Altus
MAKING FINANCIAL SERVICES FASTER

Briefing Note

FUND SHARE CLASS CONVERSIONS

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Why are we discussing conversions now?

We're talking about conversions because the FCA is talking about conversions. The FCA has announced in its December 2019 policy statement that all platform providers must support conversions from February 2021.

What's the problem?

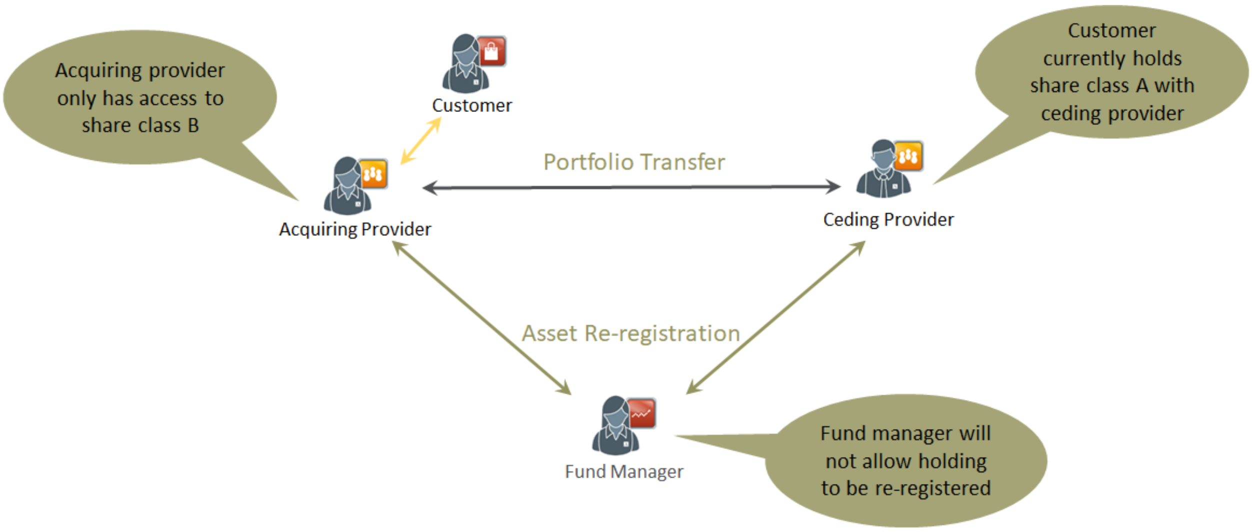
The conversion challenge has its origins in the Retail Distribution Review (RDR) from the then FSA which came into force at the end of 2012.

The RDR banned cash rebates from fund managers and consequently fund managers started introducing discounted share classes as an alternative way of giving certain distributors discounts on fund charges.

For a while it seemed possible that only a few of these restricted or 'super-clean' share classes would emerge but over the years more and more have been launched. Today there are hundreds of restricted share classes available and many funds have multiple levels of discounts.

The challenge comes when an investor wants to transfer from one platform to another and the acquiring platform does not have access to the share class currently held on the ceding platform. It is then not possible for the fund to be transferred in-specie and the holding must instead be sold, transferred as cash and finally bought again on the new platform.

It is ironic that the RDR demanded that platforms must support in-specie transfers for investors and at the same time prompted the introduction of restricted share classes which made it increasingly difficult to do so.



Whose problem is it?

Whilst the problem was easy to spot it was much harder to agree whose job it was to fix it. In the aftermath of the RDR, TISA ran a series of cross-industry meetings to thrash out the answer.

Some thought the ceding party should convert the holding to the share class held by the acquiring party before the transfer. But ceding parties might not know what that share class is and, in any case, wouldn't want the overhead of potentially holding all possible share classes.

Some thought the acquiring party should convert the holding after the transfer. But acquiring parties might not be allowed to hold the current share class, even temporarily.

Others thought that fund managers should perform the conversion at the same time as the transfer (and coined the much-derided term 'transversion'). But fund managers do not typically have any relationship with the end investor and consequently did not want to take such decisions on behalf of the customer.

A few poor souls were still vainly hoping that the FCA might relent on the cash rebate ban.

What's the answer?

The now generally accepted conclusion of the debate was that:

- Customers should be allowed to convert their holdings to access the best share classes
- If necessary to effect a transfer, the ceding party should convert the holding to a share class available to the acquiring party
- Following a transfer, the acquiring party should also allow the customer to convert the holding to the best available share class

It should also be emphasised that a conversion is not a switch. Nothing is sold or bought, the units held are simply converted from one share class to another in the same fund. Consequently, unit groupings are preserved and Capital Gains Tax does not apply.

What does the regulator say?

The FCA believes that lack of support for conversions makes transferring to a new provider less appealing to investors. And if investors are less likely to transfer then this will undermine one of their key objectives: to ensure there is healthy competition between financial services providers.

Consequently, the FCA's Consultation on Investment Platforms (CP19/12) published in March 2019 included proposals broadly in line with the solution agreed by the industry. Ceding parties must allow conversions where necessary to effect an in-specie transfer, and acquiring parties must allow investors to convert to the best available share class.

The rules will apply to platforms and any firm providing similar services and the FCA has made it clear they expect fund managers to play their part too.

The new policy was confirmed in the December 2019 policy statement. The new rules were originally due to come into effect on 31 July 2020 but due to the coronavirus crisis this was put back to 1st February 2021.

What's been done about it?

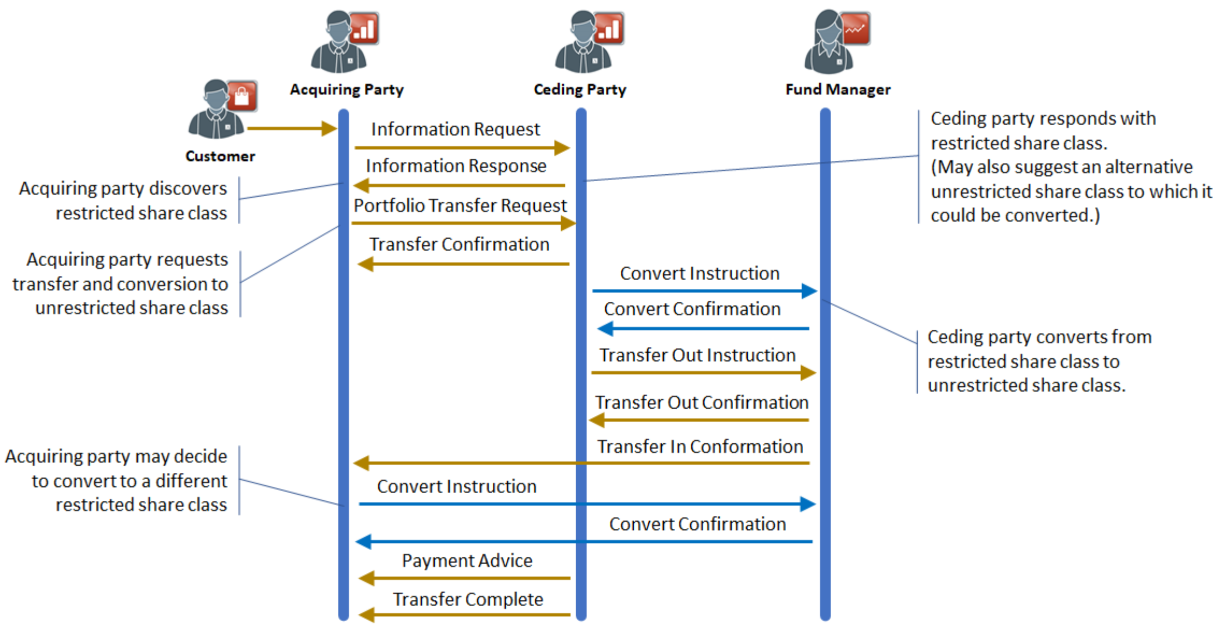
The conversions challenge will be addressed as part of the TeX open transfers framework and consequently the key steps in providing the solution have been taken by the various organisations that constitute that framework.

The component parts of the solution have gradually been emerging over the last few years:

- 2014 – TISA Share Class Conversions, Statement of recommended practice
- 2014 – UKFMPG electronic conversions market practice for fund managers
- 2018 – TeX legal framework, conversion updates
- 2019 – UKFMPG electronic transfers market practice, conversion updates for platforms
- 2019 – TeX compliant systems upgrade
- 2021 – UKFMPG electronic transfers market practice, additional conversion updates

In short, all the supporting agreements, standards and technology are already in place to support conversions, although there is one enhancement to the technical standards due in late 2021 that will simplify the process for some platforms.

What will the process look like?



The new conversion obligations will result in changes to the existing transfer process.

When acquiring parties discover a restricted share class in a customer's portfolio, they will now be able to request that the ceding party converts the shareholding to another share class before issuing the re-registration instruction.

Once the units have been transferred, the acquiring party may issue a further instruction to the fund manager to convert the customer's holding to another discounted share class.

The update to the market practice due in 2021 will allow the ceding party to offer one or more alternative share classes to which the holding could be converted. This will make life slightly easier for the acquiring party who will no longer need to know about all the possible share classes in advance.

What are platforms and wealth managers doing?

Some platforms and wealth managers are already handling conversions for customers as part of the transfer process, although this is currently a rather time-consuming paper-based process.

However, most platforms do not currently allow customers to convert unit holdings between share classes and will need to introduce completely new processes.

All have accepted that the anticipated volume of conversions will require the support of new electronic conversion requests rather than existing paper processes.

Electronic solutions for conversions are already available and most platforms are now working out how best to implement them.

What are fund managers doing?

Fund managers already support conversions with a variety of paper forms and faxes. To date, quite reasonably, they have not seen the need to automate the process as the volume of requests is so low.

But they know the new regulations will prompt a surge in requests and if they are to avoid being swamped in paper they will need to support electronic requests before that surge materialises.

What are custodians doing?

Some platforms and wealth managers use an intermediate unit holder (for example an institutional fund platform) for custody rather than dealing with fund managers directly.

Custodians are in a similar position to fund managers. They have not seen the value in automating the conversion process so far but before volumes start to rise they will need to streamline both incoming requests from platforms and the corresponding outgoing requests to fund managers.

How will it benefit the end investor?

The hope is that investors and their advisers will find it easier, to transfer between platforms and to access the cheapest share classes. They won't need to suffer the risks and costs of selling on one platform and rebuying the same funds on another.

The FCA's expectation is that this will encourage more investors to switch platforms for better deals and lower costs, and consequently that competition between platforms will increase. And ultimately, therefore, that investors get even better deals in future.