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AFG response to FSB-IOSCO consultative document on

Assessment Methodologies for Identifying Non-Bank Non-Insurer

Global Systemically Important Financial Institutions

The Association Française de la Gestion financière (AFG) is grateful for the opportunity to respond to FSB-IOSCO consultative document on assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions (SIFIs).

We understand that FSB-IOSCO should wish to complete the framework for Global Systemically Important Financial Institutions and to establish methodologies consistent with those applying to banks and insurer Global Systemically Important Financial Institutions.
But as an introductory comment, we would like to stress the **specificities of asset management** - asset managers manage assets on behalf of their clients and have a fiduciary duty toward them. In other words, assets do not belong to asset managers as they remain the ownership of investors and are kept and overseen by a depositary. **Thus the consequences of being identified as G-SIFI should be different from those of insurance companies or banks G-SIFIs and adapted to the activities and risks of the industry.**

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<u>Overall, we support the approach proposed by FSB-IOSCO regarding funds:</u>

- **AFG welcomes** the work of FSB-IOSCO and in particular the **two steps approach,** where the identified thresholds would only be used as a first filter to determine entities that should be further assessed.
- AFG suggests that **indicators** used to further assess entities should be **limited** in number and **focusing on leverage** (under interconnectedness and complexity), **liquidity** (under substitutability and complexity).

- Overall we believe that the proposed thresholds applying to entities are reasonable **but we suggest having a single size threshold for all relevant investments funds (i.e. with a leverage above 3): <u>$ 400 billion GNE.</u>**

- We believe that, in order to be easily understood and applicable, thresholds need to be as simple as possible and, in order to avoid regulatory arbitrage and ensure legal certainty for market participants, that **national regulators should not have the possibility to lower it** or have their own interpretation on how to estimate the "size factor".

<u>However AFG:</u>

- **Would like to stress that it is very difficult for us to assess the proposed methodology in an appropriate manner, as we do not know what measures will be considered and eventually applied to the investment funds if identified as systemically important. We respectfully remind IOSCO and FSB that it was already mentioned in our reply to the previous consultation and we regret that no progress has been achieved here.**

- **Regrets that the methodology would focus both on funds and on asset management companies, as we believe that asset management industry may present systemic risk only at the level of individual funds.**
  If in the end the asset management companies were to be included in this methodology, **we would suggest for asset managers' activities, which are consolidated within the documents produced by a G-SIFI entity (being a banking group or an insurer group) to be clearly excluded from the scope, as the G-SIFI entity is already under reinforced scrutiny and has to face additional capital requirements.**

- Suggests that **UCITS and AIFs** without significant leverage- as they are already strictly regulated at EU and national levels - should be left **out of the scope** and considered as safe vehicles because of their rules in terms of leverage, investment diversification, liquidity credit and counterparty risk management as well as the strict and continuous control they are subject to.

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- Believes that including **separately managed accounts or dedicated funds is not relevant when they are exclusively managed on behalf of prudentially regulated entities.** Indeed, such accounts are already captured when these entities are themselves SIFIs; moreover, in many cases, they do not bear any risk of default or run.

- **Suggests that the number of proposed indicators used to assess risk factors (interconnectedness, substitutability, complexity, cross-jurisdictional) should be limited in order not to be too burdensome to apply by indentified entities**. Their computation, in particular, needs to be as simple as possible.

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HIGH LEVEL FRAMEWORK FOR IDENTIFYING NBNI G-SIFIs

Q2-1. In your view, is the exclusion of (i) public financial institutions, (ii) sovereign wealth funds or (iii) pension funds from the definition of NBNI financial entities appropriate? If so, please explain the rationale.

We believe that further detailed research should be conducted on this matter, all the more so as there no prior reason why these three financial entities should be considered belonging to the same category. Where pensions funds are strictly regulated and do not use significant leverage (whether they invest directly or through UCITS, AIFs without significant leverage or mandates) they should be left out of scope.

Q2-2. Please explain any potential systemic risks associated with failure or financial distress of (i) public financial institutions, (ii) sovereign wealth funds or (iii) pension funds that, in your view, warrant their inclusion in the definition of NBNI financial entities so that NBNI G-SIFI methodologies would apply.

It is not for us to identify the potential risks generated by other types of market participants – regulators are better placed than us for this purpose.

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.

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AFG suggests that all UCITS, as well as AIFs without significant leverage should be considered as safe vehicles because they are already comprehensively regulated at EU and national levels and in particular as they already have to comply with a specific series of rules in terms of leverage, investment diversification, liquidity credit and counterparty risk management as well as the strict and continuous control they are subject to.

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.

In our view, this description identifies the main transmission channels, which may eventually lead to financial system instability, and we do not see other channels to be taken into consideration.

It should be noted, however, that because of their characteristics certain categories of NBNI financial entities are less prone than others to transmit their financial distress through any of the three main channels identified (counterparty channel, market channel or substitutability).

We have analyzed below the three transmission channels from a perspective of investment funds.

Counterparty channel:

AFG agrees to say that excessive leverage constitutes a central part of counterparty channel. However, we would like to highlight the fact that the use of leverage by funds is considerably limited nowadays. For instance, in Europe, all UCITS and most AIFs do not use a significant level of leverage (i.e. level of leverage under 3 as per the AIFMD). **We believe that only the use of leverage on a significant basis (above 3) – as differentiated in the AIFM Directive - should be considered while considering the counterparty channel and, should be the primary focus for identifying those funds that may pose systemic risks.**

Regarding the use of non-centrally cleared derivatives, AFG would like to highlight that, at European level, **EMIR** provides the obligation to apply **risk mitigation techniques** when the use of derivatives are not centrally cleared. Those techniques, which include timely confirmation, portfolio reconciliation and compression, dispute resolution procedures, the exchange of collateral and bilateral margining, **allow reducing significantly the counterparty risk.**

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Market channel

AFG considers that the market channel (asset liquidation) is less relevant as a vector of systemic risk. The risk of loss is disclosed to and accepted by investors, and should that loss materialize, those investors directly absorb it.

Furthermore, even in the unlikely event of significant redemptions, investment funds (such as UCITS or AIFs in Europe) have **specific management tools available (swing pricing, anti-dilution levies, redemption gates, side-pockets, temporary suspensions) which would prevent such redemption** from inducing the "*forced liquidation of positions*" and thus not result in temporary distortions in market liquidity and or prices.

When PIMCO bond funds faced heavy redemptions in 2014 and 2015 the managers were able to meet them without difficulties and without impairing the liquidity nor the market exposure of the funds: large redemptions do not imply fire sale and systemic risk.

Substitutability channel

AFG consider that investment funds are substitutable and that as a consequence financial distress will not be transmitted through the substitutability channel as far as funds are concerned. Indeed, the functions and services performed by investment funds can be performed by other funds: in other words, investors have alternative options for making their investments. **As a consequence the substitutability channel is not a relevant vector of systemic risk.**

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?

In theory, the dominant player concept is hard to define and, in practice, difficult to implement. What is a less liquid market? How could we define market segments? These are very subjective items and **we do not think that it will be workable in a regulation.** And even if the concept could be defined properly, there is no available relevant data to analyze this configuration.

On top of that, funds that invest in illiquid assets (private equity or infrastructure for example) and do not offer any redemption facility to their holders are exempt from the risk of fire sale common to others funds. If long-term investors support without possibility to redeem a contrarian investment strategy in a fund, they will have a contra-cyclical impact in periods of market tension.

Theoretically, the ratio of liquidity expressed as the positions held in the fund to the trade volume on a specific market segment seems the best method to detect such actors.

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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?

The obvious reply to the above question would be that each individual portfolio would be affected by liquidation demands in very different ways, each distinct from other behaviours occurring in the broader market. It has to be mentioned that all funds do not behave in the same way: indeed, during crisis many funds have a counter-cyclical behavior and contribute to slow down any down turn. This is particularly true for actively managed funds.

But the wording of the above question is not clear. We are uncertain as to the exact meaning of "industry-wide".

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 believe that the size threshold of $400 billion which is laid down in the text of the consultation itself is reasonable and an adequate criterion.

It should be the unique size threshold to be applied to all relevant investments funds (that is to say, all private funds and traditional funds that carry a substantial leverage, i.e. above 3).

More precisely, we would like to clarify that, if relevant, **this threshold should be applied at the level of each compartment of a fund,** as each fund compartment is completely independent from the fund as a whole.

We would also like to highlight that this materiality threshold defined at a global level should be implemented in the same way in all national jurisdictions. We believe that there should not be any possibility for gold (or "tin") plating, as this would create regulatory arbitrage and an unlevel playing field and above all a high degree of legal uncertainty for market participants.

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.

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As we already mentioned in our answer to question 6-4, **the dominant player concept is hard to define and, in practice, difficult to implement. Thus we would't recommand Option 1.**

We believe that the size threshold of $400 billion GNE is a reasonable and adequate criterion.

It should be the unique size threshold to be applied to all relevant investments funds (that is to say, all private funds and traditional funds that carry a substantial leverage (above 3).

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).

As we already mentioned in our answer to question 6-4, **the dominant player concept is hard to define and, in practice, difficult to implement. And we are not in favour of the idea of introducing GAUM, which is not a standard reference in the industry.**

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.

AFG suggests that the number of proposed indicators used to assess risk factors (interconnectedness, substitutability, complexity, cross-jurisdictional) should be limited to 2 maximum, in order not to be too burdensome to apply by indentified entities. Their computation, in particular, needs to be as simple as possible.

Interconnectedness: we see overlap between the indicators of the "interconnectedness" impact factor. **Ratio 2-3 (GNE to NAV) in order to assess the leverage seems the most relevant indicator**. 2-1 and 2-2 are alternative indicators, while 2-5 is a complementary indicator.
Indicators 2-6 and 2-7 seem not relevant. On the contrary, AFG believes that the more you work with G-SIFIs the better protected you are because of the requirements specific to G-SIFIs that ensure their financial solidity.
As for the role of institutional investors, we feel that they are professional investors that understand markets and are able not to overreact and thus to create some stability in a fund.

Substitutability: AFG consider that investment funds are substitutable and that as a consequence financial distress will not be transmitted through the substitutability channel.
On top of that, as we already mentioned in our answer to question 6-4, **the dominant player concept is hard to define and, in practice, difficult to implement. Last, the Indicator 3-1 refers to '*overall daily trading volumes of the same market segment*'; while in practice the knowledge of this data is not always easily accessible – especially for OTC trades.**

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<u>Complexity</u>: indicator 4-1 suggests that derivatives are complex and we do not share that view at all. Regarding the use of non-centrally cleared derivatives, AFG would like to highlight that, at European level, EMIR provides the obligation to apply risk mitigation techniques when the derivatives are not centrally cleared. Those techniques, which include timely confirmation, portfolio reconciliation and compression, dispute resolution procedures, the exchange of collateral and bilateral margining, allow reducing significantly the counterparty risk.

Indicator 4-3 relating to HFT does not seem relevant as investment funds are not the main players regarding HFT activities. Should it be considered as indicator of complexity creating potential systemic risk, a clear distinction has to be made between algorithms used for the purpose of executing orders generated by human managers and those that initiate orders automatically.

Indicator 4-5: AFG agrees to say that the focus should be on the liquidity profile of the investment fund. **Nonetheless, as investments funds are not using GNE, we are not supportive of indicator 4-5.**

Indicator 4-7 is not necessarily relevant, as funds that invest in illiquid assets (private equity or infrastructure for example) do not offer any redemption facility (or only a limited one) to their holders. If long-term investors support without possibility to redeem a contrarian investment strategy in a fund, they will have a contra-cyclical impact in periods of market tension.
Indicator 4-6, which aims at measuring the risk that a fund may have difficulties in meeting margin calls in adverse market conditions, does not seem as a fair indicator of the risk exposure to adverse market conditions (better measured through a leverage ratio), as there are several ways to face margin calls, starting by unwinding derivative positions and ranging from using existing available cash, repoing assets, borrowing cash, selling instruments, not to mention receiving subscriptions.
In the end, indicators 4-2, 4-4 & 4-5 seem to be the most relevant ones.

<u>Cross-juridictional activities</u>: we believe that indicators relating to cross-jurisdictional activities do not make sense necessarily. Indeed, it could be argued that a large fund operating in different countries is less risky than a large fund operating in a single country, as geographical diversification could help to reduce the risk borne in each country.

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.

We don't see any alternative indicators and would suggest limiting it as much as possible. See above Q6-7.

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.

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See above. Q-6-7

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).

AFG agrees to say that the GNE is an appropriate concept to **capture size of funds**.

Although it is true that the GNE overestimates the market risk incurred by a fund (for instance, by not taking in account the fact that some derivatives are cleared), **we would not recommand for an adjustment** as it would bring more complexity and as said previously we believe that the size factor computation should be straightforward.

AFG would also like to insist on the fact that GNE should be defined and interpreted in an harmonised way worldwide.

Q6-11. For "interconnectedness", should financial leverage measured separately from synthetic leverage?

No. We only need to have a rough estimate of the leverage of a fund in order to assess whether it may represent a systemic risk. Using the GNE, while assessing the most significantly leveraged funds, will allow capturing the overall leverage.

Regarding synthetic leverage, AFG would like to highlight that, at European level, most derivatives are now centrally cleared, and that as far as the non-centrally cleared derivatives are concerned, EMIR provides the obligation to apply risk mitigation techniques. Those techniques, which include timely confirmation, portfolio reconciliation and compression, dispute resolution procedures, the exchange of collateral and bilateral margining, allow reducing significantly the counterparty/leverage risk.

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ASSET MANAGERS

AFG regrets that the methodology could focus both on funds and on asset management companies, as we believe that asset management industry may present systemic risk only at the level of individual funds.

Indeed, the essential nature of the asset management is one of an "agency" business, where assets are professionally managed by an asset management company on behalf and in the sole interest of its clients. The fund's assets (and per se the clients' assets) are legally segregated from the balance sheet of the asset management company and safekept by a depositary that registers them in its records in the sole name of the fund.
Thus, in the event of a default of an asset management company, the assets they manage on behalf of their clients can easily be transferred to another asset management company, especially given the highly competitive nature of the global asset industry.
We would also like to highlight that European asset management companies are already regulated and comply with prudential measures. In particular, both the UCITS Directive and the AIFM Directive contain capital requirements and reporting obligations that provide regulators with a holistic view of the asset management company.
In this context, European asset managers are submitted to prudential rules, to a certain level of supervision and to adequate reporting obligations to the regulators and the clients.

If in the end asset management companies were to be included in this methodology, **we would suggest for asset managers' activities, which are consolidated within the documents produced by a G-SIFI entity, to be clearly excluded from the scope, as the G-SIFI entity is already under reinforced scrutiny.**

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.

All activities are covered in the description.

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 the event of a default of an asset management company, the assets it manages on behalf of its clients (safekept by a depositary) can easily be transferred to another asset management company, especially given the highly competitive nature of the global asset industry. Thus, we

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agree to say that "asset managers tend to have small balance sheets and the forced liquidation of their own assets would not generally create market disruptions" (p.49).

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?

AFG is not aware of securities lending business operated on an agency basis by the asset management company. For the most part, the relevant or even "dominant" market specialists of the securities lending business are international central securities depositaries or ICSDs (i.e. Euroclear Bank and Clearstream International), local CSDs, or global custodians (e.g. State Street Bank and Trust Company, Bank of New York Mellon, J.P. Morgan Chase, and Citigroup to name only the largest). A hypothetical failure of one large asset manager acting as an agent will therefore not remove a "critical function" from the broader market.

AFG would not consider securities lending as potential systemic indicator, as we actually consider it as an "efficient portfolio management" (EPM) technique which is defined by ESMA and which is strictly regulated under the 2012 *Guidelines on ETFs and other UCITS issues* (as revised in August 2014), and essentially **undertaken at the level of funds**.

With seed money, the individual amounts are usually limited and conceived as temporary. However, it is wise to supervise that the risk taken on that behalf will not threaten the own capital necessary for the asset manager to conduct its business.

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?

Regarding reputational risk it is a very subjective risk, hard to quantify, and we are not even sure it is relevant given the example of PIMCO who faced heavy redemptions and several departures of key managers in 2014/2015 without being further damaged. For all those reasons we believe that this indicator should not be considered.

As for operational risks, similarly, would not necessarily set-off a market reaction that would prove to become unmanageable. There is no standard scenario in that matter either.

In the case of SMAs and dedicated funds, the client may change of asset management company. Assets are held in a bank acting as custodian and/or depositary. They are secured there and the asset manager provides a service that many competitors are keen to take over. To change manager is simple administrative work and contracts usually stipulate arrangements for the period the effective transfer will require. The interim period is expected to last a couple of weeks or, at worst, months. For SMAs there is no risk of fire sale, but a possibility to change Asset Manager (without market impact) and/or custodian.

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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?

Valuation is a key function for asset managers who have to publish daily (or regular) NAV of their funds. This function is made difficult by the fact that there is a very limited number of data providers.

This scarcity of data providers could be source of systemic risk, especially in the case of failure of one of those few participants, or in the event of a data error which would impact not only NAV calculation but also risk control instruments, margin calls and exchange of collateral.

Thus we urge FSB to address the case of data providers of systemic importance and suggest a regulation of their internal organization, the extent of their proprietary rights, their commercial approach and their effective responsibilities.

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.

For reasons explained in previous answers, we don't think asset management companies should be under the scope of the methodology.

On a theoretical basis, the hypothetical systemic importance of a fund manager should not emanate from the size of its AUM, and one should rather focus on the balance sheet of the asset management company. The figure of 100 billion $ seems adequate as it could only capture those entities that have a significant size and may therefore have a systemic impact.

Should $1 trillion AUM threshold be considered, AFG would suggest that all UCITS, AIFs with a small leverage effect (below 3), SMAs and funds dedicated to entities subject to prudential regulation are not included in the total AUM. As a matter of fact, most mandates are signed by institutions that are prudentially regulated such as insurance companies and banks. They consolidate their holdings in their regulatory reporting and supervisors have a clear view on them. We insist on the fact that there is no need for duplication of controls and that what is once consolidated at the level of the client should not be considered at the level of the asset manager. We suggest that FSB clarify this point explicitly.

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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).

No answer.

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?

Interconnectedness: AFG is not aware of asset managers acting as lending agent and ready to indemnify lenders in the case of failing counterparty. Regarding Indicator 3-2, it is not possible to be aware of the '*total AuM invested in the same strategy for all managers*'.

Substitutability-Complexity: We reiterate that, in the event of a default of an asset management company, the assets they manage on behalf of their clients (safekept by a depositary) can easily be transferred to another asset management company, especially given the highly competitive nature of the global asset industry.

Cross-juridictional activities: we believe that indicators relating to cross-jurisdictional activities do not make sense. Indeed, it could be argued that asset manager operating in different countries is less risky than an asset manager operating in a single country, as geographical diversification could help to reduce the risk borne in each country.

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.

We can anticipate two types of difficulties: confidentiality and qualitative assessment of some indicators. For instance, we consider that commercial agreements to guarantee a performance or a capital to investors, and overall, the investment stategy, as confidential information.

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?

No answer

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Should you need any further information, please feel free to contact our Director of International and European Affairs, Arnaud Magnier at + 33 1 44 94 94 04 (a.magnier@afg.asso.fr) or our EU Institutions Relationship Manager, Arthur Carabia, at + 33 1 44 94 96 58 (a.carabia@afg.asso.fr).

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