

Direct to fund

1 Introduction

In the UK the traditional fund dealing model operates with the Authorised Fund Manager (AFM) dealing as principal with investors and the investor's cash flowing through the AFM's bank accounts. The investor's credit risk to the AFM is mitigated through the operation of the FCA's CASS rules.

At an Investment Association (IA) Discussion Group in July 2016 an alternative model was discussed where the investor's cash was moved directly between the investor and the fund and the AFM was no longer operating as a principal in the trade. In early 2017 the IA's Investment Fund Operations Committee adopted this as one of their priorities and set up the Direct2Fund Working Group (D2FWG). The D2FWG was tasked with identifying any barriers to the introduction of this alternative model (known as the Direct2fund model) alongside the existing models operated for fund dealing.

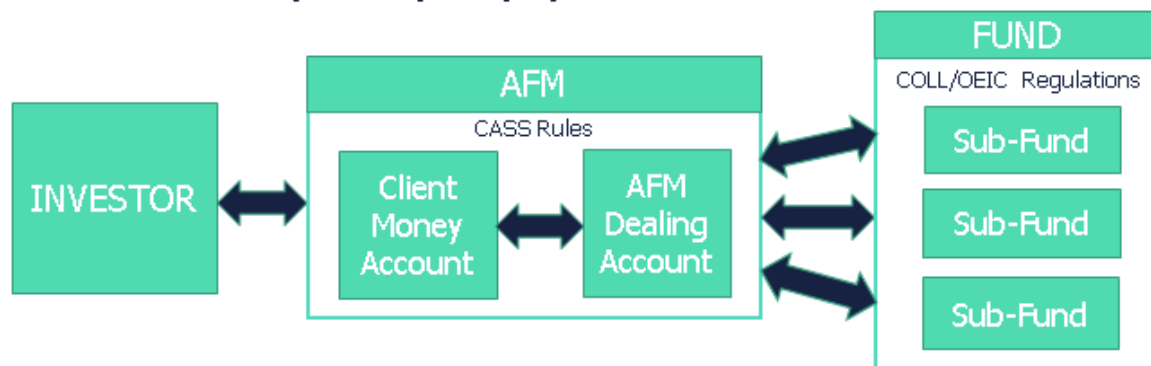
As part of their deliberations the D2FWG produced a high level operating model for Direct2fund and identified that some changes may be required in the COLL rules to operate it. The IA are now inviting the TA Forum to review this model in order to;

- Share the high level design with TA Forum members
- Consider the practicable aspects of the operating design of the model for the TA industry and to accept the proposed model as viable or identify a more viable alternative that also meets the requirements of the existing protected cell regulations.
- To identify areas where further detail is required by the TA industry
- To identify areas of where the proposed design may cause difficulty or unnecessary expense.

This paper sets out the high level operating design for Direct2Fund was constructed by the D2FWG.

2 Proposed Model (high level description)

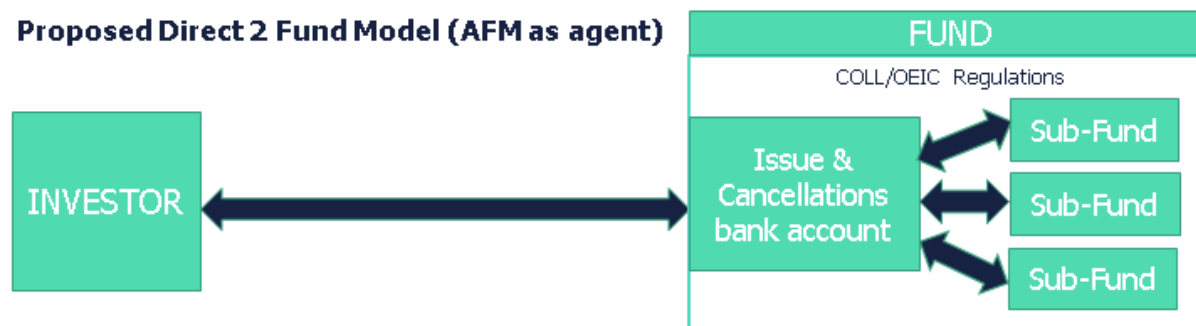
Traditional Model (AFM as principal)



In the traditional model the investor is exposed to credit risk from the AFM and mitigation of this risk is achieved via the CASS rules.

In the Direct2fund model the AFM would not receive investor cash from investor but instead the investor's cash goes directly to the fund where it is received into the Issue & Cancellations (IAC) bank account. In the Direct2fund model client protection is enhanced because the credit risk is eliminated (as opposed to mitigated).

Proposed Direct 2 Fund Model (AFM as agent)



Primarily the advantages of the Direct2fund model are:

- It would replicate the model operated in a number of non-UK financial centres
- It would preserve and enhance the competitiveness of the UK asset management industry and deliver best possible outcome for investors, businesses and the UK economy.
- It would enhance the protection of client assets

3 Protected cells & the IAC

The D2FWG's model was designed to meet the protected cell conditions as set out below.

- 3.1 COLL 3.2.6R 22A requires the Investment Company with Variable Capital (ICVC) Instrument to include a statement that the assets of a sub-fund belong exclusively to that sub-fund and shall not be used to discharge directly or indirectly the liabilities of, or claims against, any other person or body, including the umbrella or any other sub-fund, and shall not be available for any such purpose.
- 3.2 Where an Authorised Contractual Scheme (ACS) or Authorised Unit Trust (AUT) has an umbrella structure the D2FWG assumed that equivalent provisions to that contained in COLL 3.2.6R 22A for ICVCs would be necessary in the ACS contractual scheme documentation or the trust deed for an AUT.
- 3.3 In the model the nature of the IAC will be different depending on the legal structure of underlying fund. This is due to the fact that an ICVC has a legal personality whereas an ACS and AUT do not.
 - 3.3.1 For an ICVC – The IAC would be in the name of the ICVC Umbrella
 - 3.3.2 For an ACS or AUT the IAC would be in the name of Depositary/ Trustee re the ACS umbrella/unit trust

4 D2FWG's Direct2fund Model (Detailed description)

- 4.1 For the purposes of this document it is assumed that the IAC is one bank account. For operational reasons some AFMs may prefer to operate separate bank accounts for issues and cancellations.
- 4.2 The IAC will be operated by the AFM under the oversight of the Depository/ Trustee. The AFM may use the services of a third party to perform the daily activity.
- 4.3 The Direct2Fund model seeks to preserve the responsibilities of the AFM in all other aspects. The AFM would remain responsible for AML, managing cancellation rights processes, issuing contract notes, reporting and all general communications with investors. The AFM would remain be the primary interface with the investors.
- 4.4 The D2FWG believe that the existing regulatory permissions of Trustee/Depositories would permit them to operate in the manner described.
- 4.5 Investor subscriptions will be received directly into the IAC and payments will be made to investors directly from the IAC. For as long as cheques are necessary cheque payments will be made from and received into the IAC.
- 4.6 The AFM (or the TA as delegate of the AFM) would record each transaction and the associated cash payments relating to it at investor level. In the context of an umbrella fund, monies

would flow between the ICA and the custody cash accounts for the relevant sub-funds. The AFM would ensure through its record keeping and operational processes that cash received for shares in one sub-fund is only paid out to the custody account of that sub-fund i.e. it would not be possible for cash due to one sub-fund to be paid over to another sub-fund. Similarly, cash would have to be received from a sub-fund into the ICA in order to make a redemption payment in relation to shares in that sub-fund and it would not be possible to make this payment from cash received from another sub-fund.

- 4.7 **Subject to the conditions set out in section 5.1 below** payments will be made from the IAC to the sub-fund accounts in respect of the value of the shares issued in the sub-funds and will be received to the IAC from the sub-funds in respect of shares cancelled in the sub-funds. These payments and receipts would be made on the contractual settlement date. However it might be possible to make and receive these payments by sub-fund without the current aggregation (over the sub-funds) process typical today i.e. the payments to the sub-funds and from the sub-funds will be direct.
- 4.8 The AFM would provide an undertaking that the net asset value of the IAC is zero for each sub-fund. The effect of that undertaking being that the sub-fund IAC balance can be excluded from the pricing of the sub-fund. The IAC will be included in the financial statements of the fund vehicle.
- 4.9 The IAC will be out of scope of the CASS rules. However the balance on the account will be the same (or at least very

similar) to that if the AFM were to operate a Client money account. This statement merely reflects the fact that the AFM is no longer holding client assets and what was previously treated as client money is now held by the sub-fund in the IAC.

- 4.10 In some circumstances the operation of the IAC will require intra-day transfers to the sub-funds and to/from the AFM's proprietary account in order to meet the requirement stated in 5.1 below. The cash transfers performed by the AFM and required to operate the IAC (in order to maintain the balance described in 0) will be similar to the cash transfers required to maintain the required balance of a client money account in accordance with CASS. However, where the AFM is operating more than one umbrella structure the AFM will need to maintain an IAC for each umbrella structure.
- 4.11 In order to meet the requirement in 0 the AFM will be required to maintain a high degree of control of the cash movements into and out of the IAC. This would include, but is not limited to, the reconciliation of the IAC and maintaining a record of the investor/ sub-fund attribution of the balance on the IAC.
- 4.12 It is a fundamental requirement of 0 that any payment out of the IAC in respect of the issue of shares does not exceed the value of the investor subscriptions received into the IAC for the same sub-fund and valuation point. If the amount available for release from the IAC is less than the issue amount the AFM would be required to compensate the sub-fund for any interest loss.

- 4.13 In the event of the failure of a sub-fund any investor with a redemption balance in the IAC would rank as a general creditor of the sub-fund. A general creditor of an ICVC sub-fund would rank above holders of shares in the same sub fund (who would be shareholders).
- 4.14 In the event of failure of a sub-fund investors with a subscription balance held in the IAC would **not** be a general creditor of the fund since the cash is held in the IAC is in respect of the investor's obligation for the shares purchased (and the share purchase would have been performed prior to the sub-fund failure event).

5 Operating Requirement for the Issue & Cancellations bank account (IAC)

In order to meet the conditions for Protected Cell (see section 0 above) the balance for each sub-fund on the IAC should never be less than the value stated in 5.1 below.

5.1 The value of the subscriptions received from investors (see 5.1.1) where the associated payment to the sub fund is yet to be made plus

The value of the outstanding investor obligations from the sub-fund (see 5.1.2) plus

Any cash received to the IA where the records of the firm do not contain an attribution to both investor and sub-fund (see 5.1.3).

5.1.1 Subscriptions received from investors

This value will include any initial charge payable to the AFM until the associated payment has been made to the sub-fund for the issue of the shares. Arguably the value need not include the AFM's charge but the model will be easier to operate as suggested.

5.1.2 Investor obligations

This is the value that is due to the investor from a redemption trade where the associated cancellation payment from the sub-fund has been received to the IAC. For the avoidance of doubt this would include the value of outstanding cheques drawn on the IAC.

5.1.3 Attribution to both investor and sub-fund

This is a necessary condition to ensure that each sub fund can identify the assets of the IAC that are attributed to that sub-fund.