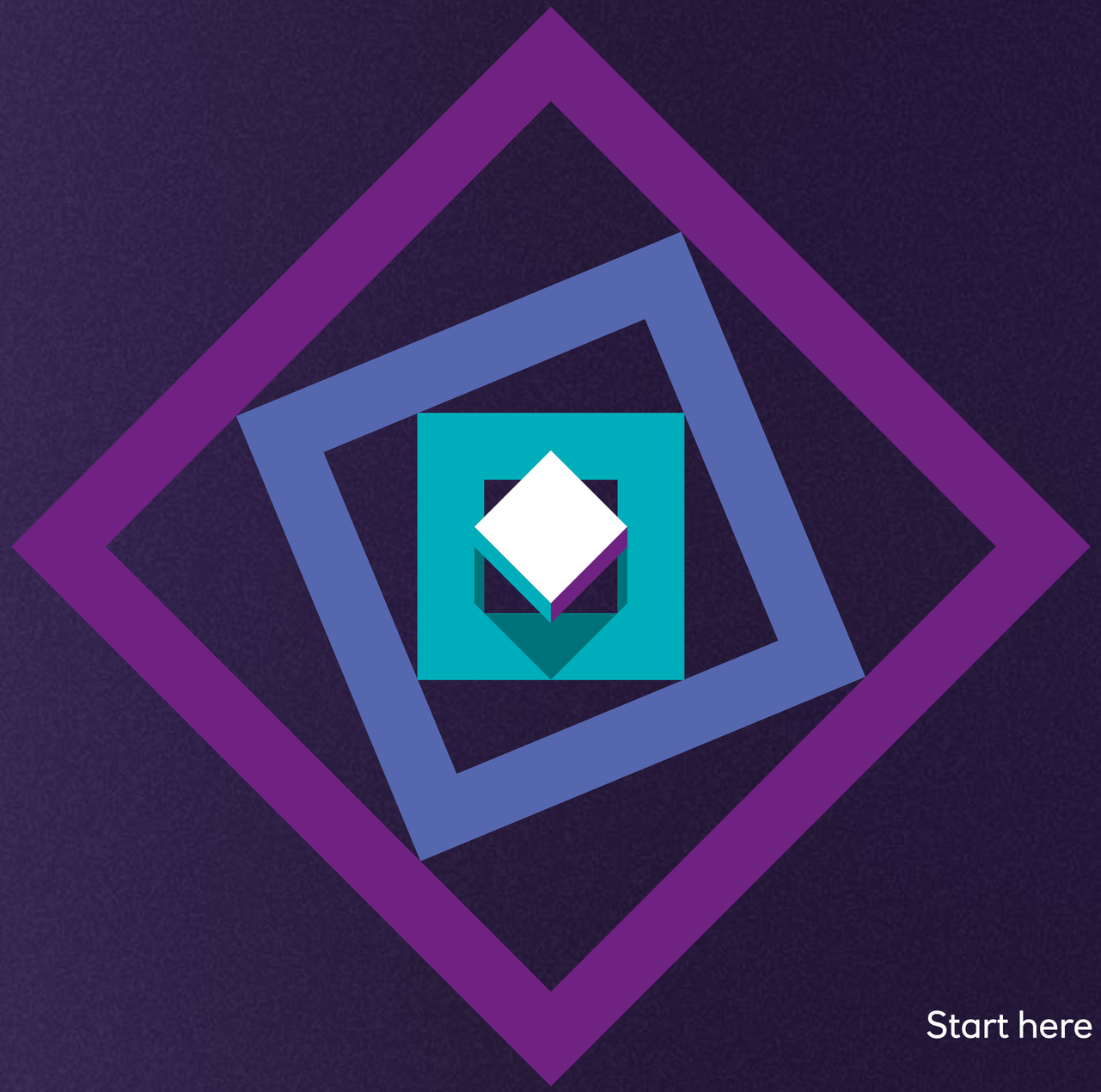
Depositary Insights

Spring 2022



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Foreword

Welcome to the Spring 2022 edition of Depositary Insights.

NatWest Trustee and Depositary Services team

Geopolitics has rapidly emerged as a key area of focus in 2022, even as the Covid-19 pandemic continues to pose challenges worldwide. It is clear that these two major external factors will shape the environment in which firms operate as we look ahead to the rest of the year.

The regulatory agenda is busy, as the articles in this edition highlight. Many of the themes developed in 2021 – ESG, consumer protection, diversity, resilience – will be progressed and implemented in 2022, meaning that the onus remains on firms to implement and evidence.

The FCA itself is undergoing a transformation: its remit has been expanded to include climate change, and its overall aim is to to become more assertive, innovative and adaptive in carrying out its duties.

The regulatory regime itself is under the spotlight, as the industry considers how to enhance its international competitiveness and attractiveness – big questions on principles-based regulation, UK/EU regulatory alignment (or divergence), and expanding access to investments will be debated throughout the year.

Across each of the developments we examine in this edition, governance is at the core. Amid an external environment of continued complexity and uncertainty, we are seeing renewed regulatory efforts to shore up standards to support consumer protection, market integrity, trust and transparency.

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

2022:
A transformational year

2022 is likely to be a transformational year in regulation for the funds sector.

The impact of key developments such as last year's COP26 climate change conference, the developing post-Brexit regulatory framework and Covid-19 recovery are driving a change in regulatory priorities. These will have a big impact in terms of the core remit of our regulators, and their approach to discharging their duties.

Dive deeper →

2022: a transformational year

Macro-factors driving change

In the case of the FCA, three primary factors (climate, post-Brexit regulation and Covid recovery) are driving a shift in terms of strategy and remit.

CLIMATE

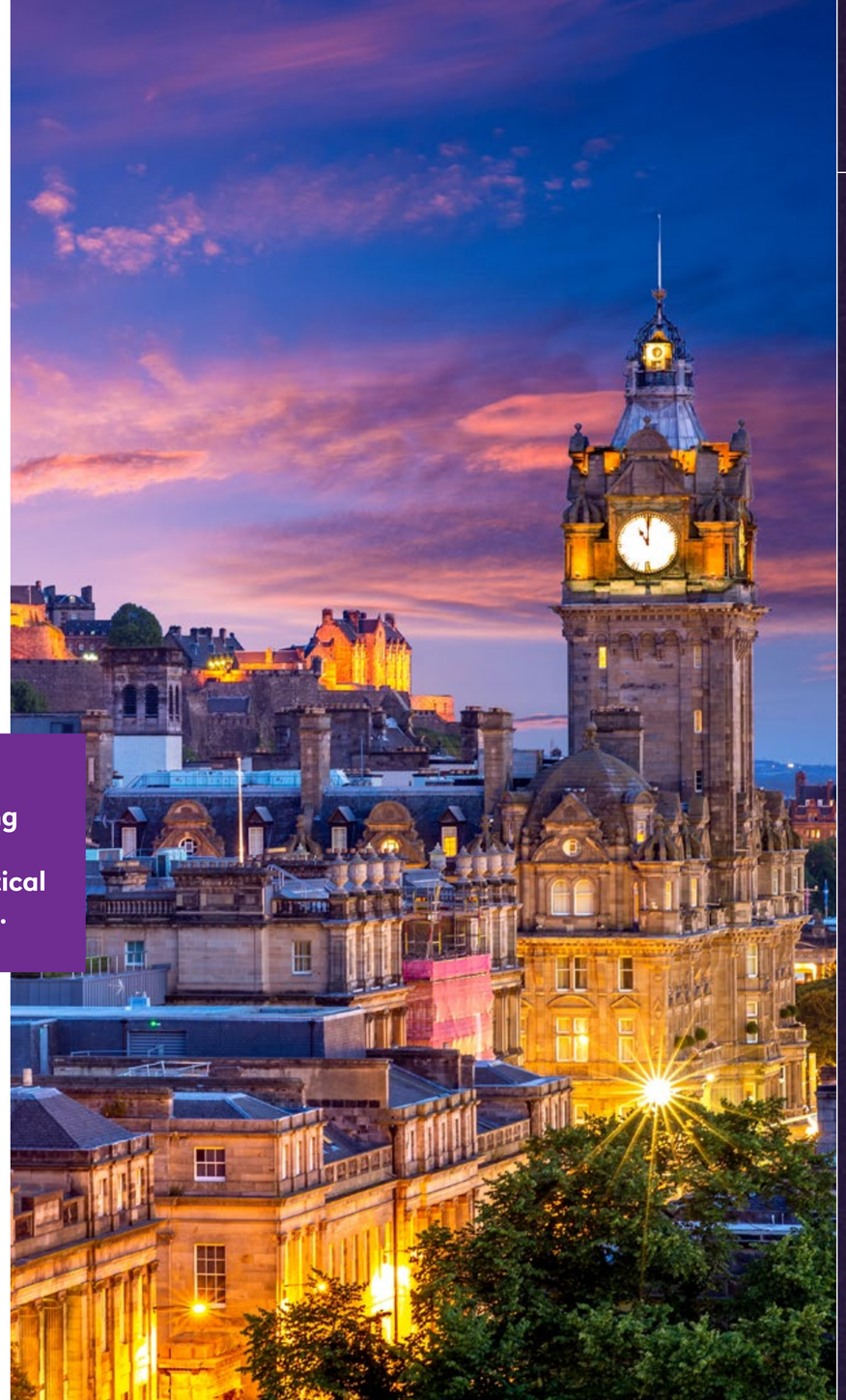
POST-BREXIT REGULATION

COVID RECOVERY

We have seen evidence of this in the FCA's business plan, in the regulatory grid, and in developments such as the HMT remit letter issued to regulators in 2021.

Climate change is now a key FCA responsibility, alongside the long-standing priorities of consumer protection and market integrity. In addition, the geopolitical situation will also be on regulators' minds.

If 2021 was the year in which the industry as a whole focussed on climate change, setting out policy priorities around the time of the COP26 climate change conference, 2022 is the year for implementation and action – as a result, boosted by its enhanced remit, we can expect an acceleration in regulatory oversight and consultation activity as key initiatives mooted in 2021 such as the sustainability disclosures requirements, UK green taxonomy and greening finance roadmap are developed.



2022: a transformational year

The post-Brexit regulatory environment continues to evolve. In 2021 we saw the introduction of the Financial Services Act and a consultation on PRIIPs, which provided indicators as to potential divergence between the UK and EU regimes. Early this year HM Treasury published the results of its call for input into the future of the UK funds regime, which had asked for insights from industry as to how competitiveness and attractiveness could be enhanced.

This included a series of notable proposals such as:

Making funds' tax treatment more streamlined and efficient

Enhancing the 'shop front' of UK fund types available (including further work on LTAFs)

There have also been proposals, raised in the Future Regulatory Framework consultations, that regulators be given the additional objective of enhancing the UK's international competitiveness.

Covid-19 recovery has made ongoing areas of policy, such as operational resilience, ever more important. In-scope firms will need to demonstrate that they have considered their important business services and the impact of any disruption. There have also been requests for information on resilience in the face of the pandemic.

The FCA's remit is further enhanced by a renewed focus on diversity and inclusion – 2022 will be a particularly active year on this front, with upcoming consultation activity followed by a policy statement later in the year.

2022: a transformational year

Adapting to new challenges

Amid a transformation in strategic priorities, driven by major economic, political and societal trends, a key question is how the FCA can adapt to meet these new challenges. Its answer is to seek to become more assertive, innovative and adaptive. There are a number of ways firms will be able to discern this.

We can expect a more probing approach towards matters such as new funds authorisations, including deeper dives and enhanced scrutiny of model portfolios.

A more innovative and adaptive approach to regulation entails a greater focus on digital and greater attention on emerging areas of risk such as cryptoassets and even the shift towards remote and hybrid working.

2022: a transformational year

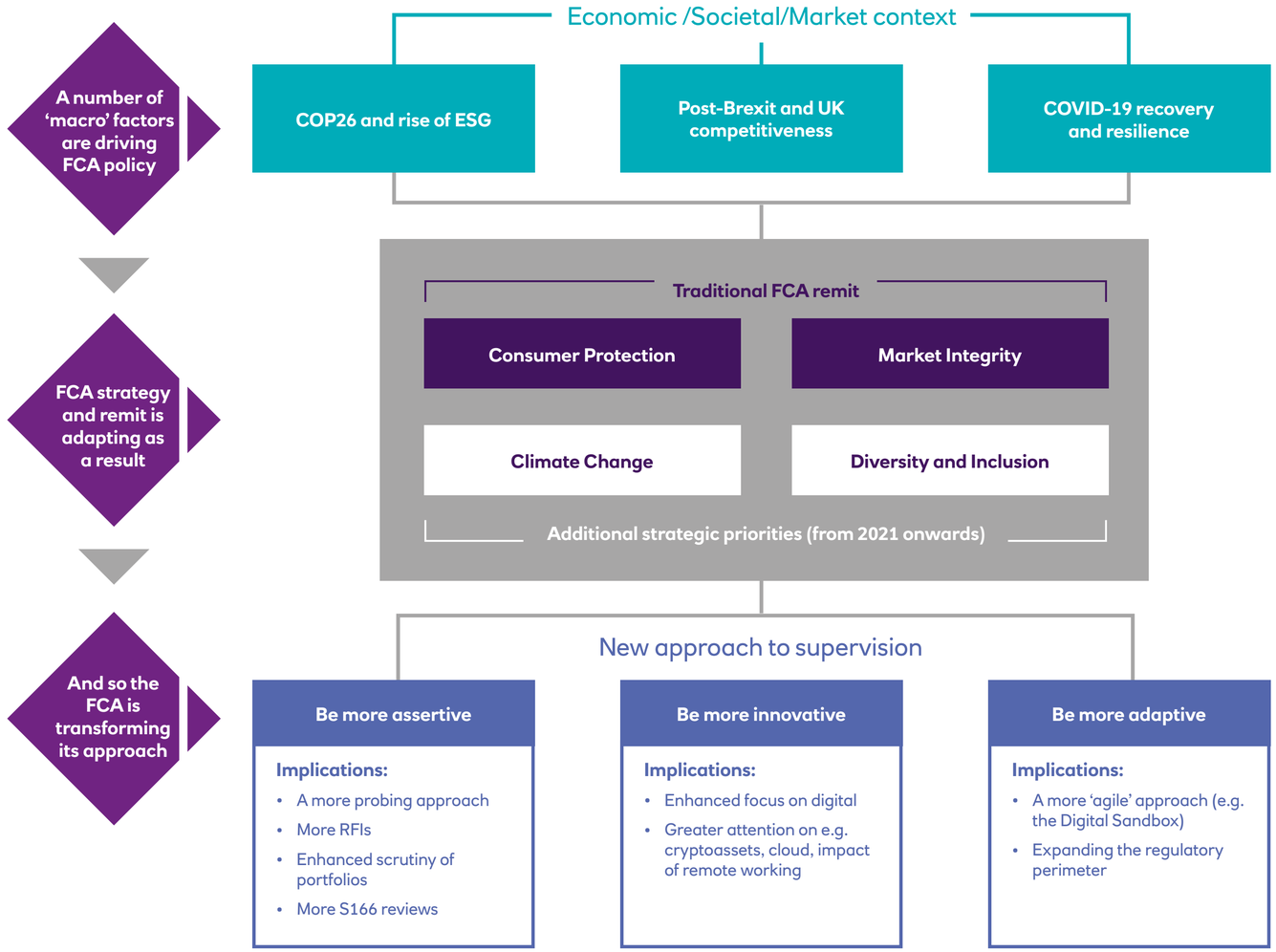
A transformational year

There are over 180 developments captured on the most recent edition of the regulatory initiatives grid, which is an indicator of the volume of regulatory activity firms are engaging with in 2022.

Many of these developments, such as new consumer duty, will be transformational for the industry. But it is also clear that the regulators themselves are also undergoing a transformation – in terms of remit and approach – driven by some of the biggest challenges and changes the market has seen for some time.

Navigating regulatory change in 2022 therefore requires a robust understanding not only of the milestones on the horizon, but also of the priorities being grappled with by regulators themselves.

2022: a transformational year



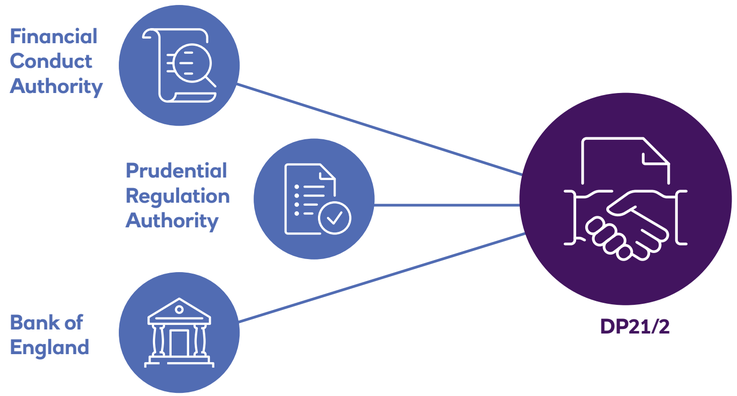
Diversity, equity and inclusion in 2022: A key priority

UK regulatory attention is increasingly turning towards diversity and inclusion: it is now core to the policy agenda.

Dive deeper →

Diversity, equity and inclusion in 2022: a key priority

In 2021 the FCA's business plan was clear that this was a priority topic, and we saw the publication of a joint discussion paper (DP21/2) from the FCA, PRA and Bank of England in July, followed by a pilot data survey in October.



In 2022 the momentum will continue to build, with a subsequent consultation paper expected in the first half of the year, followed by a policy statement.

It is understandable that this topic should be gaining increasing focus: better outcomes on diversity bring a range of benefits, in areas fundamental to UK regulators' responsibilities, such as enhanced consumer protection and positive outcomes in risk management, conduct and culture.

Diversity, equity and inclusion in 2022: a key priority

Existing frameworks

A regulatory and legislative framework has been in place for some time, for example:

Corporate Governance Code

Sets out the role of the nomination committee in developing and reporting on diversity.

Equalities Act

Legislation such as the Equalities Act sets out the law on matters such as unlawful discrimination.

Hampton Alexander and the Parker Review

Campaigns such as Hampton Alexander and the Parker Review encourage firms to improve diversity in terms of gender and race, respectively, particularly at board and senior management level.

Other initiatives

Such as the Women in Finance Charter, Race at Work Charter and Social Mobility Taskforce have also helped drive policy and improve outcomes.

But as the regulators noted in DP21/2, the conversation is still in its infancy. A range of potential areas for development were considered in the discussion paper, and these will form the basis for enhancements to policy in 2022 and beyond.

Diversity, equity and inclusion in 2022: a key priority

Areas for development

1 Measurement

The paper noted that there has been discussion as to whether diversity metrics are too input-focussed rather than outcome-focussed. It is important to consider whether the data being measured and reported is providing adequate insight. Key to this is ensuring parity of reporting across all protected characteristics.

2 Inclusion

Creating a more inclusive financial sector brings a range of benefits including by avoiding 'groupthink', which has knock-on effects for competitiveness, risk management and culture. This can be challenging to measure, however, and has arguably received less attention than diversity. We are therefore likely to see further initiatives this year in terms of improving outcomes across the sector in this space.

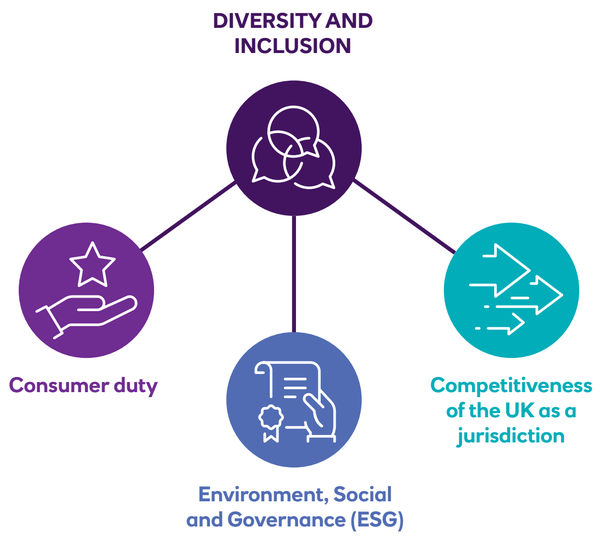
3 Tone from the top

Increasingly, focus is turning to 'tone from within', and the experience of more junior employees. This covers a wide range of areas, including succession planning, nurturing future leadership talent, and culture. A more holistic view of diversity and inclusion will examine experiences across firms, from top to bottom.

Diversity and inclusion in 2022: a key priority

At the heart of the regulatory agenda

The diversity and inclusion agenda is entwined with a range of other regulatory themes in 2022:



The discussion paper noted that a firm which can call upon a range of views and backgrounds in its decision-making is more likely to deliver products of relevance to a wider range of consumers, including disadvantaged groups. As ESG continues to build momentum, attention is increasingly focussing on the 'G' – governance – and on matters such as board composition, succession planning, and culture. And the evidence shows that more diverse and inclusive firms help contribute to a more stable, fair, and effective market.

Regulators have said they expect to see 'rapid and substantive progress'– meaning that the consultation paper in the first half of the year, and the policy statement in the second half, will be vital policy milestones for all firms to engage with and prepare for. If, as the discussion paper argued, the treatment of this topic is still in its infancy, then 2022 should be a year in which it receives an important regulatory boost.

In the investor's shoes:

Consumer duty and the consumer investment strategy

Consumer duty is already one of the regulatory headlines of 2022 – in fact, it was clear from the FCA's 2021 business plan that this will be pursued as a policy priority, and there are important milestones ahead.

Consumer duty essentially requires firms to put themselves in their customers' shoes, to demonstrate that they are acting in consumers' best interests, entity-wide; for example in terms of governance, operations, and strategy. There is also a focus on demonstrating protection for the most vulnerable customers.

Dive deeper →

In the investor's shoes: consumer duty and the consumer investment strategy

Regulatory engagement

Consumer duty has been on the agenda since 2018, when an initial discussion paper was issued.

The consultation process commenced in the second half of 2021, and in mid-February 2022 the second and final consultation closed. The UK finance industry is now awaiting the publication of the FCA's policy statement (expected by the end of July), which will provide the final word on key aspects such as the implementation period - will the FCA stick with an April 2023 implementation date, as proposed in the second consultation, or will they adopt the two-year minimum implementation period proposed by some respondents?

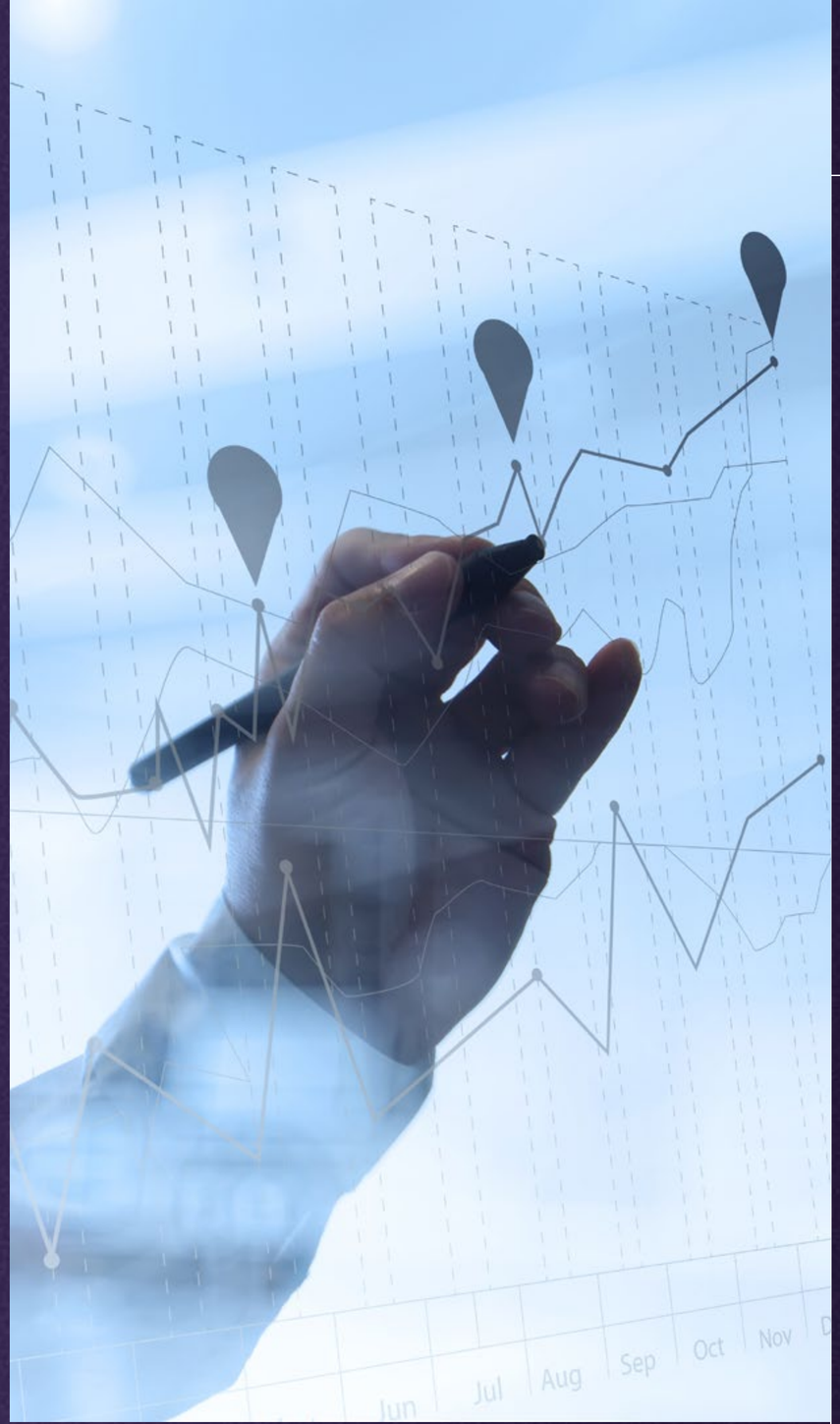
Regardless, it is clear that preparing for the new Duty will require significant focus: the latter half of 2022, after the policy statement is issued, will be an important time for pushing ahead with implementation programmes.

In the investor's shoes: consumer duty and the consumer investment strategy

The consumer investment strategy

It is also significant to note the linkages between the consumer duty and the consumer investment strategy, which we also saw published in 2021.

In an inflationary economy, the strategy is focussed on avoiding the potential risk of consumer harm posed by consumers having cash in current or savings accounts which might be better placed, depending on factors such as risk appetite, experience and appropriateness, in investment products (e.g. collective investment schemes), which could deliver a better return.



In the investor's shoes: consumer duty and the consumer investment strategy

Benefits and challenges

The benefits of the new Duty and the investment strategy are clear: the market for investments could become more attractive, and deliver better outcomes, for a wider range of potential investors.

The investment strategy tackles issues such as improving awareness and access, whilst also addressing complex challenges such as fighting fraud and improving redress when things go wrong.

The strategy aims to see a **20%** reduction n the number of consumers with higher risk tolerance of holding cash over **£10k**

Currently **8.6** million consumers hold over **£10k** of investible assets in cash half could potentially benefit from investing, according to the FCA.

However, there have been some areas of constructive challenge expressed by industry in terms of the new Duty. To ensure it is a success, key terms such as 'harm', 'good faith', and 'value' will need to be clearly defined, along with concepts such as 'best interests'.

Cost is another factor for close consideration: it has been estimated that implementing the new Duty could cost firms £2.5 billion, with significant ongoing costs thereafter. There is a risk that these costs are ultimately passed to end investors, representing a potential harm.

It has also been noted that some aspects of the Duty are already enforceable in existing regulation, and effective authorisation and supervision of firms under existing rules could deliver good outcomes for consumers without new regulation. The scale of the work required to comply should also be borne in mind, especially given the range of other regulatory priorities facing firms in 2022.

In the investor's shoes: consumer duty and the consumer investment strategy

Looking ahead: when, not if

The policy statement, when it is published, will provide clarity and may address some of these points in more detail.

Other aspects from the first consultation, such as a proposed private right of action, which had been challenged by respondents, appear to have been scaled back in response to industry feedback in the second consultation.

In any case, the direction of travel is clear. The prominence given to the consumer duty by the FCA emphasises the importance of preparation: it's a question of when, not if.

And there are clear benefits to getting it right: coupled with the Consumer Investment Strategy, these include improved outcomes for beneficiaries, as well as a more open and attractive market for a wider range of potential investors than before.

AIFMD II:

Change in Directive, change in direction?

On 25 November 2021 the European Commission published proposals on the Alternative Investment Fund Management Directive (AIFMD), following a consultation process which closed in January 2021. The proposals identify a number of areas of potential enhancement and growth for the directive, essentially creating a revised 'AIFMD II'.

While the Commission found that AIFMD is generally fit for purpose and achieving its objectives, there were a number of areas of potential challenge identified. These included overseeing financial stability risks, inefficiencies in monitoring investment funds, and the need for more alignment across jurisdictions in terms of applying consistent definitions of delegation rules.

Dive deeper →

AIFMD II: change in Directive, change in direction?

Evolving the Directive

The proposals raised by the Commission to address these challenges are more of an evolution of the existing directive than a radical departure.

Changes proposed include amendments to the National Private Placement Regime framework, particularly with regard to Financial Action Taskforce (FATF), amendments to delegation arrangements by EU AIFMs, and new rules related to liquidity management, whereby authorised AIFMs managing open-ended AIFs will need to select at least one liquidity management tool from a new Annex V AIFMD to be used in exceptional circumstances. ESMA will also have the power to require AIFMs to activate or deactivate these liquidity management tools, as needed.

National competent authorities will also have the power to permit AIFMs and AIFs to use depositary services located in other member states while the commission reviews whether it would be appropriate to prepare further measures with regard to further integrating the market. The Commission also proposes that a central securities depository be permitted to be appointed a delegate of a depositary.

Depositary matters

The depositary passport, which had been consulted upon, has been deemed, for now, to be infeasible on the basis that there is currently an absence of harmonised EU securities and insolvency law, which would make the introduction of the passport challenging.

AIFMD II: change in Directive, change in direction?

Non-EU implications

While these are not ground-breaking changes, they will have implications for EU AIFs and AIFMs, as well as non-EU (including UK) AIFs and AIFMs. Non-EU AIFMs will experience tightening of delegation rules, as well as a requirement for increased disclosures under the National Private Placements Regime (NPPR).

Non-EU AIFMs may wish proactively to adopt the proposals on a voluntary basis, if investors desire this, or for strategic and competitive reasons.

There is also an open question around the extent to which the UK will adopt the Commission's proposals in terms of the onshored AIFMD. While adoption would help ensure alignment and consistency between the two iterations of AIFMD, there is also the possibility of the FCA adopting part of the new proposals, creating its own amendments to AIFMD, or indeed retaining the directive as is, resulting in regulatory divergence. In this sense the Commission's proposals also represent something of a case study for the post-Brexit UK-EU regulatory framework, and the FCA's next moves will be closely examined – it is unclear at present when or whether a UK AIFMD II will be consulted upon.

Looking forward

Regardless of the immediate next steps from an FCA perspective, the timeframe for implementation of the new Directive will be relatively lengthy: the Commission, the European Parliament and the European Council will examine the proposals and make any amendments, and this will be followed by a two-year implementation period.

We are therefore unlikely to see the formal implementation of AIFMD II until at least 2024 or 2025, but it will bring changes to the AIF market, both for EU and third country firms, with the added question of how the UK regulatory regime will react. Watch this space!

ESG in 2022:

A year for heavy lifting

2021 was a critical year for environmental, social and governance (ESG) matters, especially with the COP26 climate change conference in Glasgow in November.

However, whereas 2021 gave us a 'roadmap' for ESG regulation (literally, in the case of the UK Government's Greening Finance Roadmap), 2022 will be a year in which a lot of the heavy lifting is done in terms of consultation and implementation.

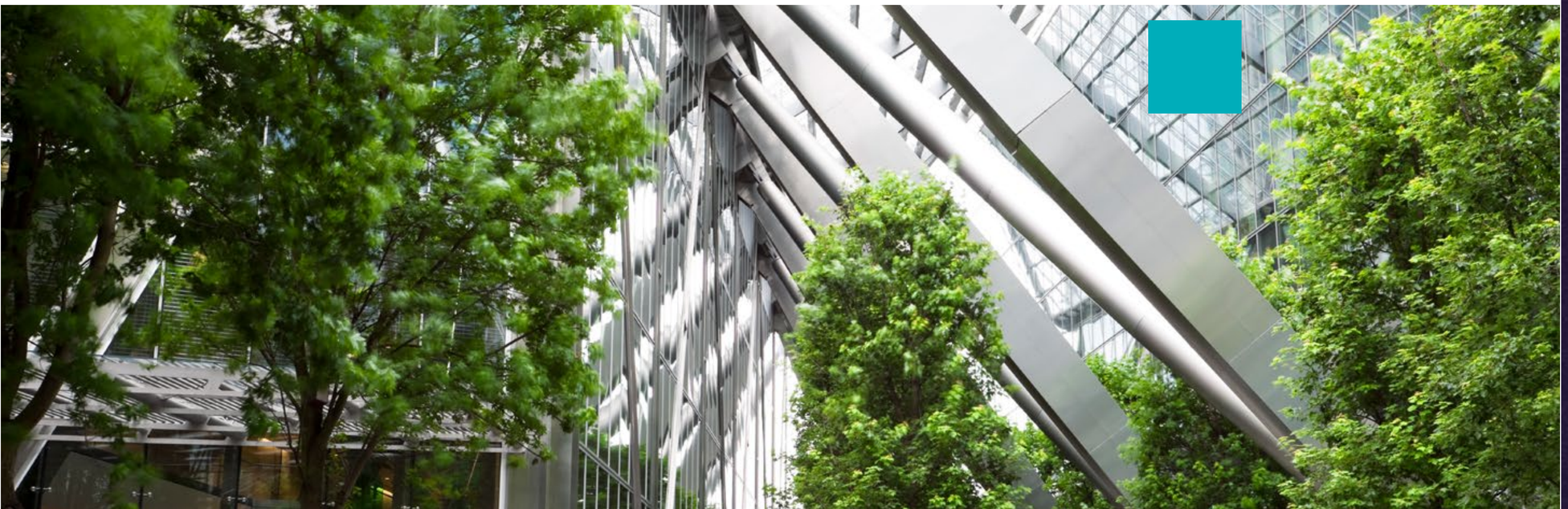
Dive deeper →

ESG in 2022: a year for heavy lifting

Empowering investors

The key theme across UK and EU regulation, looking ahead, is empowerment: empowering investors to make informed decisions on sustainable products to avoid 'greenwashing'.

Key to this is providing verifiable, transparent, quantitative data that demonstrates exactly how fund managers are acting on the claims made in prospectuses, key investor information documents and marketing material.



ESG in 2022: a year for heavy lifting

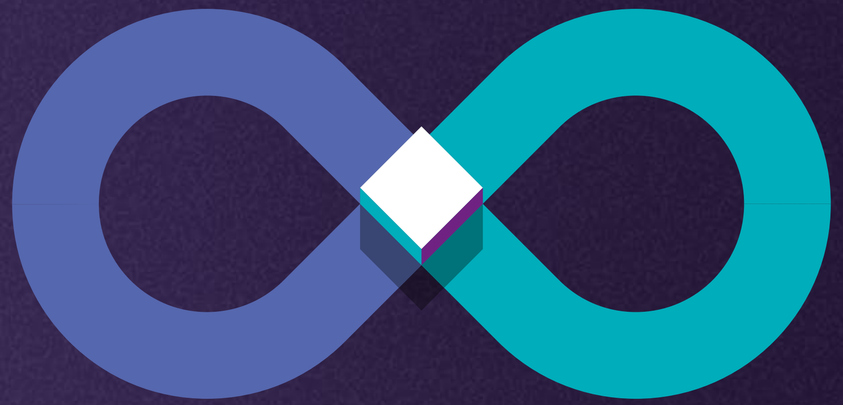
Reporting and disclosing

There has already been an important milestone in 2022: the beginning of the first reporting period for mandatory Taskforce on Climate Related Financial Disclosures (TCFD) reporting for asset managers with over £50bn in AuM. Reports from mid-2023 will be required to align with TCFD reporting standards, which will go some way towards providing greater oversight. Smaller firms will be required to report the following year.

Aside from mandatory reporting, we will also see two additional reporting windows for the Financial Reporting Council's Stewardship Code this year – in April and October – giving firms the opportunity to demonstrate how they deliver long-term, sustainable value for clients, the economy and society.

A lot of regulatory focus this year will be on the development of policy proposals first mooted in 2021 such as the Sustainability Disclosures Requirements (SDR) and the UK Green Taxonomy. SDR aims to support the consumer to make informed decisions on ESG products by providing an up-front 'label' on ESG products setting out what its characteristics are. The taxonomy will introduce a common language for sustainability investing, so that investors can be confident that terminology has a consistent meaning across products.

In the UK, ESG funds continue to gain attention and inflows – investors are attracted to the opportunities presented by sustainable and responsible investing. By enhancing the rules around ESG, regulators will help to enhance outcomes for consumers by making the market more objective and transparent, and will also support the government's aim for the UK to continue to develop as a leading international jurisdiction in this area.

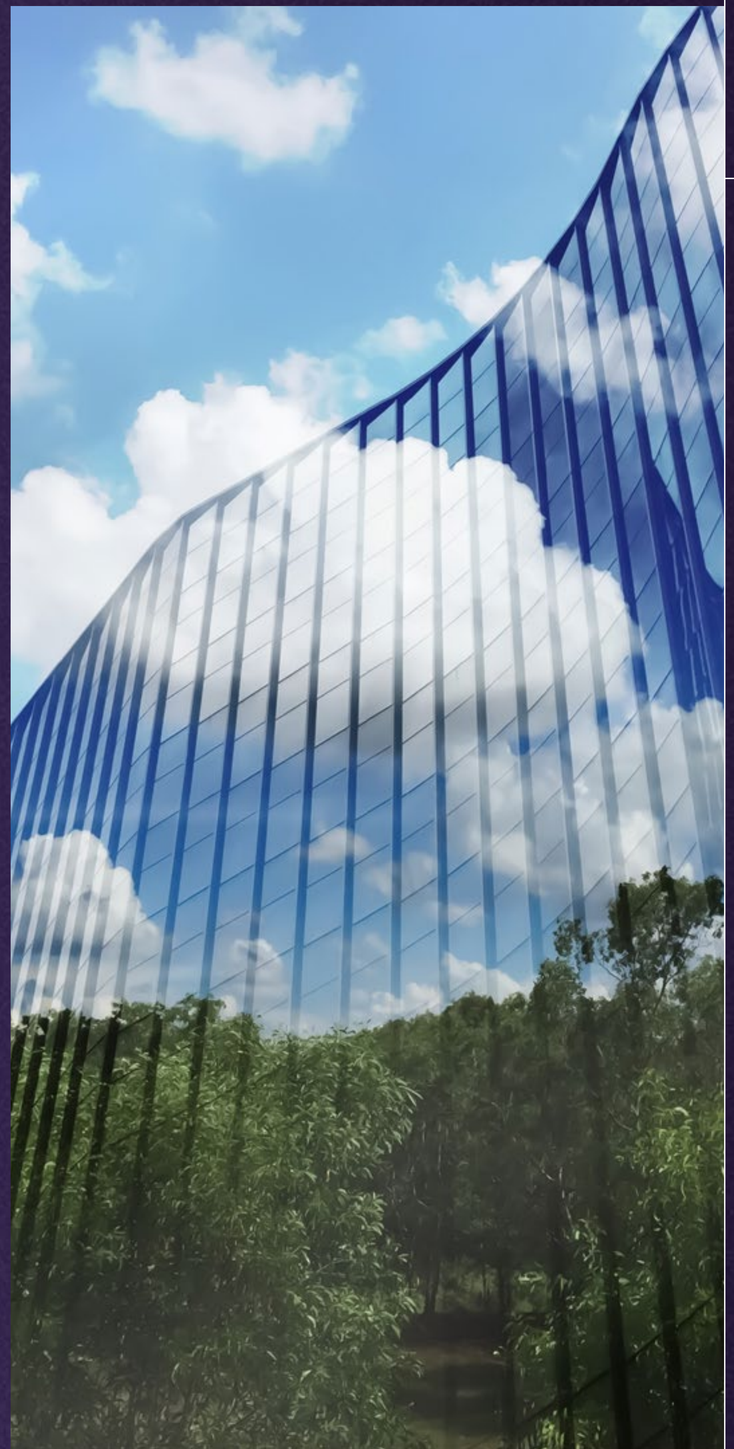


ESG in 2022: A year for heavy lifting

EU action

Other jurisdictions are also taking significant action. Particularly the EU, where the Sustainable Finance Disclosures Regulation (SFDR) sets prescriptive standards for firms to report against.

ESMA has also issued new guidance relating to MiFID II which will require firms to take into account the sustainability preferences of their clients. And the EU has also published its own green roadmap, which focusses on preventing greenwashing, building national competent authorities' competencies in sustainable finance, and monitoring, assessing and analysing ESG markets and risks.

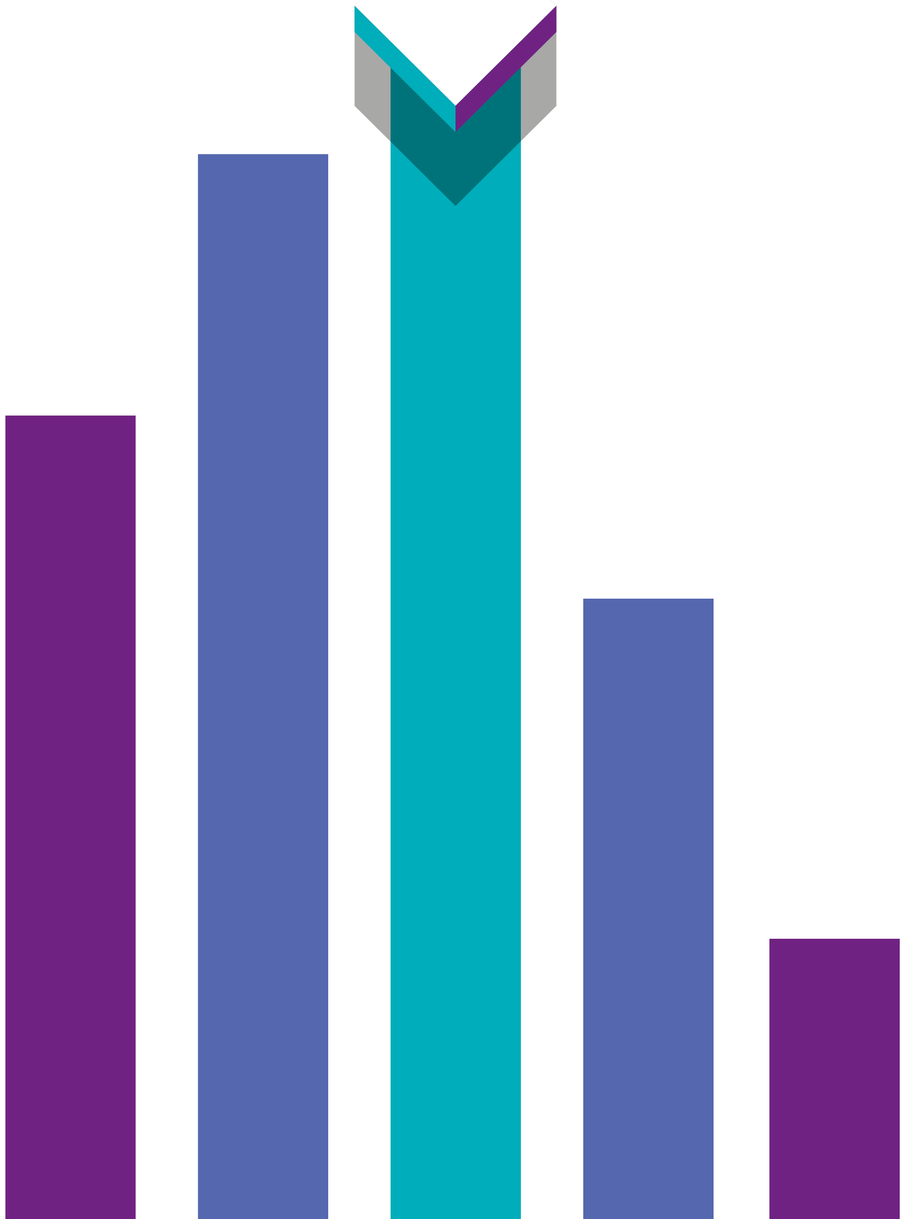


ESG in 2022: a year for heavy lifting

Get the data right

A common denominator across jurisdictions is the increased focus on data: firms are increasingly being asked to provide granular metrics on carbon footprints, for example. This poses challenges in terms of time, cost, resources and quality of information, and a key aspect is the need for good quality, credible, independently verified data.

And there are increasing risks associated with falling short on disclosures and data: there have been reports of fines and sanctions, and there is the prospect of class action in the event of suspected greenwashing. Getting data and disclosures right is therefore increasingly critical.



ESG in 2022: A year for heavy lifting

Don't forget the 'S' or 'G'

Arguably the regulatory treatment of ESG is still in its early stages, with the predominant focus on the 'E'.

As firms focus on carbon data or the prescriptive requirements of SFDR, for example, or the UK or EU green taxonomies, understandably minds will be concentrated around environmental metrics. However, we are already seeing increased focus on social and governance matters, for example in terms of diversity and inclusion. The geopolitical situation has rapidly accelerated focus on the 'S' and the 'G'.

What is clear is that across each aspect, the key to building trust and transparency lies with quantifiable, verified data, and transparent reporting, focussed on metrics and outcomes. The bar for asset managers - as set by investors, regulators and competitors - is set to keep on rising.

Fund governance in 2022:

Leading on investor protection

In 2021 the FCA devoted significant attention to the governance and infrastructure of the UK funds regime. In particular, we saw the publication of the Host AFM review, and, for depositaries, feedback and engagement on AFM replacement processes under COLL 6.5.

The whole industry paid close attention to the Host AFM review as it contained valuable best-practice feedback, not just for hosts but for market participants more broadly. From our perspective as a depositary, we closely analysed the FCA's report to ensure appropriate alignment our own robust client governance oversight structures and processes.

Building on both initiatives, we enter 2022 with a renewed focus on delivering best in class client oversight and governance and remain at the forefront of protecting investors.

Dive deeper →

Fund governance in 2022: Leading on investor protection

Enhancing oversight

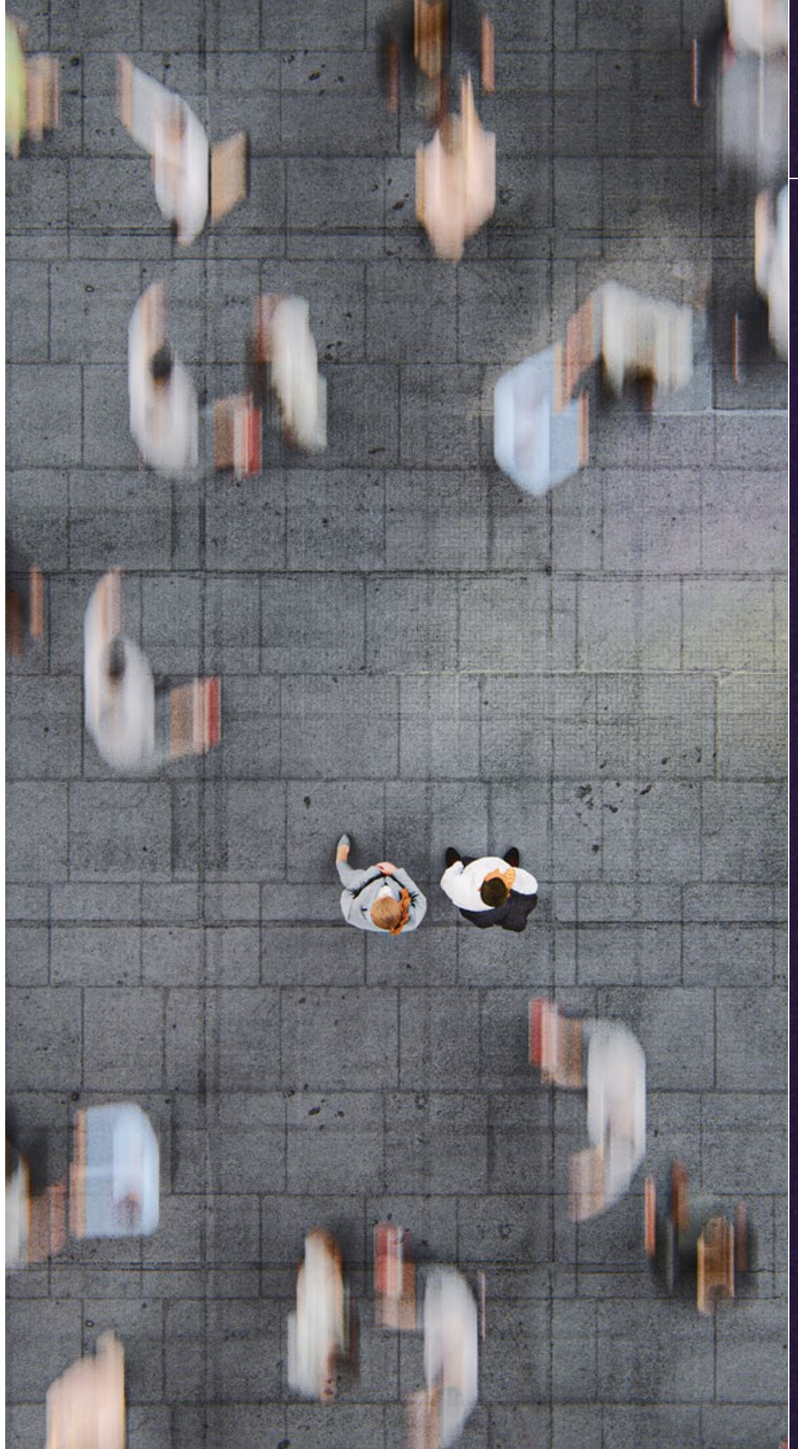
The FCA has engaged with nine UK depositaries on COLL 6.5, publishing its feedback in May 2021.

The feedback set out how depositaries could enhance their processes, governance and 'playbooks' to ensure that their engagement with AFMs was as focussed as possible on protecting end investors.

A number of other enhancements were proposed in the FCA's feedback letter to depositaries, such as robust triggers for escalation and action, and granular indicators of firm stress (including aspects such as adverse press, breaches, fines, liquidity issues or significant outflows). The feedback contained steers in terms of governance, timeframes, roles and responsibilities. As a result, the FCA's proposals will help to ensure that the depositary sector – critical to the overarching supervision and oversight of the funds industry – is fit for the future.

As an entity we have engaged with the FCA throughout the process, enhancing our playbook and oversight process execution.

This includes working closer with clients to better understand their overall health as well as their internal monitoring mechanisms and KPIs, including financial indicators, governance structures, and operational performance metrics.



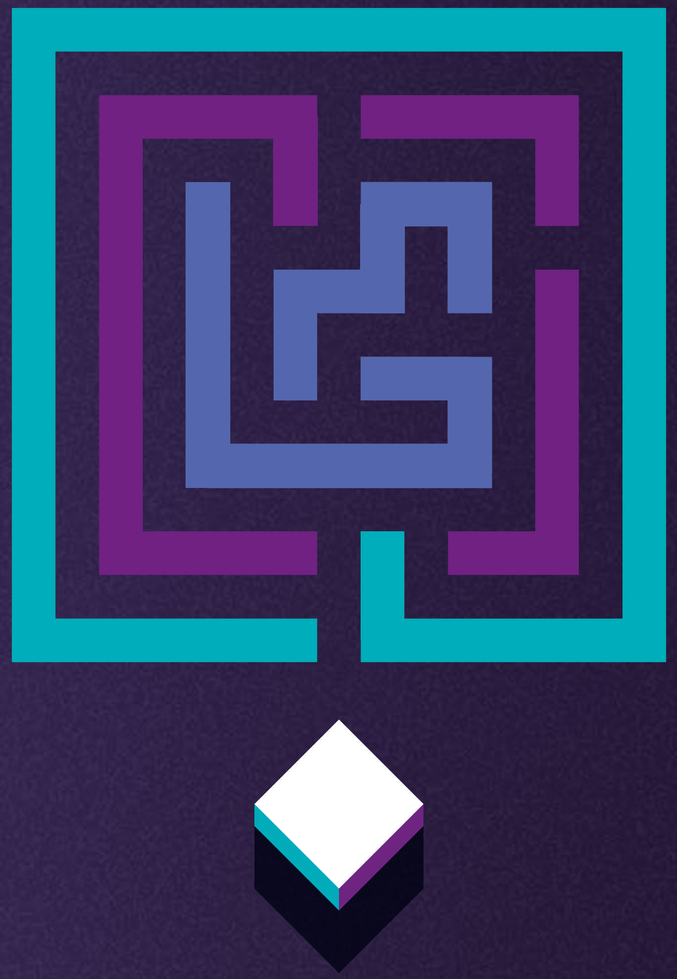
Fund governance in 2022: Leading on investor protection

Understanding the benefits

The benefits to these enhancements are clear: we will have a better understanding of how our AFMs manage their funds and associated operating models, improving our oversight and governance for the benefit of the underlying investors.

The FCA remains focussed on enhancing the integrity of the UK's financial system, and the funds industry is evolving at pace with the regulatory landscape. We play a key role in ensuring the UK funds market operates in a safe and well governed manner for the benefit of all investors and the health of the wider ecosystem.

As we look ahead to the rest of 2022 it is clear that the governance agenda remains front-and-centre: the FCA has said it will revisit the Host AFM review, following up to understand how its feedback to market participants has been digested and embedded by firms in scope. The industry as a whole should consider these insights and adapt accordingly.



Depositary Insights

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