

DEMATERIALIZED MUTUAL FUND SALES AGREEMENTS

Mutual fund sales agreements and the associated commissions processing activities are some of the least standardised and automated aspects of the world-wide fund industry. It's a commonly-held view that there is little possibility for improvement. This paper argues otherwise, and shows how the development of open standards could be achieved with no loss of flexibility or competitive potential.

CURRENT PRACTICE

In today's mutual fund industry, fund sales agreements are very often customised documents. They are individually written by lawyers using word-processors, printed onto paper and signed with ink by each party. When firms talk about «standardisation» as a means to avoid the expense and delay of the customised process, they invariably mean using their own standard form of an agreement. That is clearly not equivalent to an industry standard as every firm of significant size, whether on the sell-side or the buy-side, has developed its own «standard» fund sales agreement. The first step to contracting most agreements is therefore a «battle of forms», in which the parties involved decide whose preferred form they will use as the basis for their agree-

ment and how much modification will be necessary to make it acceptable to both sides.

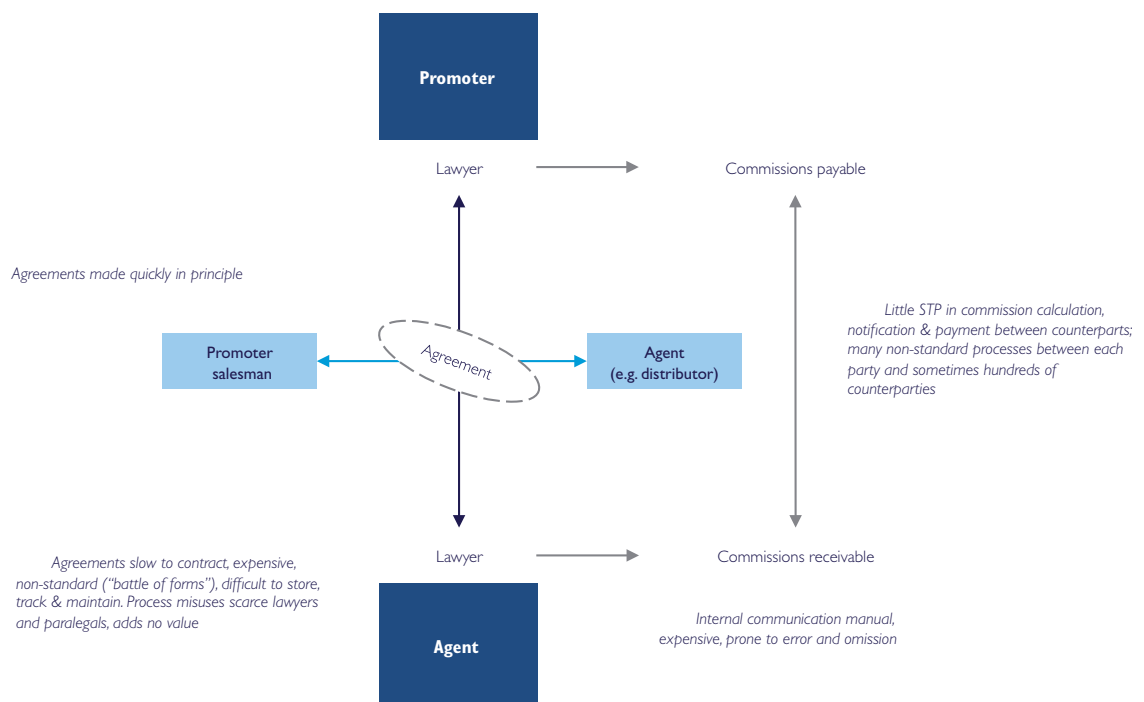
This is essentially a zero-sum effort: each party reviews /negotiates the other's agreement(s) to ensure that the other's preferred form is acceptable to it. However this work rarely achieves more than ensure that the agreement is reasonable from the perspective of both parties and that it conforms to some basic legal principles, which are commonplace in the mutual fund industry throughout the world.

This practice presents the fund industry with several problems (see also *Figure 1* below):

Expense

Fund sales agreements are expensive to implement because they need lawyers or paralegals to draft them and each amendment must be explained, considered and debated, often in writing between the

Figure 1: current practice - paper, ink, expense and delay



parties, before it is accepted. For what are often not much more than a collection of commonplace legal principles committed to paper, such agreements are poor value for money, and firms should be able to contract a satisfactory agreement at a much lower cost.

Misuse of legal resource

There is a shortage of legal skills within the mutual fund industry and time spent on fund sales agreements cannot be spent on higher value professional work, such as the design of new products.

Constraint on growth

There are limits to the legal resources that firms can employ on fund sales agreements, which constrains their ability to build and maintain distribution networks. Consequently, distribution networks are smaller than they otherwise could be and are not easily maintained as the promoter develops its product range (in fact, few distribution networks are maintained as actively as they ought to be). In effect, neither the promoter nor the distributor can realise the full economic potential of the distribution network.

Poor communication

Precedent agreements do not always ensure or enable the complete and accurate transfer of information between sales representatives, lawyers, commission calculation agents, transfer agents

and other service providers. This means that the terms of business provided for in the finished agreement might only be an approximation of what the sales representatives agreed and, notwithstanding any omission or transcription error that might arise as the agreement is implemented in the back office, often contain insufficient information for the commission calculation agent and transfer agent to allow for clear interpretation and implementation of the agreement.

No support for automation

Because no standard description of fund sales agreements exists, there is little opportunity for straight-through processing within the order-routing and commission calculation processes, and little prospect of improving the speed and accuracy with which commissions are calculated and paid throughout the industry.

A MODEL FOR THE FUTURE

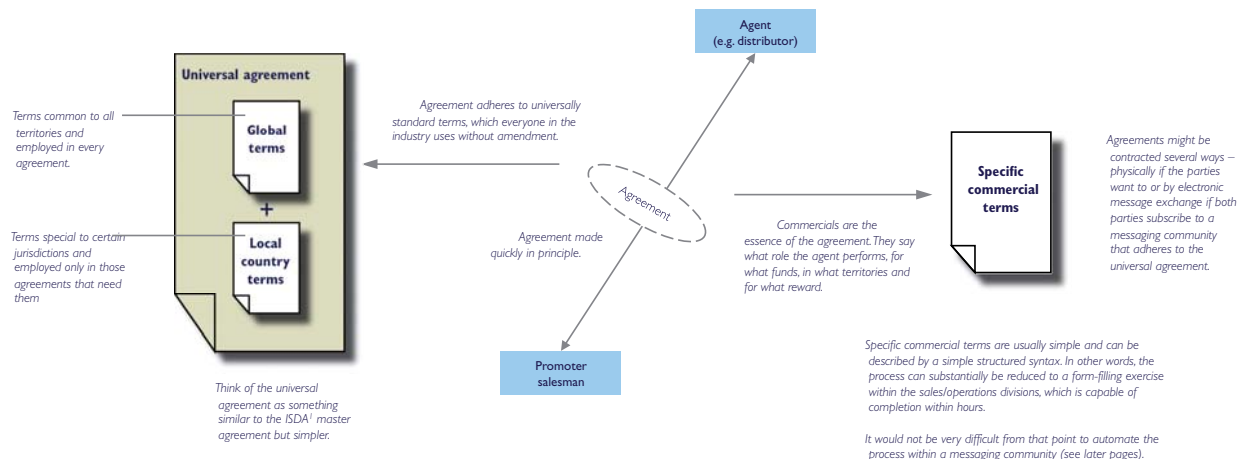
Fund sales agreements could and should be made more cost effectively, using a universally acceptable master agreement and custom-made term sheets (see *Figure 2* below). The contributors to this project have prepared a draft text for the master agreement, which provides a suitable

legal foundation for domestic and cross-border fund sales. They have also prepared a standard syntax for term sheets (see the synoptic chart at the end of this article), which encourages comprehensive and standardised communication and processing across the industry without limiting the ability of companies to do business together on entirely proprietary terms.

The concept of an industry standard master agreement is not new to the financial services industry. The best known example is the International Swap Dealer's Association master agreement (commonly known as the «ISDA» agreement). Within the mutual fund industry, the most successful standard fund sales agreement is probably the Swiss Fund Association's. The benefit of such standards is that they:

- Establish a commonly accepted legal foundation upon which industry participants can do business.
- Help to reduce legal risk and cost.
- Encourage basic standards of good practice.
- By promoting standardisation in services where difference provides no competitive advantage, help firms to concentrate their effort upon services where they believe they can make a difference, which, in turn, improves competition and service.

Figure 2: a model for the future – universally standard terms with custom-made commercials



¹ International Swap Dealers' Association, Inc.

Cross-border distribution

The draft master agreement that has been prepared in the course of this project has been written within the context of European Union law to support domestic and cross-border fund sales within the European Union and international fund sales beyond the European Union's borders, excluding the United States. With the exception of some important references to the European Directive 91/308/EEC on the prevention of the use of the financial system for the purpose of money laundering and the European Directive 2003/48/EC on the taxation of savings, the draft contains no explicit reference to national legislation, and it requires the contracting parties to declare in their term sheet which law their agreement is made under and to which courts they will submit.

The master agreement is also designed to be invoked in several parts:

- **Global terms**, which are common to all territories and which are employed in every agreement.
- **Local country terms**, which are unique to a particular country and should only be invoked if the parties are contracting an agreement for business to be conducted in that country.

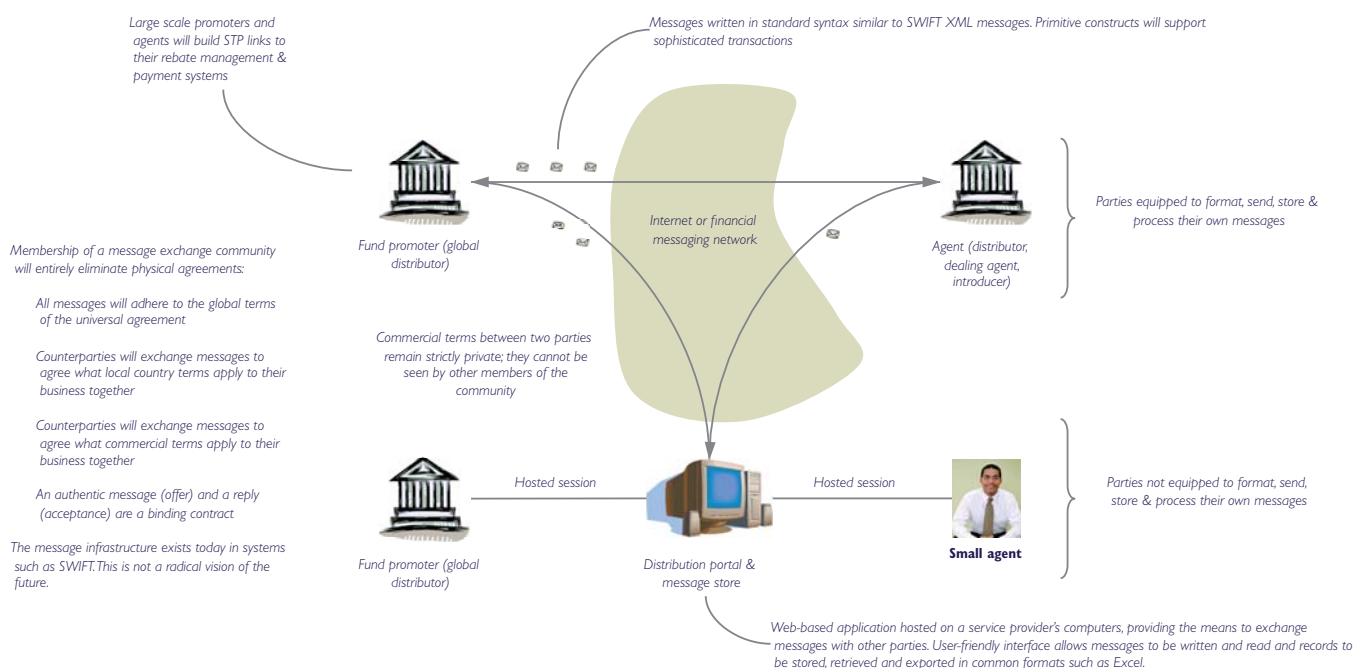
At present, only the global terms have been written. An example of something that might be included in a set of local country terms might be Luxembourg's requirement that fund sales agreements should contain provisions to defend funds against market timing.

The adoption of a standard master agreement allows firms to concentrate upon their term sheets, where they can achieve true competitive differentiation. The syntax for commercial terms allows for the creation of term sheets efficiently, either as printable documents, which may be signed in ink according to current practice, or as electronic messages, which if exchanged using a suitable message protocol over a suitable infrastructure, would permit the industry to "dematerialise" agreements in the manner imagined in Figure 3 below. To keep it simple, the syntax for commercial term sheets is limited to what must be defined in order to construct a valid agreement (which is often surprisingly little) and excludes what else the parties to an agreement might wish to define in support of the business between them (reporting messages for commissions, for example). When the

dematerialisation concept starts to win general acceptance, work on commission reporting and payment can begin.

If a firm wished to manage its term sheets in a word processor using macros to control data entry or in a simple database application linked to a document generator, it could do so very quickly. The syntax for commercial terms is well-developed, being supported by a comprehensive technical reference, and is simple for a technician to understand. Such a tool would effectively shift the agreement preparation process from the legal domain to the sales and operations domains, and reduce production time to a matter of minutes. In that scenario, agreements are transformed into operational documents with a legal basis. The contributors to this project have prepared a model term sheet in Microsoft Word (without macros) to illustrate the concept, and have prepared a concept demonstrator in software, which shows how agreements can be prepared and stored in a database application before being printed to paper or written as a structured electronic message, ready for transmission over a computer network.

Figure 3: infrastructure – emergent dematerialised platforms



It is likely to be some time before the industry will adopt fully dematerialised agreements, principally because it will take time for companies to develop the necessary message protocols and services. The vision of dematerialised fund sales agreements does not call for a single infrastructure, and there is no need for a central message repository because the messages between a fund promoter and its distributors or agents must remain private bilateral agreements. The definition should therefore be stateless (i.e., it should not call for the creation of a central repository in which all participants' commission terms will be stored, and each message need not be «aware» of previous messages that parties have exchanged). However, in practice the parties who will use the concept must keep a record of the history – or state – of the communication between them, which will form the corpus of their dematerialised sales agreements. The vision therefore allows market participants to decide whether they will build for themselves the capability to create, send, receive, store and generally manage their messages or whether they will buy the capability from specialised service companies. What is important is that the industry should promote open standards and encourage peo-

ple to adapt existing systems to exchange and manage messages (e.g., over SWIFT and through bureau service companies). The success of dematerialisation will depend on the extent to which it is adopted (the «network effect»), which in turn will be determined by how well it can be applied by a large number of companies to their normal business practices. For that reason the draft master agreement and the syntax for commercial terms have aimed to strike a balance between detail and generality, standardisation and flexibility, prescription and choice. To maintain standardisation and inter-operable, open systems, the project must go on to define a legal governance model for the master agreement (perhaps like ISDA) and a technical authority (perhaps through ISO, in co-operation with SWIFT) for the syntax for commercial terms and any common message protocols. That work will begin in the following months. It is the opinion of the contributors to this project that neither they nor any other company or industry association should profit through controlling the governing authority, which should be established to advance the concept of dematerialised mutual fund sales agreements for the common good of the industry.

NEXT STEPS

The member companies of this project intend to begin a consultation exercise to invite feedback from industry participants and associations with a view to developing the draft master fund sales agreement and the syntax for commercial terms, and encouraging their adoption as standards for mutual fund sales within Europe on a domestic and cross-border basis and internationally between Europe and other markets. ■

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Part of a collaborative project by:

BlackRock

BNP Paribas

Brown Brothers Harriman

DWS

Franklin Templeton

Fund-F

JPMorgan

Schroders

UBS

The syntax in alphabetic order

Agreement = Company, Counterparty, AgreementID, ExecutionDate, MasterAgreementVersion, {CountrySchedule}, GoverningLaw, JurisdictionCourts, ProductSet, {ProductSet}, Markets, FrontEndLoad, [Rebates], [Payments], Reports, CompanyContactPerson, CounterpartyContactPerson;

AccountType = 'CentralTransferAgency' | 'Clearstream' | 'Euroclear' | 'FundSettle' | 'Other';

AppliedLookup = 'RebateApplied' | 'LookupOnly';

BankTransfer = Currency, BeneficiaryAccountName, [BeneficiarySWIFT_BIC_Code], BeneficiaryAccountNumber, BeneficiaryBankSWIFT_BIC_Code, [BeneficiaryBankBranchNumber], [BeneficiaryBankName], [BeneficiaryBankAddress], {PaymentReference}, [CorrespondentBankSWIFT_BIC_Code], [CorrespondentBankName], [CorrespondentBankAccountNumber];

CalculationFrequency = Frequency;

Cheque = Currency, BeneficiaryName, PostalAddress, {PaymentReference};

Company = Name, PostalAddress;

CompanyContactPerson = ContactPerson, [SpecialInstructions], [CompanyContactPerson];

Counterparty = Name, PostalAddress, CounterpartyCapacity;

CounterpartyCapacity = (('Distributor', [SubNetworksAllowed]) | 'Dealer' | 'FinalBeneficialOwner' | 'FundofFunds' | 'PlacementAgent'), [CounterpartyCapacity];

CounterpartyContactPerson = ContactPerson, [SpecialInstructions], [CounterpartyContactPerson];

CountrySchedule = Country, Version;

DeMinimisEarnings = DeMinimisEarningsCurrency, DeMinimisEarningsThreshold;

DeMinimisPayment = DeMinimisPaymentCurrency, DeMinimisPaymentThreshold;

Frequency = 'Daily' | 'Monthly' | 'Quarterly' | 'SemiAnnual' | 'Annual';

FrontEndLoad = 'DealAtNAV' | (FrontEndLoadSet, [PaymentCurrency, PaymentFrequency, [SettlementWithin], [RetrospectiveAdjustmentPeriod], [DeMinimisPayment]]);

FrontEndLoadSet = [FrontEndLoadSetID], Discount, CounterpartyShare, CompanyShare {ProductSet}, [FrontEndLoadSet];

HoldingAccount = AccountType, AccountNumber, HoldingValue, ['SharedAccount', [HoldingUpdateFrequency]];

HoldingAccountSet = [HoldingAccountSetID], HoldingAccount, {HoldingAccount};

Holdings = HoldingAccountSet, AppliedLookup, [Holdings];

HoldingValue = 'DailyHolding' | 'PeriodEndHolding' | 'PeriodAverageHolding' | 'MonthlyPeriodAverageHolding' | 'QuarterlyPeriodAverageHolding' | 'GrossSalesValue' | 'NetSalesValue';

Markets = (Region | Country), [Markets];

PaymentCurrency = 'ShareclassCurrency' | SingleCurrency;

PaymentFrequency = Frequency - 'Daily';

Payments = PaymentType, (ReinvestFunds | BankTransfer | Cheque), [Payments];

PaymentType = 'FrontEndLoad' | 'Rebate' | 'GeneralPayment';

PeriodDays = 'CalendarDays365' | 'CalendarDays366' | 'BusinessDays' | '30';

PostalAddress = AddressLine, {AddressLine}, PostalCode, Country;

Products = ProductSet, AppliedLookup, [Products];

ProductSet = [ProductSetID], [ISIN, [Name]], {ISIN, [Name]};

RebateFee = 'ManagementFee' | 'DistributionFee' | 'CombinationFee' | 'TotalExpenseRatio';

RebateMethod = 'BasisPoints' | 'Percentage';

RebateRateTable = [LookupFrequency], Currency, Rows;

RebateRateType = 'FlatBand' | 'SlidingScale';

Rebates = RebateSet, PaymentCurrency, PaymentFrequency, [SettlementWithin], [RetrospectiveAdjustmentPeriod], [DeMinimisEarnings], [DeMinimisPayment], [Rebates];

RebateSet = [RebateSetID], RebateTermStartDate, RebateTermEndDate, Products, (Holdings | 'DefineLater'), RebateFee, CalculationFrequency, PeriodDays, YearDays, RebateMethod, RebateRateType, RebateRateTable, [RebateSet];

RebateTermEndDate = Date | 'Open';

RebateTermStartDate = Date | 'FirstInvestment';

Region = [RegionID], Country, {Country};

ReinvestFunds = 'ProRata' | ('SingleAccount', AccountType, AccountNumber) | ReinvestFundSet;

ReinvestFundSet = AccountType, AccountNumber, [ISIN, [Name], Ratio], {ISIN, [Name], Ratio}, [ReinvestFundSet];

ReportMethod = (('Postal', PostalAddress) | ('Email', EmailAddress) | ('Fax', FaxNumber)), [ReportMethod];

Reports = ReportMethod, {Reference}, [SpecialInstructions], [Reports];

RetrospectiveAdjustmentPeriod = (Number, 'Months' | 'Years') | Other;

Rows = Floor, [Ceiling], Rate, [Rows];

SettlementWithin = (Number, 'BusinessDays' | 'CalendarDays') | Other;

YearDays = 'CalendarDays365' | 'CalendarDays366' | 'BusinessDays' | '360';