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OPINION

Woodford scandal throws spotlight on role of depositary

VIEWPOINT

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A failure in the fund management industry has the power to thrust less known aspects of the investment world into the limelight. One example is the Woodford funds scandal, and the role performed by its depositary, Northern Trust.

The depositary has an important fiduciary oversight responsibility over the operations of a fund. It must act independently and safeguard the interests of investors.

Unlike an auditor, where a fund is typically subject to annual review with results published several months after its year end, the depositary conducts daily oversight of a fund throughout the year.

Despite its ringside seat monitoring the operations of a fund, the role and value of the depositary is not widely understood. It is often regarded as a compliance necessity rather than a pivotal part of the funds ecosystem.

Part of the problem lies with the options which funds face. Depositary is most commonly provided by banks or other service providers as part of a bundled package alongside banking, custody, and fund administration.

In this affiliated model, the costs of the depositary service can be a fraction of the overall revenue earned from the manager and fund relationship. Few firms provide depositary as a standalone, independent service. Most will only do so as part of a broader tied, business relationship.

There are clear conflicts of interest with this model. The most fundamental of which is whether the depositary will act independently in the interests of investors and escalate an error or issue it identifies in an affiliated business unit especially if doing so might jeopardise the broader, more material relationship.

There are notable parallels here with conflicts in the audit world where revenues from lucrative consulting services usually dwarf audit fees.

> Firms recognise that an independent service is integral to strong governance

Some fund management groups and fund directors insist on an independent model as they perceive it to be industry best practice. But more often than not, funds opt for the affiliated model.

Two regulatory developments may help change this. First, the FCA introduced rules on fund governance which require authorised fund managers in the UK to carry out value for money assessments. These detailed assessments will consider the value that funds deliver and require firms to assess the quality of service at their third party providers.

Second, the FCA's Senior Managers and Certification Regime comes into effect in less than a month. The FCA hopes SMCR will be a catalyst for positive change within the industry. Firms are reviewing all aspects of their operations and recognise that an independent depositary is integral to strong governance.

More emphasis should be placed on the depositary and ensuring that conflicts of interest are not allowed. The only effective way is for regulators to require stronger independence between the depositary and other providers.

In the case of the Woodford funds, one financial institution acted as depositary, fund administrator, custodian, bank and lender to the funds. There is no reason to suggest that conflicts contributed to the outcome, but the FCA inquiry will no doubt consider the role performed by the depositary.

If the inquiry highlights the importance of the role of depositary and leads to improvements in fund governance, then there may be long-term benefits for the fund management industry.

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