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Frankfurt am Main,
29 May 2015

**BVI's response to the 2nd Consultative Document by the FSB and IOSCO on Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systematically Important Financial Institutions dated 4 March 2015**

BVI[1] appreciates the opportunity to comment on the second FSB/IOSCO consultative document in the broader context of the current global debate around the alleged "systemic" nature of asset management activities. Prior to answering the relevant questions, we would like to submit some general observations and to call for the FSB/IOSCO to redress some misguided assertions affecting the debate at hand.

## General remarks

The work on NBNI G-SIFIs conducted by the FSB/IOSCO in response to the G20 mandate is clearly aimed at identifying and, in a longer term, addressing systemic risk. Hence, it should be reasonably linked to the other FSB workstreams dealing with potential sources of systemic risk, in particular to the initiatives relating to shadow banking. In this regard, we wonder and deeply regret the fact that the FSB has failed to build upon its conclusions for strengthening oversight and regulation of shadow banking entities as laid down in the policy framework published in August 2013. In this well-founded and differentiated paper, the FSB establishes that systemic risk in the shadow banking sector does not attach to specific entities/legal forms of entities, but is rather prompted by certain economic functions or activities. Moreover, the FSB develops a policy toolkit to be applied to each economic function in order to mitigate systemic risk associated with that function. In relation to investment funds, the recommended policy tools comprise in particular measures for managing redemption pressures in stressed market conditions such as redemption gates, fees or suspension of redemptions, proper management of liquidity risk or limits on leverage. These features are already present in many investment funds and form integral parts of the long-standing fund frameworks in many jurisdictions, including the EU. Hence, in its 2013 paper the FSB already recognised that the existing fund regulation, even though usually enacted with the primary aim of investor protection, has the effect of substantially mitigating systemic risk.

Against this backdrop, we further wish to highlight the following:

- It appears unreasonable to start the work on identifying systemic risk in the asset management sector by developing methodologies for filtering individual entities rather than by asking whether investment funds or asset managers can actually become systematically important in view of the applicable legal frameworks. In this context, we call upon the FSB and IOSCO to thoroughly analyse the overwhelming body of detailed rules and regulations established for the asset management industry both before and after the 2008 crisis. In particular, it should be borne in mind that sound monitoring and management of risks, including liquidity risk, lies at the heart of proper fund operations. Even though conducted with the view of protecting the

[1] BVI represents the interests of the German investment fund and asset management industry. Its 89 members manage assets in excess of EUR 2.6 trillion in UCITS, AIFs and assets outside investment funds. As such, BVI is committed to promoting a level playing field for all investors. BVI members manage, directly or indirectly, the assets of 50 million private clients over 21 million households. BVI's ID number in the EU Transparency Register is 96816064173-47. For more information, please visit www.bvi.de/en.

interests of fund investors, risk management in a fund necessarily lessens the systemic relevance of the fund's market activities.

- Given that the regulatory frameworks govern all investment funds and their managers regardless of size, adequate tools for mitigating risk are generally implemented by all vehicles. Hence, size of a fund must be considered an arbitrary criterion and the pure size thresholds proposed in the consultation paper are set at random without reference to any evidence-based analyses or relevant market data. As regards asset management firms, we are deeply concerned by the fact that the consultation paper at hand appears necessarily to lead to the designation of a handful of asset managers, primarily to ensure "consistency" with the FSB's existing frameworks for banks (G-SIBs) and insurance companies (G-SIIs). Such an approach furthermore does no justice to the fact certain "activities", against which only asset management companies could allegedly be assessed under the proposed methodology, are also carried out by other financial market players, including asset owners investing their portfolios directly and "sell-side" firms.

- The rejection of the size criterion is backed by the IMF stating in its Global Financial Stability Report from April 2015 that there is no evident correlation between the size of a fund or a fund manager and the magnitude of the corresponding systemic risk[2]. On the other hand, the IMF report is built upon the hypothesis that "plain-vanilla" investment funds can also give rise to systemic risk if their investment strategy is focused on less liquid markets. Unfortunately, the IMF fails to verify this assumption by analysis of data outside the US markets, and even in relation to those, the data basis and the findings of the IMF report have been contested by the industry. Furthermore, the IMF report investigates the trading patterns of investment funds with a particular focus on emerging markets assuming herding behaviour among the funds, but without considering the relatively small share of investment funds within emerging market flows and the role of asset owners in shaping those flows. Hence, while appreciating the general approach of the IMF report that is to assess systemic risk inherent in the industry having regard to the regulatory measures already in place, we believe it to be of a very limited relevance to the current consultation.

- The discussion at hand is further complicated by the fact that the consequences of a G-SIFI designation being referred to as "incremental policy measures" remain to this date unknown. This significant uncertainty in terms of possible regulatory treatment raises many concerns among market participants. In general, we are wary of any intended measures "incremental" to those already in place for asset management entities, and in particular, the very elaborated regime foreseen under the AIFM Directive in Europe as only one example. In this regard, we wish to renew our suggestion that the FSB/IOSCO seriously consider the extent to which the existing legal frameworks already address many of the alleged risks described in the consultative document. In any case, designation as a G-SIFI should not be a "done deal" and occur only once systemic risks have been convincingly identified and existing requirements proven insufficient.

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[2] Cf. Chapter 3 of the IMF Global Financial Stability Report: Navigating Monetary Policy Challenges and Managing Risks, page 93 and 114-115.

- A credible regulatory response to the alleged systemic risk in the asset management sector must be underpinned by reliable and comprehensive data allowing for a balanced, objective and informed assessment of potential risks. Due to the recent initiatives to enhance reporting requirements, especially in Europe, securities regulators will be flooded with data relating to both positions and risks at the fund/manager level as well as to individual transactions. Thus, it is absolutely requisite that, in a near future, market regulators be endowed with sufficient means and resources to effectively collect, store and process such data, and subsequently draw meaningful conclusions as to whether a non-bank, non-insurance entity truly deserves to be designated as "systemic". In the European context, the regulators' facilities in this regard need further improvement as demonstrated by the recent experience with regulatory reporting under AIFMD which remains suspended in many Member States, including Germany, due to the practical difficulties to implement a workable solution for data processing. Against this background, it appears consequent to momentarily suspend the NBNI G-SIFIs designation process until better evidence can be gathered and studied for the purpose of forming a more comprehensive view of the current market ecosystem.

- Lastly, we also believe that future analysis by the FSB of the asset management industry, financial stability and potential risk mitigants should also give consideration to the roles of asset management in channelling investments to the real economy. Risk mitigants should be consistent with and not undermine the comprehensive growth strategies of the G20.

**As a consequence, we urge the FSB and IOSCO to carefully consider our industry's replies to this second consultative document, acknowledging the limits of their investigation conducted so far and the potentially material implications of their work going forward. We would invite both institutions to consider rectifying their current approach, acknowledging that a more balanced and better calibrated assessment of systemic risk inherent in the asset management sector should be conducted on the basis of an in-depth analysis of the relevant regulation and better data to be collected under the recently enhanced reporting requirements.**

## Specific comments

In light of our above remarks, we would like to answer the specific questions for consultation which bear relevance for the asset management industry as follows:

### HIGH-LEVEL FRAMEWORK FOR IDENTIFYING NBNI G-SIFIS

***Q2-3.*** *Please explain any other NBNI financial entity types that should be excluded from the definition of NBNI financial entities so that NBNI G-SIFI methodologies would not apply and their rationale.*

**We believe that investment funds operating under the European UCITS regime should be generally excluded from the definition of NBNI entities due to their highly regulated nature which prevents the emergence of systemic risk. The same should consequently apply to funds subject to UCITS-equivalent regulation and supervision.**

UCITS are the most densely regulated investment vehicles not only in Europe, but probably also in worldwide terms. Under the UCITS Directive, both the fund manager and each individual fund must obtain authorisation from the competent authority before carrying on any activities in the market. The fund manager is subject to strict requirements for the management of risks, including liquidity risks, inherent in the managed funds[3]. Potential conflicts of interest must be capaciously identified, managed by internal arrangements and if not fully eliminated, disclosed to investors[4]. As regards UCITS, there are extensive provisions in place regarding assets deemed eligible for fund investments as well as applicable investment limits in terms of issuer and counterparty risks[5] resulting in a comprehensive diversification of the fund investments. There are also strict limits to the level of leverage that may be employed by UCITS. Specifically, the fund's global exposure acquired via derivatives may not exceed the total net value of its portfolio assets[6]. Direct borrowing is restricted to temporary transactions not exceeding 10% of the fund value[7]. Furthermore, all UCITS are under the obligation to disclose the actual level of employed leverage in the annual report[8].

There is no evidence based on the market development so far that UCITS as a fund category, let alone a singular UCITS, have ever generated risks which might have threatened the stability of financial markets. On the contrary, when launching the UCITS V reform in 2010 the EU Commission established that "the UCITS asset management sector was not one of the root causes of the financial crisis, and the new regulatory framework for UCITS should place significant limits on the degree and nature of the risk that a UCITS might take on, thereby also limiting the extent to which misaligned incentives might lead to wider systemic problems"[9].

Therefore, should the FSB and IOSCO consider excluding certain types of financial entities from the scope of the current initiative, we believe that UCITS and any funds subject to UCITS-equivalent rules should be among the first beneficiaries of such measures.

**INVESTMENT FUNDS**

***Q6-1.** Please explain any potential systemic risks associated with the financial distress or disorderly liquidation of an investment fund at the global level that are, in your view, not appropriately captured in the above description of each risk transmission channel? Are there elements that have not been adequately captured? Please explain for each of the relevant channels separately.*

<u>The exposures/counterparty channel</u>

Generally, it is not helpful for a substantive discussion to base any findings on speculations in terms of poor fund management. Specifically, we refer to the statements on page 32 and 33 relating to the purported inadequate management of exposures which might generate heavy losses or to the assumption that margining practices for the non-centrally cleared derivatives are inadequate. For the future, we recommend focusing the FSB/IOSCO work on facts obtained by the expanded reporting of data and by analyses of the regulatory frameworks governing the fund business.

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[3] Cf. Article 12 and Articles 38-43 of Directive 2010/43/EU (UCITS Implementing Directive).
[4] Articles 17-20 of Directive 2010/43/EU.
[5] Articles 50-57 of Directive 2009/65/EC (UCITS Directive) in conjunction with Directive 2007/16/EC.
[6] Cf. Article 51(3) first subparagraph of Directive 2009/65/EC.
[7] Cf. Article 83(2) of Directive 2009/65/EC.
[8] Cf. Box 25 of the CESR's Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS dd. 28 July 2010 (CESR/10-788).
[9] Cf. Consultation Paper on the UCITS Depositary Function and on the UCITS Managers' Remuneration dated 14 December 2010 (MARKT/G4 D (2010) 950800), page 26.

As regards potential systemic risk resulting from a fund's distress or forced liquidation, we would like to observe the following:

- Funds operate on the basis of risk-spreading: The principle of risk-spreading is inherent in all open-ended investment funds. For UCITS and many other retail funds, this principle is enshrined by regulation and translated in a set of specific limits on the issuer and counterparty risk[10]. In some jurisdictions, including Germany, such limits apply also to funds managed specifically for professional investors[11] or otherwise are stipulated in the fund rules. Diversification of the fund investments obviously mitigates the impact of a fund's failure or distress on the broader financial market.

- Leverage in European funds is limited by either regulation or fund rules and disclosed to authorities and investors: As explained above, UCITS must observe limits to the allowable leverage level resulting from both the use of derivatives (100% of the portfolio's global exposure) and temporary borrowing (10% of the fund value). Furthermore, all UCITS are under the obligation to disclose the actual level of employed leverage in the annual report. European funds other than UCITS (so-called alternative investment funds or AIFs) must define a maximum limit in terms of leverage which shall be disclosed to investors as part of the offering documents[12]. The responsible manager must be able to demonstrate to the authorities that the defined leverage limit is reasonable and being observed at all times[13]. The level of leverage effectively implemented within the fund portfolio must be reported to competent authorities on a quarterly basis[14] and in addition, disclosed in the fund's annual report[15]. More stringent reporting and transparency requirements still apply to funds employing leverage on a substantial basis[16]. Hence it is unrealistic to assume, at least for the European market, that leverage in funds can be built up without regulatory control.

- Clearing of OTC derivatives is subject to profound changes: In this context, we wish to point to the mandatory move of a significant part of OTC derivatives trading to central clearing counterparties (CCPs)[17], the additional capital charges imposed on bank institutions as funds' traditional counterparties[18], but ultimately also to the standards being developed in terms of collateralising non-centrally cleared OTC derivative transactions. Regulated investment funds (UCITS/AIFs) are also under the duty to collateralise non-centrally cleared OTC derivative transactions as envisaged by the BCBS/IOSCO margin requirements[19].

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[10] Articles 52-57 of Directive 2009/65/EC.
[11] So-called "Spezialfonds with defined terms" (Spezialfonds mit festen Anlagebedingungen) which constitute a lion's share of the German professional fund market with €1,310 billion assets under management as of 31 March 2015 (source: BVI statistics).
[12] Cf. Article 15(4), 23(1)(a) of Directive 2011/61/EU (AIFMD).
[13] Article 25(3) first sentence of Directive 2011/61/EU.
[14] Cf. Annex IV to the Delegated Regulation (EU) 231/2013 (AIFMD Implementing Regulation), positions 26 to 30.
[15] Cf. Article 109(3) of the Delegated Regulation (EU) 231/2013.
[16] Cf. Article 24(4) of Directive 2011/61/EU.
[17] In Europe, the relevant regulatory framework is the European Market Infrastructure Regulation (EMIR) - Regulation (EU) No. 648/2012 - of 4 July 2012 on OTC derivatives, central counterparties and trade repositories, accompanied by a raft of implementing measures entrusted to the European Securities Markets Authority (ESMA).
[18] Such framework has been transposed into a binding EU act - Regulation (EU) No. 575/2013 on prudential requirements for credit institutions and investment firms (CRR) - calling on the European Banking Authority (EBA) to issue further guidelines on setting limits on institutions' exposures to non-bank entities.
[19] Cf. "Margin requirement for non-centrally cleared derivatives", final report by BCBS/IOSCO from March 2015.

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The asset liquidation/market channel

Once again, we would like to clear up some misconceptions which flaw the FSB/IOSCO's assumptions on the systemic relevance of investment funds:

- Liquidity management tools: The consultative document erroneously discounts the importance and availability of liquidity management tools as acknowledged by the FSB in the context of the shadow banking debate[20]. In particular, the consultative document suggests in section 6.2.2 that because these tools are "infrequently used" their effectiveness appears to be cast into doubt and thus "warrants further investigation". On the contrary, we must clarify that the reason why measures such as redemption fees, gates, temporary suspensions, etc. are seldom, if ever, used is precisely because the funds' core risk management functions have proved capable of matching assets and liabilities at all times, including throughout periods of past and more recent market turmoil, in line with managers' fiduciary duties towards their clients. For instance, funds operating under the AIFMD framework in Europe are required to foresee and conduct ongoing stress-tests to manage the fund's liquidity profile in line with its redemption policy and the underlying investment strategy[21]. Nonetheless, we have seen some instances in the German market in the aftermath of the financial crisis where some open-ended real estate funds had to suspend redemptions precisely in order to prevent "fire sales" of more attractive investments at prices which might have harmed the interests of their investors. In this context, it should also be noted that in Germany redemptions of fund units/shares can be also suspended upon the order of the supervisory authority and also in order to suit public interests[22].

- Probability of "fire sales": Another evident misconception we wish to redress is the likelihood of "fire sales" materialising in the presence of concentrated and relatively illiquid portfolio holdings. Once again, we would like to refer to the key principle of diversification underpinning all investment management decisions. For all collective investment vehicles, portfolio diversification lies at the core of risk management and in virtually all jurisdictions which have adopted a legal framework for our industry, diversification forms the object of mandatory legal requirements. We have already pointed out the explicit diversification requirements of the UCITS Directive and their extension to professional funds under German law. Implemented in combination with sound risk management procedures and properly supervised by the competent authorities, these standards materially impede any relevant concentration implied under section 6.2.2 of the consultation paper. Investment funds with focus on less liquid assets, in contrast, are generally characterised by initial lock-up periods combined with infrequent or deferred redemption opportunities which cater for the limited possibilities to dispose of the fund investments and hence also have the effect of preventing "fire sales"[23].

- Liability structure in professional funds helps to anticipate redemptions: In respect of professional funds, such as German "Spezialfonds", it is also important to appreciate the composition of a fund's liability side made up essentially of large institutional investors who in turn have to finance long-term liabilities (e.g. insurance and pension fund providers) and are

[20] Cf. "Policy Framework for Strengthening Oversight and Regulation of Shadow Banking Entities", final report by the FSB from 29 August 2013, page 14-16.
[21] Cf. Article 48(2) and (3) of Delegated Regulation (EU) 231/2013.
[22] Cf. § 98 para. 3 of the German Capital Investment Code (KAGB).
[23] In Germany, for instance, open-ended real estate funds marketed to the retail public entail a lock-up period for new investments of 24 months and a notice period for redemptions of 12 months, cf. § 225 para. 3 and 4 KAGB.

thus certainly able to withstand any sudden or short-lived market corrections assumed in the consultative document[24]. It is highly improbable that this investor category would be suddenly requesting their appointed managers to "dump" sizeable proportions of a portfolio in a falling market scenario. On the contrary, the limited investor base of professional funds and the close interrelations between the manager and investors must be considered an advantage for anticipating redemption needs and effective liquidity management in general

The critical function or services/substitutability channel

The notion of "critical function or services" as defined in section 6.2.3 of the consultative document remains to us confusing. It is unclear whether it points to a very bespoke investment strategy that would necessarily be unique to one or very few clients – thereby largely excluding the possibility of it generating "crowded trades" that could in the FSB/IOSCO line of reasoning exacerbate downward price spirals – or whether the "function" or "service" would be something essentially different from "plain vanilla" investing when referring to a fund becoming a "source of liquidity".

However, in line with our previous reply, we would categorically exclude any concern tied to any one single fund being able to "corner" a market by, for instance, purchasing a substantial portion of the outstanding stock of one given security, or by taking a pure one sided-view of a given market by amassing huge derivative positions. Such concentrations would be not only illegal under the risk diversification requirements pertaining to UCITS and many other open-ended investment funds, but also inconsistent with the principles of sound risk management which generally command the portfolio manager to hedge investments by also taking an opposing position. It is also logically difficult to understand how highly-specialised funds, allegedly dominating markets in thinly traded securities, could possibly be at the origin of systemic risk propagation.

***Q6-2.*** *For the asset liquidation/market channel, to what extent is the potential for risk transmission heightened with respect to an individual fund that is a dominant player (e.g. its asset holdings or trading activities are significant relative to the market segment) in less liquid markets?*

With the European asset management industry representing an estimated mere €11.3 trillion (US$ 12.6 trillion) between UCITS and non-UCITS out of some US$ 225 trillion of globally investable assets as of end-2014, fears of any one fund "cornering" a relevant market have plainly no substance. According to a recent McKinsey & Company survey, it is estimated that 75% of the world's financial assets are managed directly by the asset owner[25], with the remaining approximately 25% managed by asset managers in separate accounts (approximately 10%) and funds (approximately 15%).

In line with these considerations, we certainly exclude that a traditional European UCITS fund could find itself in a situation where it would be a "very large and a significant investor" in one specific asset class, as a result of the strict diversification and eligible asset rules applied to its portfolio. Moreover, systemic risk transmissions via the market channel from an individual fund are sufficiently tempered by the ongoing monitoring of limited exposure to illiquid assets as part of the risk management process and by

[24] In this regard, EFAMA welcomes the inclusion of the new indicator "Nature of investors in the funds", relative to the "Interconnectedness" impact factor, in the revised draft methodology.

[25] Please refer to "Strong Performance but Health Still Fragile: Global Asset Management in 2013. Will the Goose Keep Laying Golden Eggs?", McKinsey & Company (2013).

the use of liquidity management tools such as redemption fees, gates or suspensions of redemptions when needing to govern unanticipated spikes of redemption requests.

As regards European AIFs, there is the general requirement that the fund's redemption policy must be compatible with its liquidity profile and the underlying investment strategy. As explained above, the AIFMD framework further provides for mandatory stress-testing of liquidity conditions to be conducted on an ongoing basis and for quarterly regulatory reporting of liquidity risk indicators. Enhanced reporting requirements still apply to funds deemed to apply leverage "on a substantial basis". All these provisions are in our view appropriate to avoid forced asset sales and amplify distress, while in parallel allowing supervisors to monitor the build-up of excessive exposures.

In sum, we do not consider any European UCITS or AIFs to have concentrations large enough to be sanctioned as a "dominant player" in any individual security or asset class, given the size and breadth of today's global markets. The applicable EU fund frameworks *de facto* prevent any fund from amassing illiquid positions in a manner that would make satisfying redemption requests impossible. Moreover, it should be borne in mind that maintaining a certain percentage of the fund's NAV in the form of cash and cash equivalents (i.e. the cash ratio) is part of proper risk management in an open-ended investment fund. Evidence suggests that in times of market stress, where outflows become more likely, a fund's cash balance may actually rise to meet growing redemption requests, acting as a built-in stabiliser. In Europe, the UCITS framework allows for short-term direct borrowings up to 10% of the fund value precisely in order to cater for unexpected spikes of redemptions.

One final aspect we wish to confute is the assumption that a sudden termination of a large securities loan may force the manager to immediately raise cash to return cash collateral to the securities borrower – see number (iii) under section 6.2.2. The reinvestment of cash collateral received in exchange for securities lending is general recallable over a very short time-span. In Europe, reinvestment of cash collateral by UCITS is only allowable if it is:

- Placed on deposit deposits with credit institutions which are repayable on demand or have the right to be withdrawn, and maturing in no more than 12 months;
- Invested in high-quality government bonds;
- Used for the purpose of reverse repo transactions provided the transactions are with credit institutions subject to prudential supervision and the UCITS is able to recall at any time the full amount of cash on accrued basis or
- Invested in short-term money market funds[26].

In Germany, these standards have been extended by regulation to all securities funds, including "Spezialfonds". According to our understanding, cash collateral reinvestment by other EU AIFs adheres to the same principles on either statutory or contractual basis.

***Q6-3.*** *Under what conditions might the asset liquidation/market channel apply to an individual fund in ways that are distinct from industry-wide behaviours in contributing to broader market contagion?*

[26] Please refer to the ESMA Guidelines on ETFs and other UCITS issues (ESMA/2014/937), paragraph 43, letter j).

The phrasing of the above question is not too clear. *Per se*, an individual fund is certainly distinct from other comparable investment vehicles in terms of portfolio composition (i.e. no two funds are identically invested in exactly the same assets at any point of time), liability composition (i.e. no two funds have the same investors/counterparties), or in terms of management (i.e. no manager will manage two portfolios in exactly the same way). The obvious reply to the above question is that each individual fund would be affected by liquidation demands in a way which is distinct from other behaviours occurring in the broader markets.

In this context, we wish to point out that any concerns about "herding" into or out of an asset class cannot be addressed by designation of certain funds or asset managers as systemically relevant, given that it is the asset owners who control the strategic allocation of their assets and, therefore, the flow of assets into and out of asset classes. Hence, we believe that the regulators need to obtain a greater understanding of asset owners and their investment objectives and constraints. Similarly, it is important to understand the role of intermediation and the governance structure around asset management decisions. Any policy options for tackling potential systemic risk associated with herding should be discussed only after that thorough review.

***Q6-4.*** *Is the proposed threshold defined for private funds appropriately calibrated? If not, please explain the possible alternative level (e.g. USD 200 billion of GNE) that could be adopted with clear rationale for adoption and quantitative data to back-up such proposed level?*

We disagree with setting initial thresholds for investment funds on the basis of a distinction between "private" and "traditional" funds. These terms derive from the US legal frameworks and are meaningless in legal terms outside the US. Regarding the EU, it would be particularly inappropriate to treat all AIFs as "private funds". As explained above, AIFs can pursue very different investment strategies and be set up as professional or retail funds. Hence, the AIF universe ranges from classical retail funds such as mixed funds which deviate only slightly from the UCITS rules in terms of their investments to highly leveraged hedge funds or closed-ended vehicles investing e.g. in infrastructure or private equity. The level of regulation applicable to AIFs also displays considerable differences, with retail AIFs generally adhering to UCITS-equivalent standards and some professional funds not subject to any fund-specific rules in addition to the liquidity and risk management standards enshrined by the EU Directive.

**As regards the proposed thresholds, we deem any estimations of systemic relevance based primarily on the size of investment funds purely arbitrary. We call once again upon the FSB/IOSCO to reconsider the general assessment of potential systemic risk inherent in the asset management sector after a thorough analysis of the applicable legal frameworks and on the basis of the data collected by the authorities under the new requirements for regulatory reporting.**

Should the institutions nonetheless insist on defining thresholds for the purpose of the current initiative, we would suggest considering size in terms of a combination of a fund's volume and its leverage. Indisputably, leverage is a material factor of systemic risk. Most financial failures result from a "liquidity crunch" due to a mismatched term structure of leverage. In this regard, we could envisage setting the initial threshold for funds with minimum NAV of USD 30 billion, as suggested in option 1 for "traditional" funds, at the leverage level exceeding three times a fund's NAV (leverage factor 3:1). Leverage in this sense should be calculated in accordance with the commitment approach (cf. below). Such threshold would coincide with the concept of funds employing leverage on a substantial basis under the EU AIFMD framework. These funds are already subject to enhanced reporting requirements pertaining to the substantial use of leverage since such use has been considered by the EU legislator as a potential source of systemic risk[27]. The size-only backstop of USD 100 billion net AUM should be dropped.

**In this context, we decisively reject using Gross Notional Exposure (GNE) as a threshold and size indicator.** The GNE approach is fundamentally flawed in that it fails to account for offsetting hedging transactions able to limit – if not completely annul – a fund's investment exposure to the broader market. The notional amount of a derivative contract does not equate to a true economic exposure, given that it only represents the present market value of the underlying asset the moment the trade is executed. Once this has occurred, the trade generates a positive or negative exposure for the parties, resulting from the mark-to-market valuation of the underlying and calling for collateral to be exchanged accordingly. In this manner, the derivative trade is re-set to zero on a daily basis along the entire duration of the contract until its expiry/termination date where collateral is returned. Throughout this period and by virtue of the continuous marking-to-market that in turn provokes the exchange of collateral between the parties the value of the trade remains at zero. Also, for every additional trade that one party executes with the same counterparty, GNE does not account for the benefits of trade reconciliations between each counterparty's respective list of trades. Instead of adding up and netting out positive against negative exposures at the pre-agreed time intervals and setting-off collateral in either one or the other direction, measuring GNE results only in one inflated figure derived from the sum of the notional amounts.

An appropriate measure of leverage should, in our view, capture the economic exposure that results from the use of derivatives and borrowing, and account for risk-reducing effect of hedging operations. Such approach is certainly most meaningful in determining the level of risk posed by an investment fund. From the EU perspective, we recommend using the "commitment approach" as defined in the AIFMD[28] for the purpose of leverage calculation. In essence, the commitment approach requires asset managers to calculate the sum of the absolute values of all positions, with each derivative position converted into its equivalent position in the underlying asset by using legally stipulated conversion methodologies. We encourage regulators to agree on definitions and harmonise the relevant reporting requirements wherever possible.

Lastly, if ultimately the FSB and IOSCO decide to set minimum thresholds, these thresholds should be considered as standards to be consistently applied by all national regulators in order to obtain a coherent view of the systemic risk imminent at the global level. In particular, funds not reaching the relevant thresholds should be neither involved in the G-SIFIs debate at national/regional level nor affected by further enhancement of standards for regulatory reporting.

***Q6-5.** In your view, which option for the proposed threshold applied to traditional investment funds is the most appropriate initial filter to capture the relevant funds for detailed assessment and why? Also, are they appropriately calibrated? Please provide evidence (data or studies) to support your argument. If you prefer Option 2, please provide a practical definition of a dominant market player that can be applied in a consistent manner.*

As anticipated in our answer to Question 6-4 above, we do not support the FSB/IOSCO approach to determine systemic risk thresholds based solely on the size of a fund. Understanding that the focus of the current initiative is to identify sources of potential systemic risks, we recommend that size be

[27] Cf. Article 24(4) AIFMD, Article 110(4) in connection with Annex IV of the Delegated Regulation (EU) 231/2013.
[28] For further details, cf. Article 8 in conjunction with Annex II of the Delegated Regulation (EU) 231/2013.

considered in terms of a combination between a fund's volume and its leverage with the latter being calculated in line with the "commitment approach" established in the EU AIFM framework. In any case, it is essential to clarify that where external party financing occurs – whether through balance sheet activities or through derivatives – what technically qualifies as "leverage" is only the positive exposure to the counterparty that is left un-collateralised and thus unsecured.

With regard to the FSB/IOSCO suggestions for "traditional funds" (a notion which has no legal meaning in the EU as explained above), we definitely disagree with setting a threshold with reference to the unspecific and unquantifiable attributes of "dominant player", "substitutability ratio" or "fire sale ratio" as envisaged under Option 2.

***Q6-6.*** *In addition to the two options for traditional investment funds, the FSB and IOSCO also considered a simplified version of Option 2 using GAUM (e.g. USD 200 billion) with no dominant player filters. Please provide your views if any on this as a potential threshold with the rationale (especially compared to the proposed two options above).*

The use of gross assets under management established by the GNE method should be discarded since it does not provide an accurate picture of the economic exposure in a fund (for further details, please refer to our reply to Q 6-4 above).

***Q6-7.*** *Please explain any proposed revised indicators set out above that, in your view, are not appropriate for assessing the relevant impact factors and its reasoning.*
***Q6-8.*** *What alternative indicators should be added and why would they be more appropriate? For example, do you see any benefits in adding price-based indicators? If so, please explain the rationale for inclusion and possible definitions of such indicators.*

As elaborated in our above comments, we have reservations with regard to the arbitrary nature and purpose of pure size indicators. We also see a substantial overlap between the first three sub-indicators of "interconnectedness", since all three are supposed to gauge leverage in different ways. Concerning indicator 2-3, we insist that GNE not be relied upon as the key leverage measure. Instead, we invite the FSB/IOSCO to consider a calculation method based on the EU commitment approach (cf. our reply to Q 6-4 above). Regarding indicator 2-7, the nature of fund investors is not always determinable and therefore the meaning of this indicator is doubtful in practice. Regarding indicator 3-1, it is not always possible to identify the daily trading volume of a market segment, in particular for products which are mainly traded on OTC markets (many fixed-income products in particular). Moreover, indicator 3-2 refers to the overall daily trading volume of "the same asset class", but the notion of the same asset class is too uncertain in practice to allow for comparability. A similar problem pertains to indicator 3-3 which refers to "the size of the underlying market".

***Q6-9.*** *What are the practical difficulties (e.g. data availability, comparability) if any with collecting data related to these indicators? Please clarify which items, the practical problems, and possible proxies that could be collected or provided instead.*

Concerning data, BVI's primary concern is the degree to which securities regulators, as direct supervisors for the asset management industry, will be able to process the enormous quantities of supervisory data that managers and their funds have begun to report under the enhanced requirements stemming from recent legislation, for instance the EU reporting regime under the AIFMD. The AIFMD reporting requirements are, in fact, very challenging, comprising extensive data on employed investment strategies and portfolio concentrations as well as asset allocation and individual risk factors of each managed fund. Specifically, the AIFM needs to fill out over 300 data fields in respect of each managed AIF on a quarterly basis. These challenges have resulted in a situation where, almost two years after entry into force of the AIFMD, not all authorities are in the position to receive reports and data processing at the EU level is still not possible for technical reasons.

Processing of data remains, however, only a first step, with the second being the opportune selection and elaboration in order to transform the collected data in the proposed indicators. We realise the practical difficulties market supervisors may confront in assessing such indicators before having had the opportunity to become familiar with the data gathering process. For this precise reason, we would suggest that the assessment methodology for NBNI G-SIFIs should be tested and further refined only once the national authorities in charge are confident that the data to assess or construct each indicator is truly available.

**In any event, we believe it essential that the authorities rely as far as possible on the already implemented standards for data collection in order to assess systemic importance of investment funds. Additional requirements, if any, must be incorporated into the existing frameworks on regulatory reporting.** The supervisory authorities must be able to assess systemic risk on the basis of comprehensive data reported through common channels and feeding into a common database. Further work is also needed on the harmonised understanding of the specific data elements which shall form basis for the effective calculation of the indicators.

Lastly, we would like to stress that additional data needed for the scrutiny of systemic risk should be collected only from those funds which reach the relevant materiality thresholds in order to avoid disproportionate burden for the entire industry.

***Q6-10.*** *For “size”, should GNE be adjusted? If so, please explain how GNE should be adjusted and the practicality of such adjustment (e.g. data availability).*

We do not agree with the use of GNE as a threshold and size indicator. Instead, we suggest using a method based on the “commitment approach” under the EU AIFM Directive (cf. our comment in relation to Q 6-4 above).

***Q6-11.*** *For “interconnectedness”, should financial leverage [be] measured separately from synthetic leverage?*

In our view, both types of leverage should be measured in combination, since they are just different means of acquiring additional exposure in a fund. This approach would be also consistent with the EU fund frameworks and in particular, with the “commitment approach” under the AIFMD.

**ASSET MANAGERS**

***Q7-1.*** *Please describe any activities or services conducted by asset managers other than described above. In particular, please explain any other activities that, in your view, should be included in the scope.*

BVI would like to strongly reiterate its opposition to the inclusion of asset management companies in the debate on systemic importance of NBNI entities. In many ways, the continued emphasis around the supposed “systemic” nature of asset managers as a result of their “core” and “non-core” activities represents a visible “step back” in the FSB/IOSCO prior analysis and one we wish to counter with a renewed emphasis. Before turning to consider each of the three individual contagion channels, we wish to highlight the following key characteristics of the asset management industry:

- Asset management is an “agency” business, where assets are professionally managed by an investment manager or management company (hereafter “the manager”) on behalf and in the sole interest of its clients in either funds or individual accounts. The manager’s relationship with its clients is of fiduciary nature and formalised by a mandate, generally known as an investment management contract. The fund’s assets are legally segregated from the balance sheet of the manager and held by the appointed depositary (typically a credit institution) who registers them in the sole name of the fund. In this manner, the fund’s assets are made entirely “bankruptcy remote” and thus are in no manner affected by the business (mis)fortunes or reputation of the manager. Ongoing speculation around the transmission of risk from the manager to the fund or vice-versa – as in a number of passages in the narrative under Section 7 of the consultative document – continues to be factually incorrect.

- Consequently, the relationship between the manager and the managed funds in in no way comparable to the services provided by banks and other commercial lenders. Transactions in funds take place between the fund (investors) and the counterparties. The manager does not act as a counterparty to such transactions, including derivative contracts or securities lending transaction, and hence does not take any risk on its own books.

- All services provided by managers, in particular asset management services, operate in a highly competitive environment with multiple competitors. Due to these market conditions, funds are regularly merged, liquidated or their management is transferred to another company. These operations have to date never raised any systemic concerns and we maintain that such concerns will hardly emerge in respect of well-regulated and supervised managers or funds. In this regard, we would like to remind the FSB/IOSCO that most failures of asset management companies over the past decades were either caused by or related to gross forms of market misconduct. Even though the global regulatory response to the 2008 financial crisis comprises measures to prevent abuses, effective supervision and tough enforcement of rules is equally important for preventing future systemic risks.

Regarding the ancillary activities or services offered by a manager in addition to its core portfolio management function, these depend to a large extent on the manager’s preferred business model and partly also on the types of clients requesting additional services. In relation to European fund managers, it should be noted that both the AIFMD and the UCITS framework allow only for a limited range of ancillary services to be provided under the UCITS/AIFM licence. These services may include investment advice, safekeeping and administration of fund units and in relation to AIFM also reception and transmission of orders[29]. Hence, UCITS and AIF managers are explicitly not allowed to provide services involving on-balance risks such as dealing on own account. Furthermore, the AIFMD establishes a rule according to which the manager's own funds shall be invested in liquid or easily disposable assets and must not include speculative positions[30].

Specifically in terms of securities lending assumed as a "critical functions" in the consultative document, we would firstly like to note that securities lending is an "efficient portfolio management" (EPM) technique as defined by ESMA and strictly regulated under the 2012 *Guidelines on ETFs and other UCITS issues* (as revised in August 2014)[31]. Secondly, it is a technique employed by many different types of institutional investors, including various collective investment vehicles, insurance companies, pension funds, corporations, foundations, national central banks, and possibly others. As such, it logically does not make asset managers unique and may thus not be construed as a potential systemic indicator only for the latter. In this regard, we welcome the FSB's ongoing work on developing policy recommendations pertaining to securities lending as a market activity in order to minimise any potential for systemic risk resulting from securities financing transactions regardless of the legal nature of the entities involved. Thirdly, securities lending undertaken on behalf of fund clients is for the most part administered directly by the fund's custody bank or independent securities lending agents under a selected securities lending programme. Only a few large managers have been able to establish their own securities lending business that they carry out for their clients on an agency basis.

As a last observation, we agree with the proposed approach to scope out asset managers captured in prudential consolidated regulation and supervision of their parent entity if the latter has already been assigned under the G-SIB or G-SII methodology.

***Q7-2.*** *Please explain any potential systemic risks associated with the financial distress or default of an asset manager at the global level that are, in your view, not appropriately captured in the above description of each risk transmission channel. Are there elements of the relevant channel that have not been adequately captured? Please explain for the relevant channel separately.*

In light of our reply to Q7-1 above, we urge the FSB/IOSCO to cease assuming that the difficulties and eventual prospect of an asset manager exiting a business can be categorised as systemic. For reasons tied to an extremely competitive global landscape and on the basis of the general nature of the asset management business with the client assets being legally and functionally segregated from the asset manager's balance sheet, we deem this question without substance.

***Q7-3.*** *For the exposure/counterparty channel, to what extent does the assessment adequately describe the types of risks posed by asset managers' activities, such as securities lending, distinct from individual funds? Are there other activities that warrant further assessment?*

As explained in our reply to Q 7-1 above, asset managers are not the counterparty to client or investment fund trades, derivative transactions or securities lending arrangements and therefore cannot be considered transmitters of exposure/counterparty risk. Investment of asset managers' own assets – which by the way are negligible when compared to that of any mid-sized bank, not to mention those of

[29] Cf. Article 6(3) of the UCITS Directive (Directive 2009/65/EG), Article 6(4) of AIFMD (Directive 2011/61/EU).
[30] Cf. Article 9(8) of AIFMD.
[31] Cf. ESMA Guidelines on ETFs and other UCITS issues (ESMA/2014/937), para. 25-35 and 41-48.

the already designated 29 G-SIBs – is generally conservative and very much in line with the principle enshrined by the AIFMD for the European market.

Another clear misconception under section 7.2.1 of the consultative document is that asset managers investing seed money at the launch of one or more funds would transmit losses to other counterparties. Frankly, we do not see how this risk transmission can occur and in what way committing seed capital would be different from managing money placed into an investment. In both cases, potential losses will be borne by the asset manager in the same manner as by other investors.

As to securities lending and possible indemnification against a borrower's default, we wish to stress that the actual indemnification is contingent and would materialise only once the lending firms' prior safeguards have proven insufficient. These include selective due diligence on counterparty borrower creditworthiness, over-collateralisation with collateral marked-to-market daily and applied haircuts on non-cash collateral. Furthermore, borrower default indemnification generally does not entail a guarantee of the investment performance of the securities lending arrangement. Rather, is must be clarified that the indemnification requires the lending agent to cover the potential shortfall between the value of the collateral pledged and the replacement cost of the securities lent. In the European regulatory environment, the risk of such shortfall occurring is fairly limited. It is general practice and in Germany also required by law[32] that borrowers post collateral for securities loans in excess of the value of the securities being lent. This collateral is marked-to-market daily and the borrower may be required to deliver additional collateral in order to maintain the required excess level. This overcollateralisation provides an additional "safety cushion" in the event that the borrower fails to return the security that is on loan. Re-hypothecation of non-cash collateral is strictly prohibited under the UCITS framework. Non-cash collateral must be placed in custody with the fund's depositary or another custodian subject to prudential supervision who is unrelated to the collateral provider[33].

On this basis, we do not see any potential for securities lending and related indemnification activities by asset managers to become systemically relevant.

***Q7-4.*** *For the asset liquidation/market channel, to what extent and under what circumstances might reputational or operational risks of the asset manager impact the entity's individual funds, contributing to high redemptions? How might it impact the transfer of SMAs?*

We agree with the statement in section 7.2.2 of the consultation paper that "asset managers tend to have small balance sheets and the forced liquidation of their own assets would not generally create market disruptions". Asset managers do not transmit risks related to asset liquidation/market channel, because even in the worst-case scenario where an asset manager were not able to operate at all, management of investment funds or client portfolios would be transferred to another manager.

In this context, we would like to note that transitioning the management of an investment fund or a client's account does not entail disposals of investments, since the assets are segregated from the asset manager's own assets and held by the fund's depositary or a custodian who are obliged by law or contract to act in the best interest of investors (not the asset manager). Depositaries hold the assets regardless of which asset manager is entrusted with the function of investment management. Under the German law, it is also the depositary who may appoint another manager for the continued management

[32] Cf. § 200 para. 2 and 3 of the German Capital Investment Code (KAGB).
[33] Cf. ESMA Guidelines on ETFs and other UCITS issues (ESMA/2014/937), para. 43 g) and i).

of investment fund assets subject to approval by the supervisory authority[34]. Individual clients can themselves re-direct the management of their security portfolios to another manager. Importantly, assets are not required to physically move in case of a change of asset manager, as they remain with the relevant depositary/custodian in denominated accounts.

***Q7-5.*** *For the critical function/substitutability channel, are there any emerging activities that might be critical to a portion of financial clients that might in turn impair market functioning or risk management if no longer provided? Other than managing assets as an agent (i.e. core function), to what extent do asset managers engage in activities that may be relied upon by investors, financial institutions and corporations, and which are difficult to readily substitute?*

Once again, we agree with the statement in the consultation paper at hand that “asset managers primarily provide advice or portfolio management service to clients on an agency basis. This model makes their provision of this particular activity generally substitutable as there is considerable competition in the market place”. The asset management industry is indeed highly competitive and there are numerous competitors across different asset classes and investment strategies.

Against this background, we have some trouble in understanding how an asset manager could have acquired a “unique expertise” in the form of a niche investment strategy and in particular, how such a unique investment strategy could attract enough assets to render the fund managed sizeable and systemically important, while continuing to be considered a niche strategy. Success breeds imitators and eventually other market participants – including those that take the other sides of these funds’ trades – will develop an understanding of the expertise, at which point the strategy will no longer be unique.

***Q7-6.*** *Please explain any practical difficulties in applying the above proposed thresholds for an initial filter of the asset manager universe and limiting the pool of asset managers for which more detailed data will be collected and to which the sector-specific methodology (set out in Section 7.4) will be applied.*
***Q7-7.*** *Please provide alternative proposals, if any, for a more appropriate initial filter (with the rationale for adoption and quantitative data to back-up such proposals).*

Regrettably, we fail to understand the evident contradictions in section 7.3 of the consultative document, where on the one hand the separation between funds and the asset manager is acknowledged, albeit immediately after denied by stating that “nevertheless, certain risks generated at the asset managers’ level might also be transmitted through the investment funds that it manages.”

**In light of our comments made above, we are not convinced that there is any evidence-based reason to anticipate systemic risk in the asset management sector or to discuss specific materiality thresholds with regard to asset managers.** Specifically, in terms of the first threshold, the FSB/IOSCO correctly assume that an asset manager’s balance sheet is small compared to other financial market players which is due to the absence of own risk in the core business activities. The difficulty we see with the second threshold based on the aggregated size of AUM is both conceptual and practical. Conceptually, for reasons explained throughout this response so far, the hypothetical systemic importance of a fund manager is not correlated with the size of its AUM. The largest asset managers tend to be highly diversified across asset classes, investment strategies and types of clients.

[34] Cf. §§ 100 para. 3, 112 para. 1, fifth sentence of the German Capital Investment Code (KAGB).

From a practical perspective, systemic exposures – if any – emanate from the assets which are strategically controlled by the investors and where the latter are free to channel their investments elsewhere.

***Q7-8.*** *Please explain any proposed indicators set out above that, in your view, are not appropriate for assessing the relevant impact factors and its reasoning. What alternative indicators should be added and why would they be more appropriate?*
***Q7-9.*** *What are the practical difficulties (e.g. data availability, comparability) if any with collecting data related to these indicators? Please clarify which items, the practical problems, and possible proxies that could be collected or provided instead.*
***Q7-10.*** *Which of the proposed indicators set out above, in your view, should be prioritised in assessing the systemic importance of an asset manager?*

Since we principally disagree with the supposition of asset managers being systemically relevant and believe to have fully confuted their asserted contribution to the relevant risk transmission channels in our answers to Q7-3 to 7-5 above, we see no benefit in further debating the proposed indicators. Nonetheless, it appears that calculation of many indicators (e.g. indicator 3-2 referring to “total AuM invested in the same strategy for all managers”) would require a consistent approach to data collection and evaluation throughout the globe.

In terms of the expected practical difficulties with collected data, we would like to point to our answer to Q6-9 above where we explain the current challenges with data collection and processing at the EU level.