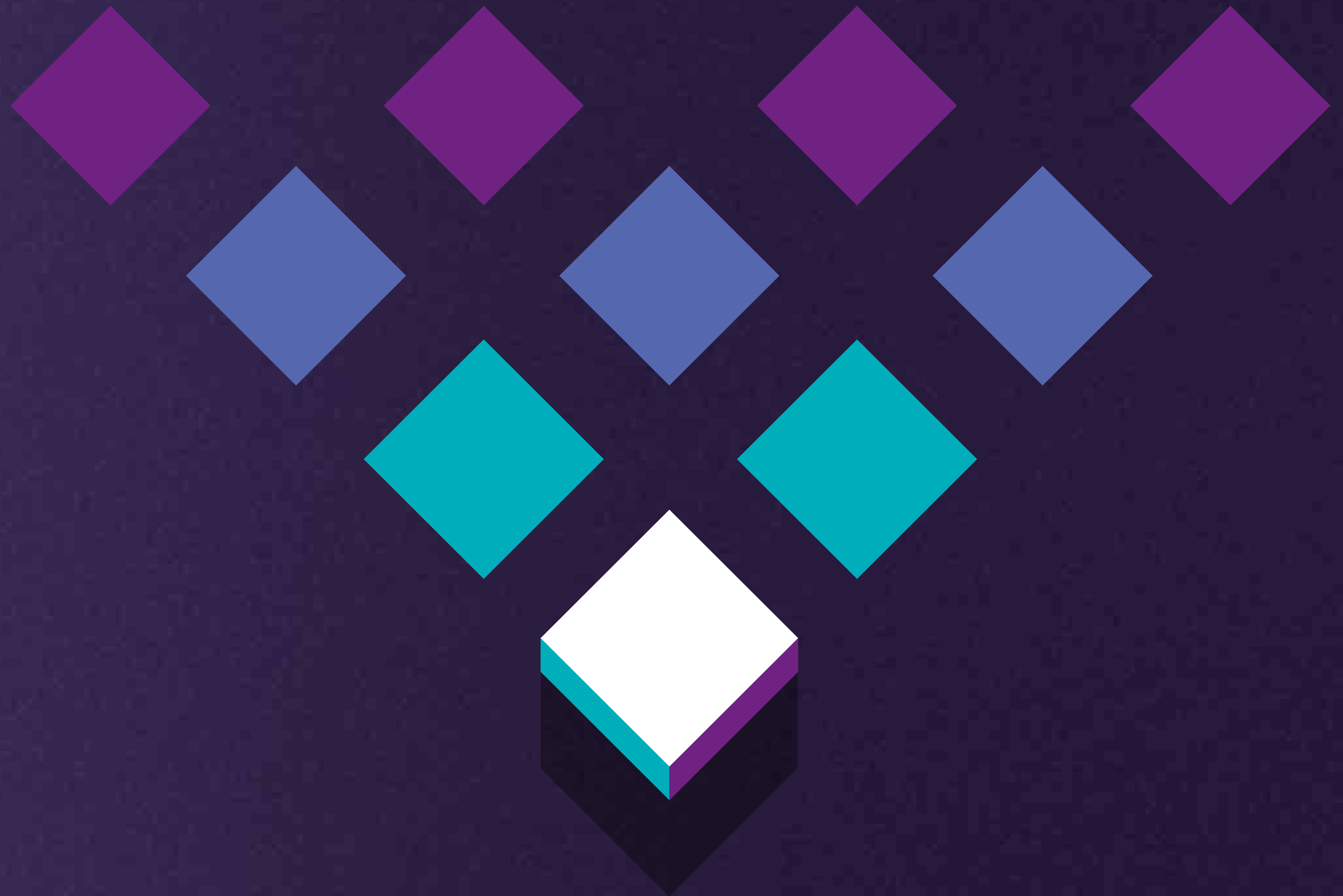
Depositary Insights

March 2023



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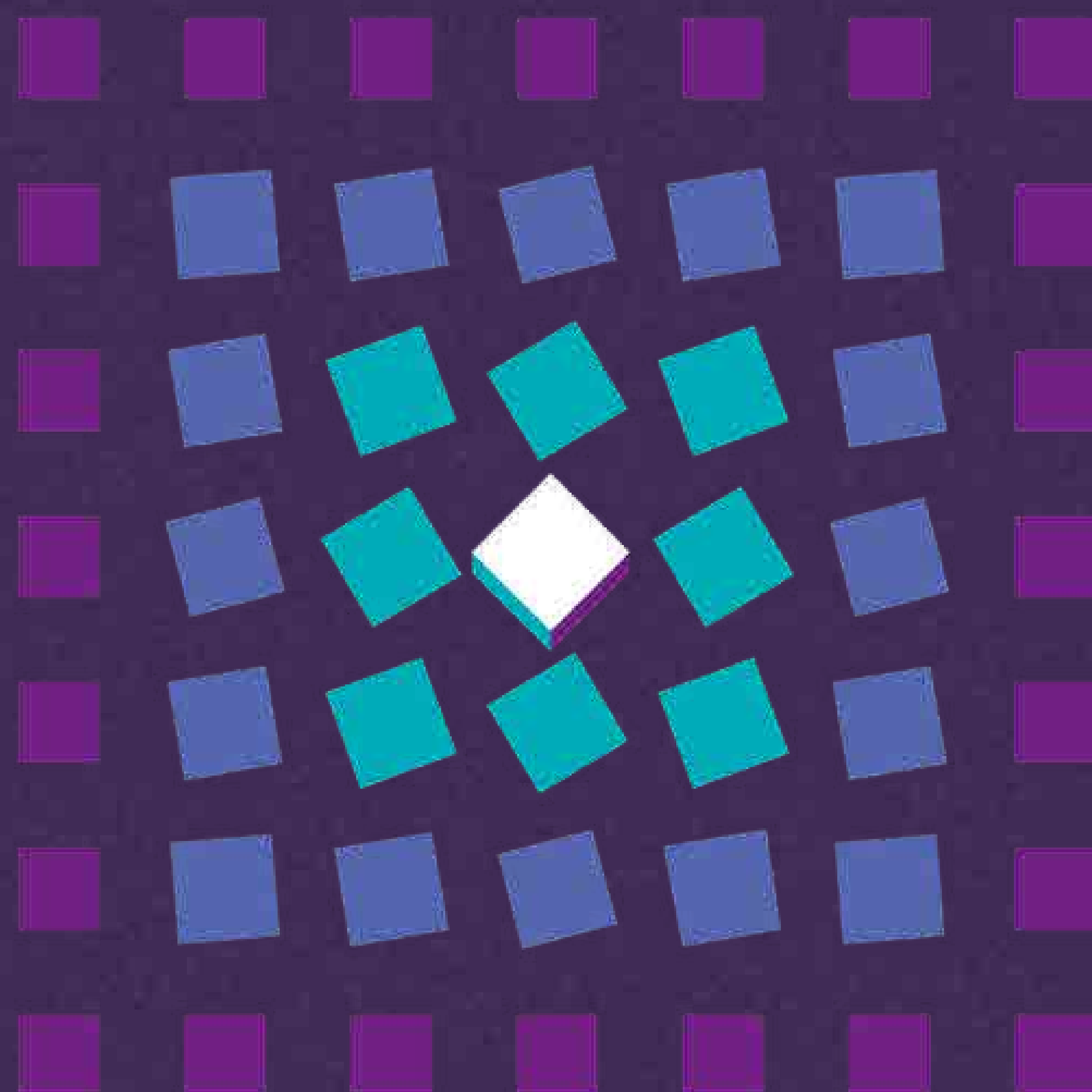

Foreword

Welcome to the latest edition of Depositary Insights.

NatWest Trustee and Depositary Services team

After a tumultuous few years, the regulatory agenda for financial services has been pushed back by six to nine months. But there are still important rule changes coming down the track and firms need to be ready. A number of headline regulatory developments such as the new Consumer Duty, Greenwashing, Operational resilience and Direct2Fund are some of the biggest regulatory shifts we've identified, and what you should be thinking about to stay one step ahead.

This edition focuses on liquidity management, post-Brexit relocation, digital asset regulation and the regulatory outlook for 2023.

As ever, we hope you find this edition helpful and we welcome your feedback.

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Liquidity in the spotlight

Ros Clark, Regulatory Risk Assistant Director, NatWest Trustee & Depositary Services

The economic downturn, war in Ukraine and the aftermath of the UK government's mini-budget have coalesced to ramp up the regulatory focus on fund liquidity.

Liquidity management has been on the regulatory radar for several years in the UK and Europe, where new monitoring and reporting requirements have been imposed on funds to protect investors and consumers.

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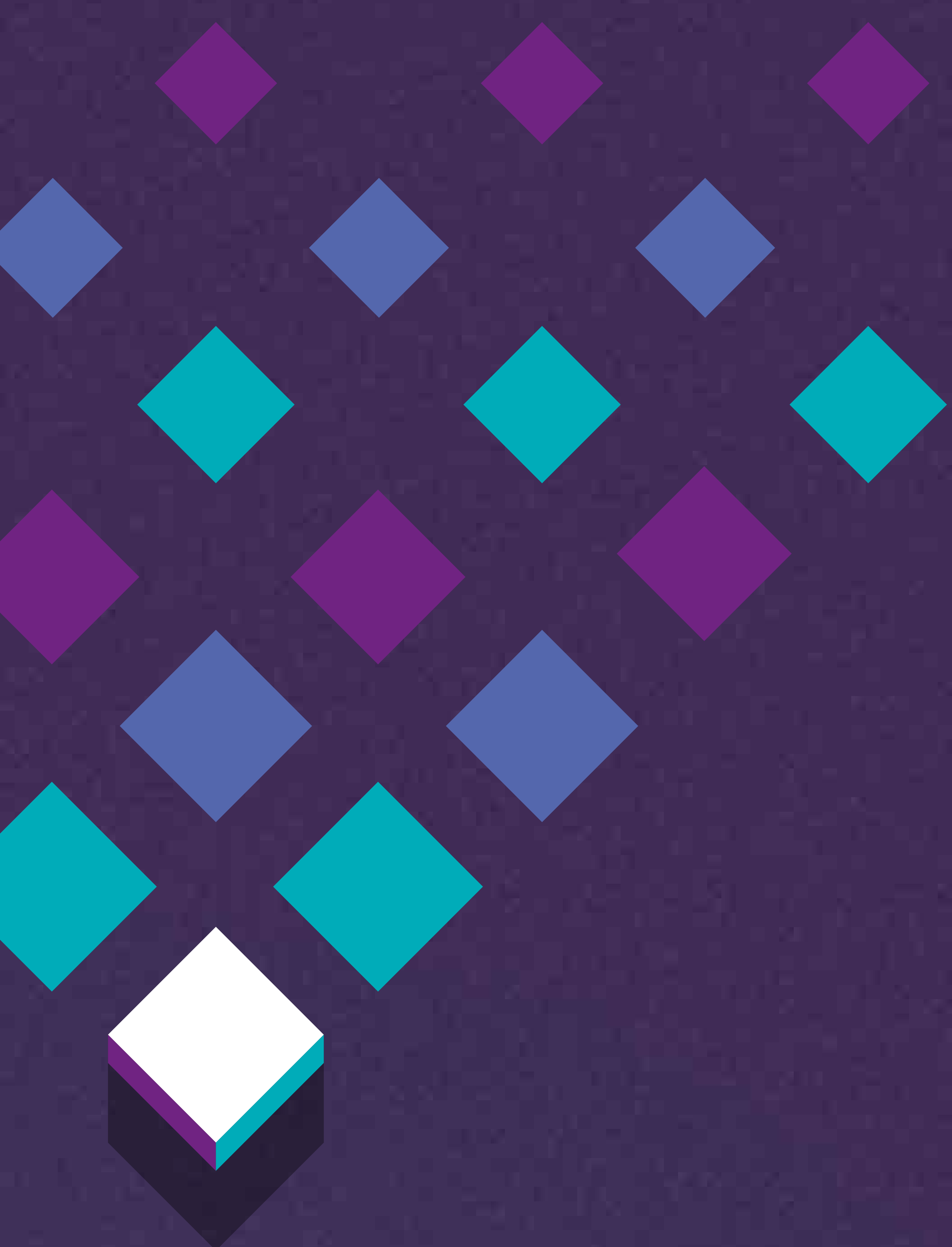

Following a turbulent few years, markets are now braced for even greater scrutiny. A raft of analyses, discussions and proposals have emerged from a wide range of regulators and policymakers in an attempt to manage funds' liquidity risk.

Most notably, policymakers have proposed reforms to EU rules on alternative investment funds, including a specific focus on liquidity management. This builds on the existing guidelines from ESMA on liquidity stress testing and IOSCO's 2018 recommendations on liquidity risk management, which were reviewed to assess the implementation of selected recommendations.

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In the wider financial markets, 2022 saw the introduction of guidance around Operational Resilience and Consumer Duty.

"Liquidity is getting a lot of attention... ...A lot of the regulatory and policy work is to ensure that there is a proper toolkit available to manage liquidity across all European jurisdictions."

Peter Capper, Senior Adviser, International Fund Regulation at the Investment Association (IA)

The IA has long called for a broader suite of liquidity management tools for those responsible for managing fund liquidity. Such a move will ensure that investors' interests are protected and that liquidity is managed appropriately, even in stressed market conditions.

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Growing scrutiny on liquidity

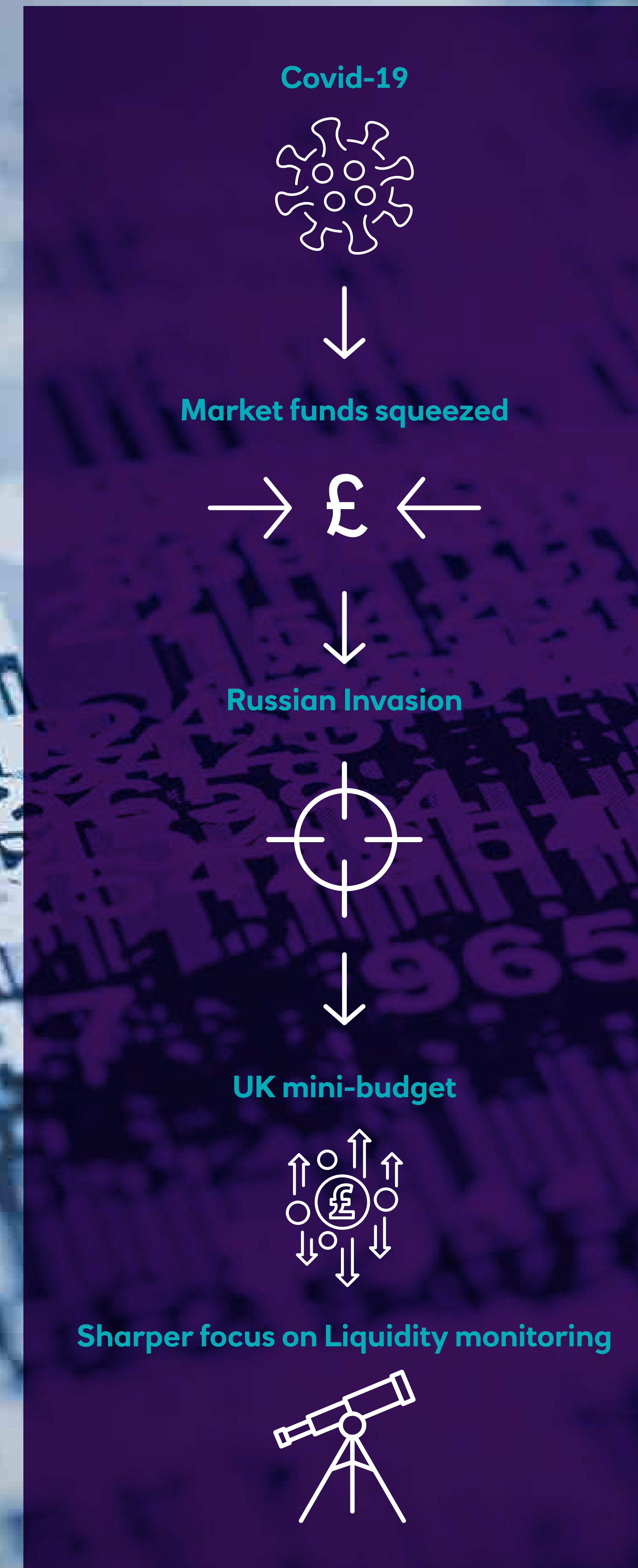
In the UK, liquidity remains a particular focus for the FCA in the wake of recent disruptive events.

From the Covid-19 pandemic, which caused a squeeze on money market funds in March 2020, to Russia's invasion of Ukraine and the UK's mini-budget, the importance of liquidity monitoring came into even sharper focus in 2022.

In its Dear CEO letter in March 2022, the FCA warned depositaries to enhance their oversight and effectively challenge fund liquidity. The UK's network of 11 depositaries, following the market challenges arising from the Brexit referendum, have agreed to notify the regulator when a fund exceeds 10% net redemptions. Furthermore, the Bank of England highlighted liquidity as a serious risk for markets this year.

Peter adds:

"If we look at the experience from 2020, and more recently in 2022, investment funds have been largely resilient, daily dealing property funds aside, yet it is necessary to have the right toolkit available ready to use when these periods of crisis come."



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The impact of war in Ukraine

Notwithstanding the human cost, Russia's invasion of Ukraine created a global economic crisis with profound ramifications for international markets.

Funds with exposure to Russian, Belarusian and Ukrainian assets have faced liquidity challenges this year and new mechanisms have been introduced to allow sanctioned assets to be ring-fenced.

Last year, ESMA released a public statement on the implications of the invasion on investment fund portfolios and reminded fund managers to take "appropriate action in case of exposures to Russian, Belarusian and Ukrainian assets, given valuation and liquidity uncertainties". The FCA subsequently authorised fund managers to create side pockets — a way to separate a fund's highly illiquid sanctioned assets (read our previous article on side pockets for more).

"Even if fund managers do not actively invest directly into Russia, the war in Ukraine is factoring into their investment decisions." Peter says.

Around the same time, in the UK, Liz Truss' mini-budget catalysed large-scale investor redemptions by pension funds, particularly impacting bond and property funds. These redemptions were largely driven by defined benefit pension schemes trying to raise additional liquidity to meet increased collateral calls.

While redemption levels have to some extent plateaued, institutional investors and defined benefit pension funds are still reducing their exposure to property funds — an ongoing trend since Brexit — and this looks likely to continue as the global economic outlook worsens.

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Woodford: a lesson in governance

While much of the current discussions around liquidity relate to external, economic factors, robust liquidity management can also safeguard against potential governance failings.

"In the years since the suspension of the LF Woodford Equity Income Fund (WEIF), governance practices around fund liquidity have strengthened enormously."

Rachel Ellison, Retail Fund Compliance Specialist at the IA.

The FCA's Asset Management Market Study, which concluded in 2017, encouraged firms to revaluate their approach to liquidity monitoring and management. Fund boards must now appoint independent directors, for example, and undertake an annual assessment of value. The FCA is still investigating multiple parties in relation to the suspension of WEIF.

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The big data drive

UK funds continue to evaluate their processes and fund compositions in the wake of recent market disruptions and, for many, this requires a greater reliance on data and technology.

Rachel adds: “Data definitely has a large part to play in liquidity monitoring but you do have to accept that unprecedented things do seem to keep happening so there will always be that shock that is difficult to prepare for.”

It is difficult to quantify a direct impact on resiliency or liquidity, but the move to electronic platforms and digitalisation of operational processes should improve data quality across the board. This will be particularly welcome in the fixed income market, the money market and short-term funding markets.

“Improved transparency in the underlying markets, where data quality can vary, will help firms to price their bonds, for example, or understand how quickly they can sell a bond at a particular price.”

says Rachel.

Liquidity in the spotlight

Educating the markets

When a fund is gated or suspended, press activity invariably results in market panic. Therefore, educating the wider financial industry and consumers about liquidity and what it means in practice will protect some funds from herd mentality in times of economic stress.

"Generally speaking, actions such as fund suspensions are taken to protect investors' interests...With the exception of money market funds, most funds are designed to be long-term investments and not withdrawn from frequently." says Peter.

Residential property offers a simple but helpful analogy. Everybody knows that if you put your house on the market, you are unlikely to sell it tomorrow and, if you do, you may have to accept a discount.

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The 2023 outlook

In terms of regulatory milestones, 2023 is unlikely to deliver any unexpected headlines relating to regulation or even new liquidity guidelines, considering the delays related to Covid-19 and Ukraine that most regulators are encountering.

However, the FSB will be doing further work on open-ended funds liquidity mismatch, while a WEIF discussion and an FCA discussion paper are likely at some point this year. The FCA has also hinted that it may publish a policy statement on notice periods for property funds.

We could also see the first Long-Term Asset Fund launch, potentially investing in infrastructure. Positioned at the illiquid end of the liquidity spectrum, these funds are key to funding the UK government's infrastructure ambitions, yet they pose a conundrum for markets given their inherently illiquid nature.

The FCA is currently anticipated to review a handful of applications — take-up has been light to date — and it remains to be seen whether these funds will drive further discussion and regulatory developments around liquidity across the rest of the market.

What is certain, however, is that funds will increasingly need to provide evidence that they are paying due consideration to liquidity management and that the FCA will continue to request data from a wide range of firms.

Ultimately, regulators want to know how funds are monitoring liquidity, what the governance structure is and how a portfolio is being managed.

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Ros Clark, Regulatory Risk Assistant Director, NatWest Trustee & Depositary Services

Regulators' efforts to combat greenwashing, bolster operational resilience and oversee the move to Direct2Fund will shape the investment industry this year.

After a tumultuous few years, the regulatory agenda for financial services has been pushed back by six to nine months. But there are still important rule changes coming down the track, and firms need to be ready. Here are three of the biggest regulatory shifts we've identified, and what you should be thinking about to stay one step ahead.

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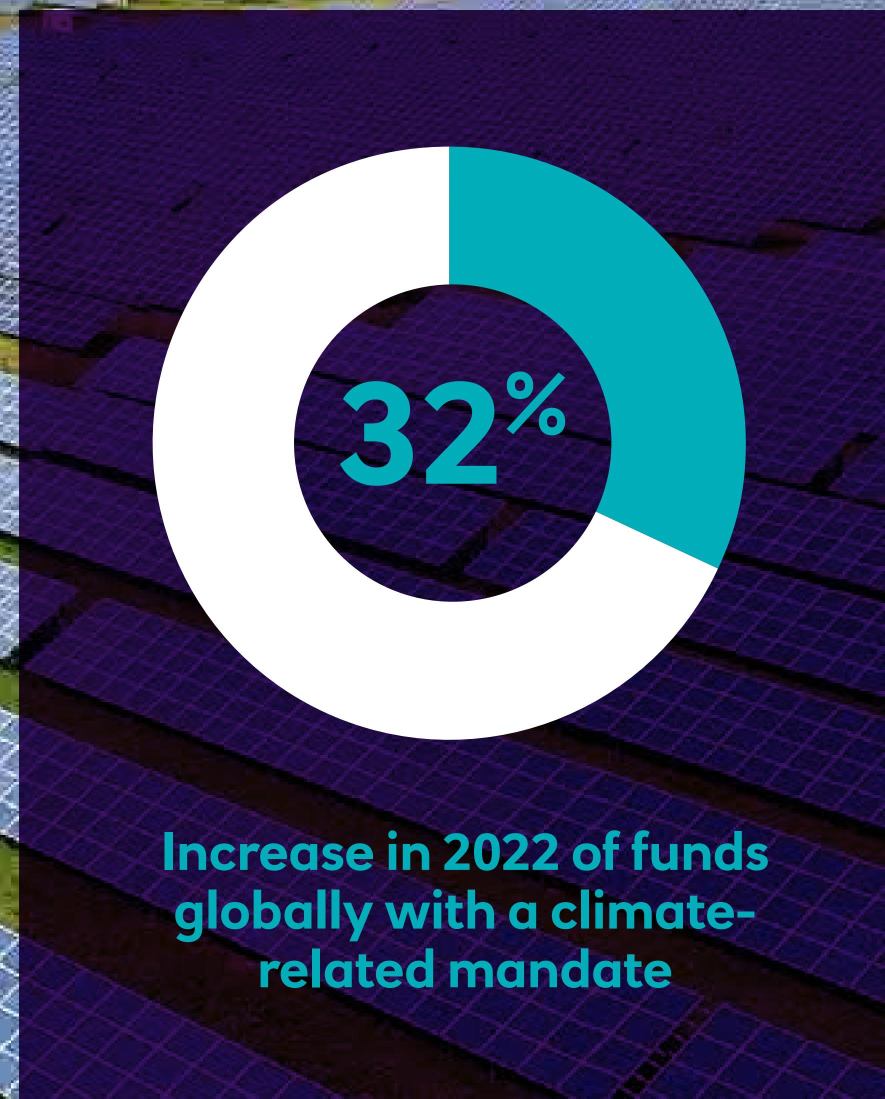
Greenwashing

Last year witnessed an uptick in applications to launch 'sustainable' or 'ESG' funds, reflecting growing consumer appetite for these funds and their more thematic offshoots.

By the end of the third quarter of 2022, for example, the number of funds globally with a climate-related mandate had increased by 32% over the year, according to Morningstar.

Now, regulation is catching up. ESMA has recently held a consultation around ESG fund names, while the three European supervisory authorities are calling for evidence on greenwashing.

Stamping out greenwashing in fund marketing will also be a key focus for the FCA this year. Back in July 2021, the regulator said it was concerned about the "poor quality" of many ESG fund launch applications, pointing to misleading fund names, limited exclusions from indices and unreasonable goals.



Increase in 2022 of funds globally with a climate-related mandate

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In October 2022, the FCA unveiled a proposed package of measures in CP22/20, which it hopes will protect consumers and build trust in sustainable investment products by eliminating the potential for "exaggerated claims" and mislabelling.

This means that firms can expect restrictions on the use of terms such as 'ESG', 'green' and 'sustainable' in their marketing materials, as well as more detailed disclosure requirements to explain investments that consumers may be surprised to see within 'sustainable' funds.

CP22/20 also includes plans to create a new category of funds that are improving their sustainability over time. This could be good news for asset managers, as it could give them the scope to buy and hold firms that don't have a perfect ESG record but can be pushed to do better through fund manager engagement.

The FCA's new Consumer Duty rules, which come fully into force from July, may also affect how firms communicate their sustainability credentials.

The rules are designed to ensure that customers understand communications from firms, that products and services meet their needs and offer fair value, and that they get the support they need. Firms launching ESG funds should assess their plans through the lens of Consumer Duty to ensure they are correctly targeted and their objectives are achievable.

Regulators will also be putting ESG data under the microscope this year. In November 2022, the FCA announced plans to develop a code of conduct for ESG data and ratings providers. Data quality can vary by provider, and firms will need to validate this with due diligence while keeping an eye on costs.

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Operational resilience

The many disruptions to global business so far this decade — Covid-19, the war in Ukraine and a spree of cyberattacks — have placed operational resilience firmly on the regulatory agenda. And this year, the FCA will go beyond its Operational Resilience Framework to assess firms' compliance.

Safeguarding operational resilience can be an onerous process, so firms will need to prepare. By 31st March 2025, larger firms that have identified important business services, such as digital applications or core business processes, which could cause intolerable harm to customers, the firm or the market if disrupted, must be managed within risk tolerance.

This will involve a process of mapping and testing to identify vulnerabilities, followed by investment where required. The aim is to ensure that firms can consistently operate without risking market integrity or harming their customers, whatever challenges arise in the wider environment.

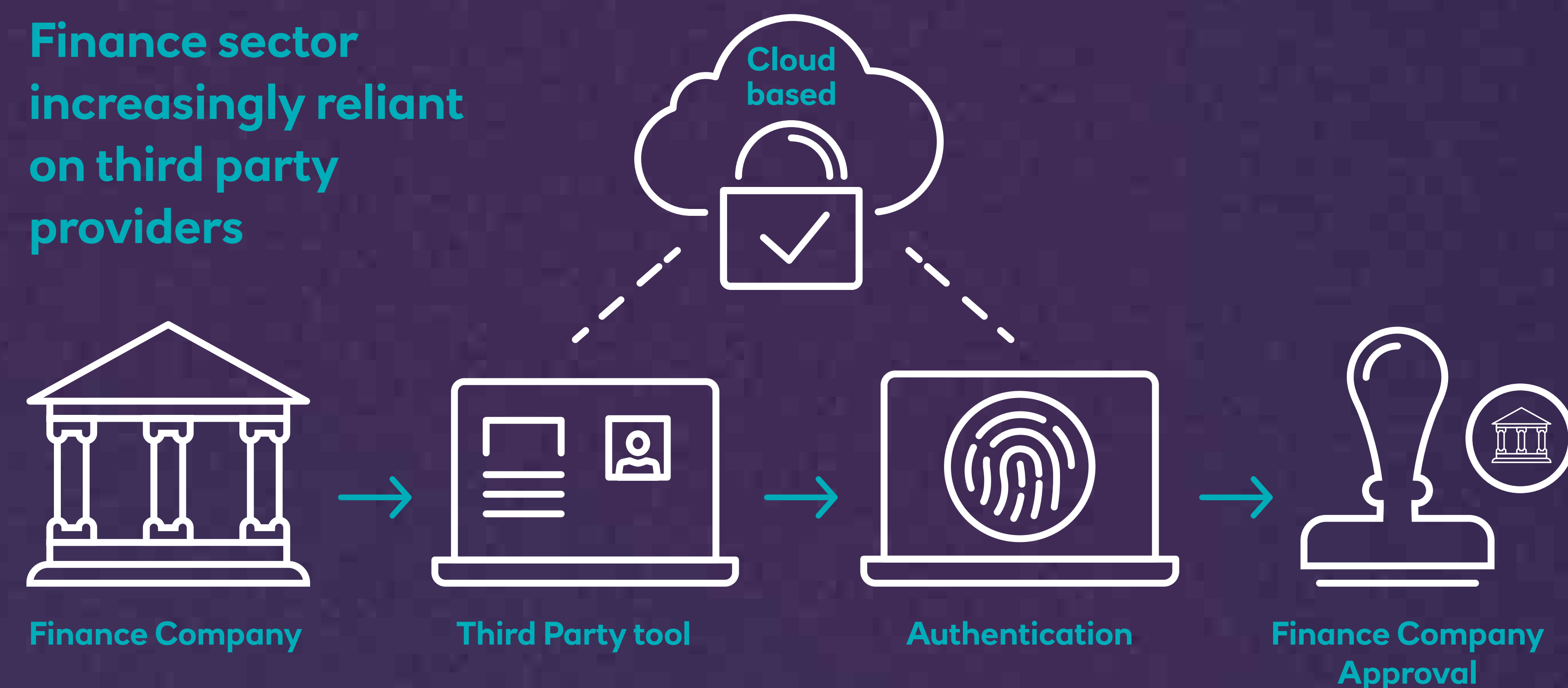
While large firms will have the most work to do here, we expect to see a trickle-down effect, which will have implications for small - and medium-sized firms too.

Regulatory outlook: What to expect in 2023

The UK fund industry has developed differently to others, resulting in a complex system with a lot of moving parts, with various third-party entities performing different functions.

Regulators will also shine the spotlight on critical third parties that may not be regulated but could also cause material impacts if they fail, such as cloud providers. Noting that the financial sector is increasingly reliant on third-party businesses, the FCA is concerned about the risk this poses to operational resilience.

Firms will be expected to look through the value chain to make sure the services they are outsourcing have appropriate preventative measures and business continuity plans in place. Tools that firms might use to do this include scenario testing, cyber-resilience testing and skilled persons' reviews of critical third parties.



Example of third party supplier providing identification verification

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Direct2Fund

Direct2Fund (D2F) is a proposed investor-fund dealing model that could offer an alternative to the traditional and rather cumbersome UK model.

The UK model, in which investors interact with funds through an authorised fund manager's dealing account, is an outlier among EU financial centres, and replicating the D2F process used in these markets would allow UK investors to transact with funds directly.

The hope is that this will make the UK investment management industry more competitive, while enabling operational efficiencies.

Findings from an Investment Association working group are expected to be published shortly, paving the way for the FCA to consult on and implement any proposed changes.

There is much for the industry to thrash out: for instance, how much direct engagement would depositaries now have with investors? And what are the implications for Know Your Customer and Anti-Money Laundering?

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There are also data protection considerations. D2F may place customers' personal information in the hands of firms that are not used to handling it, and they will need to ensure that this data is given the required protections under GDPR rules.

A crucial question is whether investors' monies will still be classified as client money and protected accordingly. We struggle to see how the FCA will ever be comfortable removing consumer protections that apply to clients' money. We know from a past large fine that the FCA handed out for failures to oversee client money held by a third-party provider that this is an issue it takes very seriously.

Tokenisation using blockchain technology may offer a way around this. By representing the ownership of an asset as digital tokens, rather than a share or fund unit, fund providers could offer tokenised collective investments and distribute them directly to the market.

This could break down the barriers between fund managers and investors and help create a more direct connection. In fact, we believe tokenisation could herald a transformational approach to dealing.

Staying ahead

Each of these regulatory trends will present firms with new hurdles to overcome while working within the unique parameters of the UK financial services model. As the regulatory agenda kicks into high gear once more, firms will need to stay one step ahead of the changes to ensure they remain both resilient and compliant.

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Stephen Doyle, Head of Sales and Client Management, NatWest Trustee & Depositary Services

Brexit caused many UK fund managers to head to Europe, but with the UK government now taking active steps to support domestic financial services, a two-way trend of relocations looks set to continue.

Two years on from the UK's exit from the European Union, we are yet to see any meaningful progress towards equivalency that might allow UK funds to distribute into Europe.

Post-Brexit relocation: Opportunities and challenges for fund managers two years on

As a result, UK managers and service providers have struggled to maintain their European distribution lines and have been forced to either establish or beef up their presence on the continent.

More than 440 financial services firms had moved part of their business, staff, assets or legal entities from the UK to the EU by April 2021, according to analysis by think-tank New Financial.

The report identified more than £900 billion in bank assets (roughly 10% of the entire UK banking system) that had either moved or was being moved at that point, while insurance firms and asset managers had also transferred more than £100 billion in assets and funds. Those shifts have continued as Brexit has bedded down.

Meanwhile, we have seen growing interest among continental funds in building their presence in the UK, spurred by the government's commitment to supporting the financial services sector, and its pioneering approach to digitalisation.

Funds considering a location must weigh a variety of factors. Chief among these is the location of their target customers, but they must also determine the cost implications, the regulatory differences, and the willingness of their existing clientele to accept the move.

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Post-Brexit relocation: Opportunities and challenges for fund managers two years on

Fund relocations post-Brexit

While the biggest managers typically already had a funds presence in Europe for a variety of reasons – including a preference among Asian regulators for Luxembourg funds, for example – many of the mid-tier UK firms struggled to adapt.

In recent years, some have opted to move UK clients back into UK entities, while others have committed to establish more substantial presences in EU member countries, primarily in Dublin and Luxembourg.

At the same time, we have seen a shift in regulatory approach, and where management companies had previously been permitted to be light on the ground in terms of staffing in those offshore European locations, the Central Bank of Ireland (CBI) in particular has recently been strict in insisting on a meaningful presence.

Like the Luxembourg authorities, the CBI has seized the opportunity to create employment locally and decreed that new offices must be staffed by experienced risk and compliance professionals, adding cost and requiring asset managers to run duplicate operations in the UK and Europe.

Post-Brexit relocation: Opportunities and challenges for fund managers two years on

While much attention has focused on the outbound movement of UK financial services firms to the EU, many service providers have found UK clients keen to return to the UK from a funds perspective. We have observed a growing number of transfers from wealth management clients that used to be UK distributing funds in Irish fund ranges bringing those back to the UK.

Likewise, an increasing number of European managers are keen to take advantage of opportunities in the UK market, such that relocations are now taking place in both directions. While Dublin and Luxembourg have been the principal beneficiaries of these trends from an employment point of view, many decisions remain motivated by governance considerations.

The UK regulatory framework is still recognised as the gold standard in terms of oversight and funds governance, with a strong population of experienced regulatory advisers and professionals, and we are seeing demand from managers seeking support with bringing investors to the UK from offshore.

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The UK's attractions

In the wake of Brexit, the UK government has made clear its intentions to support the domestic financial services industry, attract funds into the UK economy and create growth.

In December, the Chancellor of the Exchequer, Jeremy Hunt, travelled to Scotland to unveil a package of reforms to the UK's financial services regulation, dubbed the Edinburgh Reforms. These are aimed at creating an agile and home-grown regime, tailored to the UK market and capable of attracting newcomers.

The government has created the new Long-Term Asset Fund (LTAF), a new type of FCA-authorised open-ended fund that can invest in mainly long-term, illiquid assets and has the benefit of being able to bring in capital. While we have yet to see the launch of any LTAFs, we do see a flurry of asset managers showing a keen interest in that new structure.

The UK government has also highlighted its appetite to encourage digital innovation by creating legislation supportive of cryptocurrencies and digital assets. That is inevitably the direction of travel for this industry and the UK is working to modernise its regulatory landscape to be more agile and alive to those opportunities.

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Making jurisdictional choices

For funds reconsidering their geographical footprint, the most important aspect must always be where a firm's clients are based and where they are targeting growth.

If continental Europe is the priority, then a manager is going to need a European fund range, whether that is in Ireland, Luxembourg, the Netherlands, Germany or elsewhere. With the regime as it is now, and passporting no longer an option, UK managers selling UK funds into Europe require approval in each country, which is both costly and complex.

Similarly, managers looking to the UK market need to think about their target clients. The UK is a huge institutional market, with more than 80 local authority pension funds, for example, so it has always been ripe for managers to sell to institutions.

At the same time, the UK retail sector is growing rapidly and thriving, helped by digitalisation that now allows managers to connect directly with investors and is upending the established platform market. The larger UK wealth managers have enjoyed strong growth even in the down market, partly as a result of the country's position as a digital enabler and forerunner.

Tapping that UK opportunity is attractive to overseas managers but does not come without its challenges. New arrivals need to work with experienced advisers to navigate the complexities of UK corporate governance as it applies to fund ranges and fiduciary management.

Post-Brexit relocation: Opportunities and challenges for fund managers two years on

Before taking steps towards relocation, managers need to build a clear understanding of the costs involved, as there are hidden costs that can easily be overlooked. There could be a change in beneficial ownership triggered by moving location, for example, so identifying the optimum structure to move forward on a cost-effective basis is important.

Staffing can become an issue for managers leaving the UK for jurisdictions with less established advisory communities, but is typically less of a challenge for those coming to the UK from elsewhere.

Finally, managers must be careful to make sure they have clients on board with any decision. It is usual to require a vote from clients before proceeding, so it is always advisable to have those conversations earlier rather than later.

Identifying the optimal post-Brexit structure is not easy and varies enormously from one institution to another. While both European and UK authorities continue to make positive noises about some sort of trade agreement that might create equivalency for funds, we have seen little progress so far.

For now, it is a case of 'plus ça change'. Anyone in the UK seeking to sell into European markets will need a European presence, and vice versa.

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James Green, Head of Portfolio Insights, NatWest Trustee and Depositary Services

The UK's proposed new approach to regulating digital assets should start to unlock their potential to transform the investment industry.

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The best-known digital assets are cryptocurrencies, which provide an alternative store of value to traditional or 'fiat' currencies. Bitcoin, the first cryptocurrency, gained widespread popularity and has encouraged a new class of investors to trade and store their wealth in digital form.

Through a process known as 'tokenisation', the ownership of any kind of asset, whether real estate, fine art or stocks, can be represented digitally and then traded electronically in order to transfer 'title'. Blockchain, the technology on which Bitcoin is based, allows the exchange of digital assets to be validated without an intermediary and, if desired, for all transactions to be publicly visible.

If you follow the concept of tokenisation to its natural conclusion, it should be possible to replicate or replace traditional equity, bond and derivatives markets with more efficient digital solutions.

The 'tokenisation' process.

Example of tokenisation

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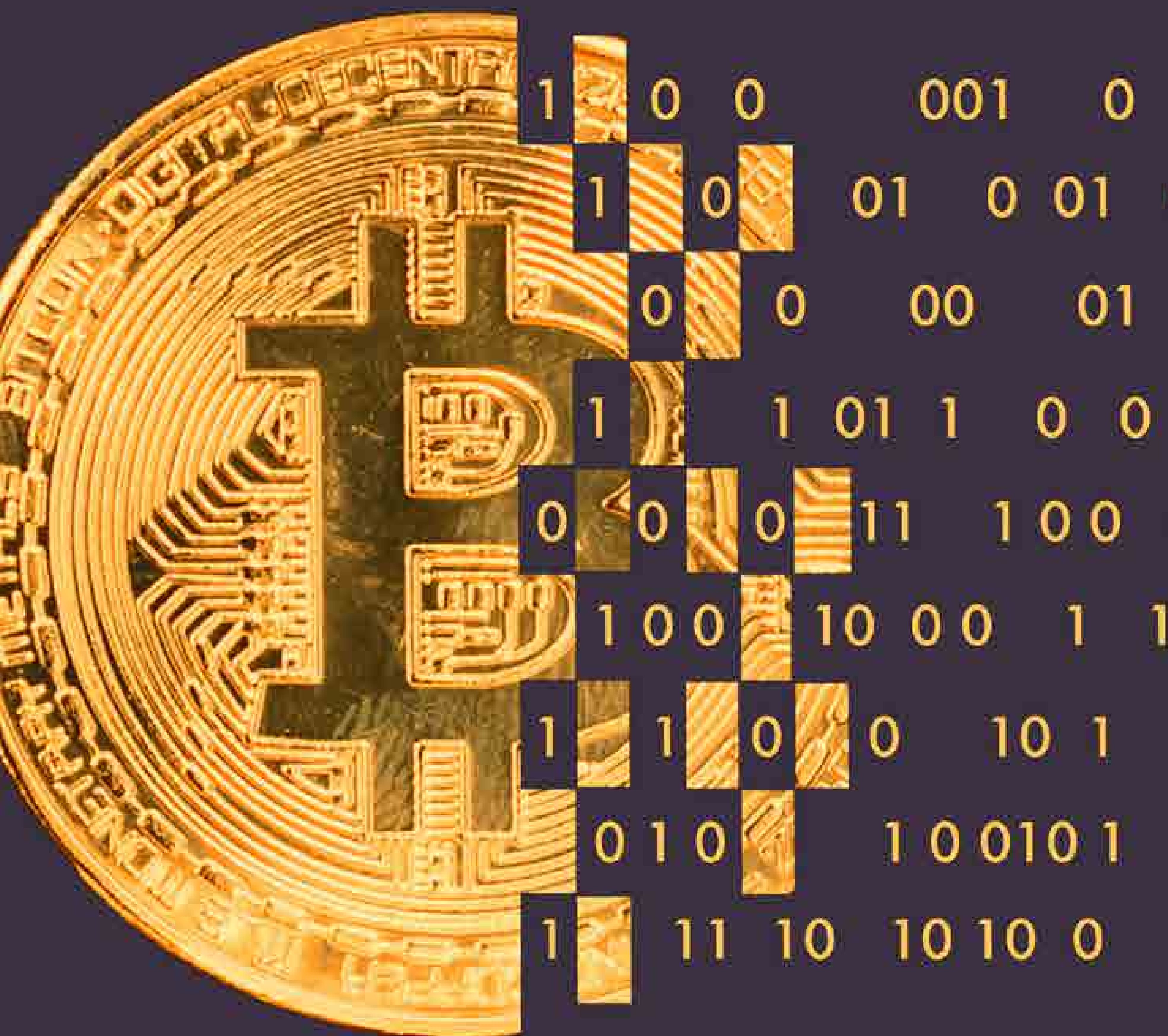

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The introduction of these technologies promises to transform the way financial markets work – all the way through capital raising, investment, trading and settlement processes. The financial marketplace has evolved over the past 200 years at roughly the same pace as technology. As technological progress is constantly accelerating, it should come as little surprise that we have reached another phase of market transformation.

A well-regulated digital ecosystem promises a much shorter, cheaper value chain, which should lower the cost of capital and investment, resulting in potentially higher returns to investors with no apparent loss of safety or stability. Yet while the technology to support such a system is increasingly accessible, realising its potential relies on robust regulatory frameworks. Proposals recently announced by the UK Treasury are an important step towards making that happen.

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A new era

Regulating cryptocurrency markets has been the subject of intense debate for several years, and it seems progress is finally being made.

In February, the UK Treasury unveiled proposals to strengthen rules for crypto lending and trading platforms, which will impact investors, asset managers and depositaries. Under the plans, crypto assets will be regulated in line with traditional finance regulation in what the government is calling “a robust world-first regime”.

This marks the beginning of a new era for UK crypto infrastructure, markets and businesses. Despite institutional and retail investors piling into the sector in recent years, the digital asset industry is not currently regulated by the FCA to the extent that more traditional markets are, leaving consumers at greater risk.

Even during boom periods, there have been calls for regulatory guardrails around exchanges and improved transparency across the industry as a whole. This pressure has mounted following significant levels of volatility and a number of high-profile scandals, which wiped billions from the crypto landscape and exposed the fragility of some business models. In late 2022 the collapse and bankruptcy filing (and subsequent contagion) of FTX, the cryptocurrency exchange platform highlighted the need for better governance across parts of the digital asset sector.

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The prospect of bringing cryptocurrency under the umbrella of mainstream financial services regulation will be welcome among fund managers who are increasingly trying to understand how to apply digital currencies, tokenised assets and blockchain technology to their portfolios and operations.

While most funds available to retail investors are currently prevented from taking direct exposure to volatile crypto markets, a rising number of Exchange Traded Products (ETFs etc) are enabling indirect access while still being exposed to the same risks. Meanwhile, globally significant financial institutions are investing in a growing number of products and services designed to facilitate institutional-scale access to the full range of digital assets.

The opportunities to reduce costs, improve transparency, and create more secure and efficient investment processes are enormous. A healthier digital asset ecosystem, backed by robust rules and regulation, will facilitate disintermediation and give investment managers a safer, faster, cheaper investment ecosystem with which to work.

In turn, this should enable portfolios that are more customisable, increased transparency and more effective oversight – all of which will, eventually, manifest in better customer outcomes.

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UK proposals

The UK Treasury says its proposals are aimed at "strengthening rules around the lending of crypto assets, whilst enhancing consumer protection and the operational resilience of firms".

Instead of creating a new set of rules, the Treasury intends to regulate them using existing financial services legislation, tailoring the terms of the Financial Services and Markets Act 2000 to the needs of the crypto market. In summary, it proposes to introduce rules that would ensure that customers' assets are returned to them if a crypto business goes bust, and require crypto-asset promotions to be fair, clear and not misleading.

The proposals would introduce enhanced data-reporting requirements, including with regulators, and implement new regulations to prevent so-called 'pump and dump', whereby a market participant artificially inflates the value of a crypto asset before selling it. They would also strengthen the rules around financial intermediaries and custodians, which have responsibility for facilitating transactions and safely storing customer assets.

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One area of particular significance to readers of this quartely update are the proposed regulations on crypto asset custody. When it comes to digital assets, custody is managed through a variety of technological mechanisms, including hot (that is, internet-connected) or cold (offline) wallets.

The Treasury points out that the irreversible nature of blockchain transactions means that controlling access to these mechanisms is especially important.

Currently though, there are no specific rules dictating what happens if access is lost or if a custodian were to go bankrupt. The Treasury therefore proposes to extend and modify custody rules for traditional finance to protect investors' digital assets. It is the Treasury's intention to require custodians to provide access to assets in the event of their insolvency and to offer redress for lost digital assets.

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Beyond regulation

Bringing these proposals into UK law will take time. The government has opened a public consultation on its proposals, which will close in April. After that, ministers will lay secondary legislation, and the FCA will then conduct its own consultation before defining rules and regulations.

And the UK does not stand alone: regulations in Europe, the US and elsewhere must converge into some form of consensus for a global system to operate effectively. As each country seeks to take the lead, standardisation may be a casualty.

For now, there are still concerns over how to administer these assets and ensure their safety. Funds must have well-defined and focused risk controls in place so they understand, at all times, what the consequences are of something going wrong and can manage the scale at which they operate.

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Education will also play a role in bringing the funds industry up to speed on a digital asset ecosystem that is often shrouded in jargon. Many in the financial services sector still struggle to clearly communicate the core principles of digital finance and often cannot distinguish between digital assets such as tokens, cryptocurrency, stablecoins or the various distributed ledger technologies. Once you understand the purpose of a digital asset and how the system hangs together, however, you realise it's not that complicated at all – different, certainly, but ultimately it is just stripping out the inefficiencies inherent in the current ecosystem.

Given the current rate of progress in technology, regulation and the wider understanding of the potential opportunities, it is inevitable that lines between digital and traditional financial services will begin to blur, as is necessary in any transition. It remains to be seen how digital assets will affect the way funds invest or manage portfolios. However, robust regulation will reduce the risks currently associated with crypto markets and, in all likelihood, make institutional investors more comfortable with experimentation.

Ultimately, a healthy, well-regulated digital asset ecosystem will be a good outcome for consumers and investors alike, so the long-term landscape looks far more certain.

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