Depositary Insights

Summer 2021

NatWest Trustee and Depositary Services

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Highlights of this issue

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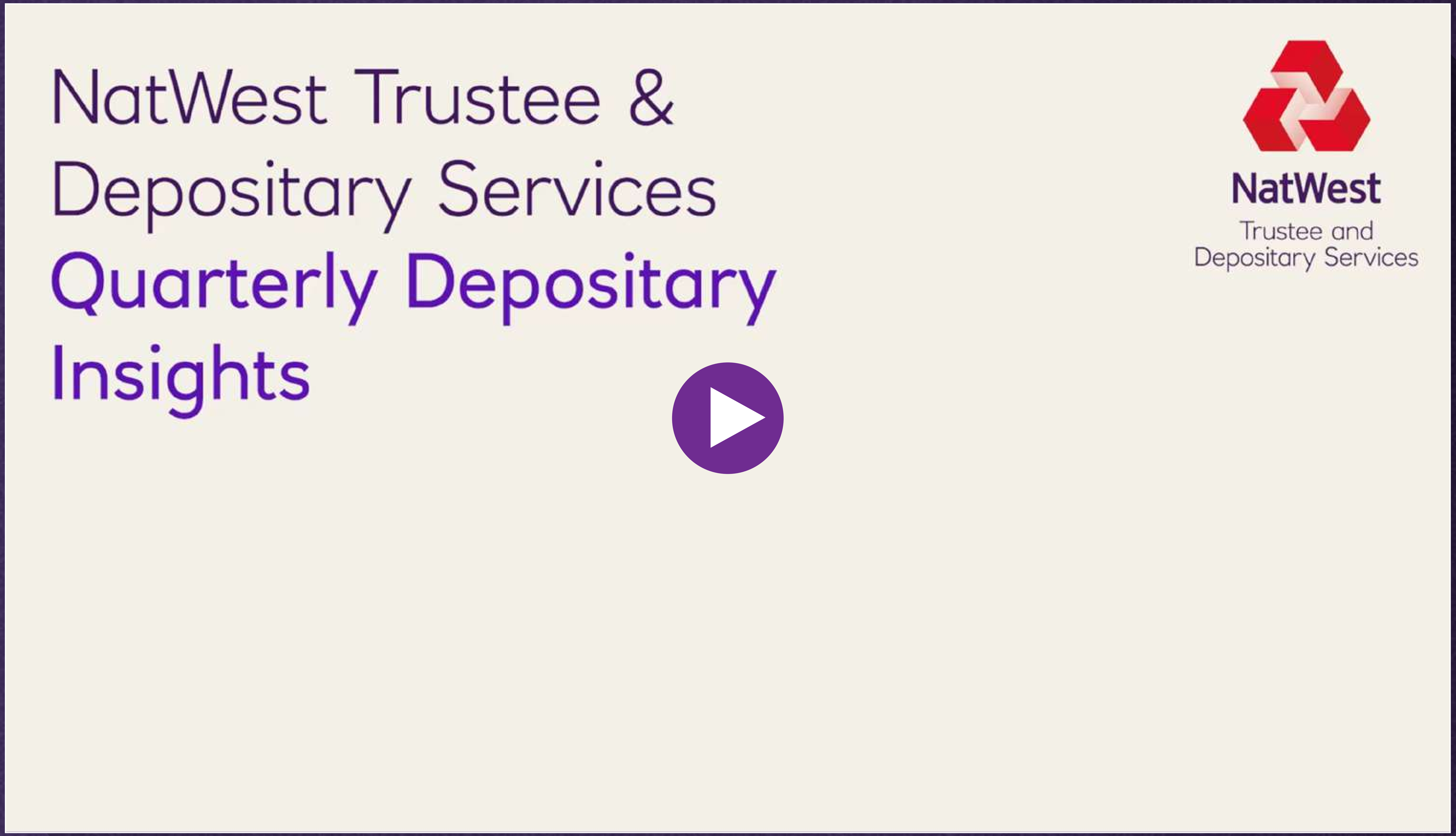

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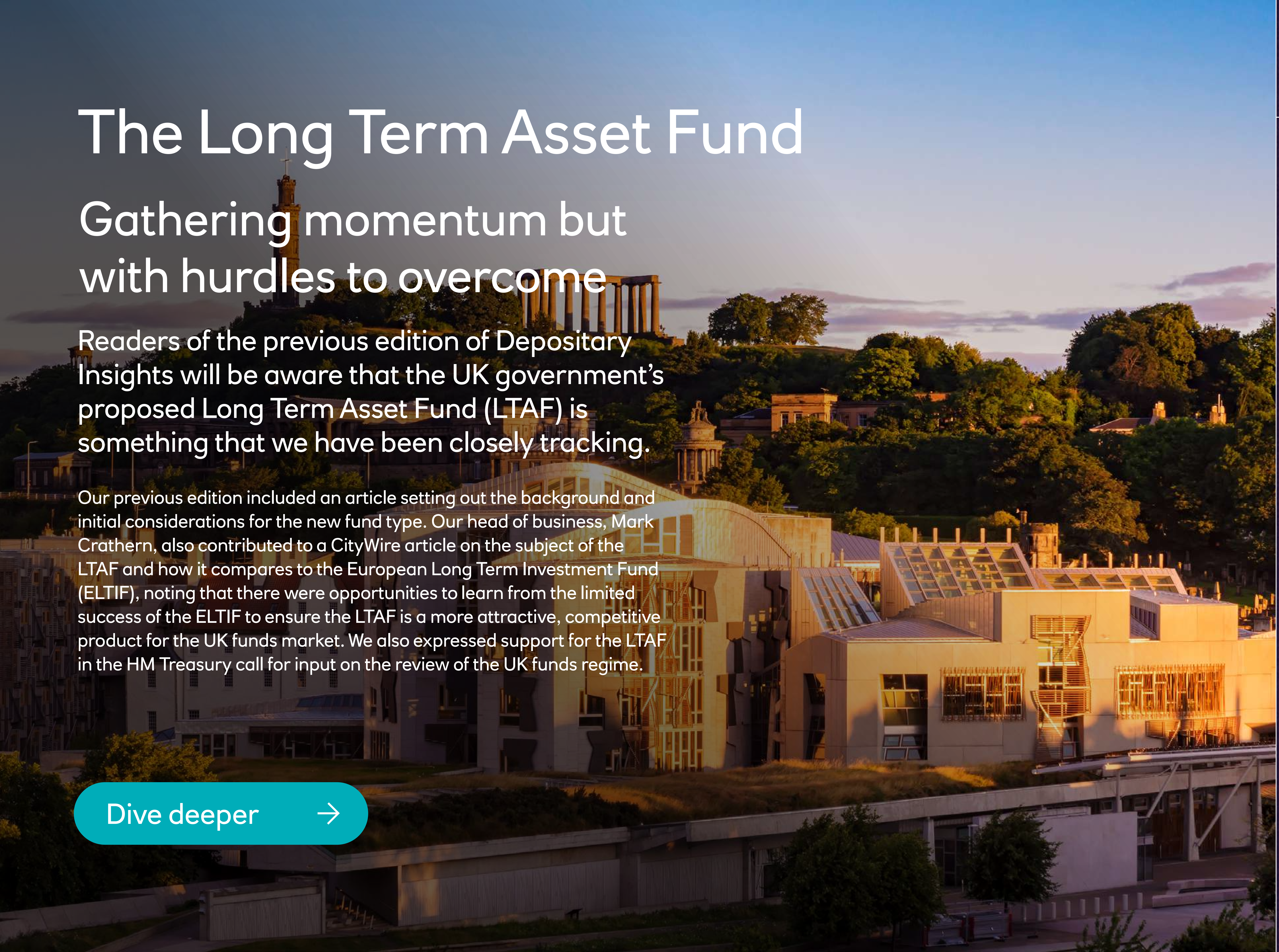

The Long Term Asset Fund

Gathering momentum but with hurdles to overcome

Readers of the previous edition of Depositary Insights will be aware that the UK government's proposed Long Term Asset Fund (LTAF) is something that we have been closely tracking.

Our previous edition included an article setting out the background and initial considerations for the new fund type. Our head of business, Mark Crathern, also contributed to a CityWire article on the subject of the LTAF and how it compares to the European Long Term Investment Fund (ELTIF), noting that there were opportunities to learn from the limited success of the ELTIF to ensure the LTAF is a more attractive, competitive product for the UK funds market. We also expressed support for the LTAF in the HM Treasury call for input on the review of the UK funds regime.

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The discussion gained momentum with the publication, on 07 May, of the FCA's consultation paper (CP21/12) on the LTAF. This was published on the same day as the FCA's Feedback Statement on liquidity mismatch in open-ended property funds, and as we noted in our previous article on this subject, the two go hand in hand from a policy perspective. It is significant that both the LTAF consultation paper and the liquidity mismatch feedback statement feature the proposal for 90-180 day notice periods.

While the liquidity mismatch proposals are likely to have up to a two year implementation period, the government has committed to have the LTAF up and running by the end of this year: the consultation paper has served to emphasise that the clock is ticking.

We had been closely monitoring the development of the policy from the very beginning, so we welcomed the opportunity to share our views on the proposals by responding to the consultation. In this article we will share the key points from our response.

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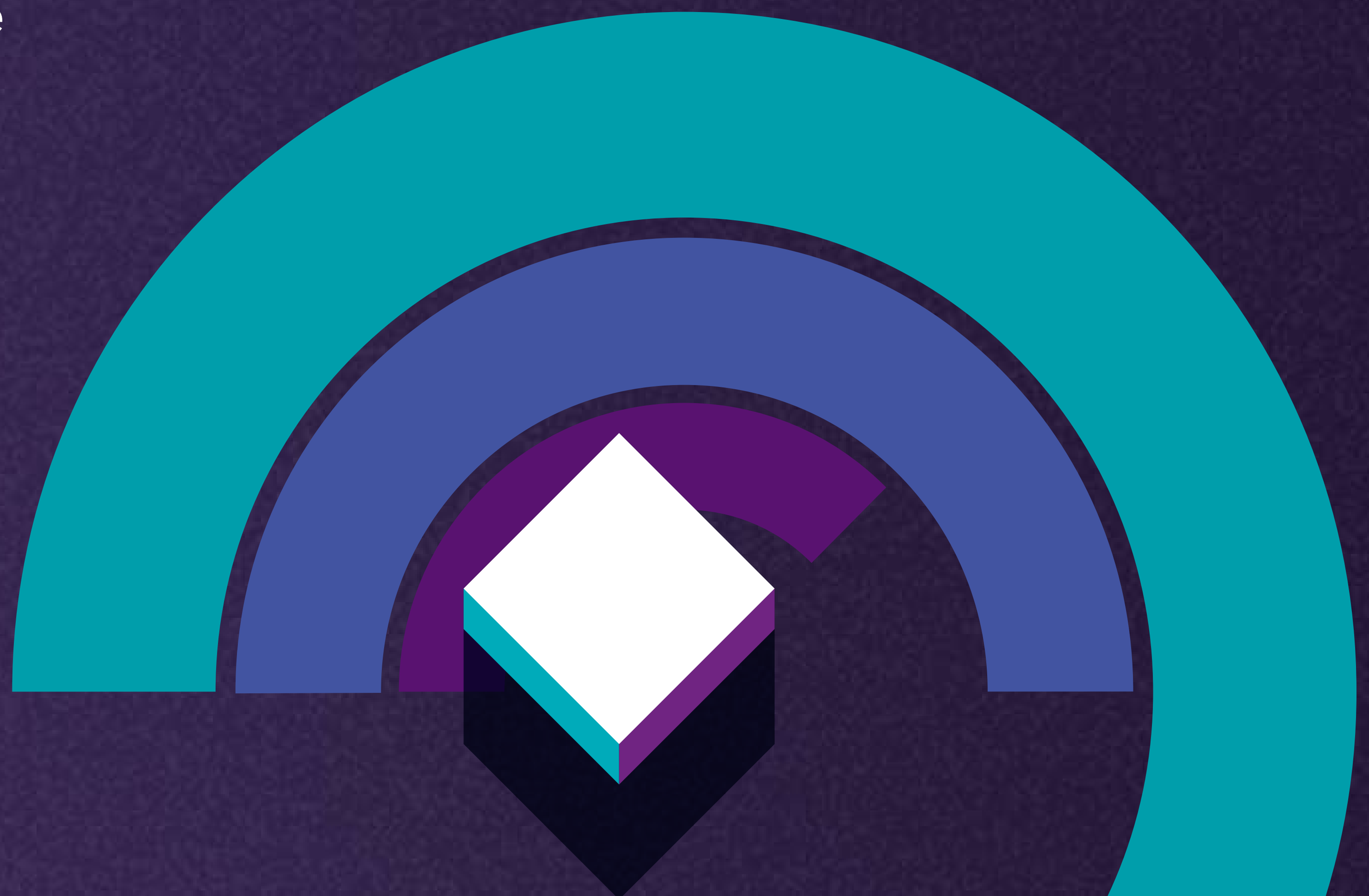
Although the LTAF has been on the radar for many months, it is worth briefly recapping its history and the key features of the proposals.

The concept of an LTAF was first mooted through HM Treasury's Asset Management Taskforce in June 2019. The basic idea was to create a new fund type to allow wider access to long-term investment in areas such as private equity, infrastructure and private debt. The proposals were accelerated when the Chancellor of the Exchequer announced, in November 2020, that the LTAF would be up and running by the end of 2021.

When the Consultation Paper was issued in May, the proposals were largely as expected, but with a number of interesting areas worthy of deeper consideration. At a high level, the FCA's proposals noted that the product would initially be targeted at direct contribution pension schemes, and would be treated as a Qualified Investor Scheme for distribution. The FCA suggested, however, that the LTAF may ultimately be expanded to a wider customer base. It will have its own chapter in the FCA Handbook and COLL rules, and will need to be managed by a full-scope AIFM. The FCA confirmed that LTAFs will not be daily-dealing. In terms of authorisation timeframes, the FCA noted that it wants authorisation processes to be "without undue delay" and going forward would consider a one-month authorisation period. The FCA also proposed that LTAFs should be able to borrow up to 30% of net assets, and that depositaries would be responsible for assessing the manager's competence to value the scheme's assets.

The consultation closed on 25 June. Given the relatively tight timeframe before implementation, we expect the next steps (feedback statements, policy statements, etc.) to appear later in Q3. However, there are things that firms can do to prepare, and as a depositary we have stood up a project to ensure we are prepared to serve LTAFs by the end of the year.



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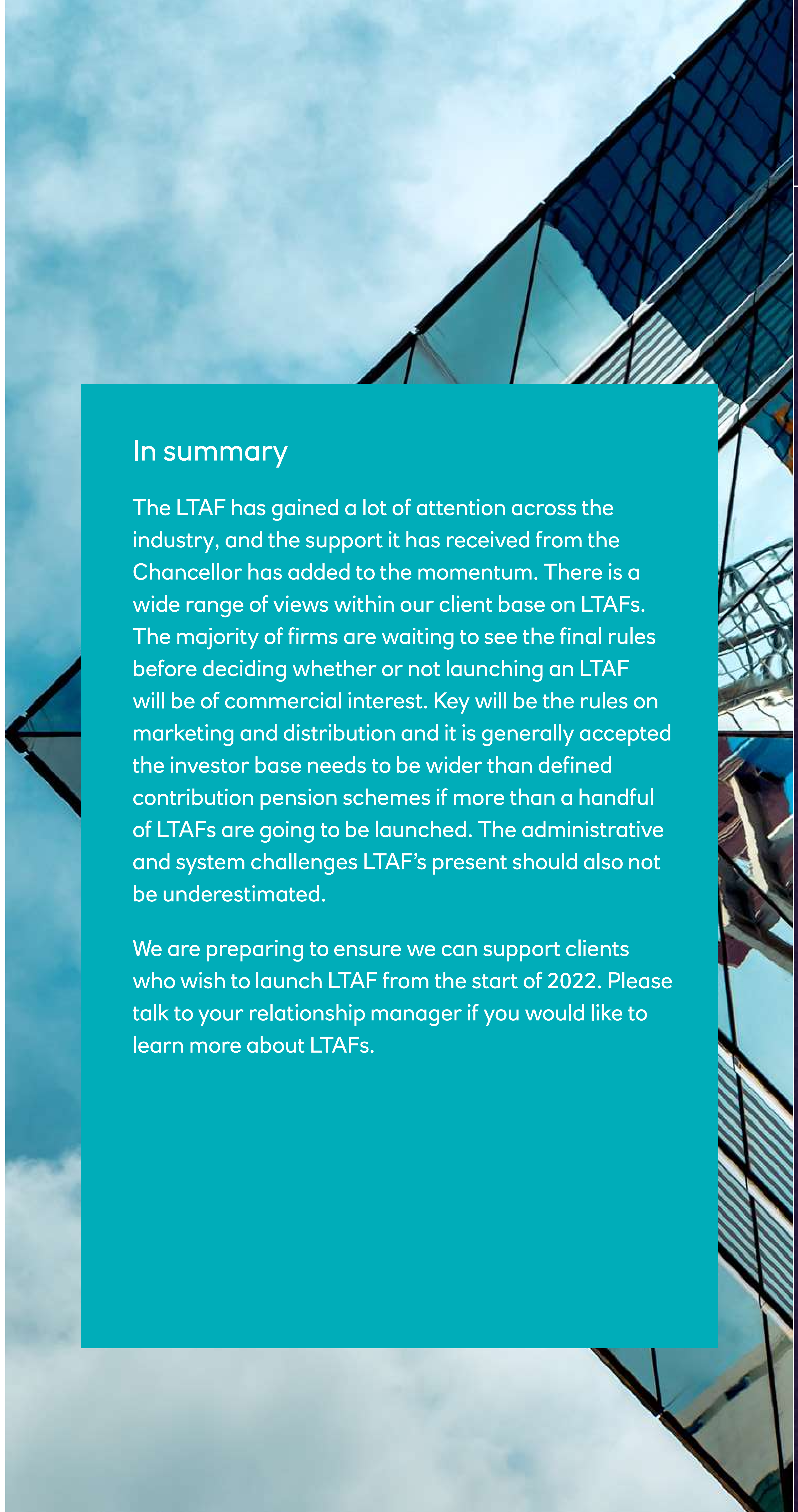
The NatWest Trustee and Depositary Services view

We welcomed the opportunity to respond to the consultation and to share our views. We have also drawn on insights from clients.

Our principle observations were as follows:

- We are **supportive of the LTAF,** allowing greater access to illiquid assets whilst providing high levels of investor protection and promoting the goals of economic growth and the transition to a low carbon economy.
- We support **restricting management of an LTAF** to firms that possess the knowledge, skills and experience necessary to understand the activities and associated risks of the LTAF and who are also **full-scope UK AIFMs.**
- A target market limited to defined contribution pension schemes may be too narrow to make the product **commercially attractive in the longer term.** We recommended **moving quickly** to expand the investor base as the risk is LTAFs will have limited commercial appeal as a fund type.
- We support LTAFs being **non-daily dealing funds** and of having a wider range of **liquidity tools,** including notice periods to manage the risks around liquidity mismatch.
- Whilst there is an investor protection benefit in registering LTAF assets with the depositary, there are also potential **legal, financial and reputational risks** and **operational complexities** associated with their management and as such we propose that the AIF's custodial assets be registered in the name of the LTAF or in the name of AFM acting for the LTAF, as permitted under FUND and AIFMD.
- We shared concerns about **proposals for a "without qualification" determination,** which would require depositaries to replicate the fund manager's asset valuation responsibilities. We argued that this could increase costs for depositaries and fund investors without increasing investor protection.
- We recognise the need for **strong governance** and note **depositaries** will have an important role to play, alongside the AFM Board, in ensuring investors are properly protected.



In summary

The LTAF has gained a lot of attention across the industry, and the support it has received from the Chancellor has added to the momentum. There is a wide range of views within our client base on LTAFs. The majority of firms are waiting to see the final rules before deciding whether or not launching an LTAF will be of commercial interest. Key will be the rules on marketing and distribution and it is generally accepted the investor base needs to be wider than defined contribution pension schemes if more than a handful of LTAFs are going to be launched. The administrative and system challenges LTAF's present should also not be underestimated.

We are preparing to ensure we can support clients who wish to launch LTAF from the start of 2022. Please talk to your relationship manager if you would like to learn more about LTAFs.

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The FCA has previously observed depositaries play an important role in preventing harm to investors in funds and the current impact of Covid-19 has made this responsibility more important than ever.

Over the past 14 months the FCA has reviewed how depositaries monitor and identify issues relating to an AFM, and the circumstances in which they would replace an AFM, to ensure a fund's governance and operations continue if the AFM is no longer able to act in its role as set out in COLL 6.5 of the FCA Handbook. The most likely scenario where a depositary may replace an AFM is as a result of insolvency.

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For a number of firms, including NatWest Trustee and Depository Services, the discussions led to the drafting of 'playbooks' which set out the people, processes and timeframes for stepping in, as well as the triggers for such a scenario.

In May the FCA issued a feedback letter to depositaries, setting out the overarching findings from its meetings over the past year, and providing recommendations for how to ensure processes and plans were robust enough to enable smooth stepping-in if required.

Key points from the FCA's feedback letter

There were a number of feedback points in the FCA's letter to depositaries, which indicate how the regulator expects procedures to evolve.

- In the letter, the FCA sets out the financial metrics that depositaries should monitor as part of the 'triggers' and indicators for acting under COLL 6.5. Triggers should be incorporated into governance processes and management information. While depositaries are not required to conduct ongoing financial monitoring of AFMs, they should be aware of any causes for concern and have a duty to inform the FCA in such a scenario.
- Emphasis is placed on the need for good governance practices including agile governance forums with clear decision makers and terms of reference. This includes having documented procedures (such as the 'playbook') which set out steps, stakeholders, scalability, timelines and how to operationalise these.
- Resourcing constraints and pressures should be understood, including potential reliance on third parties. Depositaries are expected to take steps to ensure third parties can act quickly when needed and that there are no conflicts of interest.
- Alternatives to suspension should also be considered – it should not be taken as the default response in all scenarios.

The FCA required depositaries to respond within 30 days of receipt of the letter.

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NatWest Trustee and Depositary Services view

NWTDS' senior leadership team reviewed the letter and responded setting out our next steps, with a focus on our key priorities of investor protection and strong governance.

Whilst we have a robust governance process in place in light of the detailed feedback, we will review client agreements and strengthen some provisions to enable us to improve our oversight of the AFM's financial health. We also committed to conduct a review of our playbook. We will be engaging with clients in H2 to talk through what this specifically means for you but if you have any questions then please contact your relationship manager.

In summary

The Covid-19 pandemic has led many across the industry to take a fresh look at their procedures, to gain assurance that they are robust. The discussions on COLL 6.5 are an example of how depositaries and the FCA are working together to ensure that the best interests of investors are enshrined within processes so that the focus is always on investor protection, strong governance and the stability of the market.

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On 26 January this year, HM Treasury issued a call for input on the future of the UK funds regime.

We provided initial analysis in the previous edition of Depositary Insights, and we also responded to the Treasury's paper. As we enter the second half of the year, more than six months after the end of the UK-EU implementation period which came after Brexit, it is a good time to reflect on the call for input and what the process might tell us about the future of the UK funds regime. We will also share our own thoughts on the proposals.

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The UK funds regime call for input was a key piece of post-Brexit regulatory engagement, and provided an early indication of the government's thinking on how the regime might look going forward. Its significance was increased in part by the fact that the deal agreed between the UK and the EU at the end of the implementation period contained little detail on the financial services sector, and the UK-EU Memorandum of Understanding on financial services regulatory cooperation also appears to be at a relatively high level, beyond a commitment to work together and to establish a UK-EU Financial Regulatory Forum.

Priorities that emerged from the call for input were therefore telling. A wide range of initiatives was consulted on across 38 questions, including speed to market for new funds, efficiencies that could be gained in the fund authorisation process, the branding of fund types, fund taxation, reform to structures such as Qualified Investor Schemes, the introduction of the Long Term Asset Fund, and how to grow skills and jobs across the UK. There were also overarching considerations in terms of how to make the UK a more globally competitive funds domicile.

The consultation closed on 20 April, with next steps expected later this year.

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NatWest Trustee and Depositary Services view

NWTDS responded to the consultation, considering our response through the lenses of investor protection and strong governance, which are core to our purpose. Our response focussed on themes such as how we can grow the UK as a global centre for funds; how we can enhance the 'shop front' of fund product types; our insights into the UK-wide nature of the industry; and the key role that ESG will play in terms of the future growth and competitiveness of the industry in the UK.

Growing the UK as a global funds centre

In our response we noted that whilst the UK is a global centre for investment management it ranks behind leading fund domiciles such as Ireland and Luxembourg, as evidenced by EFAMA's March 2021 Quarterly Statistical Release, which shows the UK is the fifth largest domicile for UCITS and AIF funds.

To prevent further investment fund outflows from the UK to Europe, we argued that the government's aim should be to promote the UK as an attractive location to domicile funds due to its high standards of governance and investor protection. This will require the government, industry and regulators to work together to create a dynamic UK funds regime, followed by clear promotion of the UK to send a strong message that the UK is 'open for business'.

The role of depositaries in marketing the UK as a global funds centre

We noted that the UK has a high global reputation for fund governance and investor protection, and that the depositary is a key part of this process. Arguably there is less awareness of the key role that the independent UK depositary plays in supporting the UK's international reputation, and so we noted that well-regulated UK depositaries provide a vital oversight function for UK funds, in the best interests of end investors, contributing to the UK's overall reputation for strong governance.

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Fund types and the UK's 'shop front'

We support the rebranding of the NURS regime as "UCITS Plus" or an equivalent label, as we feel that this better reflects its nature, and aligns with the popularity of the UCITS among retail investors. It is important to have an attractive and diverse 'shop front' of trusted fund types to support the international competitiveness of the regime.

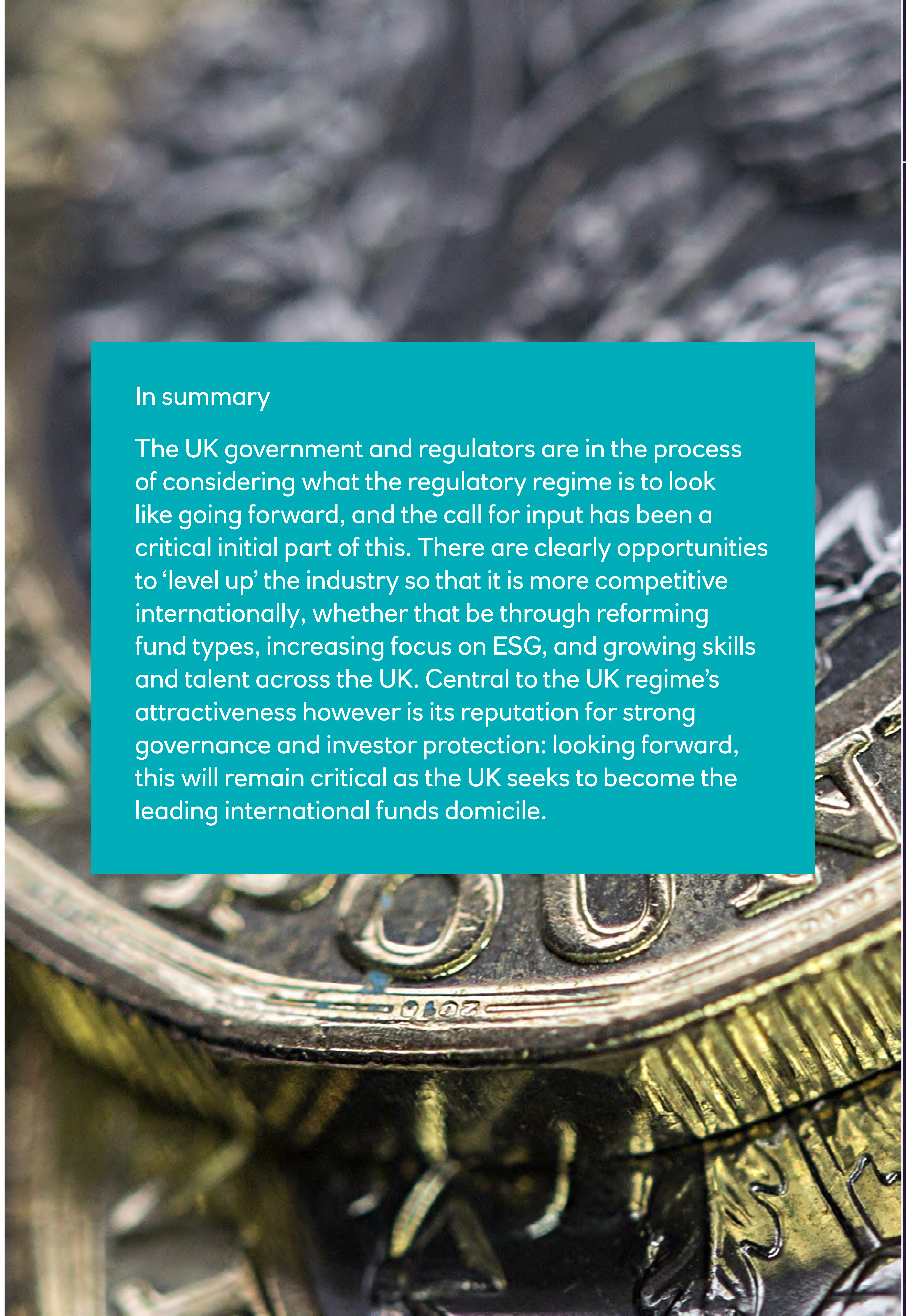
To meet the needs of domestic and international investors we therefore noted that the UK must enhance its existing fund range and introduce new fund structures such as the Long Term Asset Fund (LTAF) and the Onshore Professional Fund (OPF) regime to fill a gap in the UK fund regime.

A UK-wide industry

We consider the UK funds regime to be truly UK-wide, investing in jobs and skills across the country. As the industry as a whole looks to deliver value for end investors, we noted that locations beyond London and the South East are likely to grow and we argued that firms will benefit from government support to help achieve this. As a depositary with significant resources in both London and Edinburgh we are an example of an organisation investing in jobs and skills across the UK.

Seizing the opportunities of ESG

The UK has an opportunity to become a pre-eminent global centre for responsible and sustainable investment, responding to increasing demand from investors for products that deliver long-term value and patient capital. We see significant benefit in having an independent party with the right access to data, which already plays a significant role in the operation of the fund, providing oversight and verification of stated performance criteria, to support overarching fiduciary duties to investors.



In summary

The UK government and regulators are in the process of considering what the regulatory regime is to look like going forward, and the call for input has been a critical initial part of this. There are clearly opportunities to 'level up' the industry so that it is more competitive internationally, whether that be through reforming fund types, increasing focus on ESG, and growing skills and talent across the UK. Central to the UK regime's attractiveness however is its reputation for strong governance and investor protection: looking forward, this will remain critical as the UK seeks to become the leading international funds domicile.

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How UK and EU regulations are evolving in 2021

As we enter the second half of 2021, it is possible to detect a subtle change in the way that regulators in the UK and EU are approaching rule-making.

One set of rules is arguably more prescriptive, setting detailed requirements and expectations of firms, while the other is increasingly principles and outcomes based. While this could represent an example of how the two regimes are diverging post-Brexit, for many firms, especially those with activities in both jurisdictions, it also means there is a need for increased monitoring, to ensure alignment with both sets of rules.

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The picture from Europe

EU regulators continue to progress with regulatory reforms which set out detailed reporting expectations. The Sustainable Finance Disclosures Regulation (SFDR) is a key example; the Level 1 requirements were implemented on 10 March 2021. SFDR requires firms to describe the extent to which management of portfolios takes account of climate related risks, and to mitigate the risk of practices such as ‘greenwashing’.

The requirements under SFDR so far have been comprehensive, with detailed mandatory disclosures. Taken with the EU Taxonomy regulation, the EU has arguably taken a prescriptive approach to regulation, and the regulators have been quite specific and direct in terms of what is expected in terms of compliance. The view appears to be that detailed requirements enhance investor protection by requiring firms to be as specific and transparent as possible in their reporting.

How the UK is evolving

For some time now, UK regulators have indicated a move towards a more outcome-focused, principles-based regulatory regime, which looks rather different to the more prescriptive rules coming from Europe, but remains just as concerned with strong governance and investor protection. This is an example of how the UK regulatory regime is evolving to support the competitiveness of the UK market, post-Brexit.

In July 2020, for example, former interim chief executive of the FCA, Chris Woolard, set out the position view as follows:

> “What we need is outcome-based regulation… The Covid crisis and Brexit have only reinforced this need. We now have an opportunity to look again at our rulebook, focusing less on tick box compliance and more on promoting outcomes that serve the public interest.”[1]

This statement has been echoed by his successor in the role, Nikhil Rathi, who in a speech on 22 June 2021 noted that “we have to be agile… to build and operate an effective regulatory regime for the firms and consumers of the future”, to support competitive markets. In order to achieve this, the focus is on making the UK’s rules “more efficient and targeted”, and focussing on “high, internationally consistent and outcome-driven standards.”[2]

The message from the top is therefore that a shift in approach is underway.

1 https://www.fca.org.uk/news/speeches/role-investment-managers-post-covid-19-recovery

2 https://www.fca.org.uk/news/speeches/building-regulatory-environment-future

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Principles in practice

There are increasing examples of this more principles- and outcomes-based strategy taking shape. Arguably the Financial Reporting Council's UK 2020 Stewardship Code gave an early indication, with its twelve voluntary reporting principles for asset managers and asset owners, and the explicitly increased focus on outcomes.

Similarly, the FCA is working on a set of regulatory principles for ESG, building on a speech given by Richard Monks, FCA director of strategy on 22 November 2020, in which five "guiding principles" were set out – consistency in messaging; reflecting ESG focus in a product's objectives; setting out how a product's sustainability objectives will be met; ongoing reporting against sustainability objectives; and assurance of ESG data quality. Further work by the FCA is underway to develop these principles, with additional details expected later this year[3].

Aside from ESG, we saw another example of the UK moving away from EU regulatory requirements in the 2021 Financial Services Act. In a key amendment, the introduction of the "Key Information Document" (KID) for UK UCITS funds, which was with the onshored Packaged Retail and Insurance-based Investment Products regulation (PRIIPS) was delayed until the end of 2026 at the earliest. The proposed PRIIPS KID had received negative feedback from the UK funds industry for being too onerously prescriptive, and so its delay was a welcomed example of the UK move away from some of the more contentious aspects of EU regulation.

The challenges of the new reality

There are of course challenges in terms of navigating the new regime, particularly with ongoing uncertainty in terms of the final state of UK-EU regulatory relations. While the UK government has said that it wants to promote "globally consistent standards", the Memorandum of Understanding did not contain a commitment to equivalence.

This is something that Nikhil Rathi also acknowledged in his speech on 22 June:

> "the lack of mutual equivalence creates obvious market inefficiencies and results in increased costs for consumers both here and in the EU."[4]

This observation will be acknowledged by firms that are now required to monitor and align with different requirements for UK and EU markets, as a result of the lack of equivalence. Increased efficiencies in terms of UK regulation may be balanced by the increased demands of staying on top of the two diverging regimes.

The NatWest Trustee and Depositary Services view

As noted in our response to the HMT call for input on the review of the UK funds regime, we welcome moves to enhance the competitiveness of the UK funds regime.

Regardless of whether regulation is principles-based or more prescriptive, there is an increasing need for firms to utilise data analytics in order to conduct credible reporting and be transparent with regulators and end investors. It is a key objective of our transformation programme to enable investor transparency with close to real-time reporting.

For some firms, there is a need for increased monitoring of regulation and policy in order to ensure that developments in both the UK and the EU are fully captured and understood.

3 https://www.fca.org.uk/news/speeches/building-trust-sustainable-investments

4 https://www.fca.org.uk/news/speeches/building-regulatory-environment-future

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Cryptoassets and the funds industry in 2021

Much has been written about the ‘potential’ behind cryptoassets and associated technology such as distributed ledger technology (DLT): ‘crypto’ has captured the zeitgeist.

However, behind the headlines, there is still much foundational work to be done in terms of defining terms, scoping the opportunities, and balancing risks. All participants – from governments and regulators, to investors, fund managers and depositaries, are on something of a learning journey: the whole industry is trying to upskill – to seize competitive advantage and to avoid making costly mistakes.

As the momentum builds, it is worth taking stock of where we are now, and what might happen next, from a regulatory and policy perspective.

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Momentum and mainstreaming

In the past few years, cryptoassets have been making the move from niche to mainstream. This has been driven by a number of novel factors, such as the rise in FinTech apps, and a 'bull run' in the price of exchange tokens such as Bitcoin. Firms have also become increasingly aware of the potential efficiencies of blockchain, distributed ledger technology, and tokenisation.

For the funds industry, and its regulators, this is an inflection point at which the risks and opportunities are being carefully assessed. A number of firms have already started to move to compete in this space: some now boast dedicated blockchain units, intra-bank digital currencies, and cryptocustody services[5].

> While there are potential benefits, there are also significant uncertainties. These include price volatility, potential systemic risk, and concerns around money laundering and market manipulation. There is also something of a disconnect between understandable regulatory caution, firms' duty of care for consumers, and the more relaxed attitude of a sizeable number of retail investors: 47% say they actually bought cryptoassets as "a gamble that could make or lose money"[6].

The challenge of cryptoassets, and associate technology such as blockchain, is therefore not only one of education – simply understanding the key terms – but also one of navigating risks while acting on opportunities.

Cryptoassets have captured public attention, and firms are keen to tap in to consumer demand, where this can be done safely and in line with fiduciary responsibilities. The machinery of public policy is also moving at pace, and this will play a big part in setting the tone for "crypto" going forward.

5 https://www.jpmorgan.com/solutions/cib/news/digital-coin-payments

6 HM Treasury, UK Regulatory Approach to Cryptoassets and Stablecoins: Consultation and Call for Evidence, January 2021, Section 3.2, Page 13 (https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/950206/HM_Treasury_Cryptoasset_and_Stablecoin_consultation.pdf)

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For the UK government, crypto could become a competitive differentiator.

The UK government is in the process of firming up its own position on cryptoassets, which will ultimately set the 'tone from the top' for the funds industry as a whole. The Kalifa Review, published on 26 February 2021, set out a framework for how the UK can become a leading global cryptoasset centre, in terms of clearing, settlement, trading and exchange[7]. The report also emphasises the urgency of getting ahead in this space, concluding that "the time to act is now"[8].

On 26 April the Chancellor of the Exchequer welcomed and supported the review, including its proposals on digital finance[9].

The UK government has also sought to clarify the practical applications of all the innovation in this space: a consultation on cryptoassets and stablecoins was issued by HMT in January, and later in the year a consultation on DLT-based 'smart contracts' is expected. A taskforce on central bank digital currencies is also being established[10].

> This flurry of activity reflects a sense of urgency in terms of understanding the scale of the opportunity, and its practical, competitive, application.

For UK regulators, the task is to balance these opportunities with consumer protection.

UK regulators have already taken a series of actions on cryptoassets, with more to come. They have sought to deliver robust consumer protections whilst protecting financial stability.

Marketing cryptoderivatives to retail investors was banned by the FCA in October 2020[11]. UK regulators have also sought to clarify the regulatory perimeter, and have consulted on bringing a broader subset of cryptoassets under the FCA Financial Promotions Regime[12].

A key challenge for UK regulators has been to set standards that are robust enough to protect investors, while promoting growth and innovation.

No mean feat, but critical to get right as demand continues to grow.

7 Kalifa Review, February 2021, Page 30 (https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/965687/KalifaReviewofUKFintech.pdf)

8 Kalifa Review, February 2021, Page 13 (https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/965687/KalifaReviewofUKFintech.pdf)

9 https://hansard.parliament.uk/commons/2021-04-26/debates/2104271000009/KalifaReviewOfUKFintech

10 https://hansard.parliament.uk/commons/2021-04-26/debates/2104271000009/KalifaReviewOfUKFintech

11 https://www.fca.org.uk/news/press-releases/fca-bans-sale-crypto-derivatives-retail-consumers

12 HM Treasury, UK Regulatory Approach to Cryptoassets and Stablecoins: Consultation and Call for Evidence, January 2021, Section 1.23, Page 7 (https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/950206/HM_Treasury_Cryptoasset_and_Stablecoin_consultation.pdf)

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The view from Europe

European regulation has faced the same challenges as the UK, but with the added complexity of ensuring cross-EU regulatory alignment. On 24 September 2020 the Commission published its Markets in Cryptoassets (MiCA) proposal[13]. It aims to provide a harmonised approach to regulating cryptoassets across the EU, as there is no current cryptosupervisory regime at EU level – different jurisdictions have started to set up their own policies. It will be implemented by 2024.

Beyond Bitcoin

Some aspects of the cryptoassets zeitgeist have generated much more attention than others: there is wide awareness of cryptocurrencies such as Bitcoin and Ethereum, for example. However, for the funds industry, it may be that associated technologies such as DLT prove to be the most transformative, form an operational perspective.

DLT has been the most popular technology trialled within the FCA Sandbox[14], and the government's cryptoasset taskforce has said that it has the potential to deliver significant benefits in future[15].

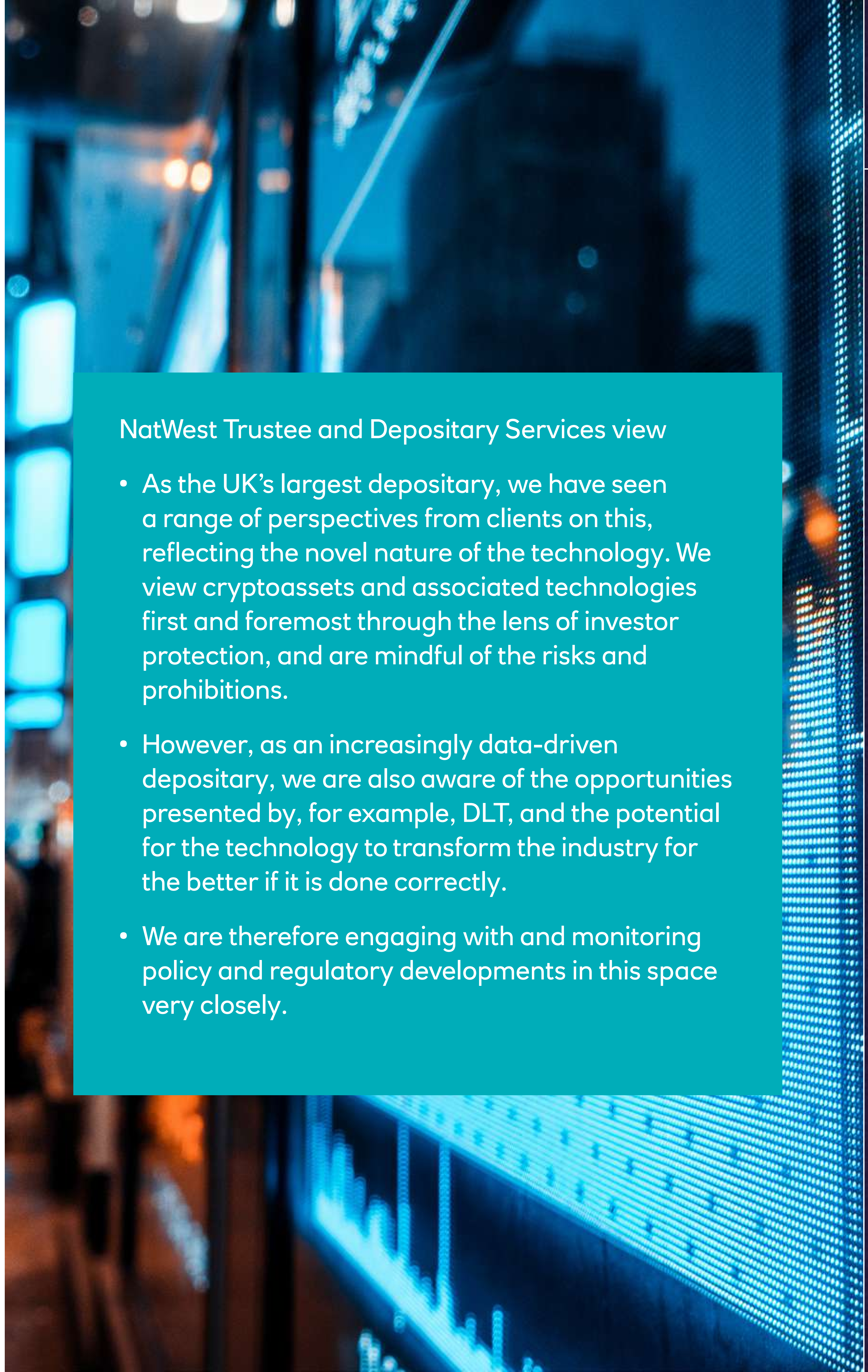
DLT enables a ledger or contract to be viewed and updated in real time by all parties to it (no single authority controls the network), presenting opportunities in terms of security and operational efficiency. DLT could facilitate accurate and time-stamped fund valuations, more stable trade settlement (with no single point of failure) and faster and more reliable AML and KYC monitoring, all of which would generate significant efficiencies.

While there has been much focus on the trading of cryptoassets (and their associated risks), firms are also increasingly experimenting with associated technologies like DLT, and these may prove just as transformational.

13 Markets in Cryptoassets, proposed regulation, 2020 (https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52020PC0593)

14 HM Treasury, UK Regulatory Approach to Cryptoassets and Stablecoins: Consultation and Call for Evidence, January 2021, Section 1.23, Page 8 (https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/950206/HM_Treasury_Cryptoasset_and_Stablecoin_consultation.pdf)

15 HM Treasury, UK Regulatory Approach to Cryptoassets and Stablecoins: Consultation and Call for Evidence, January 2021, Section 1.23, Page 2 (https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/950206/HM_Treasury_Cryptoasset_and_Stablecoin_consultation.pdf)



NatWest Trustee and Depository Services view

- As the UK's largest depository, we have seen a range of perspectives from clients on this, reflecting the novel nature of the technology. We view cryptoassets and associated technologies first and foremost through the lens of investor protection, and are mindful of the risks and prohibitions.
- However, as an increasingly data-driven depository, we are also aware of the opportunities presented by, for example, DLT, and the potential for the technology to transform the industry for the better if it is done correctly.
- We are therefore engaging with and monitoring policy and regulatory developments in this space very closely.

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The FCA recently announced that a planned consultation on the 'Direct2Fund model' had been postponed to later in 2021 at the earliest, due to the high volume of existing regulatory activity.

However, as the industry considers matters such as attractiveness of the domicile, efficiencies and investor protection, it is worth keeping the proposals in mind and on the radar. By the time the consultation is published, they may have become an even more timely and relevant remedy.

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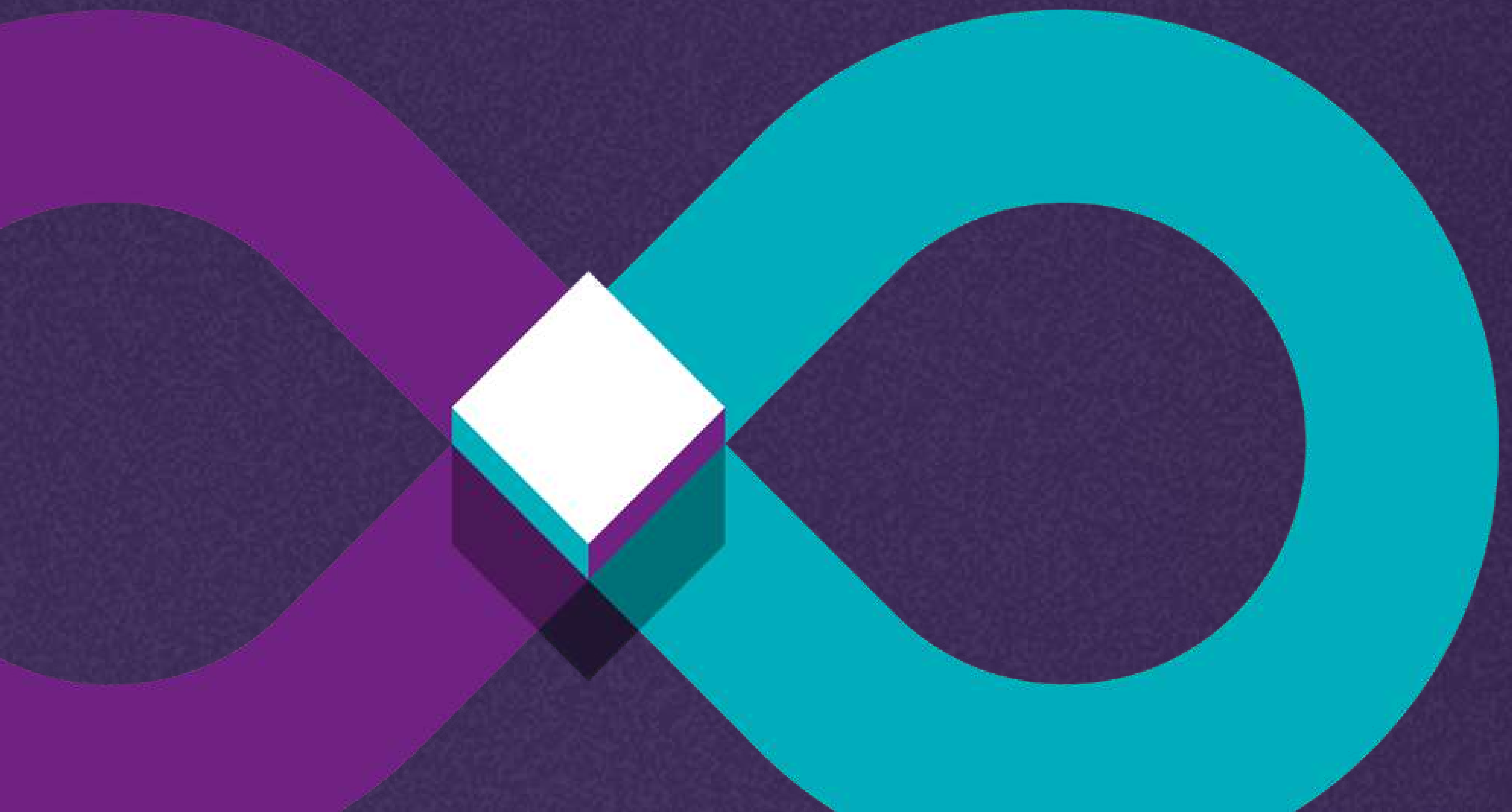
The Investment Association's (IA) Funds Regime Working Group first published its proposals for the 'Direct2Fund' (D2F) model back in June 2019. These came as part of a package of proposals aimed at enhancing the competitiveness of the UK funds industry, with an eye to the post-Brexit regulatory landscape. The model would enable end investors to transact directly with funds, removing the Authorised Fund Manager (AFM) as counterparty to the deal. This, the IA has argued, would bring with it a number of benefits and the proposal is gaining momentum with implications for AFMs, investors and depositaries.



The proposal

The traditional model in the UK at present is that the AFM acts as principal, and that the investor's cash, when invested in a fund, goes through the AFM's bank account. This can leave the investor at risk of losing money if the AFM encounters difficulties such as bankruptcy and presents a degree of systemic risk. The current model can prove burdensome from an administrative perspective, and is arguably also overly complicated: although the arrangements are set out in fund prospectuses investors may nevertheless be unaware that the AFM is performing this role. The current model is also something of an outlier internationally, with other jurisdictions following something closer to the Direct2Fund approach.

In the proposal, cash from the investor would go directly to the fund's issue and cancellations bank account. The AFM would then have the choice to act as agent or principal. Under the current system, the CASS rules help to mitigate credit risk from the consumer but the proposed model would essentially remove this risk. The risk of contagion or systemic risk would potentially also be better mitigated, as the bankruptcy of the AFM would not risk harming the end investor. In so doing, the Direct2Fund model has the potential to enhance the protections available to client cash. It is argued that this approach will help ensure the best outcomes for investors, businesses, the asset management industry, and the economy.

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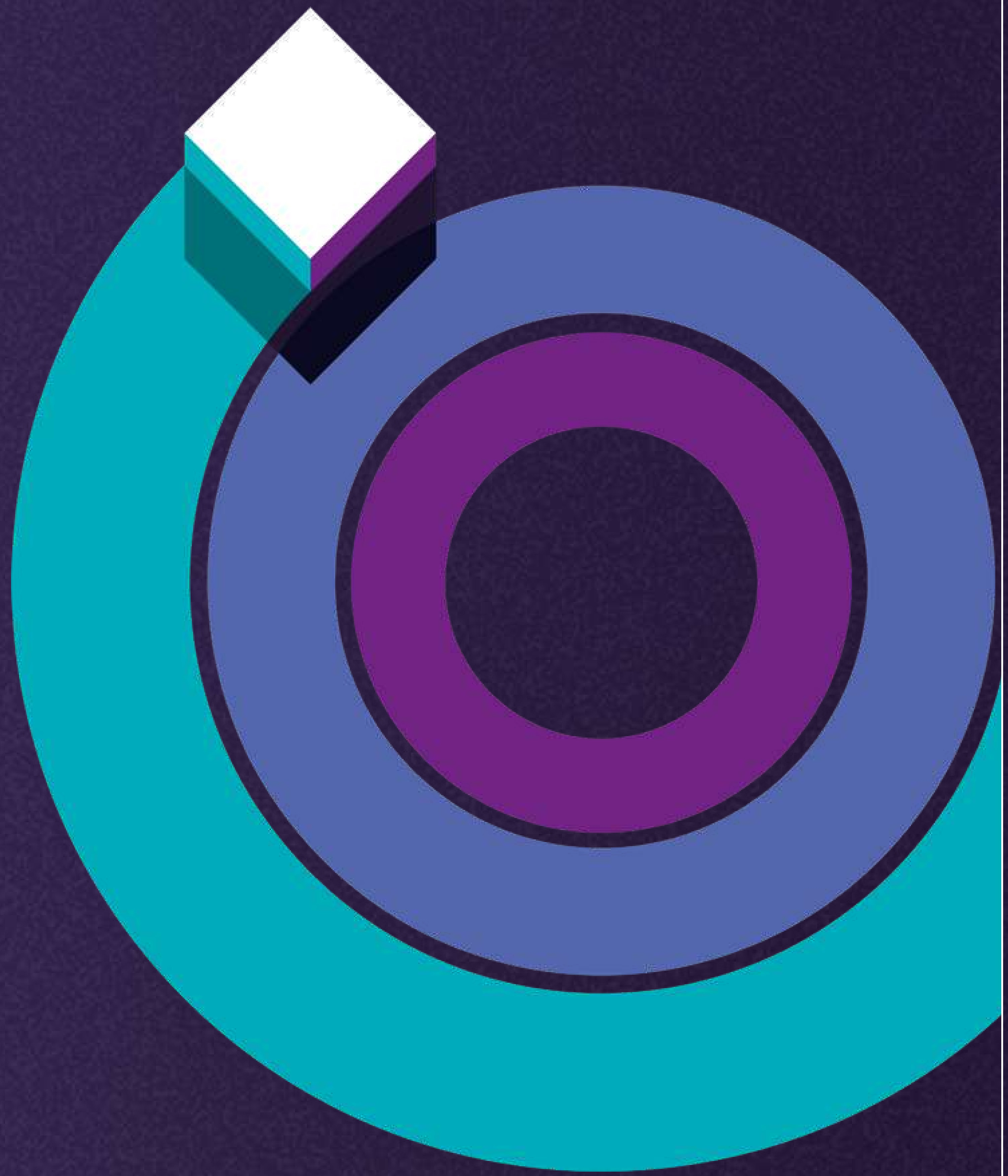

Benefits of the model

The simplified D2F model has additional benefits owing to its relatively uncomplicated nature. Its proponents argue that it reduces the administrative burden associated with the current system, thereby reducing the costs incurred by firms as they seek to comply. Reduced complexity has advantages for end investors as well: the IA argues that the simplified system will be more cost-effective and easier to understand.

Looking outwards, the Direct2Fund model has implications in terms of how the UK funds industry could be positioned internationally: bringing the UK model more in line with other jurisdictions, could further help simplify the system and reduce complexity.

There are a number of technical questions to be addressed as the D2F continues its journey from idea to reality. These were set out in a letter to the IA from the FCA on 07 December 2020, which the Association responded to in February 2021. These included questions relating to the assets and liabilities of sub-funds and collection accounts, and the segregation of assets within umbrella funds. The FCA also sought further details on the benefits and costs of the proposals and on the implications for preparation of regulatory reports.

There are also important considerations to be addressed in terms of the role of the depositary. This includes how depositaries will carry out their responsibilities in terms of COLL and FUND rules and how they will fulfil their cash monitoring duties.

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What are the next steps?

A likely roadmap has been shared by the IA which sees the first funds adopting the model in 2023.

However, there are a number of steps that will need to be taken to ensure that the full details of the model are fully thought through, and these have been pushed back somewhat by the FCA, noting the focus on other key initiatives. Interactions with existing regulation will also need to be considered in more detail to avoid issues such as duplication or creating overly burdensome requirements. For example, ISA rules will need to be reviewed by HMRC to ensure that they can support funds using the D2F model. HM Treasury meanwhile, will need to review OEIC regulations to ensure they are sufficient to enable the FCA to adopt the new rules.

A public consultation had been expected in 2021 with subsequent changes to rules expected in 2022. However, these targets may have been pushed back somewhat. The aim had been for the first funds adapted to the Direct2Fund model to be up and running in 2023.

While the changes the IA has proposed may appear to be a somewhat technical evolution of the plumbing of the funds industry, they should be seen within a broader strategic context. By creating a more streamlined and efficient model, its supporters hope to further enhance the competitiveness of the UK funds market. So while it has been pushed down the priority list for consultation – for now – the issues it seeks to address remain timely and relevant.

NatWest Trustee and Depositary Services view

- We support the proposals in principle, particularly when viewed through the lenses of investor protection and enhancing the competitiveness and efficiency of the UK as a funds domicile.
- We are engaging with the IA on the D2F model and await the publication of the consultation paper.
- We are speaking with clients in order to understand broader market sentiment and clients' views as to the benefits and potential challenges of implementing the model within the timeframe floated by the IA.

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