

Consumer Protection and the Role of the Depositary

Response to the White Paper, "Security in retirement: towards a new pensions system" prepared by the Depositary and Trustee Association (DATA), submitted to the Department for Work and Pensions

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INTRODUCTION

The Depositary and Trustee Association (DATA), welcomes this opportunity to respond to the White Paper, "Security in retirement: towards a new pensions system".

DATA supports the Government proposals to introduce a new, low-cost scheme of personal accounts for people currently without access to adequate pension savings. With around 10 million employees eligible it is essential that the highest standards of consumer protection are maintained involving compliance, safekeeping of individual's assets and appropriate oversight of the new scheme.

It is the view of DATA that whichever type of scheme or arrangement is ultimately selected 'a personal accounts scheme requires a robust governance and regulatory regime' (1.73 page 57 of White Paper). DATA aims to demonstrate that, drawing on existing experience from Depositaries' role in the financial sector, that the involvement of a Depositary readily enables transparency, compliance and will create enhanced consumer confidence.

In summary DATA believes that the Depositary is uniquely positioned to provide independent compliance regardless of which approach to delivery is taken forward.

In the UK savings market, the Depositary has held a pivotal role in providing independent governance and consumer protection. Depositaries are already regulated in the UK by the FSA and bring added benefits given they are subject to threshold tests covering fitness and properness, including integrity, competence and financial resources. While the primary purpose of this paper is to propose that a Depositary has an integral role to play in any selected retirement vehicle it is also worth pointing out that the Depositary will provide further benefit for the five tests of reform namely personal responsibility, fairness, simplicity, affordability and sustainability.

DATA is of the view that given existing Depositary fiduciary obligations to the consumer, a concept that has come down through trust law, CIS Regulations and FSA Principles, it is well positioned to offer enhanced consumer protection to the new savers. The Depositary has additionally demonstrated significant successes in consumer protection in the following areas:

- DATA has been operating successfully in maintaining stability in the collective investment scheme market for many years with responsibility for significant assets, currently £374 billion (July 2006).
- The well-publicised collapse of Barings is a useful example of the role of the Depositary and trustee. While other elements of the Barings collapse have received much publicity, the role of the trustee of the Baring unit trusts has not. It may be remembered that the initial news of the potential collapse occurred at a weekend and it was thought by many that Barings would be placed in Protective Administration very quickly. When a company is placed in administration, there is always concern as to which assets are those of the company (and therefore controlled by the Administrator) and further concern that other assets may be "blocked" by the Administrator until their ownership is established. In this case, the trustee was able to issue unequivocal assurance to unit holders of the Baring unit trusts that the assets were held by them, the trustee, and were freely tradable and would not be assets taken into administration. The statement in the national press given by the Depositary/trustee acted as an immediate reassurance to investors that their investment was safe. This was a most effective demonstration that the structure of segregation of investment management from Depositary or trusteeship is crucial to investor protection.
- No investor has ever suffered a financial loss due to the failure of a CIS operator.
- Market timing - the FSA found no evidence of late trading in the UK authorised CIS. This is due in large part to the industry framework and the important control function provided by the Depositary in UK funds.

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- The 11 September attacks on the UK showed the problems that physical disruption on such a scale brings for the financial system e.g. 4 day closure of the NYSE. In the UK it was evident that the financial system had procedures in place so that arrangements could be made to suspend dealing in CIS. The Depositary's role was to ensure that the suspension of dealing took place in the correct manner and in the interest of the existing unit holders.

Purpose of this paper

The intention of DATA in this paper is to provide you with information about the role of the Depositary in particular drawing your attention to the following:

- How does the Depositary achieve consumer protection?
- What is DATA?
- In what way is the Depositary suitable for any retirement or scheme savings vehicle?
- How does the Depositary meet the five tests for the reform package?
- What overall benefits will the Depositary bring?

How does the Depositary achieve consumer protection?

The duties of a Depositary fall under the following headings:

- **Consumer Protection** - to protect the interests of consumers
- **Compliance** - to oversee the activities of the manager of the scheme
- **Safekeeping** - to have custody of or control over scheme property

Consumer Protection

The Depositary protects consumers by carrying out its role in an interactive and proactive manner. This includes taking audit teams on on-site inspection visits and through day to day independent compliance monitoring and on-going oversight of the activities of the work conducted by those running the scheme.

Compliance

The Depositary is independent of the investment manager and oversees the activities of the manager on a day to day basis. This oversight by the Depositary incorporates (but is not exclusive to) the following:

- I) Monitoring the securities and other property purchased by the investment manager on at least a monthly basis to ensure that the scheme complies with the investment objectives and policies of the scheme plus the investment limits as set out by the FSA.
- II) Monitoring the process by which the investment manager values the scheme (and so protects investors by monitoring the price investors pay for units to ensure that the methodology and controls conform to FSA rules and best market practice).
- III) Monitoring the process by which an investment manager buys and sells units from the consumers, maintains the register of holders and pays income to consumers to ensure that the procedures and controls conform to FSA rules and best market practice.
- IV) Monitoring the investment manager's control and compliance environment generally to ensure that his dealings with the scheme property are fair to all the consumers.
- V) Should the Depositary identify any manner where an investment manager has not acted in accordance with the provisions in the scheme documents or FSA rules, the Depositary will require the manager to rectify the breach and pay compensation to the consumer if required.

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VI) The FSA rules also require the Depositary to make reports to the FSA, both on specific matters on a regular basis and in the event of a material breach of FSA rules.

Safekeeping

A Depositary is required to have custody of or legal control over all scheme property. Scheme property then becomes ring fenced for the benefit of the consumer in the event of default by one of the parties running the scheme. There has never been a loss of assets to investors in collective investment schemes arising from default of the scheme.

What is DATA?

The Depositary and Trustee Association (DATA) was formed in 1999. The members, who are authorised by the FSA, promote the role of trustees and depositaries in providing consumer protection to investors in authorised collective investment schemes (unit trusts and OEICs) in the UK.

There are 8 member firms who are responsible for the assets of 2005 authorised investment funds, representing £374 billion of funds under management (July 2006). These member firms are:-

- ABN AMRO Mellon Global Securities Services B.V.
- Bank of New York Trust and Depositary Company Limited
- Brown Brothers Harriman Investor Services Limited
- Citicorp Trustee Company Limited
- HSBC Bank plc
- J.P. Morgan Trustee & Depositary Company Limited
- The Royal Bank of Scotland plc
- State Street Trustees Limited

The key objectives of DATA include:

- To promote, support, oppose or propose changes in legislation or regulation of savings in the UK.
- To promote the support and development of the depositary & unit trust trustee in providing consumer protection.
- To promote, publish and undertake research. Increasingly DATA plays a significant part in setting best practice procedures as regulations move away from the traditional, prescriptive approach of regulation to a more risk based approach. This is achieved through:
 - DATA Executive Committee
 - DATA Technical Committee

The reputation and success of the Depositary in the financial arena has in part been due to the diversification and breadth of Depositaries who while operating in a competitive environment have retained the ability to work together as an industry to achieve significant levels of consumer protection. DATA strongly recommends avoiding single entity appointments in respect of the selected scheme in order to avoid the "Camelot" effect and to provide additional financial substance and capitalisation to further protect investors.

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In what way is the Depositary suitable to any retirement or scheme savings vehicle?

If the savings vehicle is to succeed and have a high participation rate, it needs to command the confidence of employers and employees over the long term. DATA believe that the participation of the Depositary with its corporate governance and compliance role will uphold this and Depositaries come to this environment with a significant track record within the collective investment scheme industry. The fact that the Depositary is required to independently have control of all the assets, together with ensuring that the fund manager operates according to compliance rules and regulations, adds another layer of protection for the investors. The role of the Depositary is unique in this context and its involvement in the pension reform model would add credibility, status and confidence to the entire proposition.

While the Depositary currently operates strictly within the legal structures inherent to collective investment schemes there can be no doubt that a Depositary could act equally in relation to any pensions, savings or investment product. The key role of the Depositary is to protect investors, provide consumer protection and ensure all other parties involved operate appropriately. This role can be achieved on any product or arrangement by:

- operation of law e.g. - unit trust or OEIC structures
- by contract - collectives, pensions models, life products
- by direction of NPSS board - by means of contract or SLA

With around 10 million employees being eligible for automatic enrolment into a personal account, the appropriate handling of the assets and cash on such a vast scale will be of paramount importance. The Depositary would be able to add value to whichever model chosen by operating to existing depositary protocols, for example by:

1. Initial Due Diligence - ensure best business protocols in place and proposed model has clearly defined responsibilities.

- To establish and oversee the operation of the SLA with relevant parties to the scheme - these are parties with which the Depositary already interacts.
- To agree a risk management process with each of the investment managers.

2. Ongoing Compliance/Consumer Protection Review

- Monitoring the investment restrictions in place with the investment managers.
- Should breaches occur, ensuring that the investors are not negatively impacted and that compensation is paid.
- Monitoring performance of custodians.
- Monitoring the pricing policy and activity for the scheme.
- Ensuring diversification of cash.

3. NPSS Board Reporting functionality - Depositaries are already operating in an environment where regular reporting and formal sign off is part of the role. This can easily be extended to provide the NPSS Board with straightforward assessment of compliance performance by all service providers to the scheme.

4. Capitalisation - Depositaries as a matter of course accept certain responsibilities and indeed potential financial liabilities as part of their role should there be a failure. The financial reserves and capital that Depositaries, as very significant financial institutions in their own right, bring to any scheme is of a level which gives additional credibility and sustainability should any compliance issues require some form of compensation.

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The reporting would include key measures on the operational performance of the Depositary and of appropriate third parties i.e. the administrator and the custodian. The Depositary performance information pack could include the following information:

Reporting to the NPSS Board	
Format of the Reports	Consumer Protection Activities
Depositary Review Scheme - Audits (Regular Reporting)	Audit completion reports Report & Accounts Statement of Compliance
Depositary Review Scheme - Reconciliations (Provision of multiple periodic statements)	Stock reconciliations Capital Cash reconciliations Income Cash reconciliations Units reconciliations Dividend reconciliations Withholding tax reconciliations
Depositary - Outstanding Queries (Provision of multiple periodic statements)	Outstanding Stock Differences Queries Outstanding Cash Reconciliation Queries Outstanding Dividend Reconciliation Queries Outstanding Dividend Reconciliation Queries Outstanding Withholding Tax Reconciliation Queries
Third Party Periodic Inspection Visit and Day to Day Auditing (All delivered by formal report)	Custody - Settlement Custody - Income Fund Accounting - Pricing Errors and Price Delivery Fund Accounting - Delivery of reconciliations, audit, stock, capital cash, income cash, dividend reconciliations, WHT reconciliations
Registration & Dealing Measures (Material Report notification)	Breaches/ Errors - Dealing settlement errors, negative box.
Compliance & Risk (Regular Reporting)	Formal Report on performance and exceptions and, fund, holding and investment manager level.

How does the Depositary meet the five tests for the reform package?

The government has set five tests for the reform package. It is DATA's view that whichever package is put in place the utilisation of a Depositary working to complement the role of the NPSS Board or equivalent will be beneficial to investors. The five tests are met in the following ways:

Promote personal responsibility:

- The consumer will be responsible for making the choice to either invest in the default fund, to invest in an alternative fund or should another package be selected choose the desired provider.
- The existence of the Depositary in any arrangement would give more financial and compliance credibility to the scheme and thus provide comfort to the consumer through safeguarding the assets and in turn overseeing the provision of appropriate consumer protection.

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Be fair:

- Providing independent Depositary review is designed specifically to be fair to investors. Universality of access for scheme participants to the best institutional investment management services, overseen by an independent Board supported by a Depositary, should assure fairness.
- The Depositary's role of oversight would be fundamental - e.g. overseeing pricing policy and thus ensuring consistent consumer protection.

Be simple:

- Simplicity is provided very easily through the involvement of a Depositary. This occurs given that by means of existing legal structures or single contractual arrangements, a Depositary can provide a long-term savings product additional levels of consumer protection.
- The industry will understand the role of the Depositary and the requirements that this will place on them.

Be affordable:

- The fees of the Depositary are very low. We would anticipate less than one basis point.

Be sustainable:

- Depositaries already exist, have detailed and refined compliance and consumer protection protocols and can readily apply their model to a multitude of products.
- Sustainability would be quickly evidenced simply by applying the existing combination of strong governance, public accountability and independence.

Summary and overall benefits

DATA is grateful to have been given an opportunity to respond to the White Paper. The Depositary (and Trustee) market in the UK has promoted and delivered significantly enhanced consumer protection for many years. It is the view of DATA that whichever scheme or model is selected a Depositary will provide very cost effective, transparent and sustainable independent compliance and consumer protection to investors. Further to this Depositaries provide participants in the scheme with additional comfort relative to non government supported capital adequacy matters and can already demonstrate an impressive track record in investor protection issues in the collective investment scheme industry. This would be delivered in such a way that it complements the work of other service provider participants in the scheme but ensures at all times that compliance and consumer protection matters are observed and delivered to the highest level.

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