

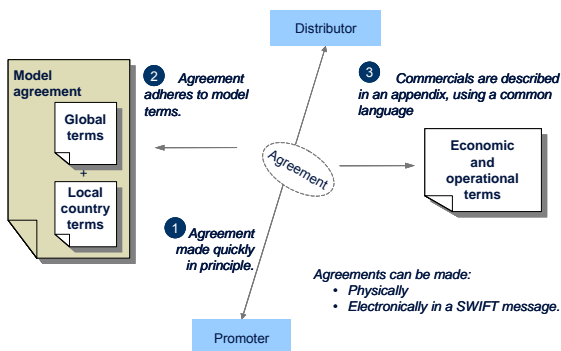
The 10-Minute Fund Sales Agreement

Noel Fessey, Schroders' Global Head of Fund Services calls for a revolution in how we make fund sales agreements and, more importantly, how we process related commissions and statements

There is common agreement in our industry that mutual fund sales agreements should not be as difficult and expensive to make as they are and that operational processing of holdings and commissions should be more efficient. Three years ago several companies began to collaborate in search of improvements.

Now we have completed the foundation of a new way of managing fund sales agreements and their related operations. We have created a new grammar to support most forms of fund sales agreement, from the simplest to the most sophisticated – for domestic and cross-border sales – and we intend to make it available, royalty-free, for the common good of the mutual fund industry. If it is widely adopted, we predict that in the future companies will prepare their mutual fund sales agreements to a much higher standard in as few as 10 minutes.

What are we talking about? In brief, we aim to improve how our industry sells mutual funds by promoting the use of a model sales agreement and a new language to describe economic and operational conditions in a separate term sheet.



We aim to encourage our industry to embrace a new generation of commercial term sheet editors and messaging systems. From the preliminary legal stages through to the back-office processes in which positions are reconciled and commissions are paid, we aim to increase efficiency and accuracy for the benefit of everybody involved. Importantly, we aim to deliver these benefits whilst preserving the commercial freedom with which parties sell mutual funds.

If you have always done it that way, it is probably wrong

In our industry, fund sales agreements are very often customised documents. They are written by lawyers using word-processors, then 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. 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 agreement and how much modification will be necessary to make it acceptable to both sides.

This is not part of anybody's wealth creation process. Nobody could claim that this activity is part of a "value-chain": it adds no value; not a cent. It rarely does more than ensure that the final agreement is reasonable from the perspective of both parties and that it conforms to some basic and commonplace legal principles. It is slow and expensive. It misuses scarce legal resources. It limits our ability to grow and actively manage distribution networks. It produces agreements that are often incomplete or ambiguous. It misses the opportunity to introduce straight-through processing in the commissions calculation process. It is no way to run a business. I once asked a colleague why nobody had thought to make obvious improvements. "Because the industry has always done it that way; you'll never change it," he said.

Divide each difficulty into as many parts as is feasible and necessary to resolve it

I understand why he thought that. The diversity of practice in our industry often confounds those who wish to shape it. The number of participants whose support would be required to make any change meaningful is too great. The chasm is too wide; we cannot cross it. It's too difficult. Better not to try.

But I don't agree. Fund sales agreements could and should be made more cheaply and more accurately, using a model agreement and a well-defined economic and operational term sheet. The idea of a model agreement is not innovative: the Swiss Funds Association has sponsored model fund distribution and placement agreements for years and many firms within our industry routinely use model agreements to lend securities, relying on SWIFT messages to manage the detail of each loan. We think it's time to apply the same approach to fund sales generally.

In our design, the model agreement is only a starting point for negotiation. It contains the provisions that you would expect to see in a well-considered fund sales agreement. You can use it as you find it. You can ignore the parts that are not applicable or delete them if you wish. If you have special needs, you can extend it through a side letter. You can choose what law to apply and which courts you will submit to. You can say whether your agreement permits funds to be sold by public offer, by private placement or both, and whether the distributor may delegate sub-distribution to third parties. If that is not flexible enough, you're free to replace our model with another model (one of the Swiss models, perhaps) or your own legal terms.

And, important though it is, that is about as much as I want to say about the legal process. You see, even though we're proposing the adoption of new model agreements, the revolution that we're calling for

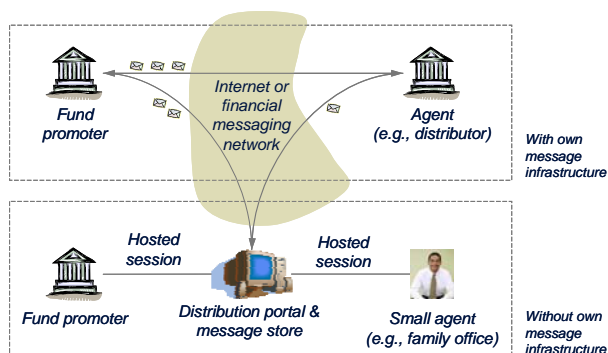
is not in the legal domain. If we want improvement then we must stop looking at fund sales agreements as legal documents, and accept that they are really economic and operational documents (which must have legal foundation). We must change our perspective.

Accept for a moment that when you see our model agreement you'll find that you're comfortable to use it as you find it. Accept for a moment that a fund sales agreement is in fact a statement of economic and operational terms. What should it contain?

It should be a statement of seven parts: (1) the **products** that are the subject of the agreement; (2) the **markets** in which they may be sold; (3) the **transaction charges** (front-end loads, back-end loads, conversion charges) that are payable on orders; (4) the **rebates** (trailer fees) that are payable on positions; (5) the **payment** mandates through which the payments are made; (6) the **reports** through which they are declared; and (7) the **contact persons** who will manage the business. If we can describe these precisely and efficiently then we can have our 10-minute sales agreement and improved back-office processing of commissions, payments and reports.

That is where the grammar comes in. We cannot efficiently share economic and operational data with our business partners – which is what we are talking about – unless we speak a common language. The aim of our technical work has been to design such a language. It is now complete, and it is ISO 20022-compatible. It is very much like the language in which Web pages are written, and it is capable of being written and read by any term sheet editor in the same way that you can read a Web page with pretty much any browser you like.

Fund sales agreements and related reconciliations, commission payments and statements made electronically, written in standard syntax similar to SWIFT XML messages.



And then we did something that unleashed the power of our imagination: we learned to talk

Our work is about more than the legal text of fund sales agreements; it is more than an electronic form-filling exercise for economic terms. It does not take much imagination to see that a term sheet editor can be linked to a fund promoter's product database, from which product details and commission policies can be extracted to compile a sales agreement in minutes. It is not difficult to imagine that once the term sheet editor has done its job, the terms can be printed and fixed to a hard copy agreement or (we predict) exchanged between the parties electronically, so as to make a

binding contract.

But we can imagine much more. We can imagine thousands of electronic conversations between promoters and their distributors about the business that they have written together. Conversations about extending the commission network to include new distributors, products and markets; about positions, reconciliations, invoices, statements and payments; about events such as product launches, mergers, closures and fee changes, which affect commissions; about client changes to commission-earning holding accounts, particularly within global custodian networks; about greater transparency in omnibus accounts, where the "fingerprinting" capability of our design will help commission-earning positions to stand out from the crowd; about changes to bank mandates and other operational payment data.

With this grammar, our industry has a new ability to talk about fund distribution networks. Just like in any language, you can use it to write short and long sentences (we prefer short). The interesting question is, what would you say?

To find out more, visit: www.swiftcommunity.net/dmfsa
www.dmfsa.info

A brief summary of the grammar

Parties to the agreement

Company: the party granting rights to sell products in markets and agreeing to pay commissions

- ◇ Can be a promoter, global distributor, fund platform, etc
- ◇ Support for several parties, such as fund representatives

Counterparty: the party receiving rights from the Company

- ◇ Can be a simple distributor or a fund platform, etc
- ◇ Choice of offer rights, including public offer, private placement and bespoke rights
- ◇ Support for several parties and affiliates

Legal model

Use a DMFSA model agreement

- ◇ Several models to choose from in the future
- ◇ Modular for international sales: country-specific schedules will be available
- ◇ Amend the model terms as you wish and declare what law and courts to use
- ◇ Declare termination conditions

Or use another industry model agreement (e.g., Swiss Funds Association) or a proprietary legal agreement

Products and markets

Declare the products that are to be sold under the agreement

Declare the markets in which they may be sold

- ◇ Exhaustive references are supported: ISINs for products, and country names for markets
- ◇ General references are supported at promoter level, e.g., "Equities", "Bonds", "Europe" and "Asia"

- ◇ Fund promoters must support general references by a public data dictionary, which allows the reference to be resolved to its members at any point in time

Transaction charges

Used when the central transfer agent collects front-end load, back-end load and conversion charges on behalf of the distributor

Optional: if not described, then the central TA will process deals at NAV and the distributor may collect the charges for itself, at rates up to the prospectus limit

Multiple transaction charge "sets" can be applied with precision:

- ◇ By **product**, e.g., "Equities", "Bonds", umbrella, sub-fund, share class, ISIN, etc
- ◇ By **holding address**, e.g., by business channel (retail, institutional, etc) and by geography (France, Germany, etc)
- ◇ By **term validity**, e.g., by start date and end date

Each transaction charge "set" contains the following key parts:

- ◇ Charge-deductible **product list** and optional aggregation policy for cumulative charges
- ◇ Charge-deductible **holding address list** and optional aggregation policy for cumulative charges
- ◇ Duration of period during which the charge is to be collected
- ◇ Instructions for sharing the charge between the client, the promoter and the distributor
- ◇ Charge rate table and instructions for reading it
- ◇ Instructions for payment currency, settlement terms, retrospective adjustments and de-minimis value screening

Three formats to describe transaction charges:

- ◇ **Constant:** same rate for all deals
- ◇ **Discrete variable:** the rate reduces as individual deal size increases
- ◇ **Cumulative variable:** the rate reduces as individual deal size, aggregated with existing investments, increases
- ◇ Aggregation can be applied with precision by products and holding addresses

Rebates

The commercial core of most agreements

Multiple rebate sets can be applied with precision in the same manner as front-end loads

Rebates can be set to terminate with the agreement or to run off for a period of time or to survive for as long as the positions remain

Each rebate "set" contains the following key parts:

- ◇ Rebate-earning **product list** and optional aggregation policy
- ◇ Rebate-earning **holding address list** and optional aggregation policy
- ◇ Instruction to calculate rebates as a function of management fee, distribution fee, etc
- ◇ Instruction for calculation frequency
- ◇ Duration of rebate period and day count convention
- ◇ Rebate rate table and instructions for reading it
- ◇ Instructions for payment currency, settlement terms, retrospective adjustments and de-minimis value screening

Rebate formula

The standard format facilitates communication

The operands provide complete flexibility

$$\text{Value of rebates} = \sum_{c=1}^{c=\text{FinalCycle}} \text{HoldingValue}_c \times \text{RebateBasisFactor} \times \text{Rate}_c \times \frac{\text{DayCount}}{\text{YearDays}}$$

See the full technical specification for detailed explanation

Aggregation

The calculation of front-end loads and rebates on individual ISINs at rates that reflect a larger business relationship

It requires two dimensions:

Product aggregation:

Taking the rate-earning ISIN as a key, aggregate products that are:

- ◇ The same ISIN ... or
- ◇ Members of the same sub-fund ... or
- ◇ Members of the same umbrella fund ... or
- ◇ Members of a special list of products (e.g., "Equities", "Bonds", product A, B, C etc).

Holding aggregation:

Taking the rate-earning ISIN as a key, aggregate holdings that are:

- ◇ In the same holding account ... or
- ◇ In holding accounts that share the same transfer agency code (e.g., agent code, plan code) ... or
- ◇ In holding accounts that are members of a special list of holding addresses

Holdings

Three factors: where is each holding, how to count it and how to value it?

Where is it?

- ◇ Depository indicator (HoldingAddressPath or Clearstream, Euroclear, FundSettle) plus account number
- ◇ Is it shared, and if so, how often is the break-down analysed?
- ◇ HoldingAddressPath design supports proprietary hierarchies, multiple transfer agents within the same agreement

How to count it?

- ◇ Daily
- ◇ Weekly
- ◇ Monthly
- ◇ Quarterly
- ◇ HalfYearly
- ◇ Yearly
- ◇ WeekEndMean
- ◇ MonthEndMean
- ◇ QuarterEndMean
- ◇ HalfYearEndMean
- ◇ YearEndMean

- ◇ **Eligible positions:** measured with respect to trade date or settlement date, with special instructions for certain positions

How to value it?

- ◇ A function for calculating a single holding value for a period in which multiple measurements of holdings and multiple NAVs are available

Commission rate tables

Reference currency:

- ◇ Required when aggregating multi-currency holdings to look up the rate

Table type:

- ◇ One or many rows (tiers) in a table, each with a threshold and a rate
- ◇ **Flat band:** aggregated holding values are used to interrogate a multi-row table to determine a single rate to apply to the entire value of the transaction
- ◇ **Sliding scale:** aggregated holding values are used to interrogate a multi-row table to determine a series of rates to apply to tranches of the transaction (a volume weighted average rate)
- ◇ There are many variations and names for these models in the industry, but all can be supported by the DMFSA design

Commercial viability screening

De-minimis earnings:

- ◇ Applicable to rebates only
- ◇ If the value of rebates does not cross the threshold, they are considered not to exist
- ◇ Optional: used to filter out commercially unviable agreements

De-minimis payment:

- ◇ Applicable to rebates and front-end loads
- ◇ If the value of rebates does not cross the threshold, they are carried forward on account until the next payment cycle
- ◇ Optional: used to filter out commercially unviable payments

General commission terms

Payment:

- ◇ Fund currency or single currency
- ◇ Combinations of both are supported within the same agreement

Settlement:

- ◇ Optional: the number of business or calendar days within which payments will be made
- ◇ Free text field available to describe non-standard settlement cycles

Retrospective adjustment:

- ◇ Optional: the time limit beyond which errors will not be corrected
- ◇ Business or calendar days or free text field

Payments

Define multiple payment mandates, arranged by business line or country as you wish

Bank transfers:

- ◇ Supports payments to any account world-wide and payments through correspondent banks

Reinvestment into funds:

- ◇ Into the funds and accounts on which the revenue was earned ... or
- ◇ Into the funds on which the revenue was earned, but on a single account ... or
- ◇ Into specific accounts and funds

Cheque:

- ◇ Mandates and payments can be linked to front-end load and rebate sets

Contact persons

The people employed on day-to-day operations

Can include third parties such as commission calculation agents

Cross-references and fingerprints

Cross-references link commission terms to payment and reporting mandates:

- ◇ Every section of a fund sales agreement is assigned a locally unique tag
- ◇ Tags can be quoted in payment and reporting mandates, to indicate which commission terms they are related to

Agreement identifiers serve as fingerprints on fund transactions:

- ◇ Agreement identifiers are globally unique, and can be used to apply a "fingerprint" to fund transactions
- ◇ Fingerprints can be transmitted in public without revealing the identities of the parties to the agreement
- ◇ Fingerprints offer improvements in global custodian omnibus reconciliations, transfer management, commissioning and sales attribution