J.P.Morgan

Can AIFMD act as a catalyst for growth of the European hedge fund industry?

The European hedge fund industry has grown since the financial crisis, with assets reaching a new high of \$640 billion.[1] Most of this growth, however, has come from the absolute return UCITS sector, a subset of the €7.98 trillion European mutual fund industry.[2 & 3] Since 2009, compound annual growth in UCITS absolute return funds has been 47% compared to only 5% for offshore hedge funds.

The growth is partly the result of hedge fund managers replicating their existing hedge fund strategies in a UCITS format in order to tap into a new investor base hungry for absolute return strategies offered as liquid funds with strong governance.

Hedge fund managers that want to tap the European pool of capital now need to consider two legislative frameworks. These are the newly introduced AIFMD for alternative funds drafted in response to the financial crisis and the more established UCITS Directive for mutual funds. The two regulations share many similarities by design but differ in terms of investment guidelines and eligible investors.

Regulatory alternatives for managers targeting European investors

AIFMD

- Implemented July 2013
- Sophisticated investors only
- Replicate all hedge fund strategies
- Platform solutions available
- Access via passport for EU-AIFs
- Access private placement for non EU-AIFs

UCITS

- Implemented 1986
- All investors eligible
- Replicate liquid hedge fund strategies only
- Platform solutions available

Source: J.P. Morgan, including information taken from UCITS and AIFMD Directives and EFAMA

Given that both hedge fund managers and investors have embraced the idea of offering absolute return products in a UCITS format, the question facing market participants is whether the introduction of AIFMD will have the same positive impact on the industry. The answer to this question will help managers determine their strategic approach to raising assets in Europe.

In order to make this determination, managers should:

- Assess progress to date in adoption of these structures and raising assets
- Compare the AIFMD and UCITS regimes and identify any key success factors
- Consider the outlook for future growth
- Assess the feasibility of their strategies under the two regimes (AIFMD and UCITS)

Definitions

UCITS funds: Funds domiciled in Europe and managed according to the terms of the UCITS Directive

AIFMD funds: Funds domiciled in Europe and subject to the terms of the AIFMD

Offshore funds: Funds domiciled in a non-European offshore jurisdiction, usually Cayman Islands, BVI, Bermuda, Jersey or Guernsey

Summary and considerations for managers

The landscape for hedge funds that are raising capital in Europe has changed considerably since the financial crisis. A once one-dimensional industry now has a wider range of regulatory structures and a broader investor base. The AIFMD and UCITS Directives have a significant influence on the way managers seek to raise assets and the investors that they target.

Asset growth from Europe since the financial crisis has come predominantly from the adoption by managers of the UCITS framework. By using this established regulatory model, managers have been able to diversify their client base to include a large pool of investors accessed through the private-wealth channel.

The introduction of AIFMD has brought the potential for greater transparency and disclosure but does not appear to have taken hold with investors yet. These funds are still purchased predominantly by an investor base already comfortable with offshore hedge funds. However, without the emergence of a trigger for either the creation of AIFMD funds by managers, or a corresponding increase in demand for funds of this type, we expect the adoption of AIFMD by the market to be slow.

By contrast, funds established as UCITS have enjoyed greater momentum in terms of both adoption by managers and raising assets. In our view, specific catalysts emerged following the financial crisis, which encouraged hedge fund managers to establish UCITS funds. At the same time, this supply satisfied a hitherto unmet demand from investors. Furthermore, UCITS was already a well established and broadly recognized brand in its own right.

Given this backdrop, there is much to consider for managers looking to Europe for distribution.

Structural requirements

Important differences separate offshore/AIFMD and UCITS funds in terms of the investment guidelines, meaning that not all strategies can be easily replicated into a UCITS wrapper. Managers have various options depending on whether it is possible to create a UCITS or AIFMD fund.

- Re-domiciling of existing offshore to AIFMD compliant funds—Managers typically choose to re-domicile to Ireland or Luxembourg. Re-domiciliation can be achieved in three ways:
    - Transfer of registered office
    - Transfer the assets and liabilities of the offshore fund to a Luxembourg or Irish entity in exchange for share in the entity
    - Cross border merger/amalgamation

  Managers need to consider the tax implications of the various options

- Creating a UCITS fund to target the retail investor base

Distribution

The adoption of AIFMD and UCITS may open up new markets for managers to market their funds. They will need to consider:

- **Which are their key target markets and what is the cost of access**—Managers have observed demand for UCITS funds from investors in countries such as Germany, Italy, France and Spain—jurisdictions that do not traditionally invest in offshore hedge funds. Managers therefore need to broaden their marketing effort to target these new investors
- **Are their current marketing resources sufficient or appropriate for the opportunity**—Targeting new distribution channels that may rely more on marketing to other intermediaries may require different sales resources, for example, sales people with new relationships, and may involve a different way of communicating the marketing message
- **What commitment from portfolio managers is required to market successfully via these new investor channels?**

Operational resources

Both AIFMD and UCITS rules necessitate additional activities in terms of investment management and compliance, which may require additional personnel and systems resources. These include:

- Use of synthetic instruments to replicate a long/short strategy as a UCITS

- Pre-trade compliance systems and oversight to ensure that active or passive breaches of regulatory limits are not triggered for UCITS funds
- More frequent calculations of NAVs for UCITS
- Extensive additional reporting is required for AIFMD funds, and there are certain local reporting obligations for UCITS
- Additional service providers are required for both AIFMD and UCITS regimes. This will add a certain amount of incremental complexity to a manager's day-to-day operations

Partnerships

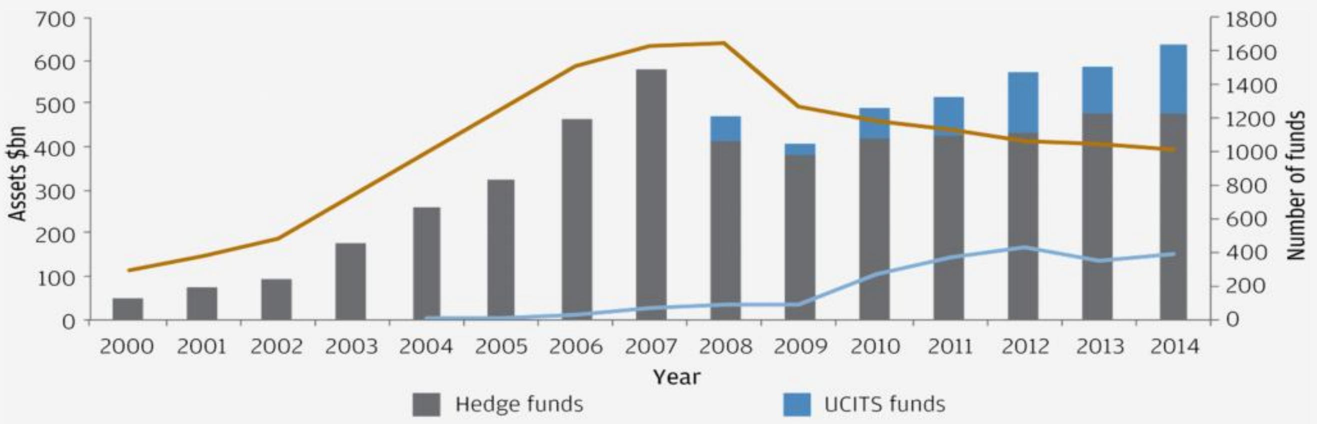
Targeting the European onshore investor base increases complexity for managers. However, many options exist to help managers in structuring and distributing their funds. As a result, managers may consider partnering with certain local providers for services such as:

- Onshore fund platforms that enable managers to benefit from shorter time-to-market and may offer incremental distribution
- Distribution either on a third-party basis or with local fund groups

UCITS and AIFMD Markets Progress Thus Far

Exhibit 1:

Growth of the European hedge fund industry

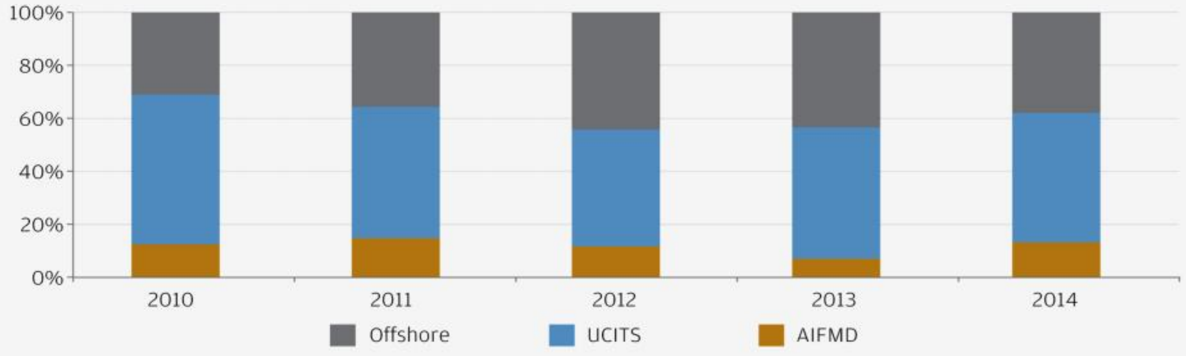


Source: Eurohedge April 2015

New launches

There is evidence that hedge fund managers have begun to adopt the new regimes. Exhibits 2 and 3 indicate the regulatory format of new hedge funds launched by European and U.S. managers since 2009.

Exhibit 2:
New hedge fund launches by European managers 2010 to 2014

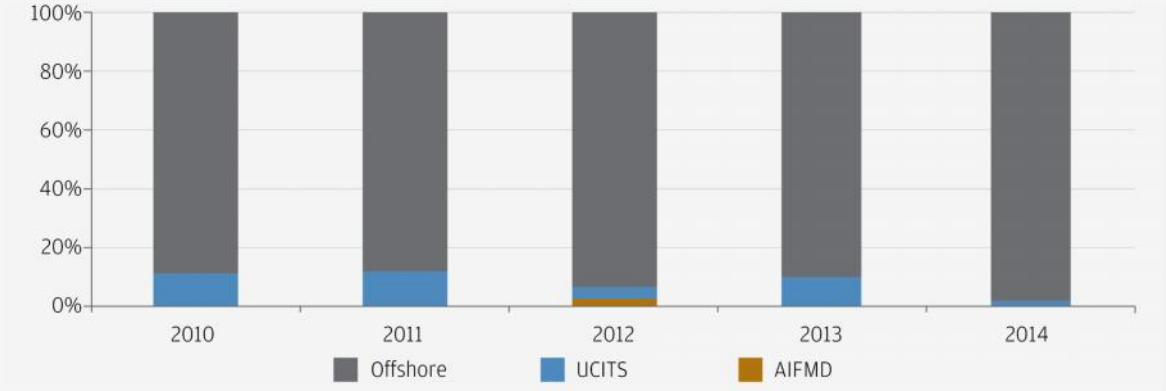


Source: Eurohedge April 2015

The data show that European managers have implemented UCITS considerably more readily than AIFMD with, on average, 48% of new funds established in UCITS format and 15% under AIFMD.[4]

If we distinguish between managers with their headquarters in the U.S. rather than Europe, the conclusion is even more pronounced. U.S. managers have largely ignored the AIFMD regime altogether, preferring offshore structures.

Exhibit 3:
New hedge fund launches by U.S. managers 2010 to 2014



Source: Eurohedge April 2015

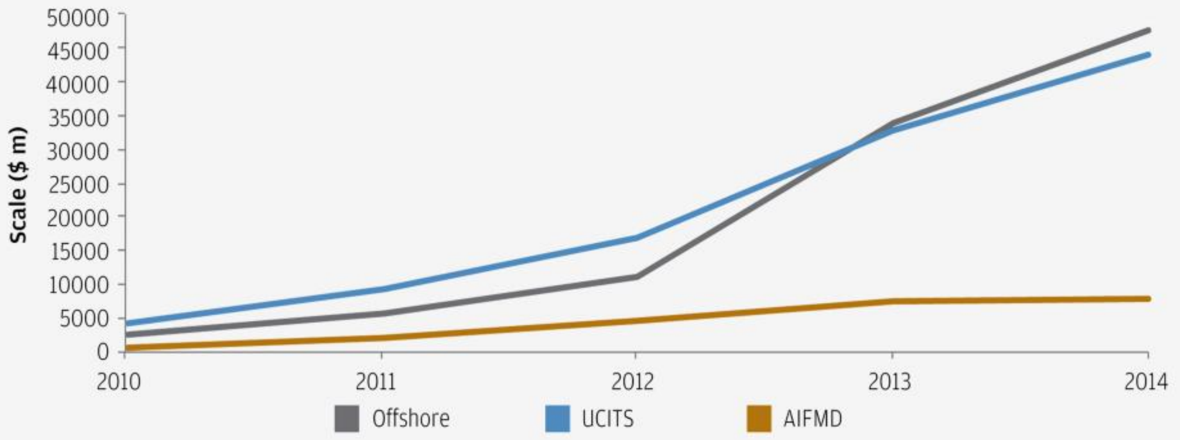
Assets raised

It is also informative to consider which regulatory regime has seen the largest growth in assets. Exhibits 4 and 5 illustrate the cumulative increase in total Assets Under Management (AUM) and AUM per fund for the cumulative 2010–2014 vintages and the fund launches for Europe based managers respectively.

The contrast between assets raised in offshore and UCITS structures is striking compared to assets raised in (now AIFMD-compliant) onshore structures.

Exhibit 4:

Cumulative assets raised for hedge funds launched between 2010 and 2014 by Europe based managers

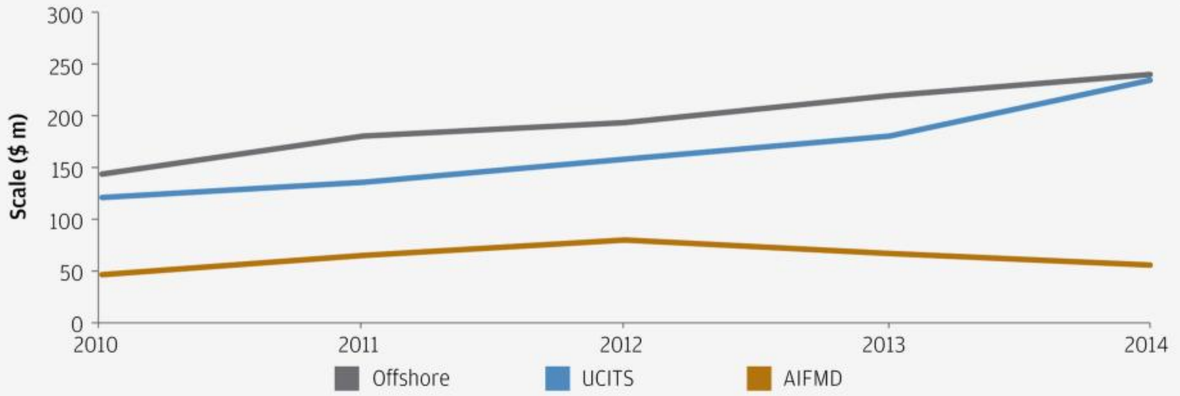


Source: Eurohedge April 2015

The growth in AUM per fund shows a similar pattern, with offshore and UCITS hedge funds enjoying much more success in raising assets.

Exhibit 5:

Assets raised per fund for hedge funds launched in 2010 by Europe based managers



Source: Eurohedge April 2015

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1. Source: Eurohedge April 2015
2. Source: EFAMA Quarterly Statistical Review February 2015
3. The U.S. mutual fund market is $16 trillion in size
4. Source: Eurohedge April 2015. Based on number of funds launched 2010 to 2014