2 THREE KEY THEMES THAT WILL SHAPE THE UK INDUSTRY

KEY FINDINGS

1. ACCELERATING IMPACT OF TECHNOLOGICAL ADVANCE

- In Chapter 1, we set out the central importance of innovation to the industry's agenda. Here, we explore in more detail the transformative potential of AI and tokenisation. We also look at some operational resilience challenges arising from this new technological environment.
- Through 2023, AI has raced to the top of the agenda for businesses globally. The likely scale of impact for investment managers is seen as very high for an industry dependant on the interpretation and manipulation of data to build its products and services. There is also clear recognition of the emerging use cases for improving the customer interaction side, ranging from communication to better support and guidance.
- While AI has dominated this year, the potential for tokenisation to transform the operating infrastructure of both the funds industry and capital market is moving up the agenda for an increasing number of firms. The UK is reaching a critical point in defining its approach, with clearer regulatory foundations expected in the near term.
- With many firms still assessing how they might engage with a more tokenised delivery infrastructure, an avant-garde is moving ahead more quickly and foresees ramifications for the future of the investment fund as a concept. This hinges particularly on mass customisation of portfolios. Although tokenisation is not a pre-requisite, it is seen by some as a powerful tool to drive transformation, especially in less liquid markets.
- Opportunity also brings risk and firms are working at pace to enhance their operational resilience at multiple levels, including dependence on critical third parties in the technology market and ever more sophisticated – and AI-enabled – cyber threats.

2. EVOLUTION OF SUSTAINABLE AND RESPONSIBLE INVESTMENT AGENDA

- After a period during which SRI assets under management and flows have grown very rapidly, SRI appears to be entering a new and more challenging phase of development. We explore this under three headings.

Client behaviour and the impact on flows.

- After a strong 2020-2021, flows to SRI funds in the UK have tapered, partly reflecting the same cost of living concerns that have adversely impacted flow across the funds market. At the same time, relative performance in 2022 was impacted by a market pull-back in the tech sector and stronger performance in oil and gas, aerospace, and defence stocks. This has served as a reminder that allocation momentum has different drivers, with a range of motivations and preferences among individual investors and asset allocators.

Complexity of delivery environment.

- Looked at through the lens of blockers and drivers, the industry faces several issues, notably:
  - The wide range of individual and institutional preferences across the themes covered by the SRI umbrella. Always a reality, this has become more evident in debates over energy security and weapons investment after the invasion of Ukraine.
  - A more significant debate about the implications of the fiduciary / agency model for the leadership role of the investment management industry in this space.
  - Increasing signs of tension over the distribution of transition costs in the context of a more challenging economic environment, which have the potential to amplify the discussion about industry role.

None of these factors are seen by firms as challenging what is widely regarded as a 'mega trend' in SRI, driven by the urgent need to tackle the global climate crisis. However, they are changing aspects of how the conversation takes place with some clients in some jurisdictions and are likely to continue to do so.

Evolving regulatory expectations.

- Regulators internationally are continuing their focus on SRI with an increasing emphasis on disclosure standards. In the UK, the next step will be a labelling approach under the Sustainable Disclosure Requirements (SDR) regime. While there is strong industry support for the overall objective, there has been a significant gap between the reality of the SRI process and the ability of a small number of labels to capture this in a way that can be both helpful to customers and operationally viable. One critical issue to resolve in all eventualities will be availability and consistency of data, which remains a central challenge internationally.

3. ONGOING IMPORTANCE OF CULTURAL SHIFT

- Attention to Equity, Diversity & Inclusion (EDI) continues to be a growing industry priority and lies at the heart of the cultural transformation agenda. Together with the embrace of new technology, success in EDI is widely seen as central to the industry remaining relevant to younger generations with a different set of expectations and tolerance, as well as contributing to the wider corporate and social good that EDI delivers.

- The focus is shifting away from diversity characteristics alone towards creating an inclusive culture that promotes belonging and psychological safety across the organisation and throughout the entire employee experience. Here too, data matters enormously and firms are placing more emphasis on gathering breadth and depth of workforce data so that firms understand where they are currently, and how to move forward effectively.

- From a UK regulatory perspective, an important next step will be an FCA Consultation Paper on Diversity and Inclusion in the financial sector, building on an earlier Discussion Paper. The CP is anticipated in the second half of 2023 and in the meantime, industry continues to make progress in EDI initiatives.

- Areas that require further attention include the need to ensure sustainable change, particularly in executive decision-making and investment roles. We expect much more activity in the years ahead to further progress this critical agenda.

In Chapter 1, we outlined an adaptation challenge in what increasingly looks like a new macro-economic and macro-financial environment. This has been driven by a series of crises that have both destabilised the existing global political and security order and contributed to a change of direction on global monetary policy that has had significant consequences for markets. Looking to the medium and longer term, the industry has set out an agenda for maintaining competitiveness that prioritises innovation, but also requires a range of further changes to be successful.

In this chapter, we look at three key themes that are a focus in this new environment. We start with accelerating technological change, then look at sustainability and EDI. These themes have something important in common, notably their resonance well beyond financial services and investment management. They are critical areas that are now at the heart of the wider global policy agenda and increasingly, in the case of both sustainability and EDI, creating points of polarisation and disagreement. Getting new technology, sustainability and culture right is therefore a challenge that will take the industry beyond its comfort zone in multiple different ways, but will ultimately define its relationship with wider society, both in terms of the product set itself and in terms of wider values and political alignment.

ACCELERATING TECHNOLOGICAL ADVANCE

Although the direction and precise pace of innovation continues to be difficult to predict, there is an increasing consensus that investment management, as part of wider financial services and the economy, is about to experience transformative change. The debate through 2022 and into 2023 has been increasingly dominated by artificial intelligence (AI), but the potential offered by tokenisation / digitalisation still appears significant, albeit with a range of views about the pace of adoption and impact. This section of the report looks both at AI and tokenisation.

A NEW INDUSTRIAL REVOLUTION?

The explosion of generative AI onto the scene in late 2022 is widely seen as the beginning of a transformative phase in technological development. AI promises to provide significant productivity benefits from a general business perspective, potentially altering the investment outlook across a range of investee sectors and companies, as well as reshaping the internal workings of member firms. A number of comments in the Survey interview process reflected the recognition of the scale of potential change ahead.

"AI is revolutionary. It's been just six months now since chat GPT, but it has the potential to have an earth-shattering impact upon us. It presents an opportunity for a significant increase in productivity across the entire economy."

Done properly, AI-enabled utilisation of data will significantly change how products are built, the level and mode of interaction between companies and their employees, and between companies and their customers. Many firms have experimented in the early part of 2023 with new AI tools to identify the ways in which greater data insight can be achieved.

"Investment in data, both in terms of actual data as well as the analysis, driving that through to decision making will be critically important."

It has also provided a new lens through which to imagine other changes within the industry, for example how AI can be paired with distributed ledger technology, or with customer interfaces, to accelerate innovation through the distribution chain. For example, generative AI could help to provide explanation and information for actual or future investors. While this would not replace the sophistication or nuance of regulated financial advice, it could help facilitate some elements of the investor journey in an accessible and scalable manner.

"Generative AI can really help to reduce the advice gap. One of the big barriers is people feeling there is a huge information wall to climb before deciding whether to take formal advice. AI could really help a consumer to navigate through those challenges."

"If you're a wealth manager right now, you have got to be really thinking about what is going to happen with generative AI and the ability to interact with your client on a digital basis."

TOKENISATION / ASSET AND FUND DIGITALISATION

Developments in this area were somewhat overshadowed by the rise of AI in the period. However, activity is accelerating internationally, and the UK Asset Management Taskforce now has a Working Group looking closely at the practicalities of fund tokenisation with a view to removing regulatory blockers in the near future. This area has not moved quickly so far in the UK and there is considerable caution in some parts of the investment community. However, there is increasing recognition of the long-term transformative potential and the need to put foundations in place today.

"With tokenisation, people will love the concept. But, until they can actually feel comfortable that it is delivering what they hope and expect, I'm not sure that you will get rapid, broad adoption. There's a long way to go before people trust in that technology."

"Over a longer time frame, it will totally change how capital markets operate but also how individuals choose to run and support their investment portfolios."

There are multiple potential advantages of tokenisation of both funds and underlying assets, using distributed ledger technology (DLT) as the foundation. Importantly, we make a distinction in the discussion here between tokenisation as part of a delivery infrastructure and cryptocurrencies which may or may not have a valuable role to play. While some firms within the investment management industry are looking at funds that provide direct exposure to crypto, the real focus is on the infrastructure. This has the potential to generate significant efficiencies through the capital market delivery chain, from asset origination to investment fund operation, as well as a potential for greater transparency and liquidity in certain markets, notably private markets.

"I'm very confident that tokenisation has a significant part to play for two key reasons. First, it allows customisation of risk exposures in a way that can't be done today. The ability to tokenise assets and to compile portfolios in a different way has to be a good thing in terms of client access. The second is in the book of record. You compare and contrast the ease of that blockchain technology relative to all the complications in terms of custodians, beneficial ownership and mutual fund wrappers. Ultimately, the client experience can be cheaper, and will be better."

Development internationally is seeing a focus on both capital marks and funds. Through late 2022 and into 2023, there were multiple experiments internationally in digital bond issuance. These proof of concepts, when paired with greater legal clarity in some jurisdictions, have now made tokenisation a reality. There are now emerging use cases within investment products, with numerous examples of tokenised funds now operating across the globe, bringing the benefits of DLT to end investors, and furthering the debate about how investment firms will deliver investment solutions to consumers in the future.

TOWARDS A MUCH MORE CUSTOMISED PRODUCT SET?

For some firms, the debate has gone further still with the question of whether the traditional concept of the investment fund itself may now be challenged by a combination of societal preferences for customisation and a delivery infrastructure that can accommodate this securely and at scale. This would, in effect, see the extension of Separately Management Accounts (SMAs) widely used today in the US at an industrialised scale. However, there is no consensus about whether Investment Fund 3.0, as the IA has called the concept, will go this far, or whether DLT is needed to deliver it. For some firms, it would be delivered using more flexible building blocks such as ETFs in combination with more modern portfolio construction and distribution technology. For others, DLT and tokenised funds represent the way forward.

"The challenging part is how do you run custom portfolios in very small pots, at scale, for large numbers of retail investors, creating hyper granular portfolios and matching that to really specific tailored needs on the customer's side? Marrying that in a way that is true to label is a really intensive heavy duty data challenge. Most of the industry systems as they stand today don't allow you to do it, but that is where the ball is headed."

"Eventually, we're going to see much more customisation. I want to have a set of stocks, that reflect my own personal wishes and as the manager we have to be able to provide that somehow. The answer to that question is a combination of ETFs and technology. You can't do it in a mutual fund."

Whatever the precise shape of Investment Fund 3.0, and whatever the technology that ultimately powers the manufacture process, there does seem to be a consensus that the net result will be a much greater focus on the value of the investment management component through the lens of the investment IP – in other words, how portfolios are constructed and risk is managed.

"Our content will remain our content. Tokenisation is about facilitation and delivery."

In sum, it seems clear that AI, DLT and consumer interactivity could converge to change the relationship between the customer and their portfolio, increasing participation and altering the nature of delegation to a professional investment manager. All of this will rest also on the ability better to bring together a whole range of wider preferences in a package that is understandable and totally transparent.

"The importance of understanding evolving client expectations whether you're talking about institutional or indeed, whether you're talking private investors; the requirement to demystify; the requirement to, wherever possible, customise, and show the potential to make returns within a prescribed volatility path, within a given liquidity, for a given fee rate, with sustainability credentials. That's what future success must look like."

OPERATIONAL RESILIENCE AND EMERGING TECH

With emerging technologies poised to reshape the underlying operating models of firms, as well as the broader financial market infrastructure on which they rely, wider resilience considerations clearly arise with that reshaping. The potential sources of disruption and vulnerabilities will likewise evolve and are already doing so. The implication is that current mapping of a firm's people, systems and processes could soon become outdated. Firms are now working at pace to ensure their future operating models are resilient by design, and it will be important that resilience teams are embedded into technology change projects and innovation drives going forward.

As of today, there is a particular focus on two areas in particular: the accelerating importance of third-party technology providers and the increase in cyber risk. Neither of these are unique to investment management nor even financial services. However, the scale of client assets under management and the global inter-connectedness of investment management firms with others in the FS sector means that resilience is a preoccupation for both individual firms and regulators.

Role of third-party technology providers

The financial services industry is increasingly reliant on third party technology providers which are underpinning operating models.

There are numerous benefits, as well as risks, inherent to such arrangements. These providers offer services at scale, which drive capability, efficiencies and scale in a number of business areas. Examples of services provided by third party technology vendors include cloud computing; data centres; information, communication and technology (ICT) services; software; information streams; and, increasingly, artificial intelligence capabilities.

From an operational resilience perspective, outsourcing and third-party service provision changes the firm's risk profile, and in many cases results in greater resilience. At the same time, it can pose risks that need to be managed.

Firms relying on third parties need to be able to demonstrate that they are effectively managing the risk of disruption and harm to their customers and end consumers. However, there are numerous challenges involved in forming assessments over third party providers' resilience in adequate detail. Driving improvements in this area is likely therefore to be an area of focus over the coming years.

Similarly, the growing importance of technology providers from outside of the financial world is creating new potentially systemic risks that firms and supervisory authorities must manage. To address this trend, proposals are afoot in both the UK and the EU to manage the systemic risks that disruption at a third party providing key services to multiple firms could cause.

In the UK, the FCA, Bank of England and PRA published a Discussion Paper regarding Critical Third Parties (CTPs) to the finance sector in July 2022. The DP contained proposals that are intended to manage the systemic risks presented by large technology providers to the BoE, PRA and FCA's objectives of UK financial stability, market integrity and consumer projection. The proposals are likely to capture major cloud service providers and other technology providers.

The proposals will complement the regulators' UK Operational Resilience Rules. They are motivated by HMT's assessment that the regulators' current powers are not sufficient to tackle the systemic risk that disruption at a third party providing key services to multiple firms could cause.

These proposals involve designating certain entities outside of the regulatory perimeter as critical to the sector and introducing minimum resilience requirements and direct regulatory supervision of their services to FS clients.

Cyber threat

The risk of disruption stemming from cyber-attacks is a persistent serious threat to the industry. What marks cyber out as unique in the catalogue of the many sources of potential disruption is the speed and scale at which incidents can play out, and the fact that such incidents are perpetrated by malicious actors intent on deliberately causing harm.

Significant incidents this year such as the Log4J zero-day vulnerability, the MOVEit vulnerability and a ransomware attack that interrupted derivatives trading for around one week, demonstrate the extent and reality of the cyber threat faced by the industry. They also underline the need for firms to not only maintain constant vigilance and a focus on cyber hygiene, but further develop incident response plans should the firm need to protect their staff and clients and help to recover critical activities, systems and data affected by cyber incidents. This is a growing area of resourcing and activity across the industry, with support from regulators and external agencies such as the National Cyber Security Centre (NCSC), the Connect Inform Share Protect (CISP) platform the Joint Cyber Defence Collaborative and the FCA's Cyber Coordination Groups.

EVOLUTION OF RESPONSIBLE AND SUSTAINABLE INVESTMENT

Sustainable and responsible investment (SRI) continues to be a dominant theme for the investment management industry, regulators and customers. There is little doubt among those we spoke to for the IA Survey or across the industry more broadly that recognition of the realities of climate change for the global economy, and engagement to mitigate and adapt to those changes, will remain a central focus for investment management firms. However, the near-term outlook from a product and broader investing perspective has become more challenging. We focus our analysis on three themes:

- Client behaviour and the impact on flows to responsible and sustainable investment funds
- The interaction of current economic and political developments with the ESG momentum of recent years
- Evolving regulatory expectations, especially around data and disclosure

CLIENT BEHAVIOUR, PERFORMANCE AND FLOW

The performance of SRI strategies, both in terms of attracting new flows and generating returns, was particularly strong through 2020 and continued to grow through 2021. Two features of 2022 in the funds market have dampened that positive narrative:

- As inflation pressures have intensified and interest rates were raised, flows to SRI funds in the UK have tapered, partly reflecting the same cost of living concerns that have adversely impacted flow across the funds market. However, the extent of the retrenchment is less marked, suggesting that SRI flow does remain stickier in the retail market, as well as in institutional.
- Relative performance has been impacted by weaker performance in the tech sector and stronger performance in oil and gas, aerospace and defence stocks. Despite the recent strength of commitment among investors to SRI funds, there is evidence from IA consumer research as well as other research that financial objectives continued to outweigh non-financial objectives for many retail investors.

"When the cost of living crisis really started to kick in and people started to question whether they could afford to make that trade, we saw a flattening of interest in SRI products both in the UK and outside the UK."

"There is a core who have stayed in those strategies because they believe it's the right thing to do and are prepared to take that financial hit over the short term. However, some investors bought for the upsides and were not prepared to withstand crises and wanted to jump ship at that point."

"The idea that because something's badged sustainable, it means that people are going to be committed forever is misguided. Sustainable investment is not immune from the ebb and flow of people's attitudes to committing risk capital."

Firms that we spoke to this year agreed that interest in SRI strategies is likely to build over the long term, though views were divergent on the ultimate drivers of demand. Some firms are of the view that the growth of such strategies is largely driven by heightened demand from customers to align portfolios to their values, while others highlight the role of regulation and intermediaries in directing capital to SRI products.

"We have seen a huge shift towards SRI demand – but it's not demand from retail consumers, it's a push from providers and from regulators."

Whether a result of regulation or customer demand, the industry agrees that SRI is an area of continued growth, with some firms envisaging that the products will become mainstream in the future as climate change in particular becomes more of a challenge.

"The long-term structural need for clients to have someone who sells them attractive risk-adjusted products that builds SRI in at the right price, culturally aligned with who they are, is a trend that isn't going away, that's structural."

"You can envisage a scenario where sustainable investment products are the only option for investors. That continuation from SRI being the niche product toward SRI being the mainstream product will continue despite the flows that we saw last year."

COMPLEXITY OF DELIVERY ENVIRONMENT

Looked at through the lens of societal drivers and blockers, the investment management industry faces a number of challenges as it seeks to further develop SRI strategies:

- **Range of preferences.** Clearly, a central focus globally is on climate change. However, climate is only one of a number of themes within the environmental sphere. Extended to the social sphere (as exemplified by the UN Sustainable Development Goals), SRI covers multiple different themes with a vast number of combinations of individual preferences and priorities across environmental and social issues. The debate over energy security and investment in weapon production in the aftermath of the Russian invasion of Ukraine illustrated some of the differences over definition and prioritisation.

- **Blurred boundary between public and private sector agency.** The UN SDGs cover critical areas of social and environmental policy that may be politically contested and/or the normal domain of government and public policy. One of the issues facing investment management firms in some jurisdictions, notably the US, is a challenge by some clients to their legitimacy in these areas. While the US debate has focused on climate change amidst strengthening political division on the issue, it raises a broader point about what fiduciary responsibility means and the role of investment managers and market-driven agency in engineering change more broadly.

- **Political and economic tension over transition costs.** Tensions have arisen between broad public support for the net zero transition and opposition to individual policies which involve a personal financial cost. This has become more evident in UK politics as a combination of rising inflation and cost of credit over the last 12-18 months have ignited a more divisive political conversation about the cost and timing of transition (see Box 2 on Climate change and the UK context). To date, the political conversation has not reduced overall support for the transition but with a general election imminent, there is potential for a knock-on effect with respect to the wider political environment in which investment managers operate.

In research for this report, and in other industry research covering similar topics, the prevailing view is that current challenges will not divert what has been described as a 'secular mega-trend' which puts a focus on SRI issues, especially tackling climate change, at the heart of the investment process.[15] However, to the extent that SRI is about much more than just climate, and to the extent that political and cultural polarisation are becoming more entrenched in certain jurisdictions, notably the US , the investment industry will need to navigate these drivers and blockers with care.

Awareness of this challenge is apparent in a number of comments made in interviews for this report, reflecting the evolving debate on what fiduciary means in the context of an 'agency' business model and a sensitivity to the central importance of Government policy and electoral preferences in shaping the parameters for change. The net zero transition in particular has been identified by policymakers as a necessary process of transformation for the global economy. There is a widely shared view that the first responsibility of the industry is to respond to this transition, assessing both risks and opportunities, but that it is for individual firms to decide the extent they wish to be regarded as responsible for driving the transition. Some firms wish very clearly to define what they stand for in SRI terms, and others look to customer preferences as a central guide for their direction of travel.

"It's really important to remember that we're fiduciaries – it's not our money. We can inform clients as to the risk and reward and the material risks represented by climate change. Every business should be thinking about incorporating material risk factors. It's not for us to say what you can and cannot invest in."

"The asset management industry is more of a reflection of the real economy rather than something that actually creates the real economy. Whose social goals are we supposed to be pursuing? That's for governments and democratically elected officials to decide, not for the asset management industry."

[15] See, for example, ESG Investing: Short-Term Shocks Will Not Detail a Secular Mega-Trend in Asset Management, a short perspective by McKinsey & Company in EFAMA, Asset Management in Europe, December 2022.

BOX 2: CLIMATE CHANGE AND UK POSITIONING

Fading memories of Glasgow hosting COP26, political uncertainty linked to the brief Truss premiership, and the instability in energy markets associated with the war in Ukraine have all led to an uncertain environment for climate-related investment and policy.

In her short period as Prime Minister, Liz Truss launched a wholesale review of net zero and its compatibility with economic growth. The subsequent publication of the Skidmore Review (which was ultimately submitted to Rishi Sunak's Government) reiterated the firm link between the UK's net zero policies and growth, but the intervening months caused some to reassess the UK's previous leadership on the subject and contributed to delay to Government work on climate-related policy, including the updated Green Finance Strategy. In June, the annual progress report of the UK's statutory Climate Change Committee warned that the UK was losing its international climate leadership role and showing a lack of urgency in domestic policy.

Momentum had been somewhat regained since the publication of the Green Finance Strategy in March, with much of the focus remaining on initiatives first announced at COP26, including incorporating the work of the International Sustainability Standards Board in the UK, and promoting the UK's Transition Plan Taskforce and its efforts to define a "gold standard" for transition plan disclosure.

Greater attention has fallen on biodiversity, aided by progress in the work of the Government-sponsored Taskforce on Nature-related Financial Disclosures and the decision in the new Financial Services and Markets Act to require financial regulators to have regard for the UK Government's legally binding environmental and net zero targets.

The UK-based investment management industry also awaits the outcome of consultations on the regulation of ESG ratings providers, a labelling regime for ESG funds, and the introduction of a green taxonomy. Taken together, and alongside the volume of new climate-related regulatory initiatives in the EU, investment managers are being required to dedicate significant resource to understanding and integrating changes in the public policy environment.

It will be hoped that the culmination of this phase of policy making will be followed by a period in which changes are allowed to settle and bed in, allowing the industry to focus on serving its clients growing demand for climate-related investment and anticipating the ways in which climate change will cause economic disruption. Policymakers would similarly have the opportunity to bring renewed urgency to the transition to net zero across the whole economy, setting clearer pathways for the transformation of high emitting sectors and providing new opportunities for investment from private finance.

An anti-ESG political movement in the United States has caused ripples in the UK and Europe but it may be in industrial policy that the US provokes a political following. The current political consensus appears to make a like-for-like response to the spending and incentives of the US Inflation Reduction Act unlikely in the UK, with the preference for a market-led, information-driven transition persisting. A looming General Election is stimulating a debate about potential trade-offs between fiscal credibility and green policies which may test this consensus.

"As an investment house you have to tailor your product offering to your customer base, but you also have to be clear about what you stand for and what your investment beliefs are."

Firms also point to the ongoing importance of communication and education about the financial implications of climate-related risks, as set apart from ethical considerations that guide some customer and firm approaches to broader SRI investment priorities.

"It's important that investors understand, completely separate from any ethical or moral viewpoint of the world, that there is real stranded assets risk in oil and gas companies, and therefore the discounted cashflows that create those share prices might not be as robust as the market currently assesses it. That is a pure financial risk which is expressed in ESG terms. You would be remiss if you weren't having that conversation with your clients, even if it isn't under the heading of ESG."

In terms of government expectations and public policy, the US has adopted quite a distinct approach to interventionism with the fiscal package set out in the Inflation Reduction Act (IRA). As we set out in Box 2, this stands in contrast to the less certain direction of travel recently in evidence in the UK. Equally, it highlights the ongoing central role of government in galvanising action that may yet become much more apparent in the UK and elsewhere in Europe. Recent UK government consultations on pension reform and the possible re-direction of long-term capital into areas of strategic importance for the domestic economy also point the way to other forms of possible intervention in due course on sustainability issues.

EVOLVING REGULATORY EXPECTATIONS

Regulators internationally are continuing their focus on the sustainability and responsible investment space with an increasing emphasis on higher disclosure standards for such products. In the UK, following a Discussion Paper in 2021, the FCA has been progressing its Sustainable Disclosure Requirements (SDR) regime and labelling framework, aimed at allowing investors to identify such products more easily and to give them greater confidence that their investments match their preferences and expectations.

"The main risk around ESG as a whole is about being true to label. It's about your customers buying what they think they're buying. Pure green and brown to green are really different portfolios in terms of ESG exposure, financial return, volatility. As you push further and further into retail, the importance of making sure you're being really explicit about what you're selling and what they should expect only increases."

With the industry broadly supportive of a label approach, the UK debate has focused primarily on how to operationalise a labelling system that will work for both the market and the end customer. There have been many central discussion points between firms and the FCA:

- How to create a label that accommodates the increasingly important 'transition' dimension of the economy without creating unrealistic expectations of what individual investment firms can deliver at investee company level.
- How to accommodate multi-asset or blended strategies that may not conform easily with minimum thresholds for a given sustainable investment label.
- How to capture the breadth of legitimate sustainable investment approaches adopted in the space without unduly restricting investor choice through strict marketing rules for investment products that will not get a sustainable label.

This has all in turn highlighted ongoing limitations in access to consistent and high-quality sustainability-related data and ratings, which is a key requirement of forming SRI strategies. A widespread and growing proliferation of providers of the data has led to a number of well-versed challenges, including the timeliness, accuracy and reliability of the output from sustainability-related rating and data providers. Furthermore, a lack of comparability and bias of the data and potential for conflicts of interest, particularly associated with providers both evaluating companies and offering paid advisory services to those same companies, is an ongoing concern.

A further critical issue for the UK industry, especially in a post-Brexit environment, is the interoperability between SDR and other international regimes, notably the Sustainable Finance Disclosure Regulation (SFDR) and supporting measures. This matters for a number of reasons relating to cross-border distribution and manufacture arrangements, where international investment management firms operating from the UK find it increasingly challenging to navigate multiple, high-touch regulatory regimes. For UK customers investing in both UK and EU-domiciled funds, there is an added issue of differences in both disclosure and potentially investment approach.

"If SDR carries on as it is, a whole section of funds is going to be crushed. There is a hygiene factor for all the RFP requests that come in – it will be "do you have an SDR label?" Exactly the same as "are you SFDR 8 or 9?" If you don't have the badge, they'll screen you out even if you are managing your portfolio in a way that could align with their values."

"I do wonder whether the end client will get a proper choice in the marketplace. With the SDR labels you're narrowing down the universe to such a small proportion of what you could have been looking at."

"One of the challenges is the regulators are using quite broad buckets for these products because you can't have 10,000 ESG labels. What's really important for the industry is within those broad buckets, that we're really explicit and clear about what it is that this fund does which could be very different from what another fund does, even though they are under the same regulatory classification."

CULTURAL SHIFTS AND THE IMPORTANCE OF THE EDI PROCESS

Attention to Equity, Diversity & Inclusion (EDI) over the past few years continues to be a growing industry priority as part of the cultural transformation agenda. Alongside the growth in societal expectations of fostering a more equitable, diverse and inclusive society, businesses are responding to the expanding body of research showing that diverse teams produce better results because they offer broader perspectives and lower risks. There is also a wider commercial risk of being unable to connect with different groups of customers as a result of negative perceptions arising from the composition of the workforce.

Furthermore, the regulators have expressed their expectations that businesses capture, measure and address workforce diversity and inclusion as part of good governance and risk mitigation. In addition, firms are increasingly being evaluated by stakeholders against a wider set of criteria, which includes the diversity of their workforce and being able to evidence this with data across different parts of the business and different levels of seniority.

"Equity diversity and inclusion is super important. We don't focus on it because the government is forcing us to or because we have a social contract. It's because our clients are diverse. We know that diverse people make better decisions because you don't have group think."

While member firms have increased their commitment and investment to act on advancing EDI, collective progress is taking time. To make meaningful and sustainable change, there are several complex issues that businesses are addressing.

"It's easy to manage people that all agree with you and all look like you and think the same way. A team of diverse thinkers is a harder team to manage, so you've got to be prepared to put the effort in."

"There's true understanding that we are a better organisation and deliver better client outcomes through being a truly diverse organisation. In order to be truly diverse, we need to be better at both the hiring and identifying potential. In hiring we as an industry need to be much braver in terms of how we construct role descriptions for example. We also need to get bolder around potential, embrace not the risk but the opportunity and put our money where our mouth is."

The focus is shifting away from diversity characteristics alone towards creating an inclusive culture that promotes belonging and psychological safety across the organisation and throughout the entire employee experience. A growing number of businesses are recognising that sustainable impact in EDI, from junior recruitment through to senior level progression, relies on a healthy business culture, aligned policies, accountability and a shared commitment to success.

Firms are placing more emphasis on gathering breadth and depth of workforce data so that firms understand where they are currently and can consider the root causes behind their data and can use it to measure future progress. The IA, in partnership with Thinking Ahead Institute, have undertaken a campaign to gather richer EDI data across the UK investment management industry and have received a strong response from the sector. The data will, for the first time, provide a more detailed overview of the demographic makeup of the UK investment management industry, allow firms to benchmark their progress and have greater clarity on where to focus their investments.

"You can't enact change without having data and then teeth. We've been talking about this now for 25 years and I don't think it's meaningfully improved."

To provide context around workforce data, there is also a growing emphasis on collecting and understanding employee sentiment by capturing real-time employee insights, such as through pulse surveys, enabling firms to identify and respond to important needs early on.

While there has been progress in addressing industry workforce underrepresentation in certain areas, such as gender, ethnicity and socioeconomic characteristics, there is a recognition that more needs to be done to ensure sustainable change, particularly in executive decision-making and investment roles. We expect much more activity in the years ahead to further progress this critical agenda.

"As a firm, our diversity at graduate level and in non-investment roles is good. We have diverse teams until you get into the investment team. Finding diverse candidates for investment roles is really hard. You have to develop your own. You are going to have to take a risk to bring people into the industry who have a different set of experiences if you want to be diverse. We've got to continue to be really conscious and to challenge our recruiters about how to make jobs accessible to people who aren't the 'ideal candidate' in terms of a CV and experience."

From a UK regulatory perspective, the FCA finalised rules in 2022 requiring listed companies to disclose board and executive committee diversity to improve transparency with investors. During 2023, an important next step will be an FCA Consultation Paper on Diversity and Inclusion in the financial sector, building on an earlier Discussion Paper. It is anticipated in the second half of 2023 and in the meantime, industry continues to make progress in EDI initiatives.