Changing Dynamics of Global Distribution
A report from J.P. Morgan’s roundtable

UCITS have become synonymous with global distribution as a means for asset managers to reach international investors. Recent directives and planned regulatory changes to cross-border products sold from Europe have therefore become a major topic of interest among international asset and alternative managers. In a panel discussion held on May 1, 2013, Patrick O’Brien of J.P. Morgan, with partners from PwC and Dechert, discussed the likely impact of these changes and other factors affecting the global distribution of cross-border funds.

Patrick O’Brien
European Fund Services Executive
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Patrick is responsible for profiling and presenting J.P. Morgan’s European Fund Services capabilities. He acts as a key liaison for J.P. Morgan’s clients, designing and implementing appropriate fund structures to meet investors’ needs across Luxembourg, Ireland and the Channel Islands.
O’BRIEN: The international funds industry has largely developed through domestic products tailored for a local investor base. However, over the past 20 years we’ve seen the emergence of true cross-border funds distributing to in excess of 75 countries worldwide. There are now more than 500 fund managers running portfolio strategies with in excess of US$4 trillion in products classified as cross-border. I’m joined by industry experts from PwC and Dechert to discuss the growth of these cross-border funds and how the changing regulatory landscape may impact the global distribution model.

Mark Evans
Partner
PwC (Luxembourg)
Mark leads the Global Fund Distribution service at PwC in Luxembourg where he specializes in distribution, regulatory and tax issues impacting cross-border investment funds.

Andrew O’Callaghan
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Andrew is an audit partner in the Asset Management group and Deputy Leader of Foreign Direct Investment in PwC Ireland, specializing in asset management/mutual funds. He also leads PwC’s ETF group across EMEA.

Christopher Christian
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Christopher is a partner in Dechert’s Financial Services Practice Group in Boston where he advises offshore funds on compliance with U.S. regulatory requirements. Christopher also routinely counsels European retail and institutional funds on organization, registration, corporate governance and global distribution issues.

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Declan is a partner in Dechert’s Financial Services Practice Group in Dublin where he advises domestic and international clients in the establishment and authorization of all types of investment funds.

Strong growth of cross-border funds to date

O’BRIEN: The UCITS funds’ vehicle allows for a single fund to register for sale across multiple countries and has become synonymous with cross-border distribution. What’s behind its success?

O’CALLAGHAN: The entire UCITS framework began in the mid-1980s with a simple concept to facilitate cross-border investment and the free movement of capital within the European Union. Europe embraced this new initiative, opening the doors to allow the selling of products from other member states. In turn, this led to international recognition of UCITS vehicles. Other countries have since recognized UCITS as an appropriate vehicle for their investors. UCITS provide the benefits of global and segmental diversification to a broad range of investors across Europe, Asia, Latin America and the Middle East.

“UCITS remain the most efficient way to access multiple local markets across the globe.”

Mark Evans
PwC
UCITS have managed to strike an effective balance between product efficiency and investor protection to support the growth and needs of an international investor base.

O’BRIEN: You can set up UCITS in every European country. So why have Ireland and Luxembourg become the domicile for true cross-border funds?

EVANS: The success of Ireland and Luxembourg as UCITS cross-border fund hubs is due to a combination of factors. The starting point is that their own domestic markets are very small, which means they can be totally focused on creating an industry framework to support and foster international funds distribution. The Irish and Luxembourg domiciles have been able to concentrate on creating product strategies and service models to support cross-border fund sales and meet the desires of investors in multiple countries. This is not the case in larger countries such as the UK, Germany or France, where the local fund industry must operate within more restrictive domestic parameters and focus on domestic investors’ needs. It’s very difficult for a jurisdiction to have both a domestic and international focus as these objectives can be in conflict. Moreover, there continues to be no real effective competition to cross-border UCITS that are now sold across multiple regions. In fact the dominance of UCITS cross-border products has grown strongly over the past ten years. UCITS remain the most efficient way to access multiple local markets across the globe through a single fund structure with the potential to access global distribution volumes and achieve significant economies of scale. Of course, the question is whether this dominance will continue in the future.

“Ultimately, the key to AIFMD’s success, and any impact on the global distribution market, will be whether an AIFMD passport emerges and brings more product efficiency for alternative strategies.”

Andrew O’Callaghan
PwC

Sources: Lipper LIM and PwC analysis, December 2012
**Evolution**

**O’BRIEN:** UCITS are now celebrating 25 years in existence. During this time, we’ve seen a number of changes, some product enhancements and some regulatory requirements. Although the Alternative Investment Fund Managers Directive (AIFMD) relates to non-UCITS, it’s also a key consideration for UCITS V and for global distribution in general. Why?

**O’SULLIVAN:** The upcoming UCITS V proposals are part of a drive to enhance investor protection around financial products. Further questions are raised by UCITS VI, which aims to look at the product anew and see whether retail product boundaries have been pushed too far with respect to product strategies. This might constrain the investment options within a portfolio that could use UCITS. We’d hope AIFMD could offset this in terms of having a passport for alternative products.

**O’CALLAGHAN:** Ultimately, the key to AIFMD’s success, and any impact on the global distribution market, will be whether an AIFMD passport emerges and brings more product efficiency for alternative strategies.

**O’SULLIVAN:** But managers now need to consider AIFMD as part of their global distribution strategies when targeting Europe.

**O’CALLAGHAN:** So are we questioning whether AIFMD’s passport benefit is a forgone conclusion? Surely it will be an enabler of cross-border distribution for alternative funds, making them more accessible to European investors?

“Managers now need to consider AIFMD as part of their global distribution strategies when targeting Europe.”

Declan O’Sullivan
Dechert LLP

**O’BRIEN:** I think the concept of passporting an alternative fund is already impacting distribution to European investors. The whole idea behind AIFMD is that regulated alternative funds should have the benefits of an EU passport. Over the past five to six years there’s been an increasing number of funds launched as regulated alternative funds using the QIF fund structures in Ireland and SIF in Luxembourg. Whilst most alternative funds continue to be launched in locations like the Cayman Islands, there is growing institutional demand from European institutional investors for EU-regulated managers running QIFs and SIFs.

**O’CALLAGHAN:** I think the AIFMD passport will eventually emerge, but it could take five to ten years to mature.

**CHRISTIAN:** I agree—AIFMD is more likely to create a brand in five to ten years’ time. Managers now need to consider AIFMD as part of their global distribution strategies when targeting Europe.

*“AIFMD is more likely to create a brand in five to ten years’ time.”*

Christopher Christian
Dechert LLP

**CHRISTIAN:** Private placement refers to a private, non-public sale between an investment fund and individual investor. The way that private placement rules work depends on the type of fund wrapper and the country the investor is based in.

Whereas UCITS can be sold under national law subject to the public offering laws of the country, many countries don’t allow for private placement of UCITS to retail clients on an offered basis—for example, France, Italy and, since July 2013, Germany.

So in over three of the largest markets, you can no longer privately sell UCITS to private investors. For Germany, this is a huge change as private placement has existed there for over 60 years. Until 2015 when AIFMD comes into force at the national level, the regime governing marketing to EU investors will depend on where the manager and the AIF are based.

Most countries in the EU are going to have to change their national regulation to incorporate AIFMD and will most likely close down private placement after a transitional period.
between 2015 and when the EU can get the passport. There’s going to be a maze of regulation which managers in the EU or outside will need help in interpreting. This will present challenges and will certainly change the dynamics of the global distribution model.

O’BRIEN: What impact is AIFMD likely to have outside of Europe and what is the future of UCITS outside of Europe?

EVANS: AIFMD may pose an underlying challenge to UCITS in some regions, especially in Asia if the AIFMD brand develops and becomes an attractive proposition for both asset managers and investors who may otherwise have contemplated a UCITS. Moreover, with the potential of an Asian “fund passport” we’re also seeing the emergence of bilateral reciprocal agreements among Asian countries to sell Asian-domiciled funds. These arrangements are also replicating parts of the investor protection and diversification rules that UCITS offer and potentially pose a long-term threat to the UCITS model.

Another potential challenge to UCITS distribution into Asia is the growing discussion around mutual recognition coming from a number of Asian countries. There’s increasing pressure on the EU to look at some sort of reciprocal arrangements with Asian regulators. The EU Commission is aware of this issue and considering how it can grant some kind of reciprocal UCITS distribution arrangement with key Asian markets. In the medium to long-term, it’s unrealistic to think UCITS can keep coming to Asia and generating billions of euros of net sales from Asian investors into UCITS that are managed in Europe or the U.S. if Asian funds are excluded from the European investment market as a result of AIFMD. This is a very important point.

O’CALLAGHAN: It’s difficult to assess what impact AIFMD will have outside of Europe. We’ve seen redomiciliation of some funds from non-EU domiciles to Ireland and Luxembourg. The mutual recognition agreement between Hong Kong and China is very interesting. UCITS currently account for over 80 percent of the funds sold in Hong Kong. In the future we’re likely to see increased demand for both UCITS and Hong Kong-domiciled unit trusts.

Retrocessions

O’BRIEN: The introduction of the Retail Distribution Review (RDR) in the UK also requires fund managers to adjust their sales channels and products for that region but is likely to spread across Europe. Is this a positive development for investor transparency or a threat to the open architecture?

CHRISTIAN: It’s possibly too early to tell. The Retail Distribution Review has been hailed as the biggest shake-up within the UK financial services’ history because it affects remuneration—how distributors, advisers, in particular, get paid. The RDR regime has brought massive changes in that UK financial advisors can no longer get paid or earn commission from the product manufacturer for the sales of third-party or proprietary products. Financial advisors now have to charge their end consumers, which means that the best-of-breed products offered
at the lowest price are increasingly attractive. This is a positive impact for investors.

The UK RDR regime will probably spread throughout Europe as a result of MiFID II’s provision governing the payment of retrocessions. This would then impact the retail bank distribution chain, the primary route in Europe for selling UCITS products. This is a key watch item for the future distribution model and main selling channels for European investors.

**EVANS:** I’m not convinced the UK RDR rules will spread across Europe, at least in their current form, as I think there’s still a general reluctance to ban outright distribution retrocessions across Europe. Instead there seems to be a preference for increased transparency and disclosure around distributor remuneration. This is going to be one of the big issues over the next few years, especially with MiFID II and various local regulatory changes, for example in the Netherlands. The EU Commission is focused on getting retail investors’ confidence back into UCITS and fund products generally, so they’re going to continue to look to either ban distribution retrocessions in various circumstances or modify disclosure rules of distribution remuneration.

“Ultimately the objective is to provide appropriate products to investors.”
**Patrick O’Brien**  
**J.P. Morgan**

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**The immediate future**

**O’BRIEN:** What are the key considerations managers should think about when assessing their distribution plans?

**EVANS:** Currently UCITS remain more expensive to establish and run than alternatives funds. However, with AIFMD, this cost differential, at least for EU-based alternative funds, will be reduced. As an asset manager, if your investment strategy could fit in either structure you need to consider whether one structure is better than the other, the type of investors you want to target, where they reside and what the most efficient way of reaching them is. Let’s face it; three quarters of cross-border funds are only sold in half a dozen countries and only about a third are sold in 20 to 30 countries. As such, it’s essential to determine who you’re going to sell to and how. Selling is going to become even more challenging in the future. I think it’s going to remain difficult to get on fund platforms and engage third-party distributors.

**O’CALLAGHAN:** I’d echo that. You shouldn’t build a product and expect the investors to come. All products should be investor-focused. Understand the impact of global regulation and the opportunities to build a product for distribution and ultimate sale. Focus on what your competitive strengths are, where your connections are, your product and distribution channels—then put all your efforts behind them.

“You shouldn’t build a product and expect the investors to come.”
**Andrew O’Callaghan**  
PwC

**CHRISTIAN:** Before you consider your distribution, you need to review your investment strategy and performance and determine whether there’s an appetite for your product and a distribution channel that works for you in that country.

You also need to decide whether you’ve got a product that can be successful from a cross-border perspective. The EU is a very difficult market to penetrate, so having a UCITS product doesn’t automatically mean you’ll be successful.

“Finally, it’s the job of the asset manager to work with fund distributors and institutional investors to ensure their financial interests align with those of the UCITS fund. It’s also essential to monitor the distribution landscape and adapt strategies as necessary.”
**Andrew O’Callaghan**  
PwC

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**O’SULLIVAN:** We’re already beginning to see some implementation of AIFMD with the first AIFMs. Hopefully the larger managers are embracing AIFMD and the opportunities it offers.

**O’BRIEN:** So in summary, managers need to consider many factors whether they’re seeking to establish or are already providing cross-border distributing funds. In the longer-term, the establishment of an AIFMD sales channel is a possibility. However, in the short-term, product design and amendments to the UCITS framework appear to be at the forefront of managers’ minds. Ultimately, the objective is to provide appropriate products to investors. As an industry, we need to monitor and adapt to all the imminent changes in the global distribution model to ensure we see the continued success of the UCITS brand. **thought**