



New Challenges Ahead Will Test Asset Managers

After almost three years of unrelenting regulatory change, will there be any reprieve for asset managers? Is there yet more to do? UCITS V, changing attitudes of non-EU regulators to UCITS, corporate governance and eligible assets: all are on the industry agenda—any of these might change product mix, distribution strategies and business models. Finally, how does J.P. Morgan see the future?



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The European asset management industry has reason to be proud of its achievements. Assets under management stood at €3 trillion at the end of 2001 but had reached €7.89 trillion by the end of Q2 2011. UCITS make up 74% of the funds in Europe and are, without doubt, one of the most successful products of Europe's single market project. No longer a new concept, they have been around for more than a quarter of a century, and over this time they have evolved and adapted to meet the needs of today's more sophisticated investors. This is due in no small part to the engagement of European policymakers who have framed regulations that provide increased flexibility in terms of eligible assets.

For example, the original idea of creating a product framework that would be eligible for cross-border marketing in European Union Member States has been a success; cross-border sales now account for almost 80% of net European funds sales.¹ But more than that, UCITS has a global marketplace with regulators as far afield as Asia and Latin America accepting the brand. In 2005 the Hong Kong regulator, the SFC, was the first Asian regulator to accept UCITS III funds. This is good news for asset managers because there are limits to the scale that can be achieved by marketing solely in Europe, although there are still significant opportunities, not least in competing for the often sizeable non-managed portion of household financial assets, i.e., cash.

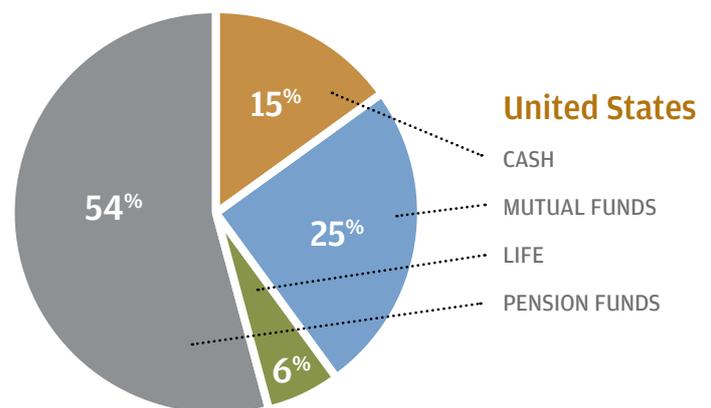
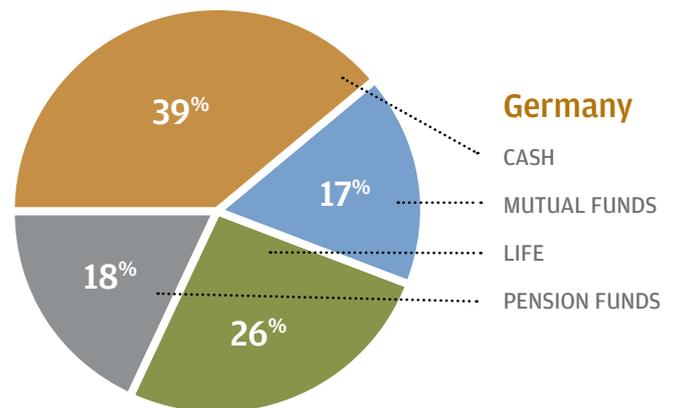
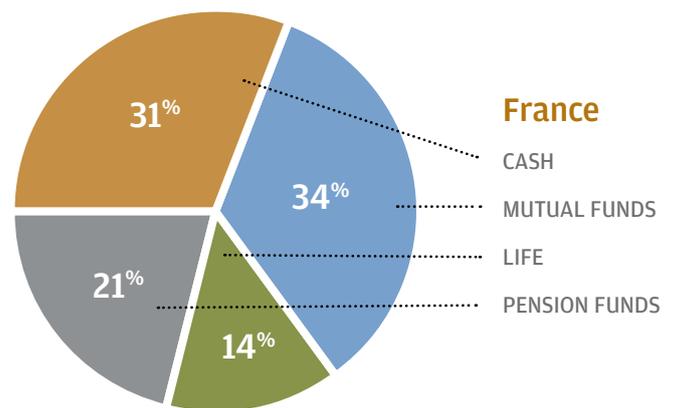
The charts on the right compare the proportion of cash in household financial assets for France, Germany and the United States. The data demonstrates that in some countries there is still a significant allocation of cash savings by households, and it is these "unmanaged" savings that provide a considerable opportunity for asset managers.

However, since 2008 the regulatory environment has shifted. We are now facing an unprecedented tsunami of regulations on both sides of the Atlantic, with the reform agenda framed by G20 commitments. Asset managers will have to adapt.

The Dodd-Frank Act

The U.S. chose to meet its G20 commitments in the wake of the financial crisis with one sweeping piece of legislation, the Dodd-Frank Wall Street Reform and Consumer Protection Act. Although it runs to more than 2,000 pages in final form, it devolves much of the detailed rule-making to regulatory authorities, such as the Commodities Futures Trading Commission (CFTC) and the Securities Exchange Commission (SEC). The Act delivers a thorough reform of the U.S. financial system aimed at creating transparency, particularly in the derivatives space, with the mitigation and early warning of emerging systemic risk. It also includes the creation of a range of new regulatory agencies. Asset

Household Financial Assets





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managers in Europe who have business in the U.S. need to be aware of the new registration requirements, which unless exemption can be obtained, are onerous. The existing private investment advisor exemption which many non-U.S. managers relied upon has been eliminated and replaced with new requirements. Fortunately the original date for registration (July 2011) was extended by the SEC; applications must now be submitted by March 2012.

European initiatives

In Europe, the approach to G20 commitments has taken a different path with a number of regulatory initiatives coming in to deal with different elements of the perceived problem. For example:

- **Alternative Investment Fund Managers Directive (AIFMD)**, aimed at dealing with hedge funds (but capturing a whole range of other product types in its wake), and
- **European Markets Infrastructure Regulation (EMIR)**, part of the EU's response on derivatives.

In common with the United States, Europe has also re-cast its regulatory structures and introduced new regulatory authorities, including the European Securities and Markets Authority (ESMA) which replaces the Committee of European Securities Regulators (CESR).

The first post-crisis legislative change in Europe, AIFMD, was aimed squarely at asset managers. The Level 2 detailed rules that give substance to the Directive are currently being drafted, and we will not know the outcome until January 2012 at the earliest. What we do know, however, is that elements of AIFMD will be incorporated in the next round of UCITS regulation in the guise of UCITS V. In particular, it is expected that UCITS V will reflect the provisions of AIFMD as they affect depositaries. It would be inappropriate for the alternatives world to be subject to more prescriptive rules than those applicable for UCITS, which were originally conceived as a type of fund that would be suitable for retail investors.

In addition, a discussion paper on ETF UCITS and structured UCITS was published in July. This followed reports on the

use of derivatives by ETFs by the International Monetary Fund (IMF),² the Bank for International Settlements (BIS)³ and the Financial Stability Board (FSB).⁴ The initiative from ESMA follows their review of the regulatory regime pertaining to UCITS ETFs and structured UCITS from which ESMA concludes that “the existing requirements are not sufficient to take account of the specific features and risks associated with these types of fund.” The ETF market is a small part of the mutual fund universe, and plain vanilla ETFs still dominate with an estimated 85% of ETF assets globally. However, according to the Financial Stability Board, 45% of European ETFs are synthetic, and this is due in part to derivatives being categorized as “eligible assets” for UCITS. The SEC also published on 31 August 2011 a concept release with a request for comment on the use of derivatives by U.S. mutual funds.

Change for UCITS is clearly in the air. Under the Markets in Financial Instruments Directive (MiFID), UCITS that use derivatives will be categorized as complex (whereas now UCITS are generally deemed as non-complex). What then are the implications for distribution? In addition, or alternatively, will the Eligible Assets Directive be redrawn to restrict the use of derivatives? If so, will asset managers utilizing hedge fund-type strategies perhaps opt-out of UCITS altogether and seek authorization as AIFMs?

It has been said that the AIFM “badge” will evolve to become a global standard as has UCITS. In my view this is unlikely, in part because a UCITS is a fund whereas an AIFM is a manager, and there is very little heterogeneity in the countless types of non-UCITS that are within scope.

There are, of course, items on the change agenda that did not emerge from the G20 commitments. Solvency II pre-dates the financial crisis, but when it comes into force on 1 January 2013 it will significantly add to the reporting burden for those asset managers with insurance clients. In recent months both the Council of the European Union and the European Parliament's Committee on Economic and Monetary Affairs have called for a further delay until 1 January 2014. Regardless of whether an extension is granted, insurers and their advisors will need to make significant changes to the way they operate and report. All of this will be time and resource intensive at a time when there are so many other regulatory changes that require attention.

Implications of FATCA

Another non-crisis related change is the U.S. Foreign Account Tax Compliance Act (FATCA). This has truly daunting implications for asset managers around the world. FATCA aims to eliminate opportunities for U.S. tax evasion by requiring the identification of U.S. account holders and imposing reporting obligations on non-U.S.

financial institutions, e.g., foreign financial institutions (FFIs) and non-U.S. non-financial foreign entities (NFFEs). If no information is provided to the IRS, FATCA introduces a 30% withholding tax on “withholdable payments” which include, inter alia, interest dividends and rents, as well as gross proceeds on disposal of any property that can give rise to U.S. source dividends or interest.

Clearly, asset managers with extensive, often remote distribution networks will find it very difficult and costly to comply with FATCA. There has been extensive lobbying for an exemption for widely held mutual funds. The legislation for FATCA is being supplemented by a series of IRS⁵ and Treasury Notices that provide further details and guidance. However, the rules are not yet final. There has been an extension of the implementation timeline for certain withholding obligations:⁶ originally FATCA was due to be effective from 1 January 2013, but this has now been pushed back to 1 January 2014. An FFI must now register as a participating FFI by 30 June 2013 in order to avoid being withheld on beginning 1 January 2014.

FATCA presents an enormous challenge for asset managers unless some measure of exemption can be obtained, perhaps by being categorised as “deemed-compliant FFIs.” Currently, deemed-compliant FFIs include certain local banks, local FFI members of a participating FFI group and certain other investment vehicles. In respect of the latter category, a fund may be deemed-compliant if:

- All the investors are participating FFIs or deemed-compliant FFIs or are FFIs exempt from all FATCA withholding.
- The fund prohibits subscription by any entity not falling into the preceding categories.
- The fund certifies that its passthru payment percentages will be published quarterly.

It is unlikely that asset managers will be able to seek deemed-compliant status, and they cannot afford to ignore FATCA. Asset manager business models are complex; their distributors are scattered around the world; they have product sets that include U.S. portfolio allocations—and some non-U.S. stocks that have U.S. source income. They will have to undertake detailed screening of their investor base to identify U.S. investors and “recalcitrant” investors; this may appear straightforward, but it is not. In reality, few asset managers have substantial exposure to a direct client base—platforms and intermediaries have served to anonymise the client. This, unfortunately, does not remove the obligation to respond to—and comply with—FATCA. The U.S. aims to capture US\$7.6 billion from FATCA over a period of ten years. (*Further information concerning FATCA can be found on page 8.*)

Looking ahead

The next two to three years will be extremely difficult for the industry as the wave of new regulations tests the resilience of the mutual fund industry. For European asset managers, the lure of Asia as a distribution hub may be subject to strain: a number of regulators in Asia have voiced concerns over the use of derivatives by UCITS, echoed now by ESMA. In addition, the long-discussed Asian fund passport is becoming a distinct possibility. Currently 90% of all offshore products sold in Asia derive from Europe. This could change if mutual recognition and cooperation between Asian regulators is successful. It would be a serious set-back for European UCITS.

Looking to the future, it is hard to predict whether the current momentum in UCITS will continue. Distribution is the lifeblood of the fund industry; the business model predicated on a European hub for globally distributed products is under threat. That is not to say that asset managers will be unable to “follow the money;” their skill in product design and innovation is easily transferable, and if local product is a requirement for Asian investors, then local products there will be.

However, the way European UCITS are distributed in Europe is also worth looking at, since for markets where proprietary distribution is dominant (France, Germany, Italy, Spain) the focus of the sales effort is new products. This contrasts with the UK where IFAs are the dominant sales channel. In the UK, the vast majority of sales are directed to established funds (85% in 2010), not newly launched products. It must be noted though that the Nordic markets, where bancassurance dominates, follows the UK in favouring “backlist” products, although these markets are small. The UK’s experience mirrors that of the U.S., where on average 90% of sales are into mature funds. The never-ending cycle of new products really needs to be addressed. Perhaps it is this that explains the enormous number of mutual funds in Europe: at end 2010 there were 35,292 European mutual funds with total net assets of US\$7.9 trillion. In the U.S., by contrast, there were just 7,582 mutual funds with assets of US\$11.8 trillion. It is, in part, the size of the average U.S. mutual fund that explains their advantage in terms of expense ratios and returns.

UCITS will need to find a new axis for growth: this could be built around the need in Europe for some form of pan-European pension saving arrangement. If this could be accommodated within the UCITS framework then there may be opportunities for the asset management industry to capture this potentially enormous market. The scale challenges of the European industry are well-rehearsed and UCITS IV provides some of the tools that



enable the industry to address this. However, there has been very little interest in master-feeder arrangements or mergers because many obstacles remain. The fund industry is just one part of the financial services landscape. Other sectors, banks, broker-dealers, insurers and others are all subject to the increasing regulatory burden. In particular there are more stringent capital and/or solvency requirements as well as much higher compliance costs to be addressed. These are likely to play a part in reshaping the industry, shaking out the weak and offering opportunities for growth. This may be the catalyst that begins to remove

large numbers of essentially moribund funds from the market and lays the groundwork for scale—a better deal all round for the investor. ■

¹ Source: Lipper

² Global Financial Stability Report, April 2011

³ BIS Working Papers no. 343, "Market structures and systemic risks of exchange-traded funds," April 2011

⁴ "Potential financial stability issues arising from recent trends in Exchange-Traded Funds (ETFs)," April 2011

⁵ IRS Notices: 2010-60: <http://www.irs.gov/pub/irs-drop/n-10-60.pdf>, 2011-34: <http://www.irs.gov/pub/irs-drop/n-11-34.pdf>, 2011-53: <http://www.irs.gov/pub/irs-drop/n-11-53.pdf>

⁶ In respect of dividends, interest and certain other U.S. source payments

And How Will the Resulting Regulations Impact Global Fund Distribution?

The key to the success of UCITS is its ability to passport freely cross-border within the EU and to distribute globally from recognised and specialist domiciles such as Ireland and Luxembourg.

The turmoil created by the global financial crisis in 2008 has expedited a raft of regulatory reform and change. One of the questions outstanding is how these regulatory changes will impact the current UCITS fund distribution model and what will the impact be to investors?

Upcoming changes

Luxembourg and Ireland are the two main domiciles of choice for fund promoters seeking to establish UCITS funds that will be marketed cross-border, i.e., mutual funds that will offer more than just domestic distribution. Over the years, these two fund centres have developed the necessary infrastructure and skilled workforce to service UCITS funds for international investors.

The distribution model facilitating this growth has evolved over the last 25 years with new markets opening up, new developments in fund structures and greatly enhanced technology. As a result, the concept of global distribution can be confusing and often hard to navigate. Identifying a single distribution model that can accommodate a diverse range of regional

requirements and local buying behaviours via distributors, banks or platforms can present many challenges.

The fragmented nature of the distribution model is evidenced by key elements, including local country tax reporting as well as varied commission structures and share class hedging. This highlights the ineffectiveness of attempting to compare the structure of a local market such as the U.S. or UK with one that tries to accommodate cross-border variations and client requirements.

Challenges

The global distribution opportunities presented by a UCITS fund also represent its greatest challenge—namely the ability to market into many jurisdictions and to different types of investors worldwide.

The key drivers of change that we have observed in the past few years are far from temporary. Regulation and change are set to cause a significant shift in our thinking and our servicing strategies and have the potential to disrupt global distribution models.

The uncertainty of these changes and their impact dominate our thinking and the strategies of our clients. It is more important than ever for securities services providers to remain at the forefront of regulatory change, to understand the complexities of distribution



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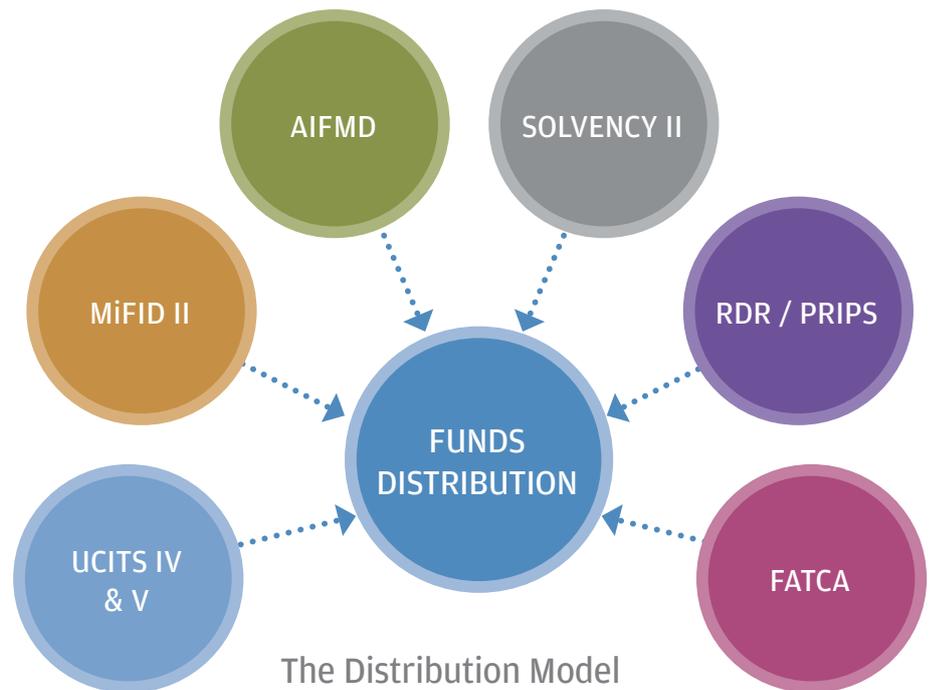
European Fund
Distribution
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and to help prepare their clients for the challenges ahead.

The UCITS directive has its own legal framework, which has recently been amended under UCITS IV. This provides more stringent rules but also provides opportunities for efficient fund consolidation and a more effective cross-border registration process.

One of the challenges facing fund promoters under UCITS IV is the introduction of the new and obligatory Key Investor Information Document (KIID). This mandatory one-page document is a sound objective although its practical implementation is not straightforward. It will help maintain transparency by providing the investor with key information on the fund in a consistent format. However, the KIID presents an additional reporting burden on distributors/fund managers, as production is complicated by translation requirements and the cost of disseminating the material. It is precisely the practical implementation that needs to be addressed when considering all the proposed regulations that will undoubtedly impact the current distribution model. Who will be held accountable for implementing the changes and where is the burden being placed—on the asset managers or the distributors?

Whilst not always straightforward, the current distribution model works well and allows asset managers to reach their investors by selecting appropriate fund features, platforms or distribution channels. Whether the intention is to protect the investor base or to provide further transparency, we need to understand how the adoption and implementation of regulatory change will alter existing access points and, fundamentally, what cost will the funds industry incur by facilitating these new demands. Investor requirements will essentially remain the same—they will continue to seek returns on investment products that they can access and understand. However, additional reporting requirements may negatively impact the total expense ratio (TER), and the returns could ultimately make



the products undesirable. Therefore, creating an efficient future model to accommodate these requirements is critical to the continued asset growth and appeal of the UCITS domiciles.

What next?

The increase in regulatory initiatives will require specific technology development efforts, i.e., to accommodate reporting for Solvency II or FATCA. Many service providers are already preparing for the combined impact of the changes and the effect the new regulatory environment will have on the fund features, structures and distribution channels.

UCITS V is awaiting the final scope of upcoming reforms, including MiFID II and AIFMD, before it takes shape. RDR (Retail Distribution Review), PRIIPs (Packaged Retail Investment Products) and Dodd-Frank will all necessitate changes to the core infrastructure of the fund administrator in order to cater for new share classes, commission and distribution capabilities, and enhanced reporting. There is little doubt the distribution model will change; the ability to understand and anticipate these changes will set the market leaders apart in the coming years. Leveraging a partner with a global footprint, experience, ongoing investment and tacit knowledge on the fundamentals of this distribution model will provide clients with the confidence to design these solutions and continue to prosper in the face of this constantly evolving landscape. ■

The Distribution Value Chain



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