Depositary Insights

Autumn 2022

NatWest Trustee and Depositary Services

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Foreword

Welcome to the Autumn 2022 edition of Depositary Insights.

NatWest Trustee and Depositary Services team

The regulatory landscape in the latter half of 2022 is just as demanding as it was at the start of the year, with several set-piece consultations and policy statements on the agenda. A number of headline regulatory developments are now firmly on the radar – such as the new Consumer Duty – meaning that firms will be focussing not just on keeping up to speed with emerging policy developments but also on implementation.

This edition focuses on some of the main policy highlights. We provide an analysis of the FCA's new Consumer Duty, an update on the second Long Term Asset Fund consultation, a review of the latest developments in environment, social and governance investing, and a deep dive into the 'side-pocket' proposals and what their impact has been. Finally, we provide a thematic overview of regulatory horizon scanning itself, and how this important responsibility is evolving to meet today's economic, geopolitical and climatic challenges.

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

This is an interactive publication.
Click on any of the menu links to navigate between sections

Consumer Duty:

Hitting the ground running

The publication on 27 July of the FCA's policy statement on the new Consumer Duty, has proved particularly timely, given the pressures consumers are facing in terms of cost of living, inflation and interest rate rises.

The original discussion paper - 'a duty of care and potential alternative approaches' was issued back in 2018 (DP18/05) – a world away from the financial realities facing the market in 2022. Two hefty consultations followed concluding in mid-February 2022. However, the publication of the policy statement on 27 July has come at a time when the need to protect consumers, demonstrate fair value and support investors' best interests has been exercising policymakers' minds with particular urgency.

Dive deeper →

Consumer Duty: Hitting the ground running

The FCA reiterated its support for the core principle of consumer protection in this year's business plan and strategy, and it is clear that the 'Duty' is going to be the centrepiece of its drive to champion investors' interests in increasingly uncertain and challenging market conditions.

The proposals, as consulted upon, were not without their critics. There was push back from some corners of the industry against the perceived tightness of the proposed implementation period (originally mooted at nine months), and the cost of implementing such a wide ranging regulatory change programme. Some also questioned whether the new rules might ultimately result in additional charges for consumers and be a tricky obstacle as the UK sought to become a more internationally competitive jurisdiction. It was clear that the new regime, though a priority for policymakers, would represent a substantial change and one which would affect swathes of industry, applying across the distribution chain.

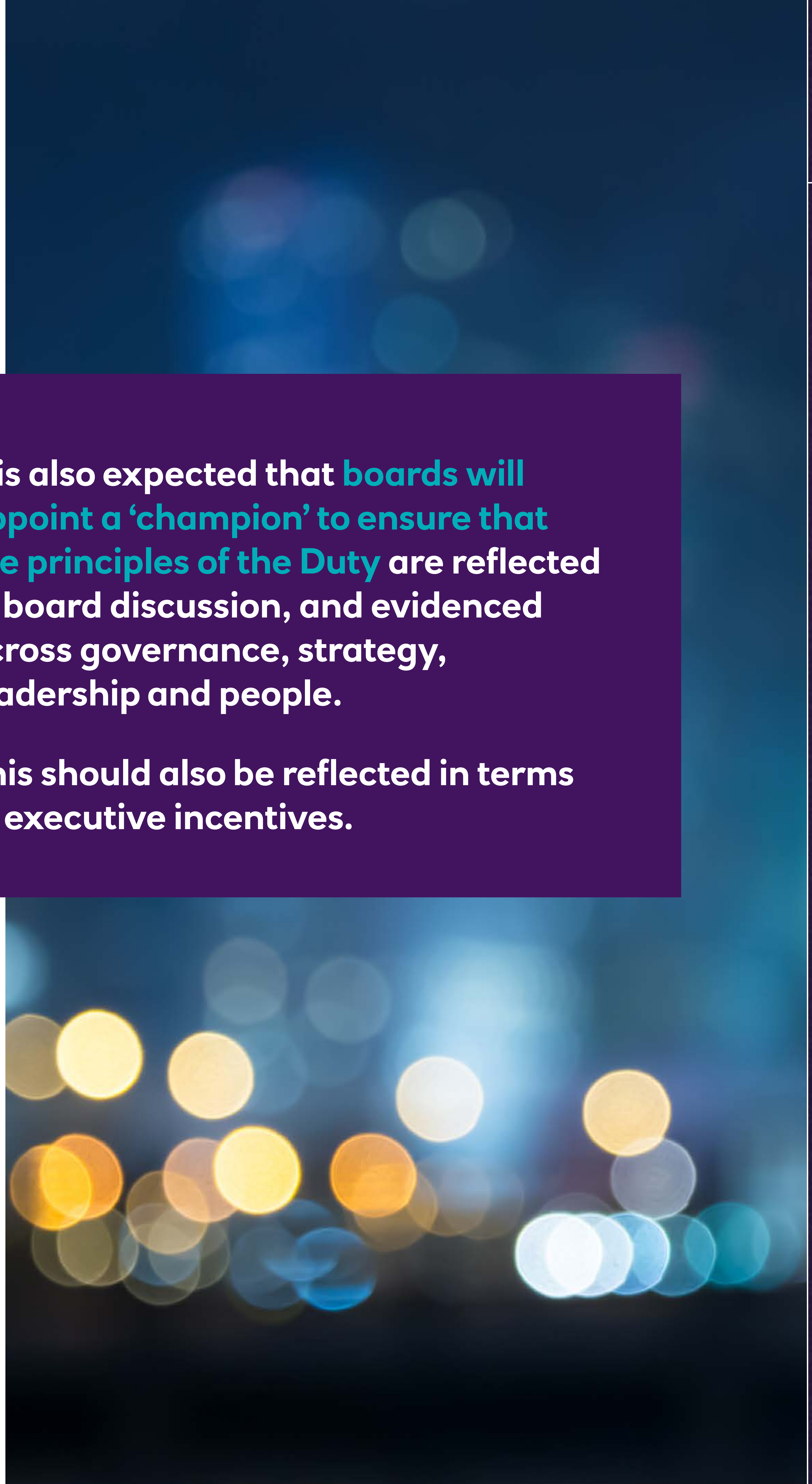
Consumer Duty: Hitting the ground running

The policy statement was therefore reviewed by firms with great anticipation, to check the extent to which this robust feedback had been reflected. There were improvements in terms of the implementation timeframe, clarifications in terms of PROD 4 and COLL equivalence and further details on some unclear definitions. The increased timeline (pushed back from April 2023 to July 2023 for new and existing products and July 2024 for closed-book products) is a particularly important example of how the feedback has been taken on board.

There are some new challenges however: the benefits of the newly extended timeframe are arguably checked somewhat by the requirement that firms' boards have now agreed and signed off their implementation plans, with the deadline for this now having passed at the end of October 2022. This means that firms have had to hit the ground running to ensure their plans have gone through all the necessary governance hoops, which for many, will have proved challenging especially for larger firms with longer lead times for preparation and syndication of board papers.

Broadly speaking however the substance of what is being proposed is unchanged. Firms will need to show how they are acting to deliver good outcomes for retail customers (known as the 'consumer principle'). There are a series of cross cutting rules which firms will need to follow: acting in good faith, avoiding foreseeable harm and supporting customers to pursue financial objectives. There are also a series of prescribed outcomes relating to products and services, price and value, consumer understanding and consumer support. Firms will need to demonstrate how they are delivering outcomes against each of these and the FCA will take a close interest in how firms are monitoring and reporting.

Consumer Duty: Hitting the ground running



There are also new requirements for boards.

They will be required to sign off on an annual report attesting to the extent to which the firm is delivering good outcomes.

It is also expected that boards will appoint a 'champion' to ensure that the principles of the Duty are reflected in board discussion, and evidenced across governance, strategy, leadership and people.

This should also be reflected in terms of executive incentives.

While the timelines may be the most noteworthy example of how the Duty has evolved to reflect industry views, it nevertheless remains a substantial package of reform. All firms across the distribution chain which can influence consumer outcomes will now be in the midst of reviewing the policy statement and progressing with implementation programmes, and there is no time to lose.

The journey towards implementation has started, and it has started at quite a pace.

LTAF Revisited:

Widening scope, widening interest?

The Long Term Asset Fund (LTAF) has itself become a long term feature on the regulatory agenda.

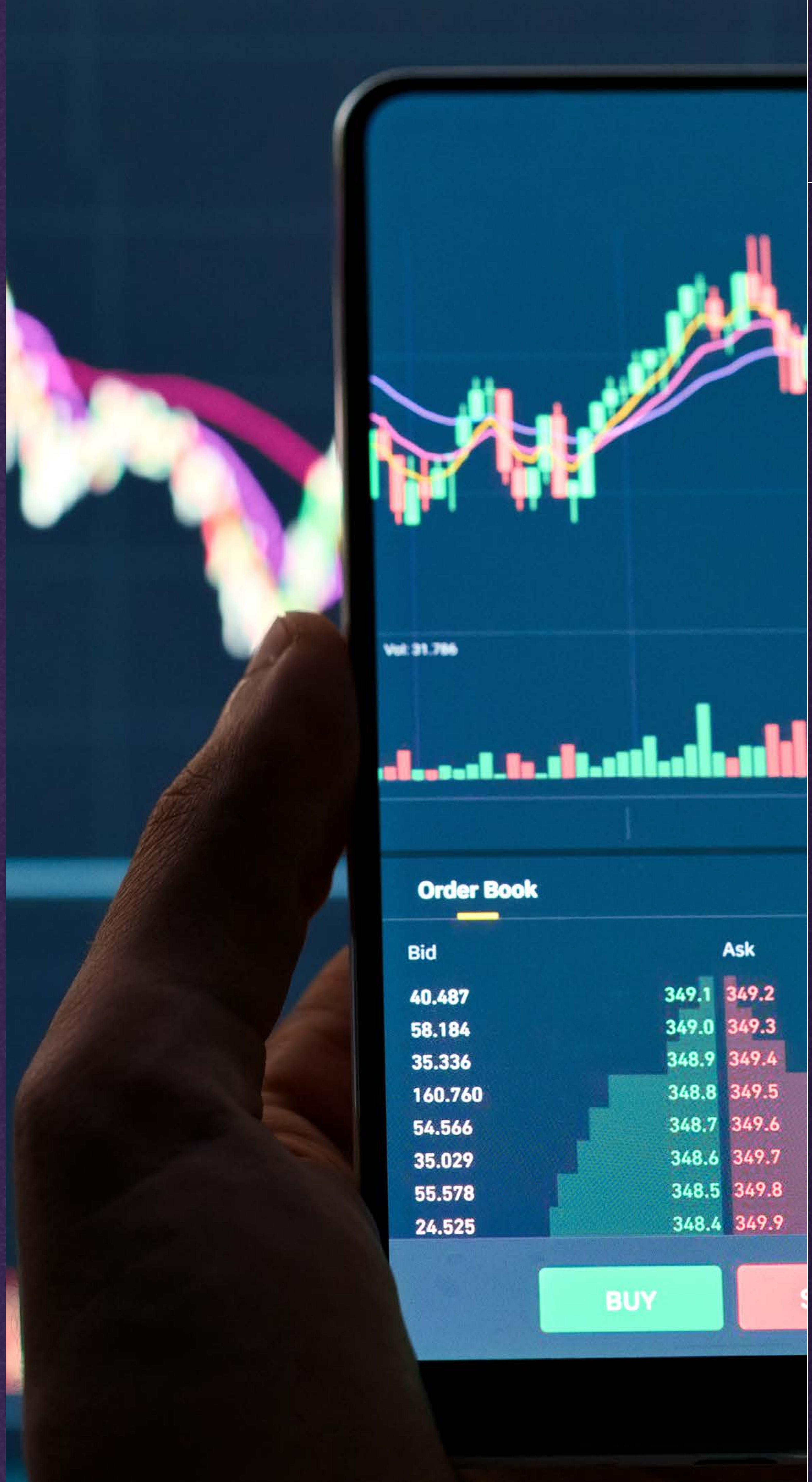
Since the then Chancellor announced, in November 2020, that he wanted LTAFs to be up and running by the end of December 2021 there has been a flurry of regulatory activity. The FCA sought to meet that ambitious deadline and ensure that the policy foundations were in place.

Dive deeper →

LTAF Revisited: Widening scope, widening interest?

The initial policy statement was implemented in mid November 2021 meaning that the deadline was indeed met. Unfortunately, the uptake of LTAFs since then has been somewhat muted with no current LTAF products on the market.

This is a disappointing outcome, but it is understandable when considering the original purpose of LTAFs when they were first proposed. The idea was to widen access to investment opportunities in private equity and infrastructure to retail investors. In its original form, however, the LTAF was targeted only at for example sophisticated investors already served by other fund types (e.g. qualified investor schemes) and so the LTAF did not add anything particularly 'new' to the mix while missing its real target: the retail market.



LTAF Revisited: Widening scope, widening interest?

The publication of the second LTAF consultation on 01 August 2022 is a welcome attempt to address this.

The consultation is likely to have met with broad support given that it attempts to resolve the main bone of contention: retail access. The shake up may even tempt a few firms to consider launching LTAFs of their own when the revised policy statement is issued and implemented in 2023.

The features of the new LTAF are aimed at widening access in a safe way that takes into account consumer protection and appropriateness. For example, an 'appropriateness test' has been proposed to ensure that would be investors understand the product they are investing in and are comfortable with the risks and redemption terms. These are set at 90 days so investors who need to redeem sooner would be better off looking elsewhere. Where appropriateness is confirmed, investors will be able to invest up to 10% of their investible assets in LTAFs.

Consumer Protection and Appropriateness

LTAF Revisited: Widening scope, widening interest?

The new consultation paper sets out a series of additional technical details which will be required to expand the scope. Non-UCITS Retail Scheme Funds of Alternative Investment Funds (NURS FAIFs), for example, will be able to invest in LTAFs (up to 35% of the NURS FAIF's value into units of a single LTAF and a maximum of 50% of its value in multiple LTAFs). The consultation paper also discusses the rule changes which will be required in COLL in order to make this happen, and the paper also clarifies that LTAFs will not be ISA-eligible, which had been an open question and subject to some debate and uncertainty.

Following the consultation process the policy statement will be issued in H1 2023, with implementation shortly after that. Given the need to go through governance, authorisation and then launch and marketing, any positive effects in terms of new fund launches may not be felt until later next year. At that point we will be able to take stock of the LTAF and consider whether the second consultation paper has done the trick.

The FCA will hope that the updated proposals will encourage firms to look again at the LTAF and reconsider whether it is something which their investors would value. Given that many of the changes proposed in this second consultation are aimed at bringing retail investors into the fold (where appropriate), this may be the boost that the LTAF needs.

Side Pockets:

Delivering at pace

One of the most important policy developments of 2022 has been the introduction of the FCA's guidance on side pockets.

These proposals aimed to address the significant number of fund suspensions seen earlier in the year: geopolitical events led to a sharp rise in sanctions and resulting exposure meant that many funds had little choice but to suspend. Over twenty funds found themselves in this position, creating a challenge for the FCA in terms of how best to enable funds to eventually re-open in a safe and appropriate manner.

Dive deeper →

Side Pockets: Delivering at pace

What was remarkable about the consultation and implementation process was the speed at which it was delivered: an example of the FCA delivering on its commitment to become a more 'innovative and adaptive' regulator.

The consultation period closed after only two weeks (16 May) and the policy statement was issued on 08 July, with implementation occurring a mere three days later. The circumstances were exceptional and the focus on side pockets, suspensions and sanctions required a significant refocus. This meant that timelines for other initiatives such as ESG related activities had to be pushed back somewhat. However, this is a striking example of the regulator moving at pace to deliver consequential changes.

The features of the side pocket proposals only apply in relation to the current geopolitical situation – they will not become a standing option to be used in other scenarios, although this is something which may be considered further down the line. The proposals are essentially for a one-for-one unit match whereby an 'internal side pocket' is created for non-sanctioned assets which can then be reopened. Existing investors will also retain units in the sanctioned part of the fund which can be redeemed as and when sanctions are lifted.

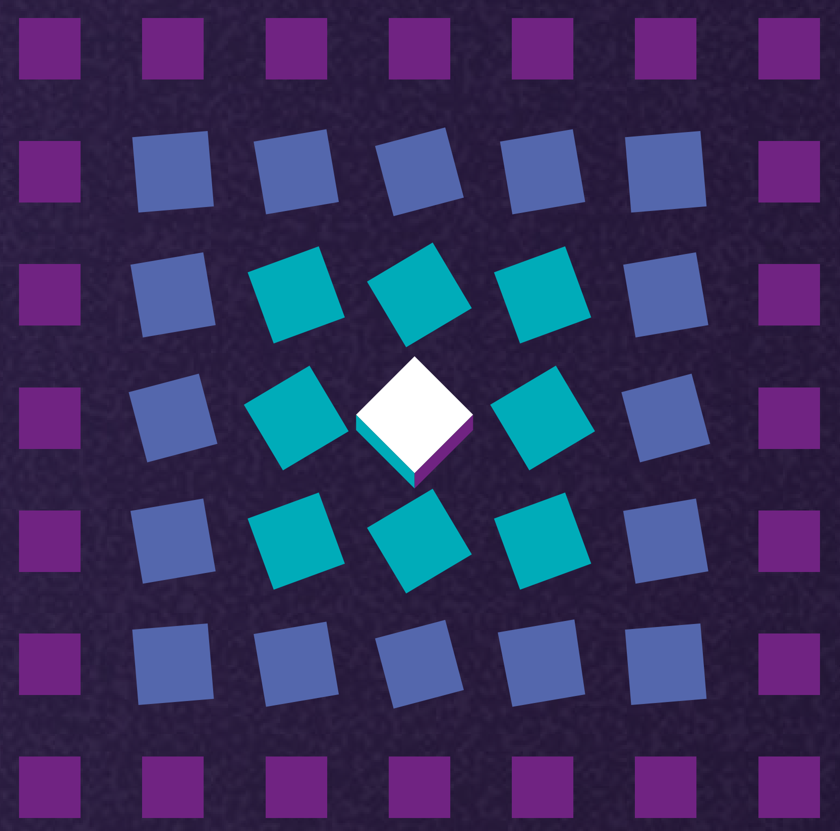
Another option – the so-called 'external side pocket' which would have set up an entirely separate fund for non-sanctioned assets - was also floated in the consultation and had some supporters, but was ultimately rejected, due to perceived additional complexity. Interestingly, European regulators such as the CSSF and CBI appear to have favoured the external option over the internal option so there is a divergence in terms of UK and EU approaches to addressing the glut of fund suspensions.

Side Pockets: Delivering at pace

There are a number of technical details for firms to chew over. The requirement for AFMs to treat the introduction of side pocket classes as a fundamental or significant change has been waived, but the AFM must provide justification in its notice to unitholders. If the AFM determines that implementing side pocket unit classes should be treated as a significant change, the requirement to give prior notice will be removed (although unitholders must still be given some form of timely notification). The policy statement also provides guidance on how voting rights for side pockets may be exercised at a unitholder meeting and provides guidance that AFMs should consider the operational needs of distributors before deciding to set up a side pocket.

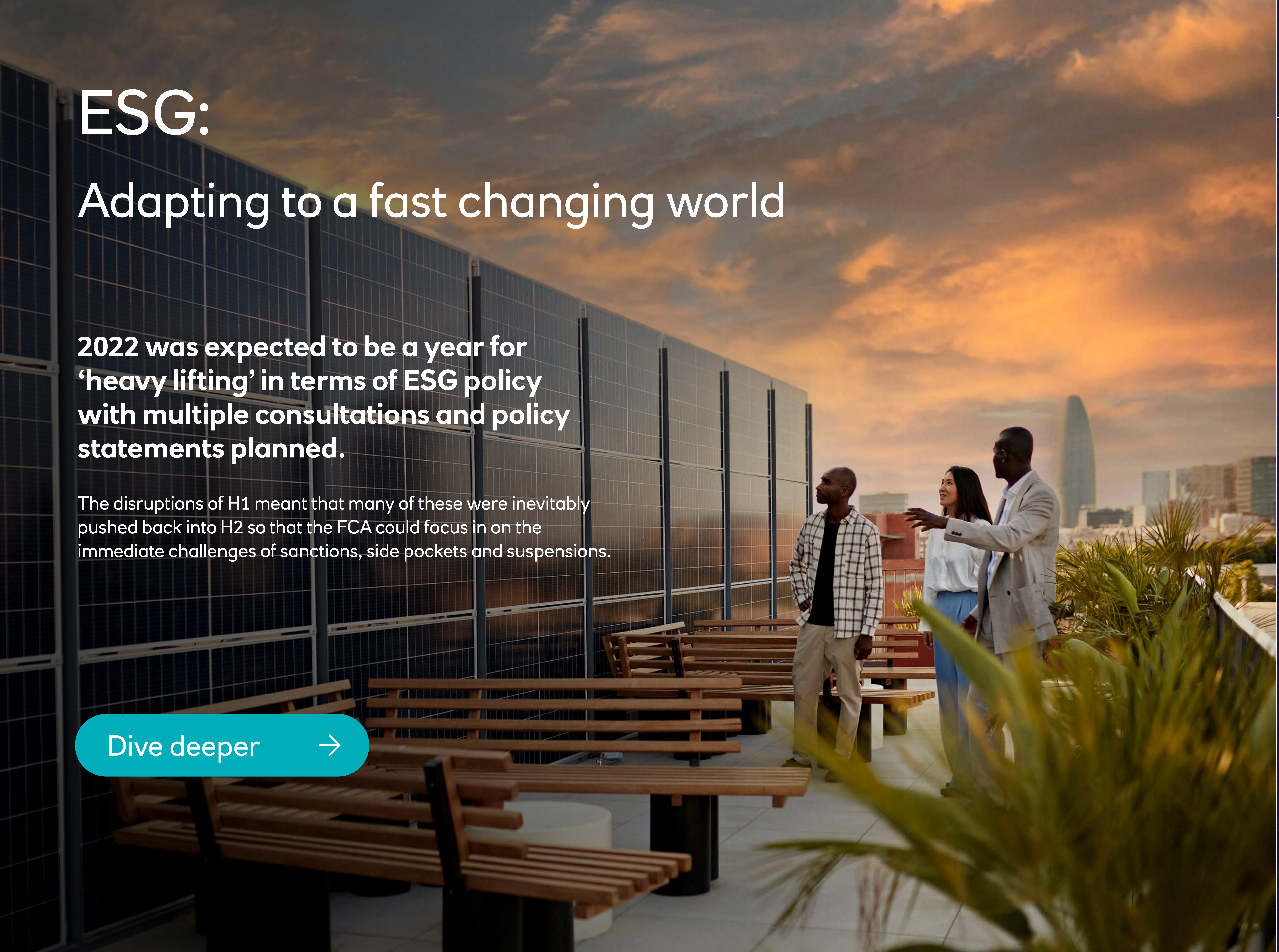
It appears that the proposals will not be adopted by all funds currently suspended: perhaps around half will take up the FCA's offer to introduce a side pocket. This means that a sizeable proportion will either remain in suspension or will be seeking their own bespoke remedy. The reason that uptake is relatively muted is because suspended funds are not one size fits all. Some have far more exposure than others, and such a sizeable exposure, that the side-pocket fund would be too small to be viable.

While the proposals may not have suited all suspended funds, and the rush to address the issue of suspensions has meant that some other regulatory milestones have been pushed back, the experience of side pockets now stands as a case study in how the FCA is able to move fast and deliver sizeable regulatory change in an agile fashion. It may act as a template for similar challenges in future.



ESG:

Adapting to a fast changing world



2022 was expected to be a year for 'heavy lifting' in terms of ESG policy with multiple consultations and policy statements planned.

The disruptions of H1 meant that many of these were inevitably pushed back into H2 so that the FCA could focus in on the immediate challenges of sanctions, side pockets and suspensions.

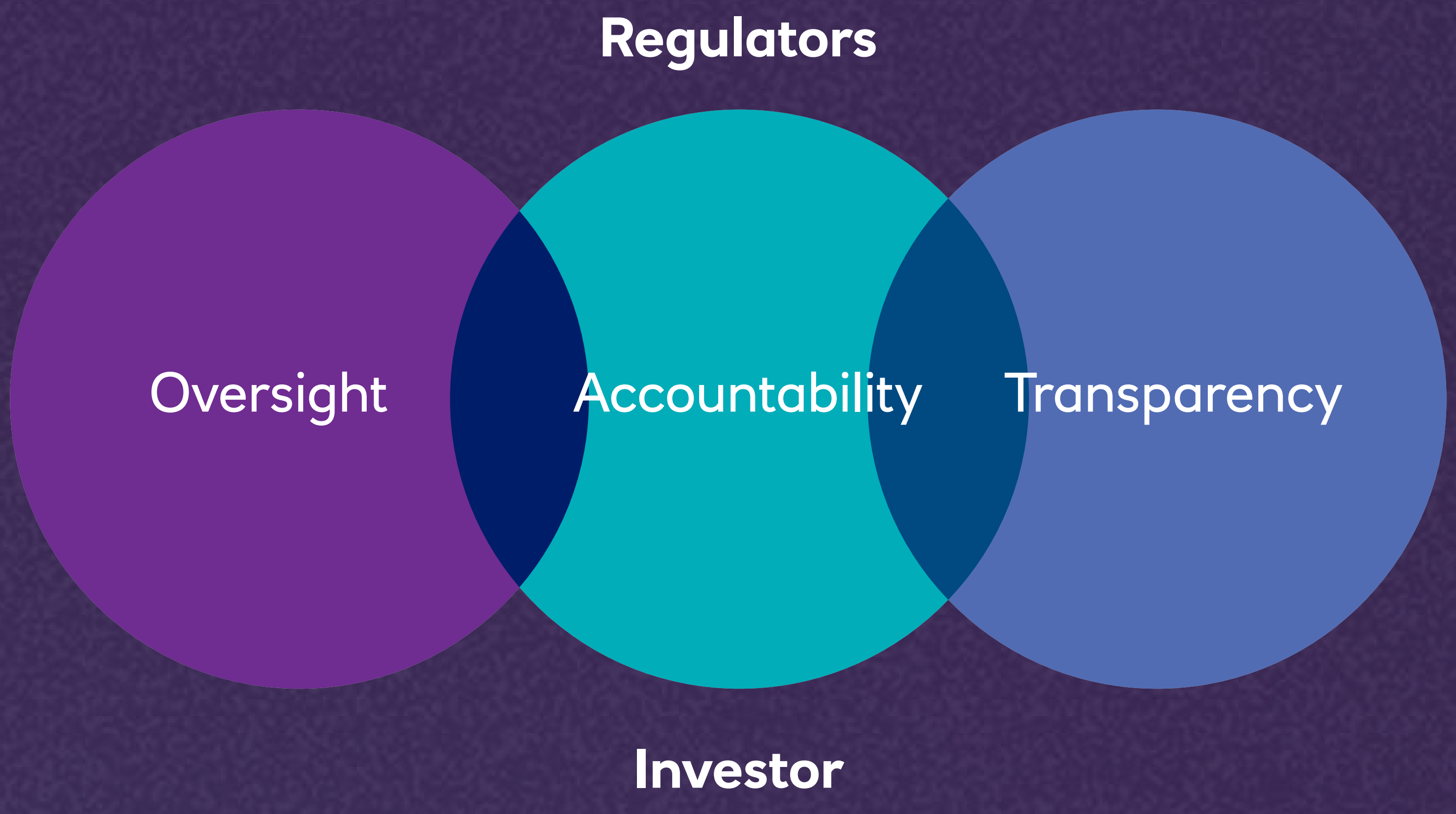
Dive deeper

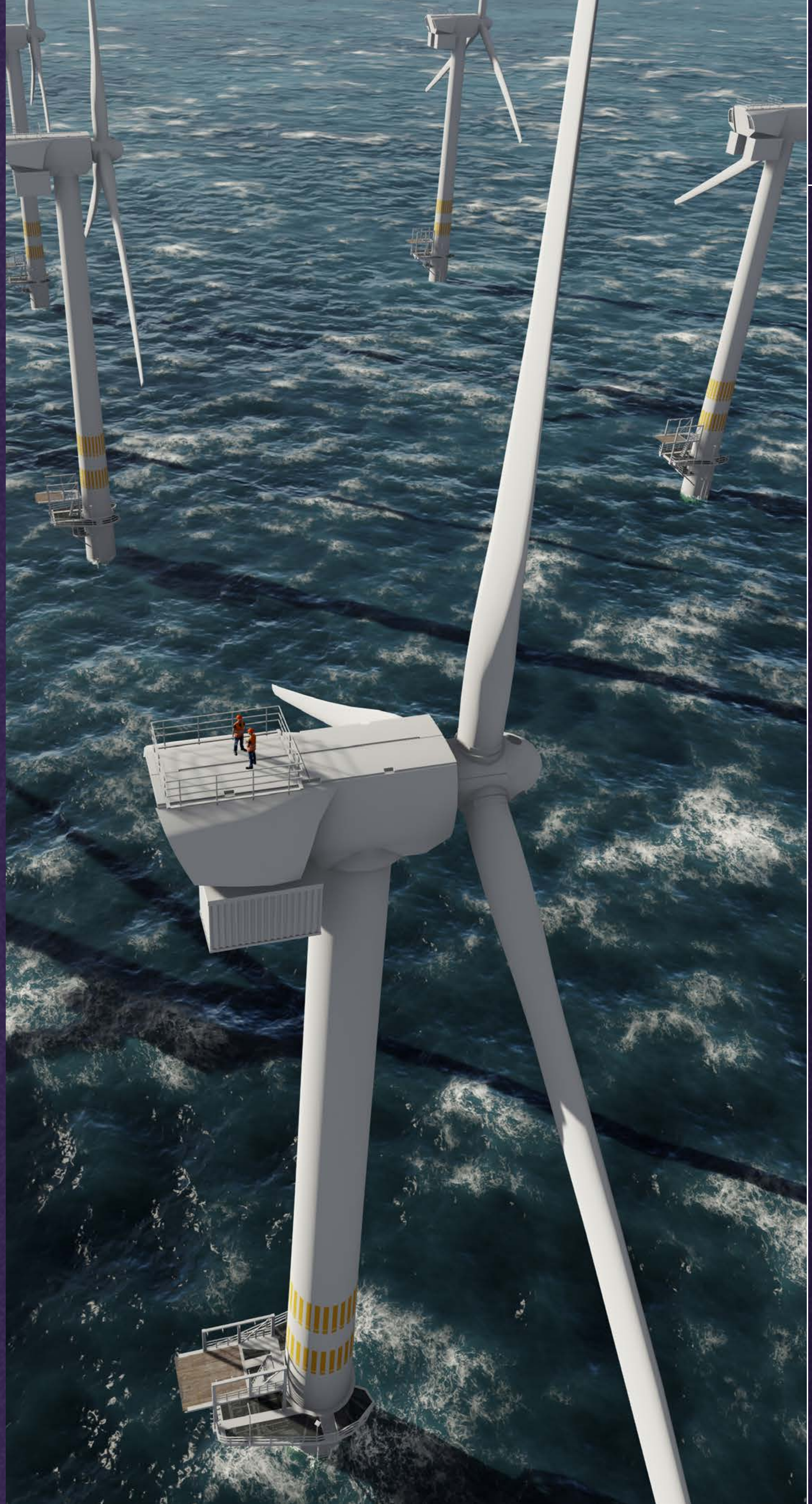
ESG: Adapting to a fast-changing world

This means that there is a lot of unfinished regulatory business, and it is likely that the latter half of this year will see a glut of set-piece engagement, particularly in the form of consultations on the Sustainability Disclosure Requirements (SDR) and the UK's Green Taxonomy.

Both of these have been summarised in previous editions of Depositary Insights but as a brief recap the SDR aims to introduce tiered fund labelling so that investors are better equipped to understand a fund's sustainability characteristics. The Green Taxonomy will deliver consistent definitions of key terminology to ensure that participants in this market are all speaking the same language.

These build on the growing demands for more oversight, accountability and transparency when it comes to ESG. How do regulators help ensure that investors really are getting what they pay for when they invest in a 'sustainable', 'green', 'responsible' or 'ESG' product?





ESG: Adapting to a fast-changing world

The industry has undergone an exponential upskilling in this area as ever more products are launched to meet increasing consumer interest and demand.

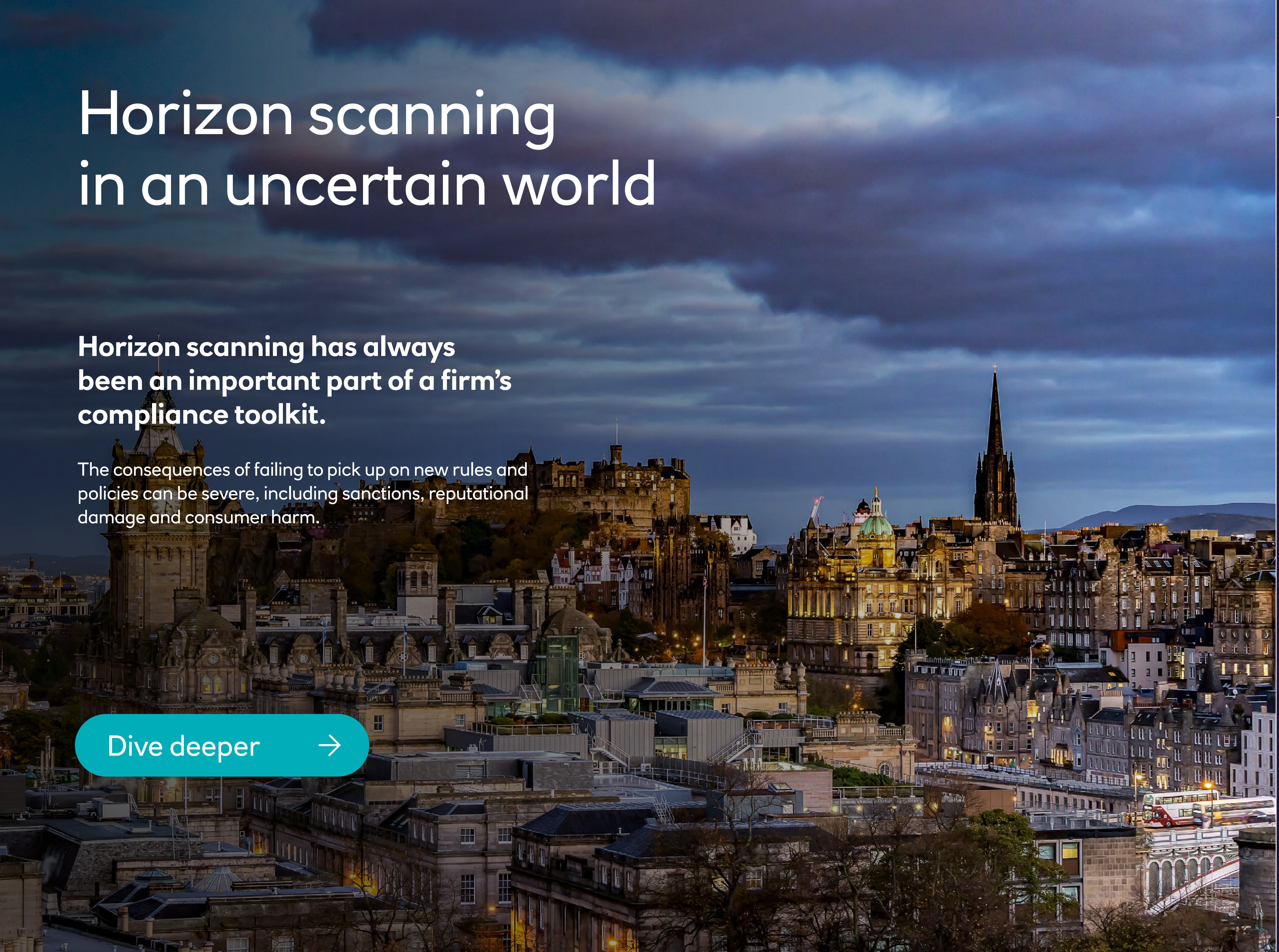
This makes core concepts such as accountability, oversight and common understanding particularly important. The landscape has shifted notably since the UN's COP26 climate change conference last year: the cost of living, global energy crises and rising inflation have added to policymakers' in trays and have meant that there is increased political scrutiny of concepts such as Net Zero. This means that the ESG movement, which has gone from niche to mainstream in a few short years, is now arguably in a more defensive position as it attracts deeper scrutiny from a regulatory and political perspective. Credible and auditable data and clear evidence of actual outcomes are more important than ever.

Big questions will be asked in terms of accountability and there may be a push for more formalisation in terms of executive responsibilities and incentives. Where Net Zero commitments are made with a long lead time, what are the consequences for decision makers if these targets are not ultimately met? And how can the industry ensure that all three parts of the ESG acronym are given equal weighting? Arguably, there has been more focus on the 'E' so far with the 'S' and 'G' getting a lower billing. There are growing voices calling for a tightening up of the language the industry uses in this respect and the SDR and taxonomy regulations will be a timely attempt to address this challenge.

ESG: Adapting to a fast-changing world

While ESG has become relatively normalised across the industry there is still plenty of scope for evolution and debate. Reforms such as the development of the EU's Social Taxonomy are examples of how policymakers are trying to address gaps that have been identified and it is likely the UK will follow suit given its stated commitment to becoming a leading jurisdiction for responsible investment.

The ESG movement does not exist in a vacuum and it is increasingly buffeted by macroeconomic and geopolitical headwinds. As regulators, policymakers and investors continue to raise expectations, and as new standards such as the SDR and Green Taxonomy are developed, firms will need to focus even more on the core themes of transparency, accountability and credibility. This applies across the piece: from reporting and communications, to prospectuses, strategy and executive responsibilities. There is plenty more 'heavy lifting' to come.



Horizon scanning in an uncertain world

Horizon scanning has always been an important part of a firm's compliance toolkit.

The consequences of failing to pick up on new rules and policies can be severe, including sanctions, reputational damage and consumer harm.

Dive deeper →

Horizon scanning in an uncertain world

Recent events however have shown the importance of following a more holistic approach, drawing upon more than the usual regulatory sources such as consultation papers, policy statements and speeches. In the past few years geopolitical, climatic, and macroeconomic headlines have triggered dramatic disruption and driven significant regulatory responses.

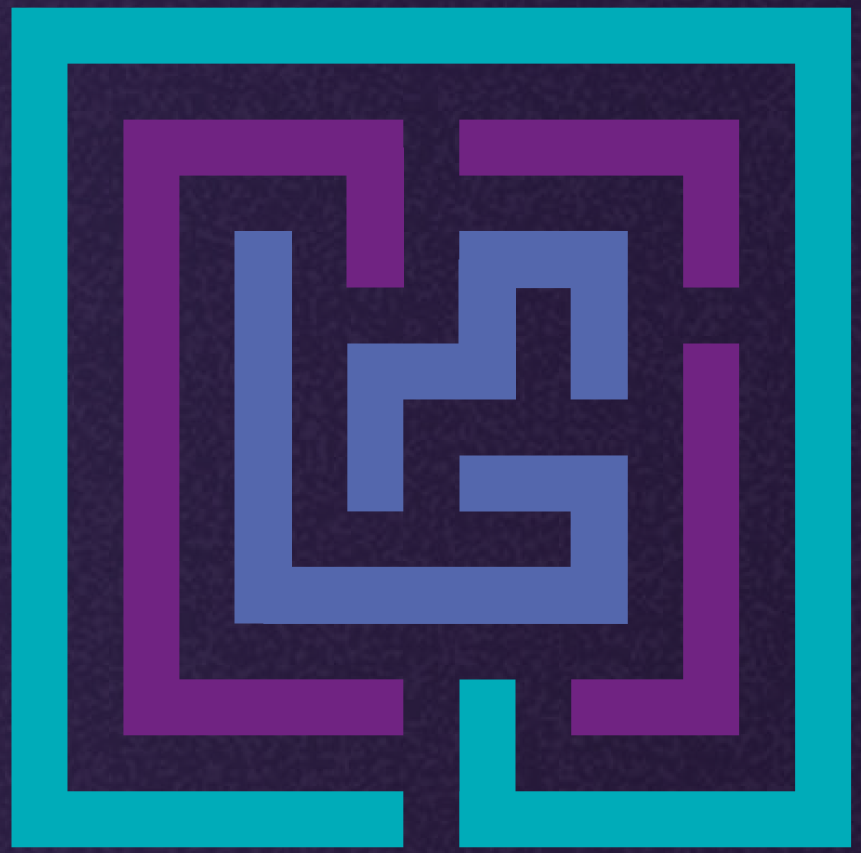
Few would have anticipated at the end of 2021 that the introduction of side pockets would be one of the defining regulatory milestones of 2022 or that so many funds would have been suspended owing to geopolitical upheaval. But it is increasingly the case that horizon scanning needs to take into account these seemingly distant headwinds and think about what the implications will be from a regulatory risk perspective.

Take another example: the debate around 'call-in' powers and adding competitiveness as a secondary remit objective for UK regulators. This is an example of a political debate about the future of regulation – or deregulation – and further down the line it will inevitably have a tangible impact on how firms are overseen and governed.

Horizon scanning in an uncertain world

Regulation is increasingly the distillation of macro trends which, at first glance, seemingly have little to do with the day to day running of a firm or a portfolio. The Covid-19 pandemic, for example, has had major policy implications in terms of home working, business resilience and supply chain disruption. Regulatory responses to recent geopolitical events have pushed other long planned initiatives further down the priority list. And global economic challenges such as the rising cost of living have made regulatory reforms such as the new Consumer Duty and the Consumer Investment Strategy more relevant than ever.

Documents such as the Regulatory Initiatives Grid have made horizon scanning easier for firms as they contain all the known upcoming milestones in one place. What they don't do, however, is set out the range of macro risks and scenarios which will challenge firms further down the line or out of the blue. The UK government's risk register is a good example of a compendium of different possible (if unlikely) events which would have a big impact on society and the economy if they were to occur. Some of these have come to pass in recent years and we can see the impact they have had in an operational and regulatory sense. Horizon scanners need to look beyond the narrow and factual day to day business of consultations and policy statements and think about the bigger picture: what is really going to influence firms' regulatory environment in six months' time or beyond?



Horizon scanning in an uncertain world

Political and macroeconomic affairs whether they be long standing debates, sudden events, or crises are arguably the ultimate upstream of day to day regulatory change. There is a complex relationship between investors, regulators, policy makers and firms and it is set within a macro environment which is constantly changing. Regulation does not exist in a bubble but is deeply linked to each of these other stakeholders and trends. A truly value adding horizon scanning process will be a holistic one which looks beyond the basic components of compliance and implementation and considers the more fundamental trends which are driving the regulatory agenda.

The past few years have signified an end to 'business as usual' horizon scanning. It is therefore increasingly important that firms take care to ensure they analyse regulatory developments in their political, economic and thematic context and consider as best they can where the next disruptor might be lurking.

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