainable labelling regime for investment funds, which offers market-attractive incentives while being underpinned by extensive accountability and ongoing conduct regulations. Section 5 makes concluding remarks on the UK's ultimately market-based governance for sustainable finance.

## 2. Legal and regulatory framework for the place of ESG factors in 'Conventional' financially focused investment management

Asset managers owe fiduciary duties to asset owners who give them mandates to carry out investments.<sup>16</sup> These fiduciary duties are a fundamental bedrock upon which other contractual duties may be established, such as for the specific purposes of investment or using certain investment strategies, such as active or passive management. Contractual duties can also include specific 'stewardship' expectations in terms of conduct vis-à-vis portfolio assets, such as whether engagement or escalation vis-à-vis portfolio assets is envisaged. These can be contractually provided for, independent of whether an asset manager is signatory to a Stewardship Code.<sup>17</sup>

This section focuses on investment management, which is fundamentally focused on generating financial returns, a default and conventional paradigm for investment management. The understanding of fiduciary duties for asset managers in this paradigm encompasses the prophylactic limbs, which are to prevent asset managers from serving their own interests to the detriment of asset owners,<sup>18</sup> but also includes the broad 'best interests' duty, which requires asset managers to exercise their powers for the proper purpose of achieving the mandate that is given to them. This means considering only proper and relevant matters and not mixing in irrelevant or improper considerations.<sup>19</sup> The Law Commission clarifies that such exercise of powers should be pursuant to the achievement of financial returns consistent with the beneficiaries' purpose for participating in such investment savings, while controlling for risks.<sup>20</sup> The relevance of ESG or sustainable factors features at the interface of risk management or control, and it is relatively well-accepted that ESG or sustainable factors that are material to financial investment risk should be taken into account. The work of Freshfields supporting the United Nations Environment Programme Finance Initiative (UNEPFI) since its 2005 report<sup>21</sup> has had significant influence on the general acceptance of financially material ESG or sustainable factors as an essential part of prudent investment management.<sup>22</sup> Under the UK Stewardship Code 2020 (administered by the Financial Reporting Council, which is the overseer of corporate reporting and

<sup>15</sup> Eg UK's Climate Change Strategy 2021–24 discusses the importance of financial flows to help reach the target of net zero by 2050 <[https://assets.publishing.service.gov.uk/media/6148b3ffe90e070438c9463d/UK\\_ECLimate\\_Change\\_Strategy\\_2021.pdf](https://assets.publishing.service.gov.uk/media/6148b3ffe90e070438c9463d/UK_ECLimate_Change_Strategy_2021.pdf)> accessed 27 Oct 2025.

<sup>16</sup> John Kay, *The Kay Review of UK Equity Markets and Long-Term Decision Making* (Interim Report, February 2012), para 7.18.

<sup>17</sup> At the time of writing, the relevant Code is the version as of 2020 <[https://media.frc.org.uk/documents/The\\_UK\\_Stewardship\\_Code\\_2020.pdf](https://media.frc.org.uk/documents/The_UK_Stewardship_Code_2020.pdf)> accessed 27 Oct 2025. The Code is to be overhauled for 1 January 2026, see <[https://media.frc.org.uk/documents/UK\\_Stewardship\\_Code\\_2026.pdf](https://media.frc.org.uk/documents/UK_Stewardship_Code_2026.pdf)> accessed 27 Oct 2025.

<sup>18</sup> *Bristol and West Building Society v Mothew* [1996] EWCA Civ 533.

<sup>19</sup> *Re Merchant Navy Ratings Pension Fund; Merchant Navy Ratings Pension Trustees Ltd v Stena Line Ltd and others* [2015] EWHC 448 (Ch).

<sup>20</sup> Law Commission (2014), para 5.76.

<sup>21</sup> Freshfields Bruckhaus Deringer, *A Legal Framework for the Integration of ESG Issues into Institutional Investment* (report for the Asset Management Working Group, UNEPFI, 2005).

<sup>22</sup> Paul Q Watchman, Jane Anstee-Wedderburn and Lucas Shipway, 'Fiduciary Duties in the 21st Century: A UK Perspective' (2005) 19 *Trust Law International* 127.

accounting standards), if an asset manager is a voluntary signatory, Principle 7 of the Code expressly articulates material ESG issues to be integrated in its stewardship approach. Principle 4 also allowed asset managers to consider material factors that may cause systemic risk, such as climate change, although the systemic risk factors tend to be interpreted as more financial or commercial in nature. The Code would be overhauled for 2026, and explicit references to ESG or sustainability have been dropped, deferring to the industry to identify what may be systemic and market risks that may be investment management's core role of delivering long-term financial value to investors. The Code has become more peripheral to whether and how sustainability features in investment management, as it is sticking to the primacy of financial value protection and enhancement, framing risks and the conduct of investment management, including engagement and voting for that purpose. Nevertheless, the Code's increasing irrelevance to ESG or sustainable investment management does not affect how fiduciary duties for investment managers are being shaped in private law and the reforms already undertaken in regulatory law.

The question of whether asset managers *may* or *must* take into account material ESG factors is increasingly being asked and shaped by private law jurisprudence. When the issue of irrelevant non-financial issues was being litigated in the UK in the 1980s and 1990s (see below), the imperative was to clarify the legal risk for taking into account any factors that are not financially framed in nature—whether such conduct can be challenged as being in breach of fiduciary duties. The 2005 Freshfields report was a significant step in the legal advance towards clarifying this position. The nature of legal risk has now changed with the tides, as reflected in the Australian case of *Rest v McVeigh*.<sup>23</sup> The issue now is that asset managers or owners could be sued for failing to sufficiently take into account ESG factors that are alleged to be material.

Case law jurisprudence has hitherto established more clearly the position on the consideration of non-financial factors that may not be material. In the 1980s, some pension schemes were sued on the basis that their investments in companies that may be linked to apartheid in South Africa were in breach of fiduciary duties due to incompatibility with pensioners' ethical and 'values' positions. The courts have consistently clarified that pension trustees who focused on achieving the best possible financial returns for their beneficiaries were not in breach, as they were primarily financial stewards, not guardians of Union<sup>24</sup> or Church<sup>25</sup> values. Case law did not completely disavow the consideration of non-financial factors, and the position, summed up by the Law Commission, is the 'Non-Financial' Factors test for whether investment managers are in breach of their fiduciary duties or otherwise.<sup>26</sup>

The Non-Financial Factors test features two questions for investment managers, namely, whether the non-financial factor is of common concern to beneficiaries, and whether there would be a risk of significant financial detriment taking into account of it. Such financial detriment could entail from the lack of portfolio diversification if certain companies had to be excluded. The incurring of some financial detriment need not mean that investment managers were in breach of their fiduciary duties, as beneficiaries could be willing to incur such a tradeoff. The crucial thing for investment managers is to engage in a process to ensure that their exercise of discretion is based on a proper exercise of their powers, and practical steps such as surveying beneficiaries or obtaining their informed consent could be undertaken. However, a significant financial detriment, which could mean clear detraction from the primary purpose of financial provision through investment management, could be contrary to the proper exercise of investment powers.

More recently, the tide has turned in terms of the nature of legal risk for investment managers. They are more likely to face scrutiny over whether they have wrongly failed to consider ESG risks or managed such risks in a manner as demanded by their beneficiaries. It now seems clear that English courts accept that non-financial risk factors can be material, although how

<sup>23</sup> See <<https://equitygenerationlawyers.com/case/mcveigh-v-rest/>> accessed 27 Oct 2025. Where a beneficiary whose obligations were far from maturing sued the superannuation scheme for failing to take into account of climate risks, gleaned from information obtained from freedom of information requests. The case was settled before proceeding to trial, as Rest developed policies for incorporating climate and transition risk into its investment management.

<sup>24</sup> *Cowan v Scargill* [1985] 1 Ch 270. See opposing commentary, Gerard McCormack, 'Sexy but not Sleazy: Trustee Investments and Ethical Considerations' (1998) Company Lawyer 39; Rosy Thornton, 'Ethical Investments: A Case of Disjointed Thinking' (2008) 67 Cambridge Law Journal 396.

<sup>25</sup> *Harries and Others v The Church Commissioners for England and Another* [1992] WLR 1241.

<sup>26</sup> Law Commission (2014), paras 6.33–6.36.

investment managers address these is very much deferred to them, as long as there is evidence that they address these.

In the *ClientEarth v Shell Plc* case,<sup>27</sup> a minority shareholder of Shell, also a non-governmental organization, asked for permission to continue a derivative claim against the corporation's directors for failing to adhere to their duty to act in the best interests of the company or acting in a negligent manner. The allegation is based on their assessment that the company's energy transition strategy would be insufficient to achieve net zero by 2050 and would not meet the Paris agreement's aims to maintain global temperature rise to only 1.5°C. The High Court refused to allow ClientEarth to proceed with the derivative claim on the basis that a *prima facie* case has not been made with regard to directors' breach of duties. The directors did not fail to consider energy transition and indeed had a strategy. ClientEarth's disagreement with the strategy did not mean that the directors' strategy was unreasonable. In that manner, it would seem that a fiduciary's consideration of relevant matters would not likely be questioned by the court in terms of business merit. This case is on directors' duties, which is a different fiduciary position from that of investment managers. However, there may be some cross-fertilizing insights in terms of the similar feature of discretionary financial management by a fiduciary of *someone else's* (in this case, the company's as a separate legal person) assets. Applying this to an asset management context, there may be a legal risk for the absence of consideration of a material ESG factor, but not how the consideration is made.

This position seems to be confirmed in the more recent Court of Appeal case of *McGaughey & Davies v Universities Superannuation Scheme (USS)*.<sup>28</sup> In that case, two beneficiaries of the USS sued directors of the investment company managing savers' funds in a derivative claim for breaches of fiduciary duties, *inter alia*, in relation to failure to divest from fossil fuel investments consistent with the USS' long-term plans to become carbon neutral. The case turned on the inappropriateness of the derivative action. Moreover, judges seemed to accept the legitimacy of the USS' long-term carbon neutral plans, indicating an implicit approval that a conventional financially focused pension management scheme should integrate material climate risks in its investment management. The Court, however, disapproved of the petitioners' divestment demand as the lack of divestment is not an indication of the directors' failure to integrate material climate risks or adhering to its published long-term strategy. In this manner, conventional financially focused investment funds can articulate and integrate material non-financial risk factors into their investment management, and are also largely able to self-define their strategies and approach for addressing such risks.

At present, it may be opined that the integration *as such* of material ESG factors in investment management in the UK is unlikely to raise excessive legal risk, as compared to the USA.<sup>29</sup> That said, there can be debates as to whether certain non-financial factors are material or not. Further, it is uncertain if there would be a gap in expectations between investors and investment managers in terms of *how* investment managers integrate or treat non-financial factors, although investor challenge in this respect is, in light of *McGaughey*, unlikely to easily succeed.

Nevertheless, there is an ESG issue that may be considered as well-established in terms of its material nature. This is due to regulatory intervention. Regulatory rules have now been made regarding the mandatory nature of climate risk management reporting for both occupational pension schemes as asset owners,<sup>30</sup> as well as by asset managers managing any tailor-made portfolios, self-invested pension schemes, mutual or alternative investment funds.<sup>31</sup> It can be deduced that climate risk should be treated as a material factor for investment management across the board.

<sup>27</sup> *ClientEarth v Shell plc* [2023], EWHC 1897 (Ch).

<sup>28</sup> [2023] EWCA Civ 873.

<sup>29</sup> See Virginia Harper Ho, 'Sustainable Investment and Asset Management: From Resistance to Retooling' and Ken Bertsch, 'Evolution of Sustainable Investing: A US Perspective' in Iris H-Y Chiu and Hans-Christoph Hirt (eds), *Investment Management, Stewardship and Sustainability* (Hart 2023), chs 4 and 13, respectively.

<sup>30</sup> The Occupational Pension Schemes (Climate Change Governance and Reporting) Regulations 2021 (OPS Regulations).

<sup>31</sup> FCA Handbook, ESG 2.



## The materiality of climate risk and regulation of investment risk management

Policymakers in the UK have given possibly the fullest extent of endorsement to the work carried out by the Taskforce for Climate-related Financial Disclosures (TCFD) under the auspices of the Financial Stability Board. This work was spearheaded by former Bank of England governor Mark Carney, which may explain its influence in the UK. The TCFD framework requires financial institutions to internalize consideration of climate risk and to make disclosure of (i) their senior management oversight of climate risk, and whether there are governance processes or management responsibilities for such oversight (under the Governance pillar); (ii) their strategic assessment of short, medium, and long-term risks and opportunities of climate risk, the particular business areas of financial impact and how these may materially affect the financial risk of assets and organizational planning (under the Strategy pillar); (iii) their processes for identifying and managing climate risks, in terms of magnitude, scope and type and the development of their risk appetites and mitigation strategies such as to control, transfer such risks (under the Risk Management pillar); and (iv) their metrics for emissions measurement of assets (scope 1 and 2 greenhouse gas (GHG) emissions, with scope 3 being encouraged but not mandatory), and other associated metrics for activities that contribute to these (such as waste management, land use, etc), and metrics for factors that affect emissions activity, such as performance metrics, remuneration policies, and internal carbon prices. The financial institution should set targets and key performance indicators for their assets, in different timeframes and explain how the measurement of various metrics helps to achieve the performance targets and goals (Metrics pillar).

The TCFD framework is a hybrid qualitative framework. It requires high-level disclosures of a financial institution's approach and processes in responding to climate risk, therefore embedding the risk oversight and management mindset in an enterprise-wide manner. To an extent that this can devolve into a form of self-selecting management of climate risk, the TCFD's requirement to measure GHG emissions and other environmental metrics encourages objective quantification of risks so that these can feed into investment management practices that are predominantly quantitative. The financial institution's setting of their own performance targets and goals can still be self-selecting to an extent. In this respect, the UK's regulations for occupational pension schemes are more prescriptive in relation to compelling trustees to consider two performance scenarios of 1.5°C, and above 2°C.<sup>32</sup>

The FCA has introduced regulations to require all in-scope fund managers<sup>33</sup> to produce a yearly TCFD-entity report by 30 June each calendar year. Such reports are based on the TCFD framework outlined above.<sup>34</sup> The FCA further requires that in-scope entities must base their metrics and performance targets on up-to-date data, identifying where there are any data gaps or methodological challenges, and use proxy or simulated data that is appropriate, based on reasonable assumptions.<sup>35</sup> Data gaps, methodological challenges, and the use of proxy data and their assumptions must be clearly identified and disclosed. Further, the yearly disclosure must include climate-related scenario analyses and how such scenarios affect investment and risk management. Presumably, these refer to scenarios of orderly, disorderly transitions, and the hothouse scenario.<sup>36</sup> The in-scope entity is also expected to set performance targets, such as net zero by a particular year, and what key performance indicators relate to each target. The absence of targets must be explained.<sup>37</sup> There is also an expectation that such targets should be broadly coherent with national policy,<sup>38</sup> and where this is not the case, in-scope entities are expected to explain.

The TCFD entity report reflects each fund manager's attitude and approach to climate risk, and the disclosure requirements embed governance and management expectations that compel forms of organizational integration and ability to evidence that high-level attention is paid to this issue. The TCFD entity report also compels certain granular measurements to be carried out, so that these, such as GHG emissions, matter for performance targets. In this manner, the

<sup>32</sup> OPS Regulations, Schedule 1, para 6.

<sup>33</sup> FCA Handbook ESG 1A.

<sup>34</sup> FCA Handbook ESG 2.1.5–7.

<sup>35</sup> FCA Handbook ESG 2.1.8–12.

<sup>36</sup> FCA Handbook ESG 2.2.3, 2.3.11.

<sup>37</sup> FCA Handbook ESG 2.2.4.

<sup>38</sup> FCA Handbook ESG 2.2.2.

climate performance of fund management is given stand-alone importance, besides conventional financial performance, and fund managers need to achieve alignment in their practices. Although there is an extent of self-selection and definition of fund managers' climate performance, the regulatory guardrails relating to certain objective measurements, scenario analysis, and the disclosure of qualifications in terms of data or methodology could go a certain distance in shaping up firms' grappling with climate performance, feeding into their strategic and risk thinking regarding the composition, allocation, and management of assets.

In sum, it can be argued that the regulation not only addresses the surface issue of the legality of integrating an ESG factor such as climate risk, but it is also able to go further in terms of how such integration should optimally take place and be supervised. This is not possible to achieve under private law. The regulation not only intends to improve transparency to the regulator, as it is explicitly stated that firms need to make a compliance statement with respect to the disclosure,<sup>39</sup> but also to the market, as the report is part of periodic reporting by funds to their clients.<sup>40</sup> Non-compliant TCFD entity reports can be the subject of regulatory enforcement, such as where reporting may be based on flawed data or methodology, approximating a form of conduct supervision for fund management of climate risk. However, it may be argued that conduct enforcement is likely challenging for the regulator as it is difficult to make a definite judgment of conduct adequacy when performance targets are left to be defined by the firm itself. A performance target may be modest, and it is not straightforward to judge the adequacy of governance, strategy, and risk management processes, which are essentially organizational and procedural in nature.

However, it can be counter-argued that there may be market pressure from occupational pension scheme trustees on their asset managers, as scheme trustees are subject to a more precise form of climate performance evaluation for their assets. In each scheme year, trustees must select one absolute emissions metric, one emissions intensity metric, one portfolio alignment metric, and one additional climate change metric in order to assess the scheme's assets.<sup>41</sup> Such metrics need to be calculated using relevant GHG emissions and other data.<sup>42</sup> Scheme trustees who do not manage in-house and use external fund managers may be able to contractually compel their fund managers to make the relevant disclosures and calculations, and to adhere to the scheme's ideal targets. In this manner, fund managers may not be completely left to define self-selecting performance targets. However, it remains uncertain that market discipline can work. This is discussed shortly.

It is also mandatory for TCFD product-level reporting to be made for all in-scope investment fund products. These are part of periodic reports that ought to be made to clients of fund managers anyway, so that the climate risk footprint of each investment fund product is made clear, and also linked to the overall TCFD-entity report. Product level reporting is standardized into five measures, namely: scopes 1 and 2 GHG emissions, scope 3 GHG emissions, total carbon emissions, total carbon footprint, and weighted average carbon intensity.<sup>43</sup> The climate value-at-risk, which is the possible maximum loss in value of the fund's assets given each climate warming scenario, must also be calculated and reported.<sup>44</sup> These measures are accompanied by contextual qualitative reporting of how the three climate scenarios would affect the fund's assets and what are the significant drivers that impact the fund's assets.<sup>45</sup> The fund is free to report on other metrics it considers useful.

Fund managers' clients, whether institutional or retail, are being helped to gain insight into a fund's climate profile and performance, hence they have an opportunity to exercise market discipline, such as voting with their feet.<sup>46</sup> Nevertheless, there are challenges for effective market discipline to be exercised. The market may not be able to appraise the soundness of fund managers'

<sup>39</sup> FCA Handbook ESG 2.2.7.

<sup>40</sup> FCA Handbook ESG 2.3.1, as the TCFD entity report is referenced by the TCFD-product level report which is part of client-facing periodic reporting.

<sup>41</sup> OPS Regulations, Schedule 1, para 15.

<sup>42</sup> OPS Regulations, Schedule 1, para 18.

<sup>43</sup> FCA Handbook ESG 2.3.9.

<sup>44</sup> FCA Handbook ESG 2.3.13.

<sup>45</sup> FCA Handbook ESG 2.3.11.

<sup>46</sup> This is the only realistic form of market discipline in collective investing, see John Morley, 'The Separation of Funds and Managers: A Theory of Investment Fund Structure and Regulation' (2014) 123 Yale Law Journal 1228.

climate performance targets, given the absence of standardization. Although regulation provides certain metrics for disclosure, especially the ones outlined in the TCFD product-level report, it is not straightforward for investors to make the connections between these metrics and fund managers' strategies, plans, and performance targets. Such evaluations require expert skills and knowledge, and in this emerging area of climate finance, even professionals acknowledge the challenges of quantification and drawing conclusions.<sup>47</sup> Hence, the FCA's requirement for fund managers to disclose data gaps, methodological assumptions, etc may all the more add to the complexity of market evaluation. It is predicted that such disclosures would not simply provide clarity to investors on climate performance and comparability. Further, it is possible that climate risk assessments can be optimistic in the short term but more uncertain for longer terms. Investors may discount longer-term adversities due to behavioural discounting. For example, even if fund managers predict asset deterioration or adverse consequences in a hothouse scenario, they are unable to tell when such a scenario may descend and may provision for optimistic predictions in the short to medium terms.

It may fall to the regulator to supervise in-scope entities' disclosures closely in order to draw conclusions regarding the strengths and weaknesses of conduct in firms' management of climate risk and performance. Regulatory enforcement and jurisprudence may become the primary source for clarifying fund managers' legal risk in climate risk integration.

Regulation nevertheless only clarifies that climate risk is material and fleshes out disclosure and conduct expectations. What about other ESG risks? How would their materiality or otherwise be determined, even if more precise conduct and disclosure may not be required in the absence of regulatory provision?

### Other regulations and materiality of non-financial factors?

It is arguable that other ESG factors besides climate risk may be material to fund managers' assets. Often, there are material ESG factors common to certain sectors,<sup>48</sup> but also unique ESG factors for each asset's business profile and footprint.<sup>49</sup> Empirical research in relation to cross-cutting ESG materiality may provide some clues,<sup>50</sup> and mandatory non-financial reporting for corporations also provides indications that those areas of disclosure are material. In the UK, non-financial reporting can be found in the Companies Act as well as in other non-corporate regulations.<sup>51</sup> The non-financial report prescribed for quoted and financial companies contains what may presumably be cross-cutting material factors, that is environmental matters (more broadly), employee matters, social matters (highly broad and vague), respect for human rights and anti-corruption and anti-bribery compliance.<sup>52</sup> It can also be argued that as most UK companies should produce a 's172 statement', which relates to how directors have taken into account of stakeholders' interests in promoting the success of the company,<sup>53</sup> the stakeholder matters can be of cross-cutting materiality, viz: long-term factors, employee matters, relations with suppliers, community relations, environmental matters, reputation factors, and fairness amongst shareholders. Fund managers taking into account of such non-financial factors in investment management would be consistent with an 'enlightened' stewardship approach to asset management recently argued.<sup>54</sup> Nevertheless, to an extent, the broad scopes of what may be

<sup>47</sup> Ioana-Stefania Popescu, Claudia Hitaj and Enrico Benetto, 'Measuring the Sustainability of Investment Funds: A Critical Review of Methods and Frameworks in Sustainable Finance' (2021) 314 *Journal of Cleaner Production* 128016.

<sup>48</sup> Such as the materiality finder produced by the Sustainability Accounting Standards Board now administered by the International Financial Reporting Standards Foundation <<https://sasb.ifrs.org/standards/materiality-finder/>> accessed 27 Oct 2025. Due to the trend of international convergence upon the IFRS' work, it may be argued that their presumption of materiality for non-financial factors would be influential for legal conclusions.

<sup>49</sup> Leandro Nardi and others, 'Doing Well by Doing Good, Uniquely: Materiality and the Market Value of Unique CSR Strategies' (2022) 7 *Strategy Science* 10, arguing that firms' unique CSR and materiality strategies benefit them but these can also be drowned out by sectoral standardisation of material factors. Also Di Wang and others, 'Sustainability (ESG) Reporting: Field Evidence on Materiality' (2024) <[https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=4687038](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4687038)> accessed 27 Oct 2025.

<sup>50</sup> Benjamin P Foster and Andrew S Manikas, 'Sustainability Standard Setting: Diversity and Inclusion as an Example' (Sep/Oct 2022) *Cost Management* 37.

<sup>51</sup> Such as s 54, Modern Slavery Act and The Equality Act 2010 (Gender Pay Gap Information) Regulations 2017.

<sup>52</sup> S414CB, Companies Act 2006 as amended.

<sup>53</sup> S414CZA, *ibid*.

<sup>54</sup> Dionysia Katelouzou, 'The Unseen "Others": A Framework for Investor Stewardship' (2024) *Current Legal Problems* 1 <<https://doi.org/10.1093/clp/cuae009>>.



‘environmental’ or ‘social’ matters required for the section 414 strategic report or the section 172 statement can be susceptible to self-definition. It is noted that the UK has decided to abandon a Taxonomy for ESG matters, which is perceived as being too strait-jacketing,<sup>55</sup> but in turn also opens up the scope for companies to self-select what would be material, perhaps balanced against investors’ demands, resulting in a rather fluid and uncertain landscape for the evolution of what is ‘material’.

However, this argument, if applied in the EU, would mean that the non-financial matters required to be reported under the Corporate Sustainability Reporting Directive<sup>56</sup> could be treated as material for investors in a cross-cutting manner. These include a range of climate factors, social factors such as employee, diversity, human rights, and other matters covered by EU and international conventions and governance factors specified in a number of international conventions such as the International Corporate Governance Network (ICGN) and Organisation for Economic Co-operation and Development (OECD’s) corporate governance principles. This is a wider range than covered in the UK’s non-financial report. Further, it is mandatory for listed companies to report on their capital and operating expenditures on Taxonomy-aligned activities.<sup>57</sup> This may mean that the six environmental objectives in the Taxonomy could be of cross-cutting material importance. However, as non-financial disclosures are often qualitative and not highly standardized in terms of manner of disclosure (at least in the UK for now),<sup>58</sup> commentators have opined that corporate disclosures do not produce optimal data to be used for investment management.<sup>59</sup> Work is still in progress in terms of standardizing corporate disclosures for mandatory non-financial reporting, as the European Financial Reporting Advisory Group (EFRAG) standards and the International Sustainability Standards Board (ISSB) standards developed by the International Financial Reporting Standards Board are only emerging. These have been built upon different bodies of voluntary non-financial disclosure templates, such as those offered by the Global Reporting Initiative (GRI) and Sustainability Accounting Standards Board (SASB). Reporting against new requirements such as Taxonomy-alignment also poses new challenges for corporates in terms of how taxonomy-aligned expenditures should be accounted for.<sup>60</sup> As the universe of material non-financial factors expands in relation to corporate reporting, this could concomitantly change investment management practices in terms of their integration and consideration of what is material for investment analysis and market pricing.

One final issue that is unresolved for the materiality of non-financial factors is whether mandatory corporate disclosures sitting outside the Companies Act regime should be treated as containing material factors for investors. These disclosures are not necessarily market-facing. For example, the ‘Modern Slavery Statement’ to be disclosed by a range of private and public companies to show companies’ due diligence in ensuring anti-slavery and anti-human trafficking, the pay ratio and gender pay gap disclosures,<sup>61</sup> all pertain more to social concerns regarding equality and ethicality. Empirical research has found that investors do not seem to treat modern slavery disclosures as material,<sup>62</sup> and similarly for gender pay gap information.<sup>63</sup>

<sup>55</sup> HM Treasury, *Green Taxonomy Consultation Response* (2025) <[https://assets.publishing.service.gov.uk/media/687659e6a8d0255f9fe28edd/UK\\_Taxonomy\\_consultation\\_response.pdf](https://assets.publishing.service.gov.uk/media/687659e6a8d0255f9fe28edd/UK_Taxonomy_consultation_response.pdf)> accessed 27 Oct 2025.

<sup>56</sup> art 19a, Directive (EU) 2022/2464 of the European Parliament and of the Council of 14 December 2022 amending Regulation (EU) No 537/2014, Directive 2004/109/EC, Directive 2006/43/EC and Directive 2013/34/EU, as regards corporate sustainability reporting.

<sup>57</sup> Regulation 2020/852, art 9.

<sup>58</sup> The uncertain nature of demands in non-financial corporate disclosure is discussed in Iris H-Y Chiu, ‘Unpacking the Reforms in Europe and UK Relating to Mandatory Disclosure in Corporate Social Responsibility: Instituting a Hybrid Governance Model to Change Corporate Behaviour?’ (2017) 5 *European Company Law* 193.

<sup>59</sup> Rodrigo Zeidan, ‘Why Don’t Asset Managers Accelerate ESG Investing? A Sentiment Analysis Based on 13,000 Messages from Finance Professionals’ (2022) 31 *Business Strategy and the Environment* 3028; Jaap Bartels and Willem Schramade, ‘Investing in Human Rights: Overcoming the Human Rights Data Problem’ (2024) 14 *Journal of Sustainable Finance & Investment* 199; Robert Eccles, Martha D Kastrapeli and Stephanie J Potter, ‘How to Integrate ESG into Investment Decision-Making: Results of a Global Survey of Institutional Investors’ (2017) 29 *Journal of Applied Corporate Finance* 125.

<sup>60</sup> Dylan Kirby, Cormac Hugh MacMahon and Sandra Thompson, ‘The Co-Evolution of Sustainable Finance Stakeholders under the EU Taxonomy for Sustainable Activities: An Exploratory Study of Irish Disclosure Experiences’ (2024) *Sustainability Accounting, Management and Policy Journal*, DOI 10.1108/SAMPJ-11-2023-0842.

<sup>61</sup> n 52.

<sup>62</sup> Paul Cousins and others, ‘Shareholder Wealth Effects of Modern Slavery Regulation’ (2020) 66 *Management Science* 5265.

<sup>63</sup> Aneesh Raghunandan and Shivaram Rajgopal, ‘Mandatory Gender Pay Gap Disclosure in the UK: Did Inequity Fall and Do these Disclosures Affect Firm Value?’ (2021) <[https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3865689](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3865689)> accessed 27 Oct 2025.

Non-financial materiality remains a shifting phenomenon for conventional investment management. Although legal risks remain for fund managers, yet it may not be easy for investors to challenge their integration or otherwise of specific non-financial factors.<sup>64</sup>

### 3. Legal and regulatory framework for investment management referencing sustainable terms

As fund managers capitalize on market interest for ESG or sustainably-themed investment products, an explosion of such labelled products has been observed since inflows started to increase exponentially from the 2020s.<sup>65</sup> However, investors often remain both confused and uncertain as to how investment management for themed products differs from conventional funds, and whether such products are also meant to deliver hybrid outcomes, that is the sustainable or ESG outcomes referenced in the product along with financial performance. ‘Greenwashing’ fears have abounded, meaning that sustainably themed funds may adopt to significantly different investment management practices, although evidence is mixed.<sup>66</sup> Hence, the UK has now introduced regulatory standards for the use of certain sustainable or ESG-related terms in fund products in order to combat greenwashing and to avoid a market for lemons for what could be a promising financial allocation strategy for socially good productivity.

The question of whether non-financial factors can be taken into account in themed investment management, such as being ESG or sustainably themed, is less of an issue. The Law Commission expressly clarifies that such themed mandates reflect the consensus between fund managers and investors to consider the relevant non-financial factor.<sup>67</sup> The more pertinent issue is how such investment management delivers on the themed representation and whether it differs from conventional financially focused investment management. There is also the question of whether single materiality is pursued, that is that fund managers consider how assets manage their ESG risks, or whether double materiality is pursued, that is that fund managers consider how their assets achieve non-financial performance alongside financial ones.<sup>68</sup>

Left to investor monitoring, there is considerable opacity for them observing how themed funds are managed. Investors may observe voting records by asset managers, but there could be both pro-ESG voting as well as pro-management (which can be ESG-agnostic) voting at the same time, which makes it difficult for investors to draw conclusions. Where fund managers are signatories to the Stewardship Code, their reporting on stewardship activities may shed some light, but stewardship activities such as dialogue with senior management may not be granularly reported in the public domain.<sup>69</sup> Moreover, reporting against the Code is based on single materiality, and changes for 2026, which de-emphasize any explication of ESG risks being material for investment funds and asset managers, would mean that investors may not be able to rely on stewardship reporting for discerning the more specific nature of ESG stewardship.

The UK has, shortly after the EU’s regulatory lead, introduced regulation in relation to fund labelling<sup>70</sup> where sustainable or ESG investment themes and strategies are used. This regime is an opt-in one, so that fund managers can choose their appropriate labels and comply with the requisite disclosure obligations and conduct expectations that underpin the disclosure. In order to prevent regulatory arbitrage and incentivize funds to opt-in, the FCA requires all fund managers who have chosen not to opt into explicit labels, but who use or reference ESG or

<sup>64</sup> Anik Bhaduri, ‘Fostering Socially Responsible Stewards: CSR and Investment Funds in India’ (2023) 23 *Journal of Corporate Law Studies* 567 arguing in the Indian context regarding the prospect of investor litigation against fund stewardship, and arguing that this is likely to be very remote.

<sup>65</sup> <<https://www.morningstar.co.uk/uk/news/209411/sustainable-funds-record-breaking-year.aspx>> accessed 31 Jan 2025.

<sup>66</sup> Ivan Arribas and others, ‘The Inclusion of Socially Irresponsible Companies in Sustainable Stock Indices’ (2019) 11 *Sustainability* 2047 on greenwashing in passive investing, but see Susana Martinez Meyers, Idoya Ferrero-Ferrero and María Jesus Muñoz-Torres, ‘Are Sustainable Funds Doing the Talk and the Walk? An ESG Score Analysis of Fund Portfolio Holdings’ (2024) 93 *International Review of Economics and Finance* 1526 who finds that ESG-themed funds in the European market have more credibility than in the US or Asia.

<sup>67</sup> Law Commission (2014), para 6.85.

<sup>68</sup> Double materiality is not the norm thus far, see Mark Hays and John McCabe, ‘Sustainable and Impact Investing: A Taxonomy of Approaches and Considerations for Fiduciaries’ (2021) 68 *Journal of Wealth Management* 10.

<sup>69</sup> Not required under the 2026 Code overhaul, see <[https://media.frc.org.uk/documents/UK\\_Stewardship\\_Code\\_2026.pdf](https://media.frc.org.uk/documents/UK_Stewardship_Code_2026.pdf)> accessed 27 Oct 2025.

<sup>70</sup> FCA Handbook, ESG 4.1, 4.2.

sustainability-related terms, to comply with a range of disclosure obligations and underlying conduct expectations too. These are slightly pared down from the fully labelled funds, but are designed in such a way as to elicit accountability for the use of terms and steer consistent conduct. In this way, fund managers may see no incentive to avoid being bonded to an explicit label for sustainably themed products.

Where terms including ‘ESG’, ‘environment’, ‘social’, ‘sustainable’, ‘green’, ‘transition’, ‘net zero’, ‘climate’, ‘impact’, ‘responsible’, ‘Paris-aligned’, ‘SDGs’, their iterations or equivalent terms signalling sustainability characteristics (broadly defined) are used, fund managers are subject to an obligation to explain why a regulatory label is not adopted instead.<sup>71</sup> They are also not allowed to use the term ‘sustainable’ in product names in order not to subvert the advantages of adopting a regulatory label. Fund managers are subject to the rule that 70 per cent or more of the fund’s assets must align with the sustainability characteristic represented.<sup>72</sup> Further, fund managers are to produce similar disclosures to those imposed on regulatory label adopters. These are consumer-facing disclosures,<sup>73</sup> pre-contractual disclosures,<sup>74</sup> as well as yearly sustainability entity reports<sup>75</sup> for the fund manager as a whole, and sustainability product-level reports for periodic client reporting.<sup>76</sup> All financial promotions must also meet the requirements of being fair, clear, and not misleading with regard to the use of terms and their representation.<sup>77</sup>

Are the above requirements sufficient to ensure that the fund managers who do not adopt regulatory labels are sufficiently credible and transparent to investors? This section makes three observations. First, the minimum 70 per cent composition rule can seem credible against greenwashing, but may not be easy to enforce. As fund managers self-select the sustainability characteristic they wish to tout, as well as the metrics and methodology for selection and performance, their assessment of assets’ compatibility with the characteristic may be difficult to challenge. Further, even if fund managers rely on ESG ratings or other analytics to assess an asset, it is well-known that ratings products in the market can come to different, justifiable conclusions.<sup>78</sup> There is therefore no standardized way to assess any asset’s sustainability characteristic as selected by the fund manager.

Second, fund managers who use attractive ESG or sustainable terms could be subject to the production of a sustainability entity report,<sup>79</sup> which is more demanding than the TCFD-entity report for a fund manager who only carries out conventional, financially focused fund management.<sup>80</sup> This is imposed only on the largest fund managers with at least £5bn or more in assets under management calculated as a rolling 3-year average.<sup>81</sup> The sustainability entity report deals with the governance, strategic, risk management, and metrics disclosures over a wider range of sustainability factors, which the fund manager may identify using IFRS, SASB, or GRI standards for non-financial disclosure. These go beyond climate risk disclosures as expected in the TCFD-entity report. In this manner, fund managers have to select carefully which ESG or sustainability characteristics they are capable of managing and integrating meaningfully in their investment management, so that investors can benefit from more specific accountability. However, fund managers can use an attractive broad label such as ‘social’ but only reference a narrow sustainability characteristic, such as board diversity in assets.

Next, fund managers using ESG-type terms but not regulatory labels are subject to pre-sale and periodic product-level disclosures regarding the objectives to be met, approach to be taken and performance indicators and metrics to be used<sup>82</sup> for the product, with accountability as to how these are applied and measured. This means that pre-sale disclosures form ongoing representations that have to be accounted for in periodic reporting, constituting an underlying form

<sup>71</sup> FCA Handbook ESG 4.3.5(3).

<sup>72</sup> FCA Handbook ESG 4.3.6.

<sup>73</sup> FCA Handbook, ESG 4.3.5; 5.2.1 (2).

<sup>74</sup> FCA Handbook, ESG 4.3.5, 5.3.2 (2).

<sup>75</sup> FCA Handbook ESG 5.4.2.

<sup>76</sup> FCA Handbook ESG 4.3.5, 5.4.3.

<sup>77</sup> FCA Handbook ESG 4.3.1, 4.3.9.

<sup>78</sup> Known as ratings variance, see Sung Eun (Summer) Kim, ‘The Duality of Variance Among ESG Assessments’ (2023) 88 *Missouri Law Review* <<https://scholarship.law.missouri.edu/mlr/vol88/iss2/7/>> accessed 27 Oct 2025.

<sup>79</sup> FCA Handbook ESG 5.6.

<sup>80</sup> Discussed in Section 2.

<sup>81</sup> FCA Handbook ESG 5.4.3(2).

<sup>82</sup> FCA Handbook ESG 5.2.1(2); 5.3.2(2).

of conduct regulation. Conduct failures, such as the failure to apply key performance indicators or metrics, or adhere to objectives, can be susceptible to both regulatory enforcement, as well as civil enforcement for misrepresentation. But conduct failures may be hard to ascertain given that fund managers can be self-selecting in terms of sustainability objectives and characteristics, and how they purport to measure achievement. Regulation also does not prescribe whether investment managers should adhere to single or double materiality. Market choice may continue to be dazzling for investors,<sup>83</sup> and it remains to be seen if investors can tell the difference between products with regulatory labels and those with only representations.

We turn next to the regulatory regime for labelled products. This regulatory regime standardizes certain conduct and transparency expectations for investment funds adopting regulatory labels. This may be attractive to investors in terms of clarifying their expectations, hence incentivizing the supply-side uptake of this opt-in regime.

#### 4. Regulating sustainably labelled investment management

The FCA now offers an opt-in regime for fund managers to affix one of four sustainability labels to their products, with standardized graphic representations. These are the ‘sustainability focus’, ‘sustainability improver’, ‘sustainability impact’, and ‘sustainability mixed goals’ labels.<sup>84</sup> Fund managers who use these are primarily responsible for ensuring they meet the FCA’s criteria, and must not misrepresent that the regulator has vetted and warranted quality of compliance with the label.<sup>85</sup> They must also ensure that the label is represented on all mandatory disclosures and in a consumer-friendly medium, and that its use is fair, clear, and not misleading.<sup>86</sup> Such representation should be followed through clearly by distributors in presenting the labelled products.<sup>87</sup> The use of the label is subject to compliance with the FCA’s criteria on an ongoing basis,<sup>88</sup> and a duty to review the label is triggered where changes occur to the product concerned.<sup>89</sup>

The eligibility to use one of the labels is based on continuing compliance with the FCA’s general criteria for all labelled products and specific criteria for each of the labels. In this manner, conduct regulation for investment managers of the labelled products is introduced. Breach of conduct can attract regulatory enforcement, which may include an order to cease using a label, notifying clients and possibly suffering market discipline in terms of outflows and reputational damage. Civil enforcement may also be possible, on the basis that the continuing compliance communicated by the label is misrepresented in one or more of the mandatory disclosures to be made to clients.

It is arguable that the labels are quite comprehensive in nature, capturing investors’ common expectations with respect to sustainable investing. The sustainability focus funds are targeted at a specific sustainability objective, and aim to cater for investors whose pro-social inclinations align with the objective, and would want to invest in assets that demonstrate proclivity to that objective. The sustainability improvers funds are targeted at assets that have room to perform better with respect to a selected sustainability objective and meets investors’ wishes to see improvement in corporate behaviour in that area. The sustainability impact funds have an explicit target to deliver a positive and measurable sustainable outcome and meets investors’ needs in relation to achieving that specifically alongside financial performance. In this manner, the sustainability focus funds are different from impact funds in that investors need not be presented with measurable sustainable outcomes, but rather continuing demonstration that assets are compliant with the objective selected. Finally, sustainability mixed goals funds allow fund managers to offer more than one sustainability aim to investors, combining two or more of the other sustainability goals, and therefore also meeting the criteria for those goals.

<sup>83</sup> The criticism that market-based governance, based on choice, need not deliver on public interest good, see Iris H-Y Chiu, ‘Sustainable Finance Regulation- Authoritative Governance or Market-Based Governance for Fund Management?’ (2023) 57 *Journal of Financial Transformation* 48.

<sup>84</sup> FCA Handbook ESG 4.1.1.

<sup>85</sup> FCA Handbook ESG 4.1.5.

<sup>86</sup> FCA Handbook ESG 4.1.8-10.

<sup>87</sup> FCA Handbook ESG 5.1.8, 4.1.16.

<sup>88</sup> FCA Handbook ESG 4.2.1.

<sup>89</sup> FCA Handbook ESG 4.1.11.

As these labels likely capture most of investors' expectations, they provide an educational means for investors in articulating their sustainability intentions. In this way, investors may be 'taught' to discriminate between labelled funds and those that do not use a label but nevertheless seek to appeal with the use of sustainability-related terms. Investors can be alerted to question what differences the latter offer, and whether their intentions are better catered for by labelled funds. Labelled funds are also subject to ongoing conduct and disclosure obligations, and in this manner, regulators are providing investors with a systematic means of monitoring fund managers' practices and accountability. What the labels do not do is to prescribe precise sustainability objectives or the granular means by which any objective may be measured or evidenced. These implementations are still in the hands of fund managers, but it is arguable that ongoing conduct regulation provides guardrails for steering behaviour in a manner that facilitates market discipline.

### General and specific criteria for label adoption (implicit conduct regulation)

Fund managers who use one of the regulatory labels must adhere to a set of ongoing conduct criteria that steer investment management practice towards evidence-based, robust, and accountable employment of investment strategies and policies that meet the expectations for the label. This article categorizes these general ongoing conduct obligations into three respects: the 'talk', the 'walk', and 'demonstrating evidence of progress', representing the entire life cycle of conduct from sale to ongoing investment management. There are also specific criteria for conduct in relation to particular labels. These are supported by precise mandatory disclosure to clients and to regulators. Mandatory disclosure to clients includes consumer-facing disclosure<sup>90</sup> that is intended to be user-friendly and promotional in nature, pre-contractual disclosure<sup>91</sup> for pre-sale representations, and ongoing annual sustainability-product level reporting<sup>92</sup> that provides continuing and consistent accountability.

Where the 'talk' is concerned, labelled funds must adopt an explicit sustainability objective.<sup>93</sup> This likely means narrowing down to one or more precise ('clear and specific') environmental or social factors, and is a steer away from the hitherto self-regulatory labelling practice of adopting broad universes of 'ESG', 'sustainability', or 'responsibility' in names without clarifying what issues the investment fund assets are concerned with. This steer is important as broad ESG or sustainable claims obscure the fact that some ESG or sustainable objectives conflict with each other or trade off against each other, making it disingenuous to claim universal alignment.

One drawback with this regulatory steer is that funds that do not use a label can continue to purport to be more 'universal', hence avoiding a sustainability label. As their disclosure obligations are also more pared down, in terms of being able to self-select their aligned sustainability characteristics and explaining their methodologies and metrics to investors, investors may be none the wiser in terms of the credibility of such offerings in a freely competitive market.

The sustainability objective adopted by labelled funds must itself be capable of measurement,<sup>94</sup> and in adopting the objective, fund managers must determine if there are negative environmental or social outcomes attendant to this.<sup>95</sup> This is less prescriptive than the EU's regulation of certain funds to demonstrate that no specific harm is done to other ESG objectives.<sup>96</sup> However, the duty to 'determine' adverse effects and the attendant disclosures (see later) can inform investors of the nature of the market choice they make.

In relation to the 'walk', labelled funds must have a robust evidence-based standard to select the assets for investment by the fund, showing alignment with the sustainable objective selected.<sup>97</sup> There is a minimum allocation rule of 70 per cent of assets<sup>98</sup> that meet the sustainable objective. Fund managers must also identify the other assets invested that are not part of the

<sup>90</sup> FCA Handbook ESG 5.2 generally.

<sup>91</sup> FCA Handbook ESG 5.3 generally.

<sup>92</sup> FCA Handbook ESG 5.5 generally.

<sup>93</sup> FCA Handbook ESG 4.2.4(1).

<sup>94</sup> *ibid.*

<sup>95</sup> FCA Handbook ESG 4.2.9(1).

<sup>96</sup> The 'do no specific harm' or DNSH principle, see discussion in TBC.

<sup>97</sup> FCA Handbook ESG 4.2.7.

<sup>98</sup> FCA Handbook ESG 4.2.4(2)(a).



70 per cent allocation and do not meet the sustainability objective.<sup>99</sup> This provides for a suitable portfolio diversification benefit, but flanked by the above need to determine adverse outcomes, it may constrain fund managers from selecting assets that undermine the fund's sustainability objective or its appeal. The standard for asset allocation can be developed by a third party, such as ESG ratings or analytics provided by an external supplier, or an index in the case of passive management. The standard must, however, be determined by an authoritative body (covering labels such as European ecolabels), industry association or a proprietary method, and applied in a systematic manner by the fund manager.<sup>100</sup> The standard should itself be assessed for appropriateness to be employed, such assessment either carried out by an independent third party or by skilled individuals within the fund manager.<sup>101</sup>

Investment management does not stop at asset allocation. The fund manager's investment policies and strategies must be appropriate for the sustainability objective. They are also to be disclosed<sup>102</sup> and can be monitored by regulators and investors. Regulation also requires fund managers to adopt key performance indicators for progress measurement, which are subject to mandatory disclosure. Disclosure relating to the application and outcomes of the key performance indicators can provide specific accountability to regulators and investors.<sup>103</sup> Disclosure to investors regarding metrics includes explanation to investors in terms of their nature, context, interpretation, and any deviations.<sup>104</sup>

Fund managers are subject to an explicit regulatory duty to measure and monitor the continuing profile and progress of assets. Fund managers must monitor<sup>105</sup> for any negative outcomes, for new assets that should be included in the allocation and for ongoing performance of assets in relation to the sustainability objective. Ongoing performance should be measured adhering to the key performance indicators selected and disclosed. The key performance indicators should be applied to accurate and complete data, allowing for appropriate proxies and assumptions.<sup>106</sup>

Funds are subject to an overall duty to monitor that they are able to comply with the regulatory label on an ongoing basis, and to restore compliance if it temporarily fails<sup>107</sup> or to cease the use of a label altogether,<sup>108</sup> with appropriate notification to clients.<sup>109</sup> The failure to take these timely actions may be a cause for regulatory action.

The ongoing monitoring conducted by investment managers of their labelled products is expected to be carried out in certain ways that regulators regard as good proxies for demonstrating such monitoring. One relates to the fund manager's escalation plan<sup>110</sup> if an asset's progress for adherence to the regulatory label falls below expectations. The application of escalation plans and actions taken are framed as duties<sup>111</sup> for ensuring ongoing adherence to the sustainability objective. Escalation plans are a subject of pre-contractual disclosure, and their enforcement and results are expected to be disclosed in the fund manager's annual report. These would provide some evidence of the quality of ongoing monitoring<sup>112</sup> for investors' discipline and regulatory supervision. Investment managers are therefore prevented from adopting an attitude of auto-piloting after asset allocation has been made.

Second, regulators and investors can monitor investment managers' compliance with the requirement<sup>113</sup> to dedicate sufficient resources, governance, and diligence to monitoring the fund's progress in achieving the sustainability objective selected. Evidence of governance and organizational resources

<sup>99</sup> FCA Handbook ESG 4.2.9(4).

<sup>100</sup> FCA Handbook 4.2.7(2).

<sup>101</sup> FCA Handbook ESG 4.2.9(3).

<sup>102</sup> In consumer facing disclosure, FCA Handbook ESG 5.2.2(7), also in pre-contractual disclosure, ESG 5.3.3(3)–(5) and annual sustainability-product level report, ESG 5.5.6.

<sup>103</sup> For consuming-facing disclosure, FCA Handbook ESG 5.2.2(8), for pre-contractual disclosure, ESG 5.3.3(6), for the annual sustainability-product level disclosure, ESG 5.5.6(7)–(9).

<sup>104</sup> Annual ongoing reporting in sustainability-product level disclosure, FCA Handbook ESG 5.5.6(8)–(10).

<sup>105</sup> FCA Handbook ESG 4.2.20(2).

<sup>106</sup> FCA Handbook ESG 4.2.26.

<sup>107</sup> FCA Handbook ESG 4.2.22(1)(b), 4.2.23.

<sup>108</sup> FCA Handbook ESG 4.2.24–25.

<sup>109</sup> FCA Handbook ESG 4.2.13–15.

<sup>110</sup> FCA Handbook ESG 4.2.9(6).

<sup>111</sup> FCA Handbook ESG 4.2.22(1)(a).

<sup>112</sup> In pre-contractual disclosure, FCA Handbook ESG 5.3.3(8); in the annual sustainability-product level disclosure, 5.5.6(12).

<sup>113</sup> FCA Handbook ESG 4.2.9(7), 4.2.20(1).

such as dedicated sustainability teams, high standards of diligence in terms of asset monitoring and the demonstration of skills and knowledge for such monitoring would be important for fund managers. Third, fund managers' stewardship policies and activities can also provide evidence of their monitoring efforts and processes.<sup>114</sup> However, as the Stewardship Code 2026 has de-emphasized ESG and sustainable risks, and leaves the investment management industry to determine the material, market, and systemic risks that affect value protection and enhancement of assets, stewardship reporting may become less useful than regulatory disclosures going forward.

Finally, specific conduct regulations are introduced for particular labels, to be consistent with the label's representation to investors. For example, for the sustainability improver label, the intention is to achieve assets' sustainable performance improvement over time. Hence, there should be an explicit time frame for improvement selected, the identification of short and medium-term targets that demonstrate the improvement, and robust evidence to show that the targets are met.<sup>115</sup> These are flanked by mandatory disclosure to explain the selection of targets, the processes undertaken by the investment manager to secure improvement, such as by active engagement, and a summary of what evidence is regarded as sufficient to demonstrate achievement of the targets.<sup>116</sup> Such conduct regulation prevents investment managers from merely offering rhetoric regarding the potential of brown assets.

For the sustainability impact label, as it purports to deliver a positive and measurable specific sustainability outcome, investment managers have to specify a theory of change in terms of how the investment would bring about the achievement of the positive outcome. Investment managers also need to specify a robust method to show how the positive outcome is being achieved and measured.<sup>117</sup> These are required to be disclosed in pre-contractual information,<sup>118</sup> and details of progress and achievement are to be made in the yearly mandatory disclosure.<sup>119</sup>

Although the regime for regulatory labels provides a set of clearer and more distinctive regulatory expectations for investment management, product credibility can only be achieved if investors monitor for compliance and exert market discipline, and if regulators supervise accordingly and hold investment managers to account through enforcement.

One potential drawback of the labelling regime is that mandatory disclosure to investors and regulators covers so many aspects of conduct that it may be difficult for investors to monitor for market discipline. The mapping of mandatory disclosure in customer-facing information, pre-contractual disclosure, and annual sustainability product-level reporting upon the conduct regulation regime outlined above provides a broad landscape for market and regulatory monitoring. Where investment managers meet the thresholds to produce a sustainability-entity report as discussed in Section 3, there is more disclosure to monitor, although these may further provide investors with insight into the manager's overall governance, strategic, risk management approaches, and the employment of metrics.

It is arguable that the FCA's regime is likely to improve investors' navigation of market choice. There are three key pieces of pre-sale information to investors which may help in terms of market choice. These are: information on the relationship between the sustainability objective adopted and financial risk, the link between the sustainability objective adopted and the non-financial outcome, and any material negative environmental or social outcome that may arise when pursuing the product's selected sustainability objective. This information is provided in consumer-facing information,<sup>120</sup> as well as pre-contractual disclosure.<sup>121</sup> In this manner, investors with hybrid preferences<sup>122</sup> can decide optimally based on priorities in terms of both financial and sustainable objectives. Any deviation from these disclosures is potentially capable of being civilly

<sup>114</sup> FCA Handbook ESG 4.2.9(8), 4.2.20(1). Mandatory disclosure is made in: consumer-facing disclosure, FCA Handbook ESG 5.2.2(7); in pre-contractual information, ESG 5.3.3(7) and in the annual sustainability-product level disclosure, ESG 5.5.6(11).

<sup>115</sup> FCA Handbook ESG 4.2.14–15.

<sup>116</sup> FCA Handbook ESG 5.3.6(1) relating to pre-contractual information, but yearly ongoing disclosure at the product level is not specified, which could be an omission in drafting.

<sup>117</sup> FCA Handbook ESG 4.2.16–17.

<sup>118</sup> FCA Handbook ESG 5.3.6(2).

<sup>119</sup> FCA Handbook ESG 5.5.7.

<sup>120</sup> FCA Handbook ESG 5.2.2(5).

<sup>121</sup> FCA Handbook ESG 5.3.3(2).

<sup>122</sup> Pro-social investors often have a range of hybrid preferences in terms of prioritizing financial or non-financial outcomes and in what proportion, Bernhard Zwergel, Anett Wins and Christian Klein, 'On the Heterogeneity of Sustainable and Responsible Investors' (2019) 9 *Journal of Sustainable Finance & Investment* 282; Miwa Nakai, Tomonori Honda, Nariaki Nishino and Kenji Takeuchi, 'Psychological Characteristics of Potential SRI Investors and Its Motivation in Japan: An Experimental Approach' (2018) 8 *Journal of Sustainable Finance & Investment* 349.

challenged for misrepresentation. Nevertheless, these disclosures do not follow into ongoing sustainability-product level reporting. This may make it difficult for investors to discover any deviation in conduct.

In relation to ongoing market monitoring of investment management, this would require continuous due diligence on the part of investors. Institutional clients of investment managers may be able to conduct more systematic scrutiny based on the full range of mandatory disclosure made. Further, as it remains to be seen if market monitoring is effective, the regulator must be prepared to monitor in its supervisory role. The FCA needs to invest in monitoring the extensive amounts of disclosure made and whether investment management conduct needs to be questioned.

However, a broader question for the FCA is how robust regulatory supervision should be, and whether regulatory enforcement may disincentivize the opt-in regime. As investors benefit significantly from the application of the conduct regime, as compared to relying on more open-ended, self-selecting disclosures and explanations for market discipline (where products are not labelled but make ESG or sustainable representations), the regulator's priority should be to steer towards label adoption, limiting the scope for the products discussed in Section 3. Hence, the regulator should consider how to navigate the landscape for not deterring label adoption while maintaining credible supervision for labelled funds to sustain investor confidence.

## 5. Conclusion

In view of the importance of non-financial factors in investment allocation and management, this article explores how the legal and regulatory framework in the UK treats the integration of these factors in asset management. It first discusses the 'baseline' position for conventional, financially focused fund management, and shows that there is increasing acceptance of integration of material non-financial factors in investment management. The universe of such material non-financial factors is also expanding, drawing from regulatory initiatives for corporate transparency. Indeed, the legal risk may lie in investment managers' failure to integrate their consideration, rather than investors challenging their integration.

The article then discusses the UK's new regulatory regime for investment funds represented to be connected with ESG or sustainable factors. Policymakers are concerned about greenwashing and whether investment management conduct for such funds is distinctive or disingenuous. The UK offers an opt-in labelling regime that covers a good range of investors' preferences in sustainable finance, incentivizing investment managers to bond themselves to the regime's conduct regulation and mandatory disclosure, which are designed to promote investor confidence. Although the choice of sustainability objectives, single or double materiality, and investment managers' methodologies, metrics and monitoring are not specifically prescribed, the regulatory regime provides conduct boundaries and guardrails to ensure that fund managers are diligent, engaged, credible, carry out monitoring, and accountable. In this way, sustainable investment is being regulated positively in terms of conduct and accountability, departing from the self-regulatory days where fund managers self-select their product's representations and investment management conduct. There is good potential for regulatory and investor monitoring to be effective, and it remains to be seen if regulatory or civil enforcement will follow. The opt-in regime, however, does leave a grey middle area where fund managers do not adopt a label and nevertheless use sustainability-related terms. The regulator has introduced certain guardrails against greenwashing and imposed accountability requirements on such funds. Such funds are, however, able to engage in more self-selection in terms of what it represents and how it intends to demonstrate adherence to its self-selection. Such open-ended accountability may not help with market discipline, but it can be argued that investors have the opportunity to demand explanation as to why a regulatory label is not adopted and whether for good reason. The potential for greenwashing in this middle area of investment selling and practice can only be narrowed down with investor education in relation to what regulation offers and is trying to achieve.

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