

THE  
INVESTMENT  
ASSOCIATION

# DIRECT2FUND

Proposals for an optional alternative to the principal fund dealing model

Update - March 2022



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## EXECUTIVE SUMMARY

The Investment Association (IA) along with its members has identified an optional alternative investor dealing model to the traditional model which is operated in the UK today. This ‘Direct2Fund’ (D2F) model would facilitate investors transacting directly with the desired fund and remove the Authorised Fund Manager (AFM) as a counterparty to the investor deal.

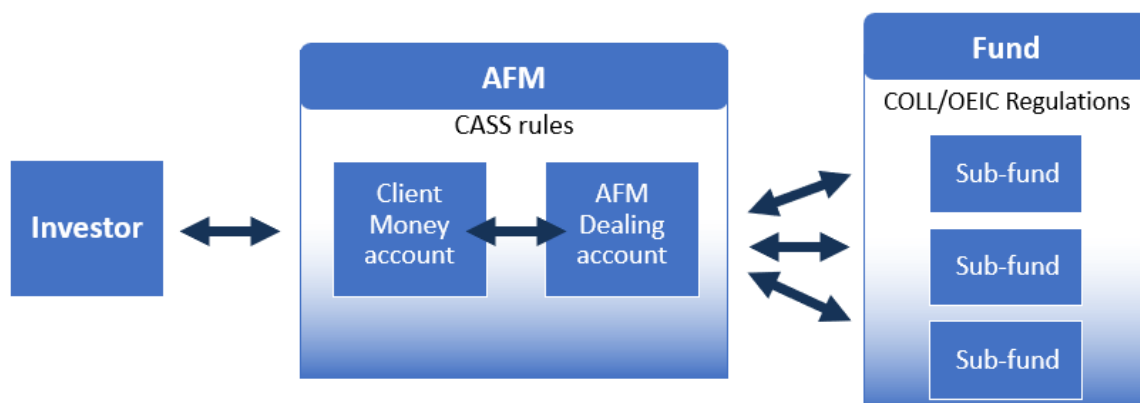
This alternative model, which would be optional for firms as part of the UK fund regime, would bolster the competitiveness of the UK investment fund industry and help to deliver the best possible outcome for investors, business and therefore the UK economy. The enhanced competitiveness arises from a replication of a well-respected model operated in a number of non-UK fund domiciles. Enhanced investor protection arises from the removal of the risk of loss to the investor’s cash assets arising from a failure of the AFM which, albeit low, does exist in the prevailing UK model.

This proposal originally formed a part of a wider set of initiatives from the IA-led UK Fund Regime Working Group, looking at the future shape of the UK fund environment post-Brexit<sup>1</sup> and was subsequently noted by Treasury<sup>2</sup> as something to be taken forward by the regulator and industry. Since then, IA work with members has further developed the proposals which are now presented in this updated document.

### Proposed Model

In the traditional model the investor’s cash flows through the AFM’s dealing account and the investor therefore has credit risk to the AFM. The credit risk to the investor is mitigated by the CASS rules.

### Traditional model (AFM as principal)

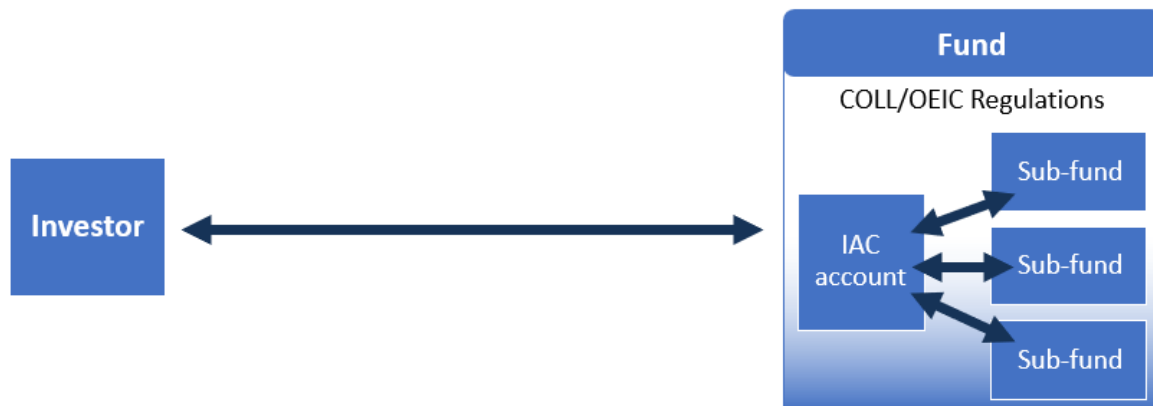


In the proposed model the investor’s cash goes directly to the fund and is received into an Issue & Cancellations bank account (IAC). The investor’s exposure to credit risk to the AFM is removed by taking the AFM out of the transaction.

<sup>1</sup> Investment Association: *IA UK Funds Regime working group - Final report to HM Treasury Asset Management Taskforce* June 2019

<sup>2</sup> HM Treasury: *Review of the UK funds regime: a call for input* January 2021

## Proposed Direct2Fund model (AFM as agent)



### BACKGROUND

As early as 2016 the IA and its members were investigating an alternative investor fund dealing model for UK funds. In the UK the traditional fund dealing model operates with the AFM dealing as principal with the investor's cash flowing through the AFM's bank accounts. This model differs significantly from the practice in other fund domiciles in Europe and the rest of the world where investors will typically transact directly with the fund itself. The traditional UK model exposes the investor to credit risk, albeit considered to be a low risk, as the settlement flows through the AFM's bank accounts. The FCA CASS rules mitigate but do not remove this risk.

Since then, an IA working group (WG), reporting into the Investment Fund Operations Committee, has been analysing in detail an alternative investor dealing model, known as the Direct2Fund model. The WG was made up of a representative group of fund managers, transfer agents, depositaries, auditors and lawyers. At different times, the proposals have been shared with other groups of transfer agents and depositaries, fund accounting firms, investment platforms and tech firms supporting the funds industry.

The WG concluded that there was a strong rationale for this alternative model, as it would:

- **Replicate** as much as possible the model operated in a number of **non-UK fund domiciles**;
- **Eliminate completely the small risk of loss** to the investor arising from a failure of the AFM;
- Bolster the **competitiveness of the UK investment management industry** and deliver the best possible outcome for investors, business and the UK economy.

With a viable model and the support of the fund management community, the IA UK Funds Regime Working Group recognised the advantages of the UK operating an alternative model and in particular the need, post-Brexit, to enhance the competitiveness of the UK as an investment fund domicile. D2F was therefore included in the Group's report to HM Treasury's Asset Management Taskforce. The report included a number of other measures, including new fund structures such as the Long-Term Asset Fund (now implemented), and taxation changes.

In late 2020 and early 2021, initial discussions with the FCA resulted in an exchange of letters going into further detail on the proposals. Since then, the IA with considerable assistance from several leading fund legal firms, have developed the proposals further and identified the extent of the impact on existing regulatory framework.

## PROPOSED MODEL

The WG has analysed in detail the broad considerations for operating a D2F model. This includes the operation of the bank accounts; interaction between the fund and the investor and the different roles and responsibilities of the AFM, fund and Depositary.

For ease we have named the account that will be used for cash payments relating to share or unit dealing transactions as the Issue and Cancellation bank account (IAC). The following describes some of the key points of consideration in operating this model:

- **Legal structure** – The nature of the IAC will be different depending on the legal structure of the underlying fund. This is due to the fact an Investment Company with Variable Capital (ICVC) has a legal personality whereas an Authorised Contractual Scheme (ACS) and Authorised Unit Trust (AUT) do not. For an ICVC, the IAC would be in the name of the ICVC Umbrella. For an ACS or AUT, the IAC would be in the name of ‘[depository/trustee] re [the ACS umbrella/unit trust]’. Unless it was an umbrella fund, a separate IAC will be required for each fund.
- **Operation of IACs** – Whilst the IAC would normally be expected to operate in respect of all the sub-funds contained in the umbrella structure, i.e. one IAC for all sub-funds, it would be for the AFM to determine the number of IACs operating in the umbrella and which IAC operated for each of the sub-funds. For example, the AFM may determine that certain characteristics of a sub-fund, such as one that was highly leveraged or open to investors who are less likely to settle on time may make it preferable to operate a separate IAC.
- **IAC Oversight** – The IAC would be operated by the AFM under the oversight of the Depositary. The AFM may use the services of a third party to perform the daily operational activities.
- **AFM Responsibilities** – The D2F 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 the primary interface with the investors and would make good the costs or expenses incurred by the fund arising from late or failed payment by an investor.
- **Investor payments** – Investor payments would be received and made directly into and out of the IAC (although there could be flexibility for an AFM to decide to create an additional account for certain purposes e.g. if redemption proceeds are being paid out by cheque).
- **Role of nominee** – In the event that a nominee or other secondary register is operating, e.g. an ISA Plan Manager, the nominee will be responsible for dealing with the payments and transactions of its own investors under existing arrangements. However, the interaction by the nominee with the fund itself can operate under D2F or the traditional model.
- **Cash transfers** – These would be made from the IAC to the sub-fund accounts in respect of the value of the units or shares issued in the sub-funds and would be received to the IAC from the sub-funds in respect of units or shares cancelled in the sub-funds. These payments and receipts would be made on the contractual settlement date.
- **Cashflow** – There is a risk that the IAC could go overdrawn, for example if an investor does not pay for units or shares by the contractual settlement date or if payments are made out of the IAC in error. The fund may be able to obtain a formal or informal credit line from its IAC bankers to cover this. In the case that it cannot, the AFM may need to provide temporary funding in some scenarios.
- **Attribution** – As an account of the fund, the IAC should be considered as ‘scheme property’. However, monies received into the IAC from clients for the issue of units or shares would need to be analysed and attributed to a sub-fund (via identification of the investor and their pending deal with the sub-fund). At the point that this attribution was made, that portion of money in the IAC would become part of the sub-fund’s scheme’s property. Monies that cannot be attributed immediately should be investigated and resolved promptly. This might require the funds to be returned to sender. Since money contained within the IAC is scheme property, once attributed to a sub-fund it would be included in the financial statements of the sub-fund.

## REGULATORY IMPLICATIONS

### Background

The D2F Legal Working Group has, since April 2021, provided further technical assistance from a legal perspective to the D2F WG. The Legal Working Group comprised experienced lawyers from a range of private practice law firms with established practices advising in relation to regulated funds.

The primary objectives of the Legal Working Group were:

- To validate the preliminary analysis undertaken relating to the feasibility of the D2F model and to undertake more detailed assessment to identify any legal or regulatory barriers to its adoption
- To support the IA's Direct2Fund Working Group in its discussions with the FCA
- To support the Direct2Fund Industry Guidance Working Group

### Overview of Work Programme

The Legal Working Group has met regularly since its inception. A high-level overview of the subject areas reviewed by the Legal Working Group in its work programme is shown below. The Legal Working Group has completed the majority of the original workplan and a number of follow up items. On reflection, whilst the vast majority of the original work plan has been completed, a few items have been deferred because the conclusions on those items will depend on the detailed D2F model that emerges, and it is preferable to undertake these items once the D2F model has been progressed with the FCA, the Industry Guidance Working Group has developed its proposals and the FCA's position in relation to the proposal more generally is known.

The work completed includes an initial review and validation of the earlier legal work relating to the D2F model, a review of the Financial Services and Markets Act 2000 provisions potentially relevant to the D2F model, a review of the OEIC Regulations and most of the chapters in the FCA's COLL and CASS Sourcebooks.

### Conclusions

In summary, the key points arising from the Legal Working Group are as follows:

- The D2F model has been validated as feasible from a legal perspective (assuming FCA is prepared to support the introduction of the model).
- No changes to primary legislation are required for D2F and no changes are required to the OEIC Regulations. The consensus is that the D2F model is compatible with the protected cell regime and with appropriate record keeping can be operated in a manner which is consistent with the segregation of assets and liabilities for each sub-fund.
- The detailed analysis of CASS revealed no impediments to the introduction of D2F, although it is not the case that CASS will cease to apply to AFMs entirely - there may be some circumstances, such as the mandate rules, where client money considerations are relevant.
- The detailed analysis of COLL has given rise to a number of further areas where rule changes or additional guidance would be required. A working log of these points has been maintained and this will be refined into a format suitable for sharing with FCA in due course.
  - We expect that there will be a specific rule relating to the D2F model should an AFM choose to adopt it, perhaps with relevant guidance applicable to the D2F model. For example, a specific provision setting out the allocation of responsibilities in the D2F Model as between the AFM and the Depositary, clarification of Depositary's responsibilities over the IAC and in relation to the operation of the D2F model, obligations on the AFM in relation to the operation of the IAC and the D2F model.
  - One key output from the COLL analysis is to recognise that the definition of scheme property covers all property of a fund and would include the IAC. Consequently, it is necessary to acknowledge that in some instances, for some particular rules, it will be appropriate to refer to the scheme property excluding balances in the IAC that are not attributed to a particular sub-fund.
  - It is also noted that overdrafts on the IAC could give rise to legal complexities, particularly in an insolvency situation. The Legal Working Group has analysed the likely outcomes of

various scenarios. In most situations it was considered likely to be possible to identify the dealing transaction(s) giving rise to the overdraft and then to attribute the overdraft liability to the relevant sub-fund(s) with the sub-fund having a corresponding claim against the investor for the payment of the subscription money. In the highly unlikely scenario that it was not possible to attribute the overdraft liability to specific sub-fund(s) the legal position is uncertain and untested but there is a risk that the overdraft liability would have to be attributed amongst all sub-funds.

- The Legal Working Group has considered the question of when title to units in a fund transfers and concluded, following the established position from original unit trust documentation and legal basis and practice, where an entry in the register was stated to be conclusive evidence of entitlement to units, and consistent with the current regulatory framework, that title transfers on T and that this is not conditional upon payment. This is the position in relation to both subscriptions into a fund and redemptions from a fund.
- Consideration has also been given to the possibility that there may be risks to the fund (and therefore investors in the fund) arising from the insolvency of the bank at which the IAC account is held. Whilst this is considered to be a highly unlikely situation to arise, it may be appropriate to ensure that there is disclosure of these risks.

### Next Steps

The Legal Working Group will continue to work with and support the D2F Working Group in its engagement with the FCA and will continue to liaise the Industry Guidance Working Group.

### High-level work programme

#### **1 Identification of legal risks of the D2F Model**

#### **2 Analysis of required changes to COLL**

- 2.1 Validating current analysis (focussed on dealing provisions) of minimum required FCA rule changes in COLL
- 2.2 Analysis of valuation rules
- 2.3 Analysis of definition of scheme property, implications of including IAC
- 2.3 (b) Analysis of usage of 'scheme property', at chapter level re: implications of including entirety of IAC
- 2.4 Analysis of COLL rules relating to depositary functions and responsibilities
- 2.5 Analysis of implications for borrowing powers and restrictions on use of scheme property
- 2.6 Analysis of COLL rules on winding up
- 2.7 Analysis of COLL /OEIC Regs provisions relating to the register and transfer (Link to 4)
- 2.8 Analysis of COLL 3 – content of constitutional documentation (Link to 7)
- 2.9 Analysis of COLL 4 – prospectus requirements and reports to investors (Link to 7) (To include transition from current model to D2F & 'significant' / 'fundamental' change)
- 2.10 Review of use within COLL of the terms 'issue' and 'cancellation'
- 2.11 [Further to 2.4] Analysis of OEIC Regs & FSMA provisions relating to depositary functions and responsibilities
- 2.12 Analysis of COLL 15 - LTAFs

#### **3 Analysis of Implications of the Segregated Liability Principle**

- 3.1 OEICs – OEIC Regulations – are amendments required?
- 3.2 AUT - Trust Deeds – assess implications – consistency with trust principles; Trust Deed modifications?
- 3.3 ACS Constitution – assess implications – modifications?

#### **4 Title transfer**

- 4.1 Validation of assessment of rules framework for transfer
- 4.2 Do we need to clarify when title transfers?
- 4.3 Implications of proposed Model 1 – title transfer on T at point when contract exists
- 4.4 Implications for OEIC Regulations, particularly Sch 4

#### **5 Analysis of position on insolvency**

#### **6 Assessing CASS Implications**

- 6.1 Any CASS issues?

- 6.2 Will D2F require any CASS rule changes?
- 7 Development of Model clauses for scheme documents
- 8 Assessing Implementation Impact
- 9 OEIC Regulations
  - 9.1 Thoroughness of references to issue and cancellation within the OEIC Regulations
  - 9.2 Scheme property references within the OEIC Regulations

## POTENTIAL BENEFITS

The introduction of D2F will be optional and we expect that its take-up will be incremental. While the investor-facing benefits may be realised upon implementation, any significant or material cost reductions for firms would take more time to be realised. However, over time, and mainly as a result of the reduced impact of client assets rules, we anticipate that some operating costs, regulatory capital requirements and PII cover would reduce.

The following wider benefits have been identified:

- **Lower investor credit risk** – under the existing model investors are subject to credit risk to the AFM, whereby the bankruptcy of the AFM may lead to financial loss for a subscribing or redeeming investor. The application of Client Money rules for the AFM of funds aims to partially limit those risks; the effectiveness of such risk reduction being dependent on the continued adherence of the rules. Under D2F, redeeming investors are subject only to credit risk to the fund from which they are redeeming and potentially the risk of the bank at which the IAC account is held defaulting. The likelihood of a bank or fund insolvency, especially UCITS funds, is minimal in comparison to AFM bankruptcy risk.
- **Improved investor understanding** – although the role of the AFM as Principal in fund subscriptions and fund redemptions is set out in the prospectus of funds, it is understandable that some investors may not be fully aware of the AFM performing this role. A D2F model is more representative of likely investor understanding than the Principal model.
- **Enhanced UK industry competitiveness** – the existing model is largely unique to the UK. Given its increased administrative burden, heightened regulatory risk through CASS application and higher AFM capital requirements for unexpected provision of fund liquidity, the UK industry is currently at a competitive disadvantage.
- **Reduced potential for contagion risk** – under D2F the insolvency of an AFM, whilst requiring the depositary to identify and appoint a replacement AFM, would not cause direct financial loss to investors. Under the Principal model, investors in the process of transacting face immediate financial loss risk, resulting the potential risk of wider contagion (e.g. directly, if an investor is selling one fund to purchase another or indirectly, through loss of confidence in the financial viability of asset management).
- **Regulatory cost** – reduced for AFMs as elements of the CASS sourcebook would no longer apply to the day to day dealing functions, and for the FCA through reduced oversight scope.





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