Direct2Fund Interim Update

August 2019

D2F Executive Summary

Simpler and cheaper to operate D2F model in isolation ✓ **ish (we are TAs afterall)**

A certain regulatory environment ✗

Widespread applicability ?

D2F Development & implementation costs ✗

D2F

- The desired outcome of Direct 2 Fund (D2F) is that client protection is enhanced by the elimination of the risk to client assets from the AFM's failure. This is achieved in D2F by ensuring that client assets are not routed through the AFM. Since the risk to client assets from the AFM's failure is eliminated there is no application of the rules that seek to protect clients from that risk i.e. CASS. For AFMs the attraction of D2F is that this enhanced client protection can be achieved without the cost and complexity that arises from the operation of the CASS rules. To the extent that the AFM's costs are borne ultimately by investors, the investors should receive greater protection at a lower cost. This result is possible due to the structural change in the business model operated. The CASS rules themselves do not change and would continue to be applicable for other business models as they are today.
- The TA Forum support the desired D2F outcome and the means of achieving it through the D2F model. We note that this "new" model is similar to business models operated outside of the UK and that many UK service providers support such models.

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- Whilst it may not be appropriate to require AFMs to implement the D2F (D2F) business model, achieving a meaningful increase in investor protection and the potential cost reduction will require widespread adoption of the D2F model. Impediments to the widespread adoption of the D2F model will limit the benefits. Simplistically if D2F is simply another business model operated by AFMs in addition to the existing traditional model the result may be an increase in costs and complexity (despite the best intentions and efforts of all involved).
- We have identified 5 such impediments to widespread adoption:

1. That the model provided is primarily suitable for ICVCs only
2. That the model provided requires an IAC bank account for each fund umbrella structure
3. The ISA regulations do not permit subscriptions direct to the ICVC
4. The cost of transferring to a D2F structure from the more traditional business model
5. Regulatory uncertainty arising from the lack of familiarity in the application and interpretation of the new model

- Successful implementation of D2F will require sufficient AFMs to be able to achieve the long-term cost reductions necessary to provide the business case to justify the cost of implementation and/or transition. The above impediments could prevent firms from adopting D2F.
- It is not within the scope of the TA Forum work to consider the legal difficulties of adopting D2F outside of ICVCs (item 1 in the list above). However the TA Forum has considered the impediments in 2 – 5 of the list above.

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- The remainder of this deck is structured around impediments 2 – 5:

2. The IAC at ICVC level
3. The ISA regulations
4. The cost of transferring to a D2F structure
5. Regulatory uncertainty

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D2F - Impediment 2 – The IAC at ICVC level - 1

- In the traditional AFM model, investor cash movements from all of the AFM's investor trading activity in all of the AFM's collective schemes can be amalgamated. This has advantages for both investors and AFMs.
  - For investors the advantages are that payments to/from the AFM can be amalgamated (including DD payments to the AFM)
  - For the AFM the advantages are that payments to an investor can be amalgamated and separate bank accounts are not required for each fund.
- This amalgamation avoids a significant cost and reduces the risk that an investor makes payment to the wrong bank account.
- As presented to the TA Forum, the IAC bank account is at the fund umbrella i.e. ICVC level. We acknowledge that this is significantly better than having the IAC at the sub fund level. However we also consider that this feature may be a major impediment to the widespread adoption of the D2F where the AFM operates more than one umbrella.

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D2F Impediment 2 – The IAC at ICVC level - 2

- Therefore, for existing AFMs with multiple umbrellas a transition to D2F would create a substantial disruption to payment flows upon implementation. Operating multiple accounts will result in the risk of investors sending money to the wrong account.
- Whilst separate IAC accounts may be necessary it is an unattractive feature of D2F (as presently presented). For AFMs it drives greater cost and complexity, while for investors it can result in a poor experience.
- The TA Forum believe that this will be a significant impediment to the adoption of the D2F model.
- Amalgamating umbrella structures to avoid the payments issue may be possible, yet appears a complex "nuclear" solution.

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D2F Impediment 2 – The IAC at ICVC level - 3

- While we cannot confidently identify a solution that will meet the needs of payment amalgamation we have identified some possibilities that we believe are worthy of further exploration and validation by IA.
  1. Joint Account. An IAC account could be established as a joint account owned by multiple umbrellas of the same AFM and Depositary.
  2. Nostro Accounts. The account names of the accounts held by the custody bank to be in the name of each umbrella (as proposed in the IA model) but a common Nostro account would provide the mechanism for payment amalgamation.
- **In addition to payment amalgamation whilst achieveing broad application the IAC will also need to support multiple payment methods e.g. Direct Debit payments and collections, cheque payments and receipts, Faster Payments**.

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D2F Impediment 2 - Direct Debits

1. A Direct Debit is an instruction from a customer to their bank or building society authorising an organisation to collect varying amounts from their account, as long as the customer has been given advance notice of the collection amounts and dates
2. The authorisation provided from the customer to the organisation to collect (as opposed to the authorisation from the customer to the bank to permit the debit) can where the CASS rules are otherwise applicable, fall within the definition of a mandate contained in CASS 8.
3. If the organisation that is provided with the authority to collect is an ICVC the CASS rules do not apply since CASS 1.2.3R confirms that CASS does not apply to an ICVC, a UCITS Qualifier, or an incoming EEA Firm.
4. This might seem an odd outcome since the risk to client assets from providing an authority to collect would appear the same irrespective of the nature of that collecting organisation. However it is also currently true that DD collections performed by, for example, energy supplies are not covered by CASS 8 because the business activity is not within the scope of application of CASS. The “odd” result for the D2F model result is therefore no less “odd” than other pre-existing precedents.
5. However, the result in 3 above depends on the application of CASS 1.2.3R and this might require a separate DD instruction for each ICVC. Any attempt to create a omnibus collection account in respect of a number of fund umbrella structures (as opposed to one) might question whether the collecting activity is actually by the ICVC and question the use of the exemption provided in CASS 1.2.3R.
6. The TA forum have separately written to the FCA to question whether there is in any event any purpose of CASS 8 in respect of DD collections since the presence of the DD guarantee provides far greater investor protection than the CASS 8 rules.

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D2F Impediment 3 – ISA Subscriptions

1. ISA Regulations require the ISA subscription to be made to the ISA Manager, and while an ICVC is FCA authorised an ICVC does not satisfy the requirements to become an ISA Manager itself.
2. Any AFM currently acting as ISA Manager could implement D2F in respect of main register holdings, but would need to treat ISA subscriptions as client money (if continuing to act as ISA Manager).
3. It was considered whether it would be viable to approach HMRC/HMT to proposed changes to the ISA Regulations and Guidance Notes in order to enable the ICVC to act as ISA Manager, or to enable the subscription of assets rather than cash. Subscription of assets would require the investor to perform a D2F subscription in the first instance, followed by an ISA subscription with the units purchased.
4. If the ICVC was to become ISA Manager it would seem to only be able to allow investment into itself (so reducing the potential range of funds available, compared with existing products). Also, units of the ICVC would be registered to itself.
5. Implementing a process by which the AFM could continue to be the ISA Manager but without handling cash raises different challenges. In addition to only permitting subscription of assets, withdrawals from the ISA would presumably also need to be made as asset transfers – and no cash income could be accepted. This would fundamentally change the ISA so that it acted as a shell into which 'accumulation only' assets would be re-registered in order to shield them from tax, with the investor first needing to buy the asset directly under D2F.
6. We therefore conclude that neither of these approaches can be recommended, given the current approach of an integrated product in which all the investor's actions take place.

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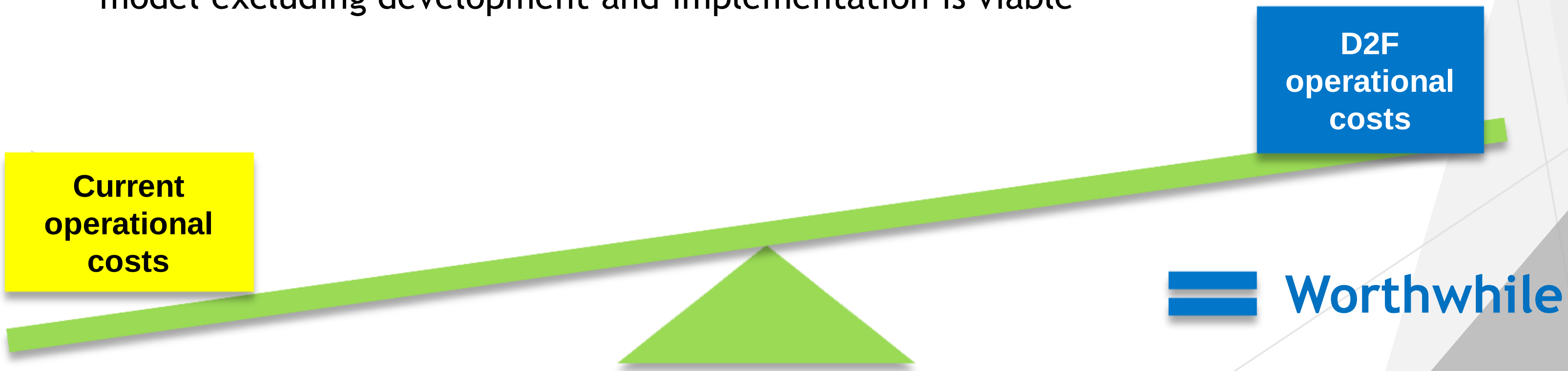
D2F Impediment 4 – Cost considerations

Whilst it is expected that the operating costs associated with a D2F model will be lower than those incurred under the CASS regime, there will be initial set up & ongoing costs that should be considered. These can be broadly categorised under the following :

1. Development/Build
2. Implementation – TA
3. Implementation – Other (AFM / Depo)
4. D2F - BAU operational costs
5. Run Off – operating a non D2F model, closure activities

- An initial assessment should be performed by Firms to ensure that the costs of operating a D2F model excluding development and implementation is viable



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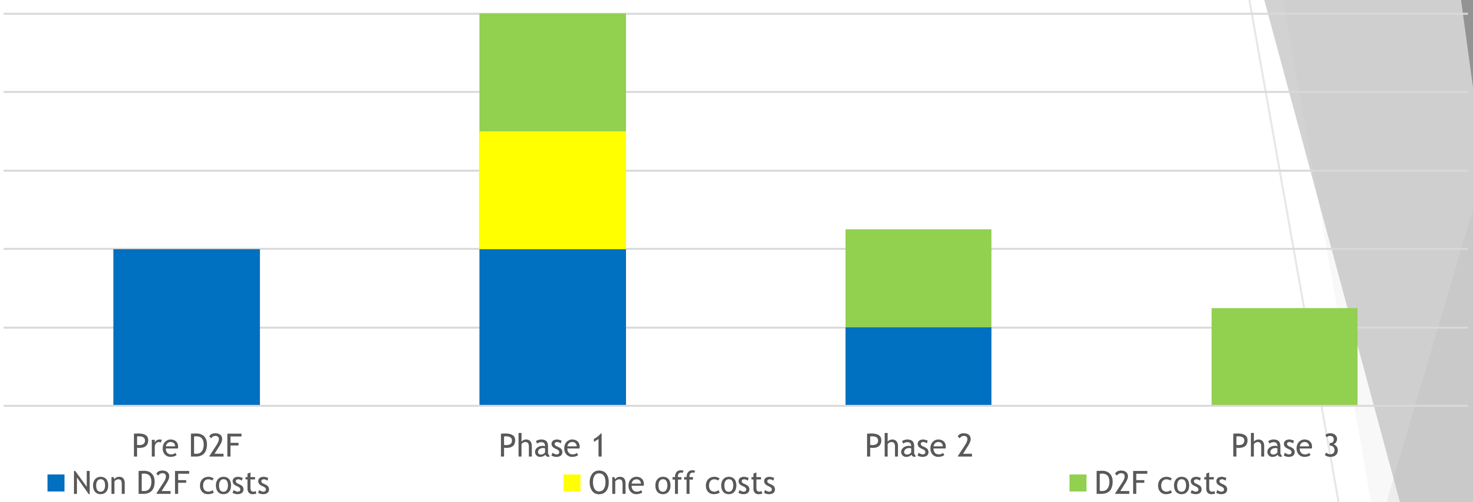
D2F Impediment 4 – Cost considerations



Current operational costs

Legal & service changes between AFM, Depositary and TA (3)

T&C changes and Investor communications (3)

Related investor mailings (2)

Transition activities e.g. inflight deals (2)

Functionality build (Including transaction types, GL Posting/configuration and cash movements, IAC access, monitoring and reconciliation) (1)

Standing data updates (2)

Training and procedural changes (2)

Operational costs of D2F (4)

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D2F Impediment 5 – Regulatory Uncertainty

- This model looks achievable from a limited review of the current COLL rules and OEIC regulations where no obvious obstacles have been identified. However, it should be considered that regulatory uncertainty arising from the lack of familiarity in the application and interpretation of the new D2F model may be a formidable barrier for initial adoption by AFMs.
- We believe that key considerations for AFMs would include:

1. Uncertainty whether the FCA will support the model and therefore there is a risk that changes could be made to the current rules (CASS and COLL) and regulations (OEIC) e.g. amendments to the rules regarding the treatment of preliminary charges that are due to the AFM in respect of investor activity.
2. It should be anticipated that we are unlikely to see firms leading the way in adopting the solution given potential nervousness in adopting a completely new and as yet untried model within the UK, as this would be a departure from the current CASS environment which has been prevalent throughout longstanding processes and procedures.
3. A business case could be complex and would need to be able to clearly articulate the requirements and benefits of the D2F model especially as there is no template to follow.
4. It is unclear what approach would be taken by the FRC with respect to this model and how it would fit alongside audits for standard CASS models.

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Important Information

This document has been compiled for the use of TA Forum members only and is for guidance purposes. This document has been written from the view point of TA's and the administration activities that they perform for regulated firms.

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