Change in motion

The European asset management distribution landscape

Building a better working world

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Executive summary

- Regulatory reform is driving a sea change in Europe's asset management industry. Initially spurred on by the global financial crisis and concerns about systematic financial risk, regulators have been empowered by a populist political mandate to implement tougher and more onerous investor protection legislation — particularly regarding fund distribution and sales inducements. These changes will come at a significant cost and alter how firms do business, raise new assets and generate revenues.
- Asset management firms face not only a complex web of new and evolving EU regulations, but also the challenge of complying with local legislation. Between new local regulations and EU regulations on the horizon, it is not uncommon to find firms facing 50 or more new combined regulatory initiatives, affecting the entire investor communication and distribution process.
- The data systems most asset management firms had in place before the financial crisis are likely inadequate for efficiently meeting the challenge of successful distribution in the new environment. Along with banking, airlines and retail, the asset management industry is now looking at implementing and leveraging big data systems not simply to lay down the data architecture for effective enterprise-wide reporting, but also to gain a competitive edge in sales, marketing, client service and business development.
- Revenue-sharing may soon be regulated out of existence across Europe due to the implementation of Markets in Financial Instruments Directive II (MiFID II), expected in 2015. Between the Retail Distribution Review (RDR) in the UK and progress on inducement bans in other EU jurisdictions (notably the Netherlands, where such a ban is already in place), payments made by fund manufacturers to distributors in any form to incentivize sales may gradually disappear. As a result, some distributors may be squeezed out of business, replaced by a system of electronic platform distribution. Electronic platforms have already taken root in the UK and are likely to emerge as a predominant distribution channel in the entire EU within a decade.
- As revenue-sharing gradually disappears, the list of winning products will be rewritten. The elimination of revenue-sharing and push toward full transparency of pricing have incentivized the major ETF providers to aggressively step up European growth. A market shift toward ETFs — particularly passive strategies — is likely.

- For much of Europe, the universal bank-centric distribution model will continue to be the most important sales channel for the foreseeable future. This is due mainly to the banks' large size, tight control of investor wallet share and substantial sales infrastructure. However, alternative channels, such as insurance firms and independent financial advisors who can skillfully navigate the new platform-dominated environment, will gradually rise in importance along with a growing trend in direct-to-consumer (D2C) supermarket distribution.
- Convergence between traditional and alternative strategies is quickly gaining momentum. The accommodating of hedge fund strategies within the UCITS (Undertakings for Collective Investment in Transferable Securities) IV and V frameworks will further drive manufacturers of traditional product who already command a strong EU distribution infrastructure to further leverage their existing resources and commercial relationships to try to grow by rolling out new alternative products.
- Investment goals wholly unrelated to alpha generation, namely environmental, social and governance (ESG), will likely emerge as a driving force behind successful European distribution strategies. This is due to the underlying demographic shifts, as well as a broad re-think by investors dissatisfied with the performance of products that only chase alpha.
- The role of social media in asset management distribution is nearing a tipping point beyond which it will become the dominant tool to establish brand identity, create product differentiation and challenge the threat of commodification. Generation Y — also known as Millennials — are also the most enthusiastic users of digital technology. By 2020, these "digital natives" will hold the majority of buying power in most European markets. By 2025, they will dominate the investor base for the European asset management industry.

Regulatory reform driving change

The drive by regulators to examine and overhaul the entire remuneration system within asset management distribution arguably started in the UK. Final implementation of the RDR in 2012 marked the end of a painful process for both the industry and regulators alike, which started as far back as the late 1990s with open debate about how, if at all, investment advisors should disclose their costs and commission structures. For decades prior, the actual complex remuneration system for advisors was a rather tightly guarded secret.

RDR requires advisory firms to explicitly disclose and separately charge clients for services. Advisors must also clearly describe their services as either independent — thus entirely free from any conflict of interest and connection with any product line — or restricted, where a connection of preference toward a product line exists. The biggest change for client-facing distributors is that they can no longer accept commission payments or revenue-share payments — any payments — from asset managers for selling products.

Instead, client-facing distributors must be paid directly by the clients they advise for the advice given — and *only* by the clients they advise.

Since the UK's RDR, the Netherlands has implemented a ban on inducements, which are the fees paid by asset managers to induce salespeople, investment advisors, financial advisors or anyone selling investment products. In what may prove to be one of the most groundbreaking legislative changes of the decade for the industry, in May 2014, the draft of MiFID II was finally adopted by the European Council, making full implementation inevitable throughout the EU. As the very last procedural step before enactment, MiFID II was formally published in the *Official Journal of the European Union* in June 2014. Member states must now introduce the necessary national rules by June 2016, and these rules must apply from January 2017.

For the European asset management industry, MiFID II will establish a far more complex regulatory environment for standards of investor protection, disclosure, managing conflicts of interest and remuneration. The biggest change for client-facing distributors will be the shift away from a sales commission, fee-based model to an advisory-services pricing model. For the business development and distribution process, MiFID II will have a profound affect in many areas:

- An EU-wide ban on independent financial advisors or discretionary portfolio managers accepting or retaining payments/inducements — effectively banning payment or retention of retrocessions or commissions to or by independent advisors or managers
- Regulatory powers to ban products — likely to lead regulators to increasingly focus on product development, oversight and targeting of products
- Enhanced provisions around suitability and appropriateness, particularly in relation to "complex" products
- A review of product suites by firms looking not only at granular P&L analysis but also potential regulatory issues

Although the jury is still out on the exact effects an inducement ban will have on profitability for both asset managers and distributors, some critics have argued that small- and mid-sized manufacturers could see new business volumes decline by some 15%–20% as a direct result of shifting consumer demand, more transparency in pricing and shrinking availability of advisors.

For much of 2015 and 2016, the initial stages of implementing, asset managers will likely be forced to review their operations carefully and make certain that key areas of client intervention, notably remuneration, provision of advice and disclosures, are compliant with the new directive.

Table 1. MiFID II and rewriting the distribution playbook: challenges for wealth and asset managers

Big picture	Inducements	Disclosure
What are the benefits and downsides of independent advice? What is the impact on our product suite and open architecture? How can we retain and enhance distribution power? How sustainable are alternative distribution models? What should be the pricing structure for products?	What fees are at risk, and what is the impact on production? Is the current distribution model fit for MiFID II? How will independent advice and the ban on inducements impact the product landscape? What is the optimal fee structure post-MiFID II?	What are the implications of the more granular disclosure requirements at product level? How do we comply with the detailed disclosure requirements when inducements are paid? What will be the impact on block trades? How do we take advantage of enhanced transparency requirements?

Regulatory reform driving change (Continued)

A likely scenario in the post-MiFID II landscape will be that a large number of smaller independent advisors will disappear — with the likelihood that more business will be directed toward larger advisors and those innovative and nimble enough to adapt to the new environment. Further, as asset managers try more aggressively to build brand identity, enhance market share and capture client wallet share, there is already evidence that the asset managers themselves will vertically integrate into the retail market by hiring more client-facing advisors. Once again, economies of scale will be decisive: large global asset managers with deep pockets can vertically integrate more cost-effectively and build out more robust D2C distribution models. Smaller and mid-sized firms may feel the squeeze.

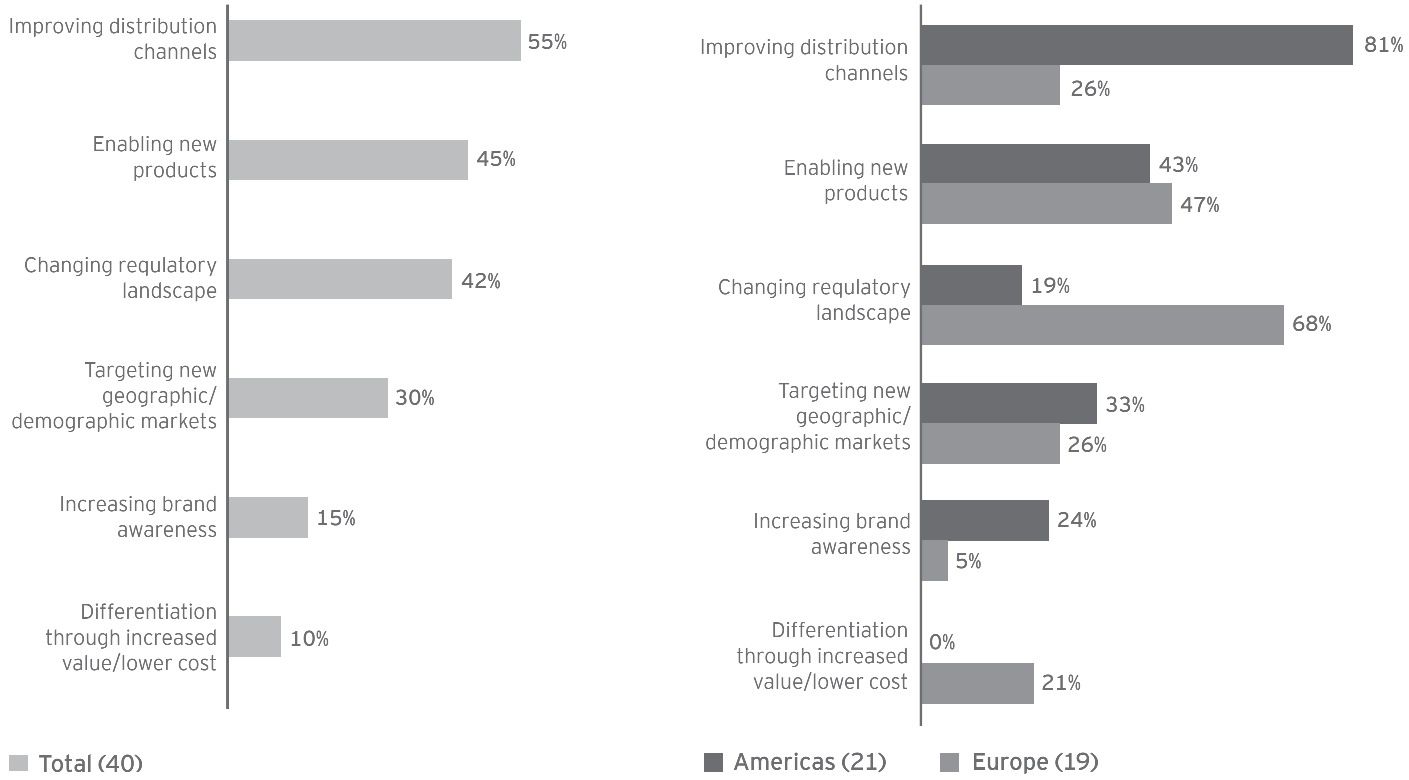
Given that MiFID II provisions entail a far greater degree of price transparency and mandatory disclosures, consumers are likely to spend differently. Reduced spending by consumers for advisory services will inevitably lead to reduced demand for many types of fund products that had relied heavily on generous commissions and aggressive sales and marketing. Another challenge may arise: how should the product suite be adjusted in the post-MiFID II landscape?

Throughout all of these scenarios, the main driving force of change in the entire system of fund distribution is regulatory development. And these post-financial crisis regulatory developments are mostly focused on investor protection and key stages of the firm-client distribution process: disclosure, transparency, pricing and suitability. Further, distribution-related initiatives such as enabling new products, targeting new markets and improving distribution channels will also prove to be key drivers of organizational change for European wealth and asset management firms.

Figure 1.

Primary drivers of change — total

Primary drivers of change by region



Source: *Managing complexity and change in a new landscape: global survey on asset management investment operations*, EY, 2014

Regulatory reform, increased price transparency, and technology paradigm shift create the perfect storm

Since the global financial crisis, MiFID II is just the latest example of how regulatory change is transforming the entire distribution landscape. Legislatures in the US, Europe and Asia have been acting in a highly correlated fashion and, to a large extent, adopting policy initiatives inspired by the Group of Twenty (G20) as well as the Financial Stability Board (FSB). (The FSB, established after 2009 as a successor to the Financial Stability Forum (FSF), is an international body that makes recommendations about the global financial system and comprises representatives from 20 major economies and the EU.)

The EU lies at the center of a stampede of global regulatory bodies all racing to implement new regulations aimed at managing systemic risk, improving public revenue collection and enhancing transparency and investor protection. Heavily motivated by politics and fueled by an electoral sentiment strongly in favor of greater transparency and accountability, many measures are underpinned by more stringent regulations on investor protection, transparency and disclosure. In the current climate of widespread public scrutiny, few politicians in Europe are willing to stand up and argue for reduced regulation, less monitoring of systemic financial risk or less investor protection.

Europe's policymaking frenzy is broadening the jurisdictions and enforcement powers of regulators, sometimes inconsistently across jurisdictions. The result is a global compliance landscape in perpetual motion and at times almost chaotic.

Meanwhile, financial markets across Europe have been characterized by far greater disclosure of information, particularly pricing, than ever before. The financial crisis left many investors very skeptical about the financial services industry and, in particular, about the value of face-to-face intermediation of financial products. Instead, investors are increasingly educating themselves, often through a web-based platform delivering an endless stream of educational information.

The MiFID II ban on inducements may force asset management firms to completely restructure how they do business with client-facing distributors. Instead of simply eliminating sales commissions, MiFID II will likely shift the distribution expense structure to focus on other areas of sales support, such as vastly greater resources poured into marketing, investor communications and just about anything and everything that will support the client-facing salesforce — short of direct monetary inducements.

At the top of the list of new priorities will be the build-out of electronic distribution platforms. This process has already gained momentum in the UK as a result of implementation of the RDR. In the near term, another priority will be how to successfully issue and manage clean and super-clean share classes. These are newly created share classes offered at rock bottom costs, as they have been stripped of all fees paid to distributors. If not successfully implemented, firms may face an immediate shortfall in revenues.

Table 2. UK retail sales is increasingly via electronic distribution platforms, 2010-13

Year	Total gross retail sales (million)	Direct sales*	Via electronic platforms	Other intermediaries
2010	£107,296	16%	37%	48%
2011	£105,164	14%	41%	45%
2012	£105,354	11%	45%	45%
2013	£134,140	8%	49%	42%

Note: Data based on transactions executed on 12 UK fund platforms. Percentages may not total 100% due to rounding.

*Direct sales includes sales through a sales force or tied agents, as well as private client sales of own funds.

Sources: RBC Capital Markets estimates and Investment Management Association (IMA)

Regulatory reform, increased price transparency, and technology paradigm shift create the perfect storm (Continued)

The increasingly regulated, sophisticated and transparent asset management industry will transform the European distribution game in other ways too:

- Asset management firms will focus more on low-cost index ETFs. The ETF firms themselves are aggressively stepping up their expansion in the European market, and advisors will increasingly seek out the lowest-cost products given that they will likely charge clients directly for services. AUM for index ETFs are already seeing steady month-on-month growth, while actively managed funds, particularly in the equity asset class, have experienced highly challenging conditions for growth.
- Asset management firms that were once giants in the industry but virtually unknown to retail investors will, perhaps for the first time, spend heavily on building brand identity in the market. Firms will be forced to support their distributors and incentivize product sales in creative ways other than direct inducements, namely by making the products themselves easier to sell and the entire sales process for client-facing distributors that much more efficient.
- Electronic distribution platforms that enable asset management firms to sell directly to investors with limited or no intermediation by advisors will rapidly gain market share. While the bank-centric model of distribution on continental Europe will continue to dominate the industry, even many of the major banks will build out their B2B electronic platforms to enhance productivity for their client-facing advisors. The rise of the machine is both global and inevitable.
- Asset management firms will reduce and restructure headcount. The market may see a fall in independent client-facing advisors and a rise in advisors working directly for asset managers in investor education, marketing and brand-building initiatives, as well as increased headcount covering compliance and technology — particularly related to increased process improvement and automation. Such restructuring of internal investment is sweeping the entire financial services industry as firms seek to manage regulatory change, protect margins and control costs through more spending on compliance, technology, outsourcing and automation.

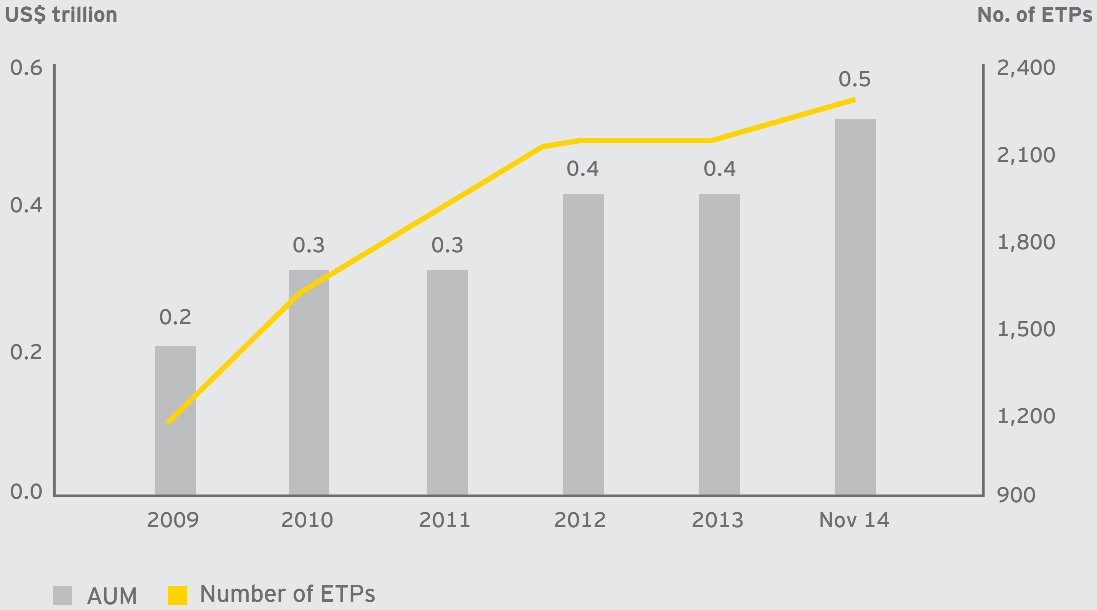
The era of ETF domination is near

In most developed markets, ETFs, particularly low-cost passive products, have been the hottest growth asset class in the entire industry. The underlying drivers of this growth are clear. As investors become more sophisticated about their personal financial planning, and as pricing becomes more transparent, investors are also becoming more skeptical about the ability of active managers to outperform the market.

The ETF is one of the very few product lines in the entire wealth and asset management industry that has consistently topped the league charts in terms of year-on-year growth, and now, globally, it accounts for some US$3 trillion in AUM. In a global context, passive strategies — which are primarily implemented through ETFs — account for some 25% of total AUM. It is widely anticipated that within five years, index strategies in one form or another will account for over 50% of global AUM. The fastest growth rate is likely to be in Europe: the major ETF providers have long been marginalized there by the old distribution structure but have now prioritized European growth and are spending heavily to support ambitious sales targets.

Figure 2. European ETP AUM and number of funds

Europe-listed ETPs gathered US$5.3b in November and on YTD gathered US$60.8b, three times the total 2013 regional inflows of US$19.4b



Sources: *Global ETP Landscape*, November 2014, BlackRock

Before the financial crisis, distributors generated top-line revenues by selling actively managed funds through a variety of mechanisms. The entire fee system was often so complex and opaque that clients rarely understood either exactly how much they were paying or what exactly they were paying for. In the UK, regulators estimated that some clients were paying nearly 10% of their invested assets in costs per annum for investment services.

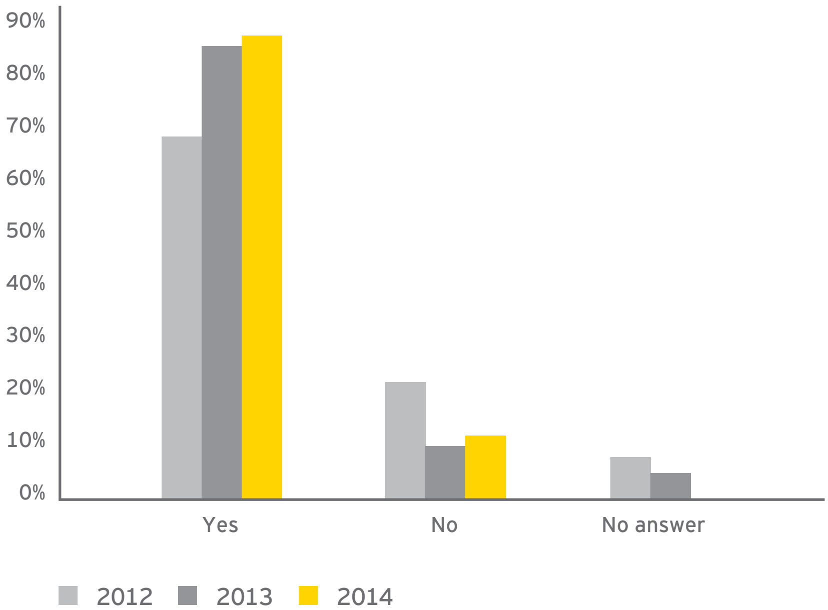
By contrast, for long-neglected ETFs, distributors were typically paid once and only once, if at all, for selling an ETF product: a one-off commission at point of sale. Given that any specific ETF strategy, such as passively tracking an index, can be implemented through highly homogenous products, investors could readily price shop from advisor to advisor seeking the lowest cost of execution.

Such commodification is an absolute taboo for the luxury goods industry, for the high-end fashion industry — and most certainly for the high-touch, high-brand-identity business model of asset management distribution in Europe. No distributor, nor virtually any player in the entire European wealth and asset management industry short of discount online brokers and the ETF providers themselves, want to travel down the road of commodification, homogenous product lines and competition based purely on price. In fact, hardly anyone in any industry — whether plumber, lawyer, physician, fashion designer or airline pilot — envies the opportunity to compete on price and price alone. But rapid advances in technology and sweeping regulatory reform won't stop to take into account protection of old pricing models. All players big and small will be forced to learn how to compete in an increasingly commoditized market.

Actively managed funds will lose one of their most potent weapons in competing at distribution: a well-remunerated, highly incentivized client-facing distributor. Active large-cap equity funds will be exceptionally challenged to find growth opportunities. With reform and near elimination of this remunerative and incentive system, active funds will be forced to compete on a far more level playing field against the major ETF providers, which are the largest asset managers in the global industry, now ready, willing and able to spend aggressively on building out their European distribution efforts. In fact, one of the key winners in the restructuring of the European regulatory landscape for distribution may likely be the ETF product class primarily because of their highly efficient cost structure.

While the ETF market is dominated by the three major players, there is always room for innovation. Projecting forward, mid-sized firms can and will compete in the growing ETF space by launching products targeted at distinct market segments with specific needs. Actively managed ETFs that target a relatively underserved niche or unique strategy may prove popular. While both niche and mid-sized firms are certainly targeting Europe in the post-MIFID II environment, the established US-based players are also looking to step up their global distribution strategy. The major ETF sponsors have significantly stepped up their investment in Europe already, demonstrating that they are increasingly focused on the substantial upside potential of the post-MiFID II market. In addition, other established ETF sponsors have recently made strategic acquisitions of small European-based firms to grow their footprint rapidly and gain cost efficiencies.

Figure 3. Market survey: will more asset management firms enter the ETF market?



Source: *EY Global ETF Survey: 2015 and beyond*, 2014

The European market as a whole is steadily moving away from investment decision-making based on face-to-face interaction with a distributor, toward financial websites, social media and content delivered via mobile technology. Any investor born after 1985 has likely never met a distributor in person, and may never. These millennials make the bulk of their financial decisions — whether job hunting, paying taxes or buying a house — based on information delivered through the internet. This market is highly receptive to the concept of transparent, low-cost ETF investment. While the segment currently does not yet make up a large part of the asset management industry marketplace, it will start to do so around 2020. By 2030, the concept of the high-touch, client-facing distributor may have gone the way of the travel agent.

Beyond alpha

Since the financial crisis, investors across Europe have, more often than not, been disappointed — by the quality of information about their investments and by their actual cash returns. The bedrock promise of the industry to generate alpha above market indices — and certainly above bank deposit rates — has often fallen short. At this point, a European distribution strategy based primarily on marketing a firm's alpha-generating abilities will likely fail, given increasingly skeptical, sophisticated and informed investors.

More and more innovative asset managers are now seeking to develop and distribute products with objectives very different from alpha — a radical departure from the industry's tradition of marketing itself on primarily its money-making ability.

One approach has been target date funds, which focus less on simple alpha generation and more on funding a specific retirement date.

Further, clients may have goals beyond funding a simple fixed retirement date. Particularly in the high-net-worth market, investors could be seeking to hit another unrelated financial goal such as purchasing a vacation house, making a sizeable charitable donation or funding a child's professional education. Institutional goals are typically focused around long-term liquidity constraints as they often are faced with managing a stream of upcoming liabilities.

European investors have also begun to develop a whole series of hard-to-quantify investment criteria, such as investment allocation based on environmental, social and governance (ESG) factors. On a broader scale, ESG investment is more commonly referred to as socially responsible investment (SRI). While still an obscure niche among retail investors in most of Europe, ESG funds have taken off in the UK. Further, public pension systems throughout the continent have begun publicly debating their obligations to focus more on broader ESG factors rather than purely chasing alpha.

The concept of SRI driving distribution in European asset management is nothing new. During the struggle against apartheid in the 1970s and 1980s, European students and academics, soon joined by their American cohorts, were at the forefront of persuading university trustees to invest in ways that did not support the South African government. While anti-apartheid is one of the more famous and oldest examples of SRI investment, the category has grown exponentially in the last five years, in no small part due to the investors coming to believe there is more to managing their assets than merely chasing after alpha. SRI-based investment now includes investments driven by religious beliefs, such as Sharia compliance, by economic equality, such as provision of affordable housing, and by environmental stewardship, such as reduction of carbon emissions. The major indexing firms have responded to market demands, rolling out, for instance, the Dow Jones Sustainability Index, the FTSE4Good Index Series (owned by the London Stock Exchange) and the series of MSCI ESG Indices.

While it is difficult to measure precisely the size and growth potential of SRI-based funds, some simple demographic trends strongly indicate that they will continue to be a driving force in European fund distribution. For instance, many private bankers estimate that the high-net-worth market in Europe will continue to grow at nearly a double-digit rate for the next five years. High-net-worth clients are typically the most receptive to SRI investment products. Similarly, Europe's rising number of middle-class Muslims, one of the fastest-growing demographic segments in France, Germany and the UK, will also drive interest in Sharia-compliant investment funds.

Figure 4. Growth of sustainability themed investments in Europe (€ billion)

Source: *European SRI Study, Eurosif*, 2014, p. 11.

Data, data, data

Implementing a winning European distribution strategy within the new regulatory environment is almost all about data. This data-centric strategy will encompass how to source data within the firm and how to collect and analyze business intelligence about specific markets and investor trends.

Data on any particular European market is vast, complex and ever-changing. On the compliance level, each jurisdiction will periodically roll out new legislative initiatives that affect fund distribution. This local data must be combined with developments at the EU level. In terms of broader business intelligence, Europe is far from being a single, homogenous market. On the contrary, each market generates an ongoing stream of business intelligence.

Europe is an extraordinarily fragmented market for fund distribution channels. In Central and Eastern Europe, funds are mainly distributed through retail banks. In Switzerland and the Scandinavian countries, distribution is dominated by the private banking sector. Continental Europe distribution is still dominated by retail banks but with continued growth in the private banking channel expected. The independent financial advisor channel, prominent in the Netherlands, UK and Germany, is rapidly losing its dominant position in the face of legislation banning inducements. In the UK, electronic platform distribution is slowly starting to predominate, while in Spain and Italy, by contrast, the retail banking industry for the moment firmly holds the balance of power in distribution of investment products, with limited emergence of electronic platforms. Understanding this entire landscape and implementing a winning distribution strategy will be driven by data and business intelligence on a market-by-market basis.

In meeting regulatory requirements at both the local and the EU level as well as implementing a pan-European distribution strategy, asset managers should focus on data. Financial data is created, controlled and extracted from a variety of sources within the firm and across several functionalities, as well as externally across geographies. The right distribution strategy must integrate and meticulously coordinate the entire enterprise data architecture across the entire firm.

On top of continuing to demonstrate compliance with global regulations, the right data management strategy can be readily leveraged to manage risks and win the business development game. Above and beyond simply meeting filing deadlines, there exists a compelling business case for firms to look at redesigning their entire enterprise data architecture and aggressively meeting the challenge of big data. Vastly more robust and powerful data processing speeds and storage capabilities in the face of plummeting marginal costs make it both practical and highly cost effective to analyze entire data sets and not just subsets — such as client transaction histories across the firm as opposed to simply focusing on trading activity in one particular fund or asset class.

Analysis of multi-structured data involving a series of different data sets can provide insights that enrich what a company knows or reveal opportunities previously hidden. For many asset managers, analyzing data more thoroughly to get small improvements of even 15 basis points in many key performance indicators can deliver tangible and valuable results in terms of profitability and growth. Essentially, data has become an asset and, like any other asset carried in the balance sheet, it can be effectively managed to achieve a return on investment.

Commercial advantages that big data can deliver: it's not just about form filing

- Deepening "know your client" (KYC) and "know your distributor" (KYD) insight
- Implementing aggressive fraud detection and shoring up cybersecurity defense
- Identifying clients and market segments presenting the most revenue potential
- Monitoring product-specific metrics (sales, profitability) regressed against market environment
- Identifying potential client and market demand for new products
- Identifying clients at risk of defecting to competitor firms
- Determining the effectiveness and ROI of marketing campaigns on a granular market-by-market and product-by-product basis

Convergence: vertical integration across product lines

Business school case studies are filled with examples of companies in mature markets that continue to deliver exceptional organic top-line revenue growth. For example, there are century-old agricultural and industrial equipment manufacturers that looked at spiraling home-ownership rates and decided to build on brand name in farm tractors and move into the booming residential landscape business, targeting retail buyers for the first time.

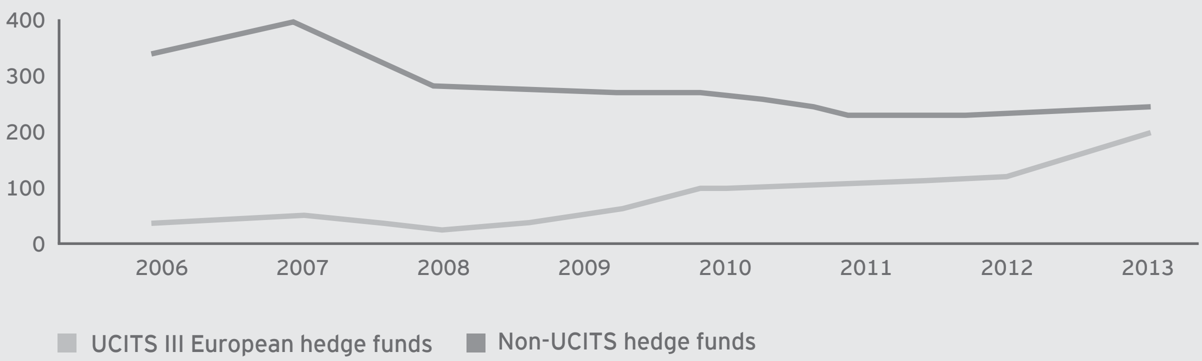
Asset managers have started to go down this same path, striving for organic growth within their own industry by leveraging their competitive advantages and name-brand recognition to offer new products in different asset classes. This could mean a traditional manager rolling out alternative products for the first time or, conversely, an alternative manager offering traditional products.

For traditional asset managers, the convergence with the alternative management product space is being driven by their desire to find ways to secure higher returns for investors and also to develop products that provide better margins. On the other hand, hedge fund managers are seeking to launch products with greater liquidity, more transparency and less volatility. In all cases, asset management firms are seeking to squeeze out more growth and more revenues and enhance margins in the face of escalating costs and intense competition by more aggressively leveraging their pre-existing infrastructures and capabilities.

A historical turning point in pan-European distribution of alternative products was the enactment in 2001 of UCITS III. The UCITS III regulation enabled alternative products to be registered and passported throughout the entire UCITS regulatory regime. Particularly since the financial crisis, when the entire distribution game became far more challenging, European asset managers have seized the opportunity to market alternative-style investment strategies under the UCITS brand. UCITS funds are now domiciled in 28 European countries, the largest being Ireland, Luxembourg, the UK, Germany and France. Overall in 2013, according to EY data, net assets of UCITS-registered funds increased 9%, with 23 countries recording an increase in net assets. Twelve countries recorded double-digit percentage growth during the year.

UCITS-registered alternatives are booming. According to a study by research firm PerTrac, the AUM of alternative UCITS have grown from approximately €5.40 billion in January 2002 to €150 billion in October 2011. During the same period, the number of UCITS alternative funds climbed from 100 to over 1,200. A recent study by Hedge Fund Intelligence revealed similar trends, with more than half of Europe-based hedge fund managers having either launched new products under the UCITS IV regulations — the latest implementation of the legislation — or having future plans to do so.

Figure 5. AUM: UCITS hedge funds vs. non-UCITS hedge funds (US$ billion)

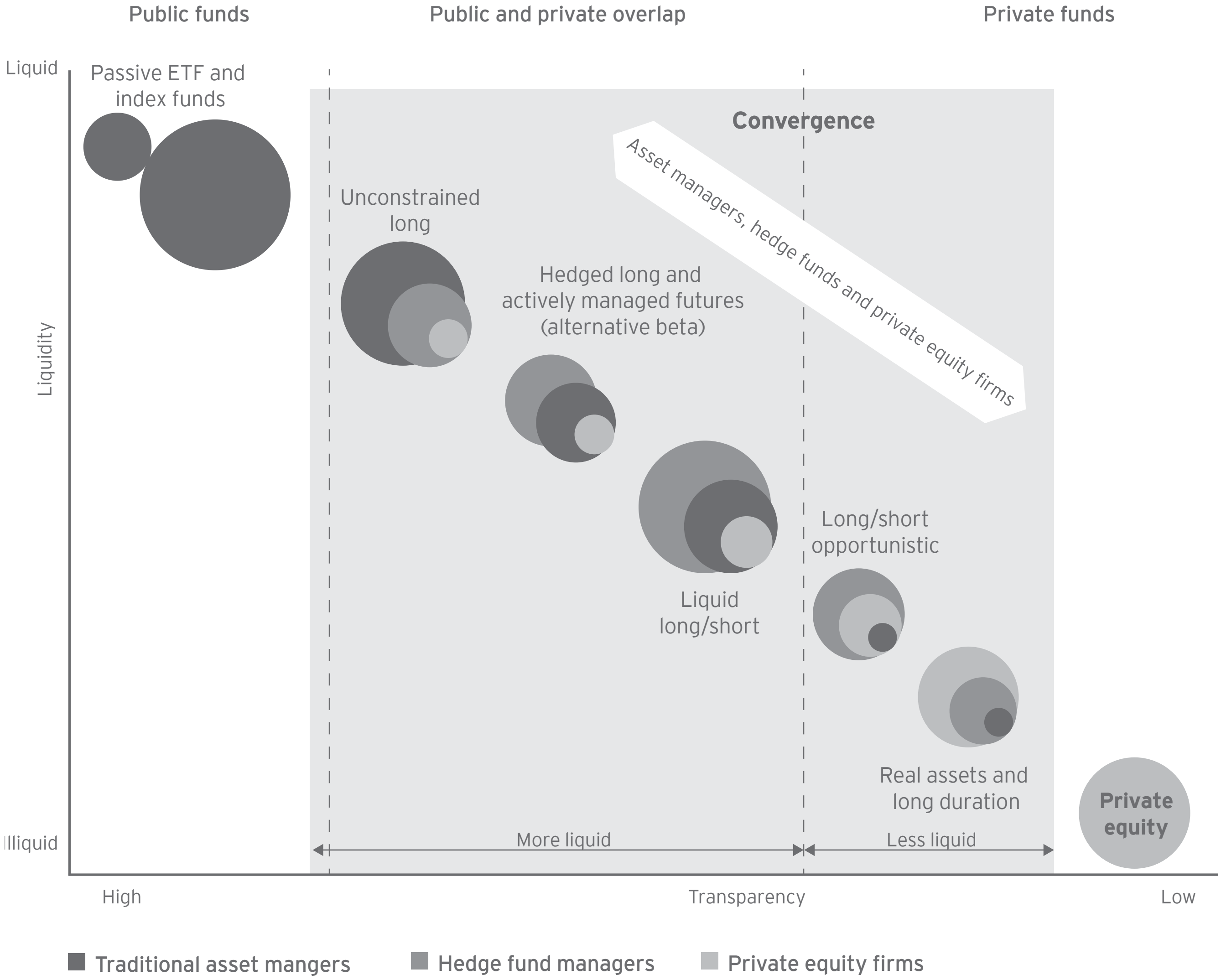


Source: Eurekahedge

Convergence: vertical integration across product lines (Continued)

Traditional managers' increased interest in rolling out alternative products has clearly driven the solid growth of the European market for alternatives. By the end of 2014, some US$2.8 trillion in assets were held in hedge funds globally. Out of this total, some US$450 billion are held by Europe-domiciled alternative fund managers, making Europe the second-largest region for hedge funds in the world outside of the US.

Figure 6. Convergence in 2013 and beyond: uninterrupted area of overlap in offerings from traditional asset managers, hedge fund managers and private equity firms



Source: *The Rise of Liquid Alternatives & the Changing Dynamics of Alternative Product Manufacturing and Distribution,* Citi Prime Finance, May 2013

Table 3. The UCITS regime: historic timeline

UCITS Directive	Date	Key topics amended/addressed
UCITS I	1985	Original UCITS Directive published
UCITS II	Abandoned	UCITS II was abandoned in 1998 after EU Member States failed to reach an agreement on its scope and purpose. Key provisions included much of the framework of UCITS III.
UCITS III	2001	Firms were given until February of 2007 to ensure their funds were compliant with UCITS III. UCITS III was divided into two distinct directives: ‣ Management Directive: This created the "European Passport" whereby a UCITS fund authorized in its home state could be sold anywhere within the EU. The passport required the use of a "Simplified Prospectus" detailing the key features of the fund. ‣ Product Directive: This allowed for investments in a wider range of asset classes, with a corresponding distinction between non-sophisticated and sophisticated funds.
UCITS IV	2009 (present legislation)	UCITS IV became effective July 2011. Key provisions included: ‣ Streamlined regulator-to-regulator notification procedures ‣ Management company passport ‣ Key Investor Information Document replaces simplified prospectus ‣ Master-feeder fund structures ‣ Framework for domestic and cross-border fund mergers
UCITS V	Spring 2016 (estimated)	UCITS V amendments were proposed by the EU Commission in July 2012 and approved by the European Parliament in April 2014. UCITS V will be aligned with the AIFM Directive. Key provisions include: ‣ Depositary regime updates, including their appointment and eligible entities, oversight duties, cash-monitoring duties, safe-keeping duties, delegation and overall liability ‣ Establishment of remuneration policies and practices that promote sound and effective risk management and do not encourage risk-taking. Remuneration structures must include rules on variable and fixed compensation, including a requirement that at least 50% of variable remuneration be in the form of units in the fund. ‣ Creation of a sanctions regime and whistle-blowing procedures for reporting incidents to authorities
UCITS VI	To be determined	Potential areas covered may include: ‣ Eligible assets, use of derivatives and efficient portfolio management techniques ‣ Liquidity management ‣ Depositary passport ‣ Money market funds ‣ Long-term investment funds ‣ Consistency with AIFM Directive

Social media in European distribution

European asset management firms typically lag their US counterparts in leveraging social media, developing user-friendly consumer internet applications and spending on online marketing. However, European firms are catching up quickly due to not only the seamless globalization of the industry, but also rapid regulatory initiatives that are restructuring the pricing and distribution model throughout the EU. Most all European asset managers seeking to build brand identity have already started to aggressively leverage the major social media sites.

By 2020, Generations X and Y will hold the majority of buying power in most European markets. By 2025, this segment will dominate the investor base for the European asset management industry. Gen X and Gen Y turn to social media when seeking investor education, step one in the distribution path. Further, a 2013 study of 4,000 affluent investors by Cambridge, Massachusetts-based Cogent Research found that 69% of these investors use social media to seek out financial information. And with the rise of smartphone use, social media is rapidly becoming a 24/7 ubiquitous investor education tool.

Social media is perfectly aligned with the new era of relentless cost-cutting and the trend toward margin compression. It is an old adage that 90 cents of every euro spent on traditional advertising is wasted. The problem is that one cannot effectively identify where exactly that 10 cents of non-wasted budget is being spent. However, by intelligently leveraging social media and search analytics, a fairly granular breakdown of hit counts and other data can be developed and mined. Aggressive use of social media can optimize spending and enhance effectiveness of market research and advertising.

Social media can also provide free and direct access to insights from the market. One can observe what is being said online about the brand, key executives and the issues most important to the firm, without the cost of focus groups and surveys. This can provide a potential gold mine of data about client wants, needs and concerns.

According to EY's recent global regulated funds survey, *Driving growth and aligning interests*, two in three managers believe that social media will have a significant influence on product and distribution strategies over the next five years. As one European manager commented, "I see it as an important channel for raising awareness of the firm. Therefore the brand becomes more important. As digital platforms continue to grow, it will become easier to contact end customers."

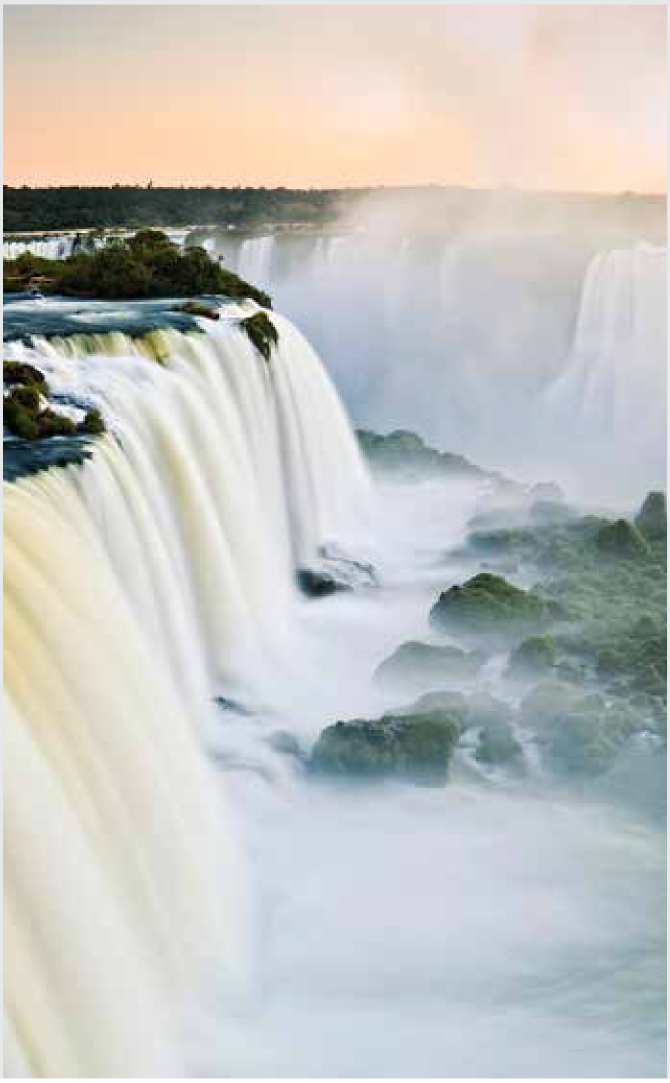
Even those not as bullish about the growing ability of social media to materially impact distribution results do at least recognize the benefits in simply building brand identity. According to another European asset manager, "I don't see anything significant, since we're primarily a B-to-B business, not directly interfacing with the consumer. Our group, however, utilizes social media as a communication channel to increase visibility for our products."

A more focused strategy on leveraging social media can help meet the challenge of the escalating complexity and costs of compliance in the area of investor protection. With MiFID II now set for implementation in 2015, there will be increased requirements regarding product suitability. Asset managers must take reasonable steps to ensure that products are distributed to an identified target market and that the appropriate products reach the right customers. MiFID II is one of many reasons asset managers must carefully review how they communicate with their distributors and, ultimately, investors.

The UK's RDR is starting to force asset managers to reach out and communicate a brand message to individual investors far more aggressively than before. In the past, the bulk of investor communication and the creation of brand identity were left largely in the hands of highly incentivized, client-facing advisors, who are now much less incentivized due to the RDR ban on sales commissions. Apart from RDR, regulatory bodies across Europe are taking some action in parallel to the vast adoption by the industry and investors alike of social media as a primary means of education, communication and decision-making.

Platform distribution: 20 is the new 30

Pundits of how digital technology is quickly transforming the entire global financial services industry typically have pointed to 2030 as the crucial tipping point in market segmentation. From that point on, it has been argued, the bulk of the investor market will be digital natives. This is a crucial demographic segment that came of age post-1995. They fully embrace digital technology and the internet in their everyday lives. Whether handing in school homework, finding a job or filing a tax return, this group regularly gathers information and conducts transactions online and self-service.



There will certainly be a tipping point when the bulk of the market is in fact digital natives. But the actual date of that tipping point may have been miscalculated. Given a variety of metrics the market has seen, including the exponential growth in use of smartphones among baby boomers, that key tipping point will likely arrive around 2020, rather than a far more distant 2030. Seeking financial advice and executing financial transactions in the investment space is inevitably moving toward the web and, for the wealth and asset management industry, some form of electronic platform distribution.

The era of mega financial platforms arguably started in the US during the early days of online trading, in the midst of the NASDAQ equity boom in the 1990s. Large, national, online B2C discount brokerage firms were quick to offer not only do-it-yourself electronic transactions in specific securities, but also purchases of shares of both closed-end and open-end regulated mutual funds. Today, much of the European asset management industry looks at retail fund distribution platforms in the same way that the retail financial advisory industry first viewed online discount brokers in the late 1990s. Back then, in the early days following the deregulation of commission structures — when any firm could charge any commission — competition on price was anathema to the entire wealth and asset management industry. As a result, discount fund platforms were viewed as irrelevant and marginal and as targeted primarily at low-income investors — a market segment that major distributors and asset managers were perfectly content to overlook.

Within a decade, almost all the global wire houses offered web-based portals for clients to access their accounts, benefit from investor education and execute trades. Even the much-feared threat of cross-channel cannibalization has been faced, negotiated and in many areas overcome. High-brand-equity retail distributors that based their entire business models on high-touch sales have rolled out platform distribution portals to complement their high-touch services.

Today, interesting enough, a high-net-worth client can walk into the city center office of a global wire house, discuss her multimillion-euro portfolio, and ultimately execute advisor-recommended purchases of fund products for perhaps a 200 or 300 basis point fee. During the same visit, while waiting in the reception area, she could also choose to execute purchases of similar if not identical investment products on her smartphone through an electronic platform owned and operated by the same wire house — for a fee of perhaps 50 basis points or less. Both channels — the low-cost electronic platform and the high-margin, white glove service — can manage to exist side-by-side. This dual structure is by no means a vote of no confidence in the traditional intermediation service; rather, it marks a recognition that the electronic platform channel is too large, and growing too rapidly, to simply ignore.

Platforms are difficult to define across European markets. Broadly speaking, the trend has focused on web-based portals that handle the sales, custody and promotion of investment products either on a B2B basis targeted at wholesalers or a D2C model aimed at the retail investor. By far the furthest along the development curve is the UK asset management market, which has followed down the commercial path first pioneered by the UK insurance industry. Since 2000, the bulk of sales of auto and home insurance products have shifted from a traditional brick and mortar-based distribution to a point where the vast majority of industry revenues are generated through electronic platform distribution. Those few insurance firms and insurance advisors that failed to adapt rapidly enough to the platform trend have essentially disappeared from the marketplace.

According to data from the UK Investment Management Association, the top three fund distribution platforms account for over 60% of new AUM raised in 2013. While size, deep pockets and economies of scale certainly help in the race to become the biggest and best platform, there is always room for smaller, highly adroit firms that can successfully leverage first-mover advantage.

The B2C fund platform market has been rapidly expanding in the UK at a 26% compound annual growth rate between 2011 and 2013, with gross retail sales continuing to rise at a strong rate throughout 2014. In one of the world's largest fund markets, in the face of such robust growth figures, the leader in electronic platform distribution is a relatively niche player: Hargreaves and Landsdown (HL), a Bristol-UK-based, national, independent financial advisory firm with a modest market capitalization of some £4.5 billion. HL owns and operates Britain's largest electronic fund distribution platform, controlling an estimated 32% of all electronic platform distribution in the UK. The largest competitors to HL are Barclays Stockbrokers (13% market share) and Fidelity Personal Investing (7% market share) — both wholly owned subsidiaries of global financial institutions. At the same time, it is interesting to note that both Fidelity and Barclays simultaneously offer a highly developed personalized service delivered by client-facing advisors.

Further, HL is far from a thin-margin discount broker targeted at the lower end of the market. Instead, it has positioned itself as the high-touch, premium-priced option targeting the high end of the market. While competition in the UK market is increasing and investors have many cheaper electronic fund platform options to choose from, HL has built substantial brand loyalty and does not at all compete purely on price. The HL client base has typically been more than willing to pay a premium for a high level of customer service, a wide choice of investments and HL's strong reputation for transparency and investor education. Despite the introduction of the RDR, which has squeezed margins across the board for the entire distribution industry, HL is successfully protecting its 70% operating margin — even in the face of the introduction of a new RDR-compliant structure.

One key trend in Europe, including the UK, is the cross-border nature of the scope of coverage — a considerable challenge given regulatory issues from market to market. This is not surprising. According to data from the European Fund and Asset Management Association, it is estimated that some 76% of new assets flowing into the EU during 2013 could be classified as cross-border, in that the fund was domiciled in one jurisdiction yet also raised new AUM in other jurisdictions. The growth of platform distribution will likely parallel this strong trend, in that most new fund products offered by European managers will, from the outset, be marketed across the EU and, at the same time, in distant markets where UCITS have gained critical momentum, such as Brazil and Chile.

Table 3. E-platform acronyms

Platform model	Definition
B2B	Owned and operated by major asset managers and intended for use exclusively by institutional investors
B2B retail	Owned and operated by major asset managers — or in some cases, independent distributors and investment advisory firms — and intended for use exclusively by client-facing advisors.
Closed architecture	Broad term used to describe a platform that offers investment products from just one asset management firm, who typically own and operate the platform.
Open architecture	Broad term used to describe a platform that offers products from a large — possibly enormous — number of asset management firms. Some platforms can list thousands of fund products offered by hundreds of asset managers.
Guided architecture	A platform that may appear nominally open in that it offers a large number of products from different asset managers. However, there is a very definite degree of "nudge" in that the user is first and foremost directed to the products of the distributor that owns and operates that platform.
B2C (or D2C)	Business to consumer (or direct to consumer). Originating with low-cost, online discount brokerage boom of the late-1990s, these platforms target end retail investors directly. B2C platforms often offer a giant hypermarket of products and libraries of investor education resources. The UK asset management industry by far has the most developed B2C channel.

Action items for European distribution

1. Focus on technology: Whether it is a new business operating model focused on data management, implemented to reduce costs and improve sales effectiveness, or a robust electronic distribution platform, technology initiatives will be the driver behind any winning distribution strategy.
2. Hail the smartphone: Predictions of the imminent demise of the client-facing advisor are greatly exaggerated. Just as there will long be High Street travel agents, readers of printed books and people mailing handwritten letters, there will also always be a crucial role for client-facing advisors. But the relentless underlying trend is clear. Whether an asset management firm is looking at investor education, client account management or the actual fund purchase transaction, any winning distribution strategy must be based first and foremost on a mobile technology view of the world.
3. Think global, act global — forget about local: Long gone are the days when a successful distribution strategy for any mid-size or large asset management firm could be targeted purely at a single European market. Given the drive for economies of scale, the predominance of EU-wide UCITS registration and the globalization of investment markets, any distribution strategy will be focused on the cross-border, pan-European market right from day one.
4. Think laterally toward new products and new markets: Firms winning in distribution will focus on new products that cost-efficiently leverage their core existing resources and footprints. Many new products launched may be outside firms' former comfort zones. Traditional asset managers might offer products more commonly offered by hedge funds, or investments that seek to optimize alternative factors other than total return or alpha. Some key growth areas for new product development may include SRI and Islamic finance. In terms of new geographic markets, firms will rapidly expand their UCITS registration capabilities to target the emerging markets, notably Latin America and Asia ex-Japan.
5. Seize regulatory reform as a game-changing opportunity — not a costly burden: Winning in distribution will entail fully leveraging major regulatory initiatives, such as the UCITS platform, MiFID II and RDR, and doing so more adroitly and cost-efficiently than the competition. Some asset managers have bemoaned RDR as a pitfall that de-incentivized their independent financial advisors. Winning firms, by contrast, will seize the opportunity to build brand equity and aggressively take on the challenge of communicating directly to investors, strengthening their name and winning market share from slower competitors. Similarly, the ever-expanding global reach of UCITS registration will be leveraged by highly adroit firms to build distribution far beyond Europe.
6. Use MiFID II to get ahead: The new ban on sales inducements will reshape European distribution in a similar scope and magnitude to the process now unfolding in the UK after implementation of RDR. For much of the industry, this rewriting of the rule book may appear to be a costly burden. But the truly entrepreneurial and innovative firm will instead see such regulatory evolution as an ideal opportunity to rapidly restructure its operating model and expand distribution, by focusing on client connectivity through investor education, expanding electronic platform channels and enhancing brand identity.

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