The Future of Asset Management

Exploring New Frontiers
J.P. Morgan is committed to helping our clients mitigate risks, enhance revenues and increase efficiencies.
New challenges, New answers
The main challenges we believe the asset management industry faces today.

Imitation is the sincerest form of flattery
Traditional long-only asset managers and hedge fund managers will need to reassess their operating process to support new strategies.

The future of the pan-European operating model
Implementing a truly Pan-European mutual funds operating model to achieve significant cost savings.

The rise of the distributor
Emerging markets and the shift in power in the relationship between asset managers and distributors.

Global regulation: let’s get practical
Investment management firms should focus on what regulation means for them from a practical point of view.

Capitalising on growth
How asset managers can capitalise on growth as investors come back into the savings industry.
New challenges, New answers

The last two years have seen an extraordinary amount of change in the asset management industry. The industry’s ability to renew itself has never been more important. There is a growing recognition that this time around, the recovery will demand more change by market participants. As the recovery gains momentum, we are focused on how J.P. Morgan can support this renewal.

Conrad Kozak
Head of Worldwide Securities Services
One of the certainties in this tumultuous environment is that the asset management industry is at a critical juncture, beyond which it will look very different than it does today.

Asset managers are facing new challenges, particularly as a result of new regulations. As a global service provider, we are looking at providing the industry with answers and practical solutions to these new challenges.

With this in mind, we have addressed the main challenges we believe the asset management industry faces today:

- the convergence of traditional asset managers and alternative fund managers,
- UCITS IV and its impact on asset managers’ operating models,
- the shift in power to the distributors as they increasingly own the client relationship,
- and dealing with increased regulatory scrutiny.

Some of the issues have a greater impact on funds in different locations or of different sizes, but no matter where a fund management company is based, a fund is domiciled or the size of the fund or the manager, we believe these challenges are universal.

The trend of traditional asset managers and alternative fund managers adopting each other’s investment strategies is having a profound impact on both ends of their models: distribution will have to change as each strategy tries to attract investment dollars from a new constituency, and the back office support of these managers has to keep pace with their changes and evolving needs.

One model may have worked for alternative managers whose end investors were sophisticated institutional investors or for fund managers who hadn’t previously contended with the demands of an institutional client. These managers are finding they have to change their approach as well as their fee models. If they don’t, regulators may do it for them.

Our look at UCITS IV examines how the changes to the UCITS framework could require fund managers to alter their operating models to best take advantage of the latest iteration of enabling legislation. While the decision to operate an offshore model or on-shore model used to be straightforward, anyone wanting to manufacture UCITS funds will be able to choose the business models that suit them best.

Distributors have become a far stronger influence and we discuss how the industry focus is shifting from production to distribution. While performance remains one of the most important factors when investors choose a fund, the ease of accessing and keeping track of their investments is increasingly important, too. As a result, distribution is becoming just as critical a factor as performance to determining a fund’s success, and will be addressed with renewed vigour.

In addition to UCITS IV, there is a raft of financial regulation being proposed, through which regulators hope to establish a framework to avoid systemic risk to ensure the stability of financial markets and to protect consumers. We admit no one has all of the answers to these often vexing issues. But we believe our broad perspective on the industry and close consultative work with clients of many sizes has enabled us to identify not only today’s challenges, but what the future will look like and the solutions they need. We hope this will enable fund managers to meet the demanding needs of their clients.
The blurring of the definitions of traditional long-only asset managers and hedge fund managers is being accelerated by changes in distribution strategies and regulatory pressure. In looking to diversify their product mix (albeit for different reasons), both groups will need to reassess their operating processes to support new strategies.

Imitation is the sincerest form of flattery

As traditional asset managers and hedge fund managers increasingly compete for the same investment dollars by selling similar products to the same groups of investors, they face tough questions about their existing operational structures. The key challenge is how asset managers will successfully integrate their alternative strategies into their long-only business, and how much longer hedge fund managers can rely on prime brokers to support their operations.

For traditional asset managers, the convergence with alternative managers is being driven by their desire to find ways to secure higher returns for investors. In addition, they are seeking to develop products that provide better margins, as asset values have fallen in the last 18 months while high cost bases remained fixed. Asset managers are now routinely introducing hedge fund techniques to their core investment approaches to complement traditional long-only strategies.
At the other end of the investment spectrum, hedge fund managers are seeking to launch products with greater liquidity, transparency and control. A catalyst for this was Lehman Brothers’ bankruptcy filing; few hedge funds, on 15 September 2008, considered the impact of this event on their assets held within Lehman’s European prime brokerage business.

It has taken many months for the $35bn of prime brokerage assets to be recovered and returned to their owners, and a substantial portion still remains locked in multi-year bankruptcy proceedings. As a direct result, hedge fund managers, either through their own prudence or as a result of underlying investor pressure, are now much more interested in the credit standing of their counterparties, how and where their assets are held, and whether these assets will be recoverable in the event of bankruptcy. The Madoff scandal amplified concerns and resulted in rising investor demand for transparency and increased scrutiny of assets invested by fund managers.

More than anything, convergence is about the reorganisation of managers’ operating models to accommodate these challenges and exploit their clear opportunities

In light of these changes, the convergence of asset managers and hedge fund managers presents three challenges:

- product breadth and depth (including techniques and instruments),
- in-house and outsourced operations functions,
- and distribution focus and processes.

More than anything, convergence is about the reorganisation of managers’ operating models to accommodate these challenges and exploit their clear opportunities

Product diversification

In the past, hedge fund managers and traditional fund managers sold to distinct client bases; today, they are both addressing the same groups - institutional investors, high net worth individuals and retail investors - and, therefore, need to have a much deeper product offering.

‘More than anything, convergence is about the reorganisation of managers’ operating models to accommodate these challenges.’

Evidence of convergence is clear. The so-called ‘Newcits’, or regulated UCITS professional funds, launched by hedge fund houses such as Man Group, Brevan Howard and GLG Partners, now total around $35bn in assets across over 200 funds. In the lacklustre markets of the past 18 months, both retail and institutional investors in Europe are increasingly attracted to absolute return funds in a concerted effort to seek out higher returns than what is currently derived from standard benchmark products.

As a result, some Newcits have experienced considerable investor interest, such as Gartmore’s European Absolute Return Fund. Traditional fund managers are now focusing more on alternative products such as derivatives, exchange traded funds (ETFs) and absolute return vehicles in order to secure a piece of this growing segment. With significant fixed cost bases and poor aggregate revenues over the past few years, forays into in-demand absolute return products that yield higher margins are high on managers’ agendas.

New asset classes will continue to squeeze the traditional core of actively managed funds. Beta products such as ETFs and passive equity funds, along with alpha products including absolute return, REITs and short extension funds (130/30) are being offered alongside core equity and fixed income strategies. The mix of products offered by an investment manager will depend on the extent to which the firm can support such product diversification from a managerial, operational and distribution perspective.

The operating model

In adopting absolute return and hedge strategies, traditional asset managers often created incubators, which are separate investment and operational processes removed from their mainstream operations, due to the complex nature of alternative product offerings. New products have been bolted on to standalone processes, with expertise often limited to a small number of people within the firm. In a bull market, such additional expense can be absorbed, but in today’s cost-conscious world where such products are becoming mainstream offerings, the infrastructure to support them must also move into the core operating environment of the manager.

The use of different techniques, such as significant leverage (synthetic or real), shorting (synthetic or physical), and of instruments such as derivatives is no longer confined to hedge funds. These techniques and instruments are increasingly deployed across many diverse products and are often used to support the investment style of traditional long-only funds, sometimes at the whim of portfolio managers seeking greater management flexibility.
The functionality and processes that support such capabilities challenge both front and back-office processes. They must be incorporated into an investment manager’s standard operating model, including a detailed focus on risk management, timely valuations, decision-support tools, client reporting and transfer agency strategies. As a result, traditional managers are increasingly turning to their service providers to help them understand how to overcome these challenges. Providers that have prime brokerage divisions are uniquely positioned to dovetail their traditional transaction processing products with an investment banking mindset to satisfy the demand for consultative assistance.

Conversely, hedge fund managers, under pressure from both regulators and investors to increase transparency, will be required to have operational structures that can stand up to the same level of intense scrutiny as those used by traditional asset managers.

Increasingly, hedge funds are looking beyond their traditional prime broker partners for third-party operational support. While UCITS structures require the appointment of depositary banks and independent administrators, hedge funds are leveraging their newly-gained experience in this regulated sub-segment by utilising similar independent services for their offshore unregulated fund vehicles. This trend will create operational challenges for smaller managers who rely heavily on their prime brokers or significant day-to-day support. With thinly-staffed back-offices and a demand for greater transparency and security in both the regulated and unregulated space, hedge funds are seeking broader support from their new custodian and administration partners, who clearly understand the alternative manager mindset, as well as the requirements for regulated funds like UCITS.

### Challenges for hedge fund managers

Hedge fund managers are increasingly attracted to UCITS because they provide the transparent and regulated environment that many investors are now looking for as they seek greater protection for their assets. By launching UCITS products, hedge fund managers could potentially attract new investors that were previously wary of the unregulated nature of hedge fund products or concerned about transparency and liquidity.

However, the leap in understanding for alternative managers in moving to UCITS III products, even those that mirror hedge fund strategies, is sometimes underestimated. Traditional UCITS managers already have established sophisticated distribution channels and marketing strategies, while the distribution of regulated funds is new to hedge fund managers.

<table>
<thead>
<tr>
<th>CUSTOMER SEGMENT</th>
<th>FUND TYPE</th>
<th>PRODUCTS REQUIRED</th>
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<tbody>
<tr>
<td>Hedge Funds</td>
<td>Unregulated Funds</td>
<td>✓</td>
</tr>
<tr>
<td></td>
<td>Regulated Funds (UCITS) - most synthetically leveraged</td>
<td>✓</td>
</tr>
<tr>
<td>Asset Managers</td>
<td>Regulated Funds (Non-UCITS)</td>
<td>✓</td>
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<td></td>
<td>Regulated Funds (UCITS)</td>
<td>✓</td>
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<tr>
<td></td>
<td>Synthetic Long/Short Funds (UCITS)</td>
<td>✓</td>
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<tr>
<td></td>
<td>Unregulated (Hedge) Funds</td>
<td>✓</td>
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<tr>
<td>Alternative Separately-Managed Accounts</td>
<td>Internally/externally managed pensions</td>
<td>✓</td>
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<tr>
<td></td>
<td>Internally/externally managed SWFs</td>
<td>✓</td>
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</table>
UCITS regulations that require risk management, measurement and reporting may be onerous new requirements for hedge fund managers whose previous primary focus was the management of portfolios. In addition, the 2007 UCITS III regulations require independent derivatives valuation and puts limits on counterparty exposure, both of which are new territory for hedge fund managers.

The fee structure of traditional UCITS is yet another challenge for hedge fund managers, who may find it presents significant fee compression.

As a result of these regulatory challenges, not all hedge fund strategies can be mirrored within the UCITS construct, and there may well be significant variance between a hedge fund’s performance and that of a mirror UCITS.

Integrated services

Concerns about the safety of assets, along with those of operational and counterparty risk have sparked increased interest from investment managers in integrated services across custody and prime brokerage. More than ever, managers are looking to divide their assets between specialist providers (prime brokers for leverage and custodians for unencumbered long positions) in response to both regulatory and investor demand.

However, such asset segregation is not without its challenges: employing multiple prime brokers and separate custodians can create significant operational risk, in addition to increasingly complex relationships with depositary banks, fund administrators and transfer agents.

Most hedge funds simply do not have significant middle or back offices to support these ever more intense operational needs - they have traditionally relied heavily on their prime brokers to assist them with all of their day to day settlement needs.

This has led to increased interest in the integration of prime brokerage and custody. Integrating a custody account with that of the prime broker enables collateral to be automatically moved back and forth. As fund managers will be increasingly required by regulators to ensure the safety of assets used in hedging, the combination of custody and prime brokerage will become attractive.

Convergence between hedge fund managers and traditional asset managers will continue and as their strategies resemble each other, so too will their front and back-office operations. They recognise that the investment required for the infrastructure to support the growing breadth of product offerings will only increase. For this reason, they will seek out new structures and solutions, such as combined prime brokerage and custody that will relieve them of the burden of an increasingly complex and costly operating environment while continuing to generate higher returns both for end-investors and company shareholders.

‘As fund managers will be increasingly required by regulators to ensure the safety of assets used in hedging, the combination of custody and prime brokerage will become attractive.’
The future of the pan-European operating model

In order to benefit from the potentially significant cost savings delivered by the UCITS IV directive, investment management companies must implement a truly pan-European mutual funds operating model.

In adopting the UCITS IV model, fund managers will have an opportunity to save a great deal of money, in addition to widening their distribution channels across Europe and globally. But there are some complex decisions to make about how they should approach UCITS IV.

The single management company passport introduced in UCITS IV will allow managers to bring expense ratios down, closer to those enjoyed by US funds. Overheads will fall, there will be fewer duplicates of funds and of middle and back office functions. It will also make it simpler for managers to do business across Europe.

Certainly, the European Commission has serious ambitions enshrined in UCITS IV. In its 2008 paper, Impact assessment of the legislative proposal amending the UCITS Directive, the European Commission estimated that UCITS IV reforms, which will enable fund rationalisation through cross-border mergers or the use of master feeder structures, could deliver savings of up to €6bn annually to the funds industry through the elimination of the rationalised funds’ fixed costs and through the economies of scale achieved by the larger resulting funds. Moreover, the reduction of the administrative burdens via the management company passport and the simplification
of notification procedures could deliver annual operational savings of between €381m–€762m and €45m respectively. Costs of managing investment portfolios are not linear; the larger the pool of assets, the lower the overall costs of management. The average fund size in Europe is US$ 170 million compared to the average US fund size of US$ 1.2 billion. Therefore, significant expense savings could be realised if funds in Europe were much larger.

**Operating models**

The European Commission has said it expects the fund management industry to take advantage of the new framework. But it is not clear yet whether the industry will implement en masse, and if they do, what operating model the industry will opt for.

This very much depends on what the investment manager looks like today. For large asset managers with a number of management companies operating in different jurisdictions, the single management company passport will be of great benefit. Using the passport, they will be able to wind down management companies and opt for a single company in a single country. The choice of country may depend on where their principal operational expertise is today. For most, Luxembourg and Ireland are centres of excellence and it may make sense for this reason, as well as for tax considerations, to base their management companies in one of these countries.

But this leaves a question of what will happen to managers that have a strong base in their home countries. For example, will a manager with a strong UK unit trust or OEIC base close down its UK operations and merge its funds into Luxembourg funds? Many UK retail investors are reluctant to invest ‘offshore’ and investment management companies operating in the OEIC environment will want to determine whether they will continue to attract domestic investors if they move their funds to Luxembourg or Dublin. In addition, UCITS IV is silent on tax. For example, UK investors may face capital gains tax if their UK fund is merged into a Luxembourg fund. The impact of varying domestic tax regimes on a domestic investor base will be a key consideration when deciding whether a merger or master feeder arrangement is viable.

The likelihood is that the market will split – those investment managers already operating an onshore and offshore model will consolidate where they can, while those that don’t won’t.

**Tax implications**

At present, tax appears to be the major obstacle to a fully rational approach. For example, SICAVs and VCCs in Luxembourg and Ireland respectively do not qualify for treaty relief in respect of dividend income, so the challenge will be to find a rationalised model that preserves the tax status of the investors from a treaty jurisdiction. Tax transparent funds may be the answer, but work remains to be done to ensure that, operationally, differing tax treatments can be economically integrated to meet that challenge.

Over the longer term, it is unlikely investment managers will want to continue to operate with two different approaches. Once investors are educated to the level where they are comfortable with offshore investing, and if the tax obstacles can be overcome, the market will see more Luxembourg and Dublin-based products launched, while local products will be put into feeder structures or will disappear.

The ideal model would be a fund range located in a single jurisdiction and distributed globally. The benefits of this structure for cost savings to managers and performance improvements for investors would be substantial. But the ideal and reality are often at odds.

However, there will still be demand for local investment products where investment culture, tax or other
concerns are paramount, and it is not clear that the issue of a harmonised tax regime will be on the European agenda anytime soon. Still, there will be a significant dilemma for managers with large fund families in a number of locations as they decide whether to merge their funds or adopt master feeder arrangements. Or, they may decide to leave things alone.

**Master feeder structures**

Master feeder structures may be adopted where managers see the most potential for rationalisation. This doesn’t require costly unwinding and merging, and enables the identity and domicile of a fund to remain intact while potentially benefiting from scale economies through asset combination. This is likely to appeal to groups whose asset management activities are fragmented and/or where there may be more than one brand name across the group because it will preserve local “identity”. The type of model adopted may be particularly influenced by investor preferences: in Germany and the Nordic countries, for example, investors are happy to buy offshore products, while in France, investors tend to prefer local products, in which case, we believe local feeder funds may well dominate.

It is also not clear what the tax implications of the master feeder model will be, since tax regimes across Europe are not harmonised. Perhaps this is where technology will have a significant role to play but it is likely that tax will be, as it so often is, a stumbling block to progress and potentially costly to resolve. For example, fund companies could opt for tax transparent structures and build in the necessary differential data capture and reporting requirements for varying tax treaty requirements.

In the long run, some groups may adopt a hybrid model. In this scenario, local funds are likely to be feeders into masters in centres of operational excellence, while fund ranges will merge where tax or investor preferences permit. The European Commission clearly envisages vast cost savings for the industry. What isn’t yet clear is whether the initial costs will be deemed prohibitive when set against long-term savings and whether costs will be sufficiently reduced within the master feeder arrangements because local rules will still apply to each master and feeder. The Commission may have to revisit UCITS IV fairly quickly and possibly, have to grapple with the thorny issue of tax. When it does, the industry needs to have prepared a coherent response.

Another approximation to master feeder arrangements is a model that utilises share classes within existing funds, tailored to the relevant distribution channel. The ultimate model here may be to introduce a hedge share class, where a manager will have multicurrency capabilities within funds in Luxembourg or Dublin, and specific currency hedge share classes that are sold into local funds supermarkets in different countries.

Hedge share classes are probably the least expensive model for investment management companies to implement, although tax would remain an issue.

Companies that are new to the market will have a significant advantage because they are unencumbered by existing investors and products and can utilise the whole UCITS toolbox to design an efficient mutual fund model.

**Processing models**

UCITS IV requires major decisions to be made about how funds are managed on a pan-European basis. Whether

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‘Whether managers opt for the single fund range approach or adopt master feeder structures, or a combination of these, they must provide an audit trail of many disparate pieces of information to satisfy the transparency requirements of UCITS.’
managers opt for the single fund range approach or adopt master feeder structures, or a combination of these, they must provide an audit trail of many disparate pieces of information to satisfy the transparency requirements of UCITS. All of the operational processes across different instruments and different funds, regardless of where they are domiciled, must be processed and reported uniformly and in a timely manner.

The data management challenge faced by fund management companies becomes even more complex as regulators impose increasingly stringent transparency and reporting requirements. Most companies operating funds out of Dublin or Luxembourg have already outsourced fund administration. This is likely to continue and the choice of service provider will be determined by the latter’s capability, capacity and efficiency in processing and reporting on vast banks of data in an environment where risk control is at a premium.

The ultimate choice for fund management companies will be about efficiency and which model will realise the most savings and enhance margins. Managing multi-country operations on multiple platforms is a day-by-day problem for fund managers. The meshing of requirements that differ from jurisdiction to jurisdiction and provide management information that enables proper oversight to be conducted continues to be a significant challenge.

There are many variables to consider under UCITS IV. The only thing that is clear is that operating processes, based on global, scaleable platforms that can provide a single book of records for both investment servicing and fund accounting, will go a long way towards delivering the efficiencies and risk mitigation now being sought by the industry.

**Master Feeder Structure**

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<tr>
<th>UK INVESTORS</th>
<th>LUXEMBOURG</th>
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<tr>
<td>UK</td>
<td>EURPEAN INVESTORS</td>
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<td></td>
<td>(e.g. Italy)</td>
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<tr>
<td></td>
<td>ASIAN INVESTORS</td>
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<td></td>
<td>(e.g. Hong Kong)</td>
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<tr>
<td>UCITS FEEDER</td>
<td>UCITS MASTER</td>
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<tr>
<td>DEPOSITARY A</td>
<td>DEPOSITARY B</td>
</tr>
<tr>
<td>AUDITOR A</td>
<td>AUDITOR B</td>
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</tbody>
</table>

Minimum 85% Agreement

The Future of Asset Management

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Demographic challenges are impacting savings trends across the world. Growth of personal savings — that is, savings outside of government schemes — is greatest in emerging markets like Asia and Latin America. Emerging markets in these regions had been slower to establish government or corporate-backed pensions and savings plans. In the last 10 years, when it became apparent the demographic trends were making these plans difficult to maintain in more developed markets, such as Western Europe, countries that hadn’t yet established these plans have left it to the private sector to help people save for retirement.

In developed markets where corporate-sponsored defined benefit plans have played such an important role, accounting rules and markets have taken their toll and employers are switching their employees to defined contribution arrangements, making employees bear the risk.

As power shifts towards distributors, asset managers must develop products that meet their requirements along with those of underlying investors.

The rise of the distributor
The good news is that this is the single largest growth enabler in the asset management industry globally. Individuals now recognise they need to take more personal responsibility for their retirement provision, which will be done via retail channels. The vehicle of choice is the mutual fund. Globally, the mutual fund vehicle that has widest applicability is the UCITS. UCITS is not only capable of cross-border distribution within the EU, but it is increasingly popular around the world. For example, in Asia Pacific alone there are over 3,500 Luxembourg-domiciled UCITS registered in Australia, Japan, Singapore, Hong Kong and other markets. In Latin America, over 1,000 Luxembourg-domiciled UCITS have qualified for distribution. The UCITS model has been accepted by regulators around the world as a successful standard that is appropriate for retail investors. That recognition by regulators and by global and pan-regional distributors will continue to drive the expansion and growth of the UCITS brand around the world.

Given the complexity of that distribution, asset managers have to work with distributors to access the wall of money from retail investors. The asset manager and distributor have to form a workable partnership through which their brands and objectives are complementary to best serve the end clients.

Because the end-client relationship is now often owned by the distributor, the balance of power in this relationship has changed. Asset managers’ success is increasingly determined by the performance of their distributors, who often dictate what kinds of products they will put forward to their end clients.

For example, some fund supermarkets now dictate conditions to fund managers to the point that if they don’t comply, their products won’t be distributed. Investment management firms need to consider how their products will meet their distributors’ requirements, along with the requirements of the end investor. Few but the very largest firms that want end to end control of their brand will choose to distribute directly into the retail space. The rest will either need to find the right ‘shelf space’ within a fund supermarket or forge selective relationships with powerful distributors in various markets in order to get the most out of their distribution strategy.

### Growing complexity

While distribution is gaining in importance, it is also growing in complexity. There is no one distribution model, even within individual markets, and this inconsistency has led to a high degree of variability in the retail investment industry [see chart on page 16]. This inconsistency also means that distribution is the most expensive component in fund architecture, which has to be managed.

The attraction of UCITS funds to investors in various markets around the world makes the products easier to sell. However, for a European-based asset manager with Luxembourg-domiciled funds to sell, the prospect of distributing into countries on the other side of the globe is daunting and expensive.

The rise of the distributor

‘A shift in distribution implies a change in the balance of power in favour of the client, as distributors forge closer relationships with investors and increasingly ‘own’ the client relationship.’

As asset managers seek to meet the demands of distributors and expand their product range into new markets, there are some conditions that must be met by the asset managers and by their transfer agencies:

- **Local language support** – Support staff must be able to speak the local language and documentation must be in the languages appropriate to the location;
- **Understanding the local culture** – Language capability is not enough. Staff should also be well versed in the local customs and understand what is appropriate for that country;
- **Reporting** – an understanding of local regulations and an ability to adhere to a variety of reporting requirements;
- **Time zone support** – For European investment management firms, Asia is many hours ahead and systems and services must be available during the Asian business day;
- **Technology** – Global distribution is complex and requires robust and reliable technology platforms to connect to distribution platforms, in the way the distributors want to connect.
Solutions

In building better relationships with their distributors, investment management companies need a transfer agency infrastructure that will be able to support distributors as they tap into the pools of assets in Asia and Latin America. As distribution models become more complex, it is critical that a transfer agency provider can service local and global investors, distributors and promoters, and be able to service their current and future needs.

These capabilities are costly, and servicing a far-flung but important market could account for a significant amount of investment managers’ expenses at a time when they are looking to increase efficiencies and reduce costs.

In addition to the conditions listed above, a transfer agent providing international distribution support must be able to manage the entire commission/rebate/trailer fee process, maintaining fully-automated links to all major local and cross-border dealing and settlement platforms.

The ideal transfer agent will also be able to promote distribution into multiple markets by leveraging its geographic footprint, which would enable it to deliver local paying agency and product/distribution consulting.

Transfer Agency is of critical importance to asset managers getting distribution right. It has a direct impact on the asset gathering capability, so the successful ones will stand out amid a bundled product and service offering.

For this reason, distribution increasingly will be about partnerships as investment firms realise that capital intensive activities that do not generate direct revenues should be stripped out of their operations and handed over to third parties that can do the heavy lifting.

Building an efficient distribution network will be about partnerships, rather than going it alone.

Europe 31,670 registrations – the key markets:
- Austria 2,925
- Belgium 1,364
- Finland 1,531
- France 2,535
- Germany 3,530
- Italy 2,171
- Netherlands 1,964
- Norway 1,049
- Spain 2,475
- Sweden 1,383
- Switzerland 2,571
- UK 1,709

Asia Pacific 3,528 registrations – the key markets:
- Australia 50
- Hong Kong 899
- Japan 58
- Korea 310
- Macau 429
- Singapore 1,230
- Taiwan 515

Middle East 788 registrations – key market Bahrain with 700

Americas 1,114 registrations – key market Chile with 950

Africa 612 registrations – key market S. Africa with 60

Source: Lipper Hindsight
In the wake of the financial crisis, Europe's regulators are placing more stringent demands on the investment industry. Industry participants must engage in the lobbying process in order to ensure regulations reflect their needs and the needs of their investors.

The regulatory landscape for the investment management industry continues to evolve and no part of the industry will emerge untouched. Amid the uncertainty about current and proposed regulation, investment management firms should focus on what it means for them from a practical point of view. In addition, since any regulatory changes are likely to be transformative, the industry should consider engaging with regulators who can impact their business from the very start of the process.

UCITS IV, the proposed Directive on Alternative Investment Fund Managers (AIFMD), Solvency II and plans for regulating OTC derivatives all present challenges that need to be met. In the face of these significant changes, the industry and its trade associations should be prepared to offer practical and appropriate suggestions to Finance Ministries and EU legislators, so their voices are heard. Any lobbying effort seeks to ensure legislation meets its objectives while addressing the needs of the industry and its end investors, and the fund industry should set this as a goal.

**Industry response**

The implications of changing regulation are manifold. The cost of running and distributing funds may increase, which will challenge the industry to find new ways to contain costs in an environment of low subscription rates. As a result, new fund offerings could shift from active to passive in order to mitigate this increased cost of compliance. It is also likely that asset managers will seek to rationalise their product...
offerings and, where possible, adopt common standards across all products and integrate platforms.

In light of the regulatory changes facing the industry, some of which are listed above, there are a number of ways that the industry can respond. For example, many hedge fund managers are already embracing the UCITS framework, in part because of investor pressure in the wake of the financial crisis. But if the industry perceives the regulatory pressure they face through the UCITS regime, as well as for their traditional hedge fund business, is an onerous obstacle to their business, companies that are flexible may turn their arbitrage expertise to regulatory regimes and could “shop” for a friendly regulator.

Below is a look at two of the more pressing regulatory changes facing the industry:

**Directive on Alternative Investment Fund Managers (AIFMD)**

The draft AIFMD covers European based managers of all non-UCITS collective investment funds. It will require them to be authorised by and provide detailed information to local financial markets regulators, and to meet minimum capital adequacy requirements. The current draft also impacts depositary duties and may have far-reaching consequences for the availability of non-EU alternative products to EU institutional investors. While it is clear that the directive will have amendments, it is likely to be adopted and live by 2012 in all member states.

A critical issue within the draft AIFMD is that of depositary liability, which may have significant implications. In the initial draft of the Directive, a stricter standard of liability for depositaries is proposed, which includes a reversal of the burden of proof in respect of lost assets. This area is one of considerable concern to Depositaries and investors alike and likely to continue to be debated over the next few months.

In addition to increasing costs, potentially substantially, this is likely to result in depositaries wanting more visibility in the activities of the asset manager, as they may be required to put their balance sheet to use on behalf of the fund manager. Asset managers will need to choose their depositary wisely and be prepared to adhere to the stricter controls this will imply. They will also need to ensure that their depositary is committed to the industry for the long-term.

**Over-the-counter derivatives**

The market events of past two years have thrust the previously little-known world of over-the-counter (OTC) derivatives processing into the spotlight. For several years, the industry has been working to streamline and automate processing, and to increase the use of industry utilities and infrastructures.

The recent focus on systemic risk by governments and regulators has included a reappraisal of how the OTC derivatives market operates, and looks likely to result in increased requirements for operational change in an aggressive timescale. As investment managers continue to increase their use of derivatives, they will need to pay close attention to the regulatory changes now being proposed.

The buy-side community is within the scope of many of these changes, and impact on operational processes could be significant. Buy-side participation in the ISDA Governance structure has
increased recently, with eight buy-side firms and two buy-side trade associations signing the latest set of industry commitments to the regulators.

As a result of the amount of complex change facing the industry and the need to respond quickly to these changes, investment management firms are increasingly looking at outsourcing their OTC operations.

### Transparency

The days of doing the minimum to comply with new regulations are disappearing. The industry, particularly in the US, is going beyond regulatory requirements. Not only do these fund managers want to differentiate themselves by being fully transparent, but many say that they expect more onerous regulatory requirements may be in the pipeline.

Achieving transparency while being fully compliant, however, is no easy task. Full transparency requires much higher levels of reporting and poses significant data management issues. Many asset managers do not have extensive compliance and legal teams, just as they do not have large middle and back offices. Securities services providers, as holders of investment data, are best placed to provide the reporting and processes that are necessary to achieve higher levels of transparency.

### The industry’s voice

The current debate over financial industry regulations highlights the increasingly important role regulators are playing in the financial services industry. The financial crisis has brought regulators to the fore and politicised regulation to a much greater degree than in the past. The industry cannot afford to let change happen to it; it needs to fully engage in the regulatory process and make its voice heard.

The changing regulatory environment will force all players in the industry to focus on the impact of regulation on their product offerings, how their organisations are structured and the risks they are prepared to take on.

It will lead to a reassessment of asset manager business models as they cope with an increased focus on risk management and mitigation, increased capital requirements, transparency and reporting and product design restrictions.

Asset managers cannot afford to ignore regulations, no matter how technical and controversial they seem to be. These regulations, and others that will come, will materially change the environment in which participants in the investment industry work.

<table>
<thead>
<tr>
<th>Regulations</th>
<th>What is it?</th>
<th>Who does it impact</th>
</tr>
</thead>
<tbody>
<tr>
<td>AIFMD</td>
<td>Requires asset managers to be authorised by and provide detailed information to local financial markets regulators and to meet minimum capital adequacy. Stricter standard of liability for depositaries</td>
<td>Applies to European based managers of all non-UCITS investment funds</td>
</tr>
<tr>
<td>Solvency II</td>
<td>Requires insurers to publish details of the risks facing them, capital adequacy and risk management.</td>
<td>Insurance firms</td>
</tr>
<tr>
<td>UCITS IV</td>
<td>This enables fund rationalisation through cross-border mergers or the use of master feeder structures</td>
<td>Europe fund management industry</td>
</tr>
<tr>
<td>Review of Retail Distribution</td>
<td>This review is designed to give consumers more confidence and trust in the retail investment market</td>
<td>Retail investment industry</td>
</tr>
<tr>
<td>Dutch Authority for the Financial Markets</td>
<td>To replace a ban on short selling with mandatory reporting on all short positions</td>
<td>Banks and insurers</td>
</tr>
</tbody>
</table>
The forces of convergence, regulation and the increasing complexity of distribution are fundamentally changing the anatomy of the investment management industry. This is an industry in a state of flux, whose participants are unclear about the future.

But it is also an industry returning to growth, with CAGR of 5.6% predicted for Europe to 2013 and CAGR of 15-18% for Asia in the same period. In Europe, growth in the savings market will continue to be driven by long-term pension provision; shortfalls must be addressed by bringing investors back into the market. How well asset managers can capitalise on this growth will depend on how they tackle the issues raised in this report.
In addition, asset managers are increasingly seeking growth outside their home markets, particularly Asia, but in doing so face questions as to how they will support operations far from their home base. Both factors contribute to an increasingly complex distribution structure.

Regulation
In the aftermath of the financial crisis, regulators around the world are seeking to restore trust and confidence in the financial industry and markets. Regulators are placing more exacting demands on the investment industry and this will continue to be a factor in 2010. For this reason, asset managers must make their voices heard and need to be fully engaged in the regulatory process.

All four of these areas present challenges to investment managers’ operational structures. Choosing the right partners for middle and back office operations and partners who understand the complex distribution and product needs will enable investment managers to launch more products and enter countries faster than if they were operating their own middle and back offices.

In an environment of falling margins, managers cannot afford to let operating costs rise. For all firms, costs grew faster than assets in 2008 and profitability will remain a challenge in the years to come. For many, 2009 was also a difficult year. The increasingly sophisticated technology required to manage new product and regulatory initiatives will continue to be a significant cost for managers.

For this reason, outsourcing is expected to become an increasingly popular route for managers as they focus on areas core to their business and hand over areas that are not. It was not unusual 25 years ago for an investment manager to undertake its own custody, fund administration and transfer agency. Those days are long gone and we are about to see another evolution in outsourcing as asset managers hand over more of their middle and back office functions.

‘In an environment of falling margins, managers cannot afford to let operating costs rise.’

‘The increasingly sophisticated technology required to manage new product and regulatory initiatives will continue to be a significant cost for managers.’

Convergence
Traditional long-only asset managers and hedge fund managers are increasingly competing for the same investment dollars, are offering similar products to the same group of investors. To develop and manufacture products successfully, both fund managers and hedge fund managers will need to integrate the new products into the bulk of their business in order to realise operational efficiencies.

UCITS IV
This EU directive promises to deliver significant cost savings. To capitalise on these savings, asset managers will need to assess existing product offerings, distribution channels, investor preferences, tax and future product development needs. The opportunity to merge funds, utilise a master-feeder structure or a combination of these, may be appropriate, while the single management company may similarly be attractive. Asset managers will ultimately decide the model that is most efficient for their current and future needs.

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Distribution
The industry focus is shifting from manufacturer to distributor, with the distributors becoming a far stronger influence in product design, given their close relationship to investors.
What should you be thinking of now?

**Convergence:**
- The operational processes for traditional and alternative strategies should be integrated to deliver efficient solutions
- Separate infrastructures for alternatives need to converge with core business over time
- Streamline and integrate product manufacture
- Outsourcing of non-core activities to focus on your core business

**UCITS IV:**
- Evaluate opportunities for streamlining management company structure utilising the single management company passport
- Determine whether fund mergers and/or master feed arrangement are most appropriate to your new operating model
- Outsource fund administration

**Distribution:**
- Work closely with your service provider to build a robust scaleable distribution platform to tap into growth
- Implement a transfer agency infrastructure to promote distribution into multiple markets
- Ensure that products meet the distributors’ and end investors’ requirements

**Regulation:**
- Play an active role in the regulatory process
- Consider the impact of that changes such as those around depositories may have on your business and product
- Achieve high levels of transparency and reporting
- Outsource OTC operations
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