alfi association of the luxembourg fund industry

Luxembourg, 21 September 2016

Response to the FSB Consultative Document "Proposed Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities" (22 June 2016) (the "Consultation")

Introduction

The Association of the Luxembourg Fund Industry (ALFI) is the representative body of the Luxembourg investment fund community. Created in 1988, the Association today represents over 1,300 Luxembourg domiciled investment funds, asset management companies and a wide range of service providers such as custodian banks, fund administrators, transfer agents, distributors, legal firms, consultants, tax experts, auditors and accountants, specialist IT providers and communication companies.

There are 1,899 UCITS and 1,988 AIF domiciled in Luxembourg (as at June 2016), each of which offers underlying sub-funds to investors.

The Luxembourg Fund Industry is the largest fund domicile in Europe (funds totalling in excess of €3,487 billion as at May 2016) and a worldwide leader in cross-border distribution of funds. Luxembourg-domiciled investment structures are distributed on a global basis in more than 70 countries with a particular focus on Europe, Asia, Latin America and the Middle East.

We thank the FSB for the opportunity to participate in this Consultation.

We support the submission of the European Fund and Asset Management Association (EFAMA).

General remarks

We support efforts to promote resilient and transparent financial markets and we appreciate the opportunity to engage with regulators on potential risks to the financial ecosystem.

We welcome that the FSB has focused in this Consultation on asset management activities.

In general, we believe asset management activities do not entail structural vulnerabilities and would like to stress that, in Europe, the sector is highly regulated and regulations such as the UCITS Directive, AIFMD, MiFID or SFTR already address the concerns raised in the Consultation.

We do not believe that some of the scenarios envisaged by the FSB, such as securities lending activities, if conducted in accordance with current European standards, or transfer of accounts,

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present a systemic risk to the functioning of markets and we explain our reasoning later in this response.

We also note that a number of EU regulatory initiatives have both taken place and been initiated since the start of the recent financial crisis (e.g. AIFMD reporting, Solvency II, the UCITS Directive, MiFID, MMF Regulation and underlying guidelines from ESMA) dealing with:

i) Transparency of information;
ii) Supervision of the asset management industry.

Whilst these regulatory initiatives have been in place for a relatively short time frame, there have been a number of market events which have provided some evidence of the effectiveness of these tools. We would recommend that the FSB takes the impact of these initiatives into account as part of its systemic risk remit. In particular we call for more work to be conducted to assess the considerable amount of data that is being reported by asset managers to their regulators under recent regulatory developments such as AIFMD and to feed information back to the market on the aggregate trends observed.

We note that the EU is undertaking a CMU initiative[1], which seeks to develop capital markets such that European companies are no longer so reliant on bank financing. Rather than concentrating systemic risk in the banking sector the development of capital markets, especially when combined with ongoing transparency of positions held in investment funds, has the positive effect of spreading risk across a wide variety of asset owners with varying investment objectives and time horizons. This thereby reduces the risk of any one market event leading to material market inflows or outflows by any one set of asset owners. Various European governments have also put in place schemes which are designed to direct financing to small and medium sized businesses. Investment funds play a part in directing finance to such companies, thereby creating liquidity and diversifying the recipient's sources of lending. Moreover, detailed rules on risk management, ring-fencing of assets etc. ensure a higher level of investor protection if investment funds are used for this purpose.

Last but not least, we are of the view that the scope of the present FSB WS3 work fails to adequately account for the behaviour of direct asset-owners, i.e. large institutional investors that choose to manage their funds in-house and/or rely on the services of investment advisors/consultants. We encourage the FSB to adopt a more holistic approach to monitor financial market risks by looking at a wider spectrum of actors, e.g. from the large, direct asset-owners like SWFs to perhaps more remote cases where even individuals may destabilise markets.

For a glossary of commonly used abbreviations and terms, please refer to **Appendix 1**.

[1] See http://ec.europa.eu/finance/capital-markets-union/index_en.htm

Response to the consultation

General questions

Q1. Does this consultative document adequately identify the structural vulnerabilities associated with asset management activities that may pose risks to financial stability? Are there additional structural vulnerabilities associated with asset management activities that the FSB should address? If there are any, please identify them, as well as any potential recommendations for the FSB's consideration.

We welcome the fact that FSB has moved away from concerns on "Shadow Banking" activities to better understand asset management activities.

We agree with the focus on the risks identified, although we believe some risks are over-emphasised, such as securities lending and transfer of accounts. We also consider that maturity transformation is a banking concept, not an asset management concept.

In Europe, we believe that these risks identified in the Consultation are already adequately mitigated by the suite of regulations currently in place: the UCITS Directive limits the risks for retail CIS, AIFMD requires risk management including liquidity risk management, disclosure and detailed reporting to authorities of both liquidity and leverage, corporate governance in place address the risk of dependence vis-à-vis asset manager, and finally the combination of the UCITS Directive, SFTR and AIFMD adequately mitigate any risks linked to securities lending.

Indeed, all significant fund structures are subject to regulation and supervision in Europe, either directly as an investment fund structure (retail products or UCITS) or indirectly through its manager under AIFMD. If both regulations have different focus perspectives (the UCITS Directive puts more emphasis on prescriptive asset limits on liquidity and leverage to provide risk limitation – whilst AIFMD addresses risk management, disclosure and regulatory reporting at a governance level), both adequately address the concerns raised in the Consultation as further detailed below.

- Liquidity risk

  - The UCITS Directive requires that such funds invest the majority of their portfolio into liquid assets (such as transferable securities and money market instruments) so that shareholder redemptions are honoured without harming the interests of other investors. Investment management activities are subject to comprehensive risk management control which includes liquidity stress testing in both "normal" and "stressed" market conditions. These risk management reports are provided to "internal" stakeholders such as the fund board and conducting officers, but also to "external" parties, such as the financial sector regulator, in our case the CSSF.
  - AIFMD: The directive imposes similar liquidity risk management controls, with disclosure to investors and detailed reporting to regulators which are centralised at European level).

- Leverage risk

  - The UCITS Directive limits fund leverage and requires disclosure to investors. Furthermore, the CSSF requires detailed reporting from UCITS. Risk is controlled via prescriptive limits provided for within UCITS Directive.

- AIFMD: The directive imposes risk management controls on the funds activities, disclosure to investors and detailed reporting to regulators (centralised at European level). Funds with higher leverage are subject to additional reporting and scrutiny.

Concerning the above two points, namely liquidity risk and leverage risk, it is important to highlight that all funds (UCITS and AIF) within the EU are obliged via regulation to perform stress testing. Further, we believe that it is important to ensure that the scope is broad enough to cover all participants in the financial markets if the true systemic risks are to be understood. Therefore we strongly recommend that pension funds, insurers, endowments, sovereign wealth funds are included in scope of the reporting obligations as this will provide a more complete picture of the system for which the systemic risk is measuring.

- <u>Transfer of mandates</u>

  We would like to highlight that investment funds, unlike other types of mandates, benefit from their own structure, separate from the asset manager, whose role is increasingly limited to the role of a service provider amongst many, in the corporate life of the fund. Therefore, we do not believe that the transfer of an asset management mandate between entities poses a threat to financial stability for the following reasons:

  - The fund is controlled by a board of directors which is increasingly made up of non-executive directors and overseen by a management company/AIFM which may operate independently of the asset manager. This structure is in place to ensure investor protection and that the fund is managed in the best interests of its investors. Please refer to the fund governance survey conducted by ILA and PwC[2], illustrating the increasing focus on independent governance. Even when funds are not structured as independent corporate entities (like common funds), they are usually managed by a management company or AIFM who usually appoints asset managers as delegates. The fund's assets are held by a custodian in the fund's name – and not in the name of the asset managers. Under the UCITS Directive the custodian is not allowed to undertake asset management activities to preserve the segregation of duties and the custodian/depositary's independence. These factors ensure that if the asset manager were to fail, the fund's assets would not be compromised.
  - Similarly, the fund board is free to select another asset manager and such changes are sufficiently frequent to be considered "business as usual" for market participants. It should be noted that if the fund manager was to change this would not necessarily mean that the fund would change its custodian/depositary. The new asset manager would continue to select assets which it thinks are best to meet the fund's investment objective and policy.
  - Given there are a large number of asset managers, we do not consider the market to be overly dependent on one player.
  - Financial exposure to one counterparty is limited (regulatory limits as specified for UCITS) and mitigated by risk management requirements. Counterparty exposures are reported regularly to the regulator (AIFMD requirements and CSSF ad-hoc reporting), preventing funds to be overly exposed to one counterparty, including its asset manager.
  - Changes in service providers occur frequently and such transfers are considered as business as usual operations whose operational risks are fully understood and mastered.

[2] ILA/PWC Luxembourg Fund Governance Survey 2014:
http://www.ila.lu/ILA/documents/PWCILAFundGovernanceSurvey201412418.pdf

We therefore do not believe that the change or failure of an asset manager would pose a problem for the fund as its assets are held separately by the custodian regardless of the market conditions. We also point out that the change of the asset manager does not imply or automatically require that the custodian/depositary be changed as well.

- Securities lending

  We do not believe that securities lending activities pose a threat to financial market stability for the following reasons:

  - The UCITS Directive requires that securities lending transactions be adequately collateralised and with reference to a haircut policy in accordance with ESMA 10-788 by cash or liquid, good quality assets and that this collateral is held by a third party – usually the fund's custodian. The activity is controlled through limits on the reinvestment of collateral and general UCITS limits on counterparty exposure which enforces use of a diversity of counterparties to protect both the fund and its investors from impairment. Disclosures to investors on these activities are required and made in both the prospectus and the fund's semi-annual and annual reports.
  - These requirements will be further strengthened with the SFTR that requires greater disclosure of securities lending in both the fund's prospectus and the fund's semi-annual and annual reports. It will also centralise European reporting of such transactions to allow European financial regulators a better overview of the activity and mitigate risks to the financial system.
  - AIFMD: requirement that securities lending is fully collateralised and that collateral is held by a third party. Leverage and counterparty exposure are reported to authorities. Disclosure to investors is required. These requirements will be further reinforced with the SFTR that escalates to a European regulation and further develops the disclosure requirement in the prospectus.

Q2. Do the proposed policy recommendations in the document adequately address the structural vulnerabilities identified? Are there alternative or additional approaches to risk mitigation (including existing regulatory or other mitigants) that the FSB should consider to address financial stability risks from structural vulnerabilities associated with asset management activities? If so, please describe them and explain how they address the risks. Are they likely to be adequate in stressed market conditions and, if so, how?

We agree. As mentioned above, we would like to stress that regulation in Europe largely meets these recommendations and could be referred to as a best practice answer to the FSB's concerns.

Q3. In your view, are there any practical difficulties or unintended consequences that may be associated with implementing the proposed policy recommendations, either within a jurisdiction or across jurisdictions? If there are any, please identify the recommendation(s) and explain the challenges as well as potential ways to address the challenges and promote implementation within a jurisdiction or across jurisdictions.

Our experience in implementing AIFMD reporting has demonstrated that it is extremely difficult for authorities to define:

- KPI/data fields on which to report that would be useful to monitor the risks;
- a harmonised reporting system that would be consistent across countries.

These difficulties have resulted in huge investment for the industry with little benefit to the industry, regulators or investors. The information gathered by the authorities is not yet transmitted to market participants and we are still waiting for evidence that the massive volume of data reported is being used for further analysis. For example in the case of AIFMD we understand that although entitled to receive this data, systems are still being built to allow systemic risk authorities such as the ESRB to receive and analyse the data even though AIFMD has been in force since 2014.

We also believe that such reporting should be on a fund-by-fund basis to avoid inappropriate or misleading comparison of fund types.

Liquidity mismatch between fund investment assets and redemption terms and conditions for fund units

Q4. In your view, is the scope of the proposed recommendations on open-ended fund liquidity mismatch appropriate? Should any additional types of funds be covered? Should the proposed recommendations be tailored in any way for ETFs?

Requirements in Europe applicable to UCITS and AIF already reduce any liquidity mismatch as the fund's portfolio should be sufficiently liquid to honour investor redemptions. We believe that this is appropriate. The rules require that the fund manager has an understanding of the investor base and their liquidity needs. We believe regulatory authorities could helpfully encourage intermediaries in the distribution chain to provide more detail on underlying investor types to managers to allow them to refine existing processes. Similar rules should apply to all funds open to all types of investors.

Q5. What liquidity risk management tools should be made available to funds? What tools most effectively promote consistency between investors' redemption behaviours and the liquidity profiles of funds? For example, could redemption fees be used for this purpose separate and apart from any impact they may have on first-mover advantage?

We bring your attention to the AMIC/EFAMA paper "Managing fund liquidity risk in Europe" dated April 2016[3] which sets out the parameters considered by asset managers and requirements that are already set in regulation. The paper goes on to make a number of recommendations, including:

- Supervisory convergence for the types of liquidity management tools;
- Convergence in the data being requested by different regulators;
- Encourage development of industry and association best practices.

ALFI members, particularly of open ended funds, are very familiar with liquidity management tools and techniques and they should be able to select the most appropriate mechanism for their fund. There are indeed many techniques available in regulated fund prospectuses to assist fund liquidity as already outlined in the IOSCO Principles of Liquidity Risk Management for Collective Investment Schemes such as:

- Price Swinging[4] (see example of dilution protection via Price Swinging in **Appendix 2**);
- Redemption accepted but payment deferred (probably using fair valuation);
- Gates (see example in **Appendix 3**);

[3] Please see: https://www.efama.org/Publications/EFAMA_AMIC_Report_Managing_Fund_Liquidity_Risk_Europe.pdf
[4] See ALFI Swing Pricing brochure dated 10 December 2015: http://www.alfi.lu/node/3104

- Side pockets, in certain circumstances (see example in **Appendix 4**);
- Redemptions in kind;
- Suspension of NAV calculation, resulting in no shareholder subscriptions and redemptions; and
- Redemption fees paid to the fund.

The techniques above are commonly available and used when appropriate and can be considered a ‘tool box’ where, depending upon the individual circumstances at hand, certain techniques may be more important than others. We believe that their sometimes infrequent use is not a reason for ignoring such concepts which have worked well when required. Price swinging is the most prevalent example used by the majority of Luxembourg domiciled funds on a very regular basis.

Q6. What characteristics or metrics are most appropriate to determine if an asset is illiquid and should be subject to guidance related to open-ended funds’ investment in illiquid assets? Please also explain the rationales.

With regard to illiquid securities, UCITS are subject to the requirements of the “UCITS Eligible Assets Directive 2007/16/EC” that sets out the criteria for UCITS investable universe. The directive considers that assets traded on a regulated market are liquid unless there is evidence to the contrary.

Ex-ante and ex post

For Luxembourg domiciled funds UCITS must prudently assess this taking into account the following factors amongst others:

- The volume and turnover in the transferable security;
- If price is determined by supply and demand in the market, the issue size, and the portion of the issue that the asset manager plans to buy – also evaluation of the opportunity and timeframe to buy or sell;
- Where necessary, an independent analysis of bid and offer prices over a period of time may indicate the relative liquidity and marketability of the instrument, as may the comparability of available prices;
- In assessing the quality of secondary market activity in a transferable security, analysis of the quality and number of intermediaries and market makers dealing in the transferable security concerned should be considered.

Assets which are not traded on a regulated market cannot be considered as being “liquid”. The UCITS will therefore need to assess the liquidity of such securities where this is necessary to ensure that redemption requests can be honoured without comprising the ability to manage the fund in the best interests of its investors.

Ex post

In addition to specific liquidity monitoring at the level of an asset, it is important to note that a UCITS is obliged to put in place a risk management process which enables it to monitor and measure at any time the risk of the positions and their contribution to the overall risk profile of the portfolio, including its use of financial derivative instruments. This process is controlled by the Permanent Risk Management Function, which must be independent of the investment management process, which undertakes an ongoing review of all risks to the fund.

UCITS and AIF will calculate the proportion of the portfolio assets that can be disposed over a timeframe: the greater the investors' need for liquidity the shorter the time period.

The risk management process must be presented to the CSSF on an at least annual basis or in the event of a material change. A UCITS must also undertake periodic reporting of its risk positions to the CSSF. These are varied and include risks obtained through its investments (including derivatives), strategies (such as Efficient Portfolio Management), global exposure (which must be presented on a commitment or VaR basis) and counterparties amongst others are also provided to the CSSF.

Q7. Should all open-ended funds be expected to adhere to the recommendations and employ the same liquidity risk management tools, or should funds be allowed some discretion as to which ones they use? Please specify which measures and tools should be mandatory and which should be discretionary. Please explain the rationales.

We believe that an open-ended fund should be free to select liquidity risk management tools that are calibrated to the fund's investment policy, investment universe, investment strategy (which are not the same risk for a UCITS/AIF) in conjunction with the redemption time-period and the type of investors.

The liquidity risk management tools for UCITS are accepted by authorities when the fund is approved, properly disclosed to investors and appropriately controlled by the fund's management using documented policies and systems that are appropriate to this task. Similarly the AIFM must ensure that adequate liquidity risk management tools are in place, this is reviewed by the AIFM's home state regulator.

We believe that financial regulators and the fund directors (who are responsible for the production of the prospectus) must work together during the prospectus/KIID approval process to ensure that disclosures are both relevant and pertinent to the fund (and market conditions) and that blanket statements which may not address these factors or protect investors be avoided.

Q8. Should authorities be able to direct the use of exceptional liquidity risk management tools in some circumstances? If so, please describe the types of circumstances when this would be appropriate and for which tools.

Please see above.

Within the EU, MiFID confers intervention powers to regulatory authorities regarding the investment funds operations. We believe that the regulatory authorities should allow private sector flexibility during exceptional liquidity market events. Therefore, we are reluctant to advocate that regulators should impose blanket rules in stressed markets, as this may amplify detrimental market behaviour.

Leverage within funds

Q9. In developing leverage measures (Recommendation 10), are the principles listed above for IOSCO's reference appropriate? Are there additional principles that should be considered?

We agree with the recommendation 10. We provide further information in our response to Q10.

Q10. Should simple and consistent measure(s) of leverage in funds be developed before consideration of more risk-based measures, or would it be more appropriate to proceed in a different manner, e.g. should both types of measure be developed simultaneously?

We understand the need for regulators to have a consolidated/harmonised leverage measure, but we would like to highlight that in Europe, asset managers are already required to calculate fund leverage under four methods:

- UCITS:
  - Commitment; or
  - Sum of notionals for funds using VaR.

- AIFMD:
  - Gross commitment method; and
  - Net commitment method.

We therefore advocate against introducing a fifth method and would recommend to adopt the AIFMD net commitment approach as the most appropriate methodology for an economical and systemic risk point of view, as described in article 8 AIFMD-CDR[5].

Q11. Are there any particular simple and consistent measures of leverage or risk-based measures that IOSCO should consider?

The leverage calculation must take due consideration of hedging and netting – if not, the figures may be largely overstated through currency and interest rate hedging. This may lead to financial sector regulators using incorrect information to identify potential systemic risk issues with the consequence that incorrect decisions on this topic are made.

The hedging derivative position or derivative position fully covered by other positions do not increase the fund portfolio exposure to the market and thus do not contribute to increasing/amplifying systemic risks. They shall therefore be excluded from the leverage calculation.

Q12. What are the benefits and challenges associated with methodologies for measuring leverage that are currently in place in one or more jurisdictions?

Currently there are too many methodologies and reporting frequencies across jurisdictions. Funds within the EU subject to AIFMD will provide quarterly, semi-annual or annual data depending on the assets under management of the AIFM, these data are to be provided within one month following the reference period. For funds in the U.S. which are subject to Form PF the reporting frequency is based on the fiscal year end (not calendar year end) and funds have 60 to 120 days to report. When consolidated at a macro level by regulators this is likely to lead to misleading reporting on the systemic risk.

Please see above our response to Q9 and Q10, where we recommend that the leverage is calculated using the method described in article 8 AIFMD-CDR.

[5] See also FEAM position paper on leverage.

Q13. Do you have any views on how IOSCO's collection of national/regional aggregated data on leverage across its member jurisdictions should be structured (e.g. scope, frequency)?

We stress the importance of harmonisation of, not only content of information to be reported, but also the reporting format required so that financial sector participants may develop consistent reporting framework across jurisdictions which will better aid the detection of systemic risk issues.

There should be common reporting standards to allow comparisons between the Americas, EMEA and Asia. Multiple and divergent notions of leverage and differing reporting schedules do not allow for a holistic view on the system for which systemic risk is being measured.

We would recommend to build upon the recent ESMA experience which introduced a common reporting standard across 28 jurisdictions. This required the collection of significant amounts of data to be reported however after nearly three years it has not yet achieved the intended level of transparency on the systemic risk. Therefore, we suggest that the use of data is well understood prior to the implementation of any new regulatory requirements.

Q14. Do the proposed policy recommendations on liquidity and leverage adequately address any interactions between leverage and liquidity risk? Should the policy recommendations be modified in any way to address these interactions? If so, in what ways should they be modified and why?

According to the AIFMD, managers of highly leveraged funds in Europe are subject to additional reporting and supervision.

Operational risk and challenges in transferring investment mandates or client accounts

Q15. The proposed recommendation to address the residual risks associated with operational risk and challenges in transferring investment mandates or client accounts would apply to asset managers that are large, complex, and/or provide critical services. Should the proposed recommendation apply more broadly (e.g. proportionally to all asset managers), or more narrowly as defined in Recommendation 13? If so, please explain the potential scope of application that you believe is appropriate and its rationales.

We would like to repeat our statements on transfer of mandates as mentioned in our response to Q1:

- Transfer of mandates

  We would like to highlight that investment funds, unlike other types of mandates, benefit from their own structure, separate from the asset manager, whose role is increasingly limited to the role of a service provider amongst many, in the corporate life of the fund. Therefore, we do not believe that the transfer of an asset management mandate between entities poses a threat to financial stability for the following reasons:

  - The fund is controlled by a board of directors which is increasingly made up of non-executive directors and overseen by a management company/AIFM which may operate independently of the asset manager. This structure is in place to ensure investor protection and that the fund is managed in the best interests of its investors.

Please refer to the fund governance survey conducted by ILA and PwC[6], illustrating the increasing focus on independent governance. Even when funds are not structured as independent corporate entities (like common funds), they are usually managed by a management company or AIFM who usually appoints asset managers as delegates. The fund's assets are held by a custodian in the fund's name – and not in the name of the asset managers. Under the UCITS Directive the custodian is not allowed to undertake asset management activities to preserve the segregation of duties and the custodian/depositary's independence. These factors ensure that if the asset manager were to fail, the fund's assets would not be compromised.

- Similarly, the fund board is free to select another asset manager and such changes are sufficiently frequent to be considered "business as usual" for market participants. It should be noted that if the fund manager was to change this would not necessarily mean that the fund would change its custodian/depositary. The new asset manager would continue to select assets which it thinks are best to meet the fund's investment objective and policy.
- Given there are a large number of asset managers, we do not consider the market to be overly dependent on one player.
- Financial exposure to one counterparty is limited (regulatory limits as specified for UCITS) and mitigated by risk management requirements. Counterparty exposures are reported regularly to the regulator (AIFMD requirements and CSSF ad-hoc reporting), preventing funds to be overly exposed to one counterparty, including its asset manager.
- Changes in service providers occur frequently and such transfers are considered as business as usual operations whose operational risks are fully understood and mastered.

We therefore do not believe that the change or failure of an asset manager would pose a problem for the fund as its assets are held separately by the custodian regardless of the market conditions. We also point out that the change of the asset manager does not imply or automatically require that the custodian/depositary be changed as well.

Securities lending activities of asset managers and funds

Q16. In your view, what are the relevant information/data items authorities should monitor for financial stability purposes in relation to indemnifications provided by agent lenders/asset managers to clients in relation to their securities lending activities?

Any risks arising from securities lending are already adequately addressed by the UCITS Directive, AIFMD and SFTR reporting. Residual risks are limited due to collateral requirements (including their timely receipt and payment, quality usually limited to cash and highly-rated bonds, liquidity, haircuts and mark-to-market daily) and independent custody.

As stated in our response to Q1, we do not believe that securities lending activities pose a threat to financial market stability for the following reasons:

- For both the UCITS Directive and AIFMD: the rules require disclosure of securities lending in both the fund prospectus and the fund's semi-annual/annual reports. Securities lending must be collateralised by cash or liquid, good quality assets and this collateral is held by a third party – usually the fund's custodian. The activity is controlled through limits on the

[6] ILA/PWC Luxembourg Fund Governance Survey 2014: http://www.ila.lu/ILA/documents/PWCILAFundGovernanceSurvey201412418.pdf

reinvestment of cash collateral and counterparty exposure to protect both the fund and its investors from impairment.
- The UCITS Directive goes further to define more prescriptive limits on collateral and counterparty exposure.
- The SFTR contains rules for a wider scope of market participants on securities lending activities, collateral and the reuse of collateral. It will also centralise European reporting of such transactions to allow European financial regulators a better overview of the activity and mitigate risks to the financial system.

Indemnification, although we understand this to be a new area of interest, is far from becoming a "systemic" factor and appears devoid of any associated contagion risks, although may dent an individual firm's reputation to a certain, but in any case limited, extent. As the consultative document correctly points out, very few asset management companies provide agency-like securities lending services. Moreover, as the FSB duly recognises there are multiple levels of security built into an asset manager's agency lending business to avoid client indemnification. Among these, the over-collateralisation of the lender's exposure via the marking-to-market of the value of the securities on loan remains fundamental and is practiced widely. Were an indemnification obligation to be triggered, notwithstanding the aforementioned guarantees and despite the fact that asset management companies hold indemnity insurances for professional liability risks (inter alia, against potential losses arising out of securities lending), the actual amount of the indemnification would not cover the full exposure of the loan. Rather, it would oblige the agent lender to only cover the shortfall between the value of the received collateral and the replacement cost of the lent instruments. We therefore deem balance sheet exposure for the asset management company in such rare events to be minimal and prudently backed either by reserves of unencumbered cash and/or by standing multi-year credit facilities, negotiated in advance and carrying charges. On the basis of these arguments and evidence, we disagree with the argument linking financial stability concerns to the extremely rare and limited event of client indemnifications. Additionally, we strongly disagree with the FSB's statement that "(…) the scale of exposures can be as large as that of some global systemically important banks (G-SIBs)" and wonder as to any evidence to substantiate it.

Q17. Should the proposed recommendation be modified in any way to address residual risks related to indemnifications? For example, should it be more specific with respect to actions to be taken by authorities (e.g. identifying specific means for covering potential credit losses) or more general (e.g. leaving to authorities to determine the nature of appropriate action rather than specifying coverage of potential credit losses)?

We believe that the SFTR could form the basis, however, we would recommend that single sided reporting is used. The market has experienced very low levels of matching when dual reporting is used, this is partly due to the number of variables (optionality) within the reporting fields.

Please refer also to Q16[7].

[7] Reference is also made to a BlackRock Viewpoint paper "Improving Transparency: the value of consistent data over fragmented data": https://www.blackrock.com/corporate/en-gb/literature/whitepaper/viewpoint-improving-transparency-august-2016.pdf

Appendix 1: Glossary of commonly used abbreviations and terms

AIF	Alternative Investment Fund(s), a fund constituted in accordance with the AIFMD and its supporting delegated regulations.
AIFM	Alternative Investment Fund Manager(s), the manager of an AIF.
AIFMD	EU Directive on AIFMs (2011/61/EU)
AIFMD-CDR	EU Commission Delegated Regulation (231/2013) supplementing AIFMD with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision.
AMIC	Asset Management and Investors Council of the International Capital Markets Association (ICMA)
CIS	Collective Investment Schemes
CMU	Capital Markets Union, is a plan of the European Commission that aims to create deeper and more integrated capital markets in the Member States of the EU. With the CMU, the Commission will explore ways of reducing fragmentation in financial markets, diversifying financing sources, strengthening cross-border capital flows and improving access to finance for businesses, particularly SMEs.
CSSF	*Commission de Surveillance du Secteur Financier* (Luxembourg commission for the supervision of the financial sector).
EFAMA	European Fund and Asset Management Association
ESMA	European Securities and Markets Authority.
ESRB	European Systemic Risk Board, which is responsible for the macro prudential oversight of the EU financial system and the prevention and mitigation of systemic risk.
EU	European Union
FEAM	Forum of European Asset Managers, which is a lobby group of fourteen Pan-European asset managers.
KIID	Key Investor Information Document, which is a disclosure document that must be handed over to investors in accordance with the UCITS Directive.
MiFID	Markets in financial instruments directive (2014/65/EU), the directive governs the provision of investment services in financial instruments by banks and investment firms and the operation of traditional stock exchanges and alternative trading venues. It has been in force since November 2007. A recent revision aimed at making financial markets more efficient, resilient and transparent, and to strengthen the protection of investors.
MMF Regulation	This refers to a new EU Regulation on Money Market Funds, which is in the process of being adopted.
SFTR	Regulation (EU) 2015/2365 of the European Parliament and of the Council of 25 November 2015 on transparency of securities financing transactions and of reuse and amending Regulation (EU) No 648/2012, which improves the transparency of securities financing transactions and helps identifying the risks associated with these financial transactions, as well as their magnitude.

Solvency II	Directive 2009/138/EC whose aim is to ensure the financial soundness of insurance undertakings, and in particular to ensure that they can survive difficult periods. This is to protect policyholders (consumers, businesses) and the stability of the financial system as a whole. Solvency rules stipulate the minimum amounts of financial resources that insurers and reinsurers must have in order to cover the risks to which they are exposed. Equally importantly, the rules also lay down the principles that should guide insurers' overall risk management so that they can better anticipate any adverse events and better handle such situations.
UCITS	Undertaking for Collective Investment in Transferable Securities, a fund constituted in accordance with EU Directive 2009/65/EC (“UCITS IV”), as amended by EU Directive 2014/91/EU (“UCITS V”).
VaR	Value-at-Risk, which is a measure of the risk of investments.

Appendix 2: Example of dilution protection via Price Swinging

Table 3.2.1. Comparison of Fund Pricing Rules (USD million)	
Transactions	**UCITS Swing Pricing**
Beginning NAV	100
Net flows	-15
Purchases	+5
Redemptions	-20
Total Costs of Selling Assets (0.1 percent, including bid-ask spread)	0.015
Transaction Costs Incurred by Investors Purchasing Fund Shares [(1)]	-0.005
Transaction Costs Incurred by Investors Redeeming Fund Shares	0.020
Transaction Costs Incurred by Fund and Remaining Investors	0
Ending NAV	85
Memo	Estimated transaction costs borne by trading investors

[(1)] Because fund NAV has swung to the bid price because of net redemptions, purchasing investors benefit to the extent that they purchase units that are cheaper than preswung NAV. This benefit is offset by the costs paid by redeeming clients.

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Appendix 3:

Gate Example

		Day 0	Day 1	Day 2	Day 3	Day 4	Day 5	Day 6	Total
	Fund Performance		1%	-5%	-5%	-5%	-5%	-5%	
A	NAV/share	100	101	96	91	87	82	78	
	Net Flow Requested (N1):								
B	Investor's Shares	100	-10	-18	-14	-3	-3	0	**-48**
C	% Of Overall Fund NAV		-10%	-20%	-20%	-5%	-5%	0%	
	Proceeds If Gate Was Not Applied [A*B]		1010	1727	1313	249	225	0	**4524**
	Net Flows Allowed (10% Gate)								
	Gate Brought Forward (b/f):								
E	% Of Fund				-5%	-10%	-5%	0%	
F	Investor's Shares				-4	-7	-3	0	
	Gated Flows Approved For Redemption (N2):								
G	% Of Fund		-10%	-15%	-15%	-10%	-10%	0%	
	Investor's Shares [F+((G-E)/C)*B]		-10	-14	-12	-7	-6	0	**-48**
	Gate Carried Forward (c/f):								
	% Of Fund		0%	-5%	-10%	-5%	0%	0%	
	Investor's Shares			-4	-7	-3			
	Actual Proceeds Received		1010	1295	1066	623	462	0	**4456**
	Proceeds Foregone As A Result Of The Gate "Delay" Mechanism		0	-432	-247	374	237	0	**-68**
	Investor Performance Lost								**-1.50%**

Investor impact due to inability to redeem full request each day. Assuming future NAVs drop in value, this lower NAV is then applied to any shares c/f in the gate mechanism

Since the investor cannot redeem everything he/she wants to, when he/she wants to (due to the gate), the investor effectively loses 1.5% in total performance because the NAV drops -5% every day, so gated deals therefore get a lower NAV.

(N1): Scenario involves a daily dealing UCITS and assumes same the investor submits separate redemption requests on 5 consecutive dealing days. The gate model is described in the fund prospectus, including threshold at which it becomes effective. It gives the power to defer redemption requests to future dealing dates, with gated deals b/f then being typically FIFO prioritised over new requested received on later days. Proceeds are paid pro-rata from available portfolio proceeds [see (N2)]

(N2): Ability to accept redemption requests is determined by the fund's ability to redeem a proportionate, representative portion ("slice") of fund portfolio. Only a representative slice is acceptable otherwise remaining investors could be left with a more illiquid profile of portfolio from which to realise their redemption proceeds. This protects investors against a first-mover advantage

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Appendix 4:

Side Pocket ("SP") Example

	Day 0	Day 1	Day 2	Day 3	Day 4	Day 5	Day 10	Liquidation	Total
Fund Performance		1%	-5%	-5%				-14%	
NAV/share	100	101	96	91				79	
Net Flow Requested:									
% of Fund NAV		-10%	-20%	-20%					
Shares Subscribed/(Redeemed)		-10	-18	-14					
Share Roll	100	90	72	58					
Investor Equity		9090	6908	**5250**					
SP Re-organization:									
Non-SP (75%)									
Net Flow Requested: % of Fund NAV (N1)					-10%	5%	-5%		
Shares Subscribed/(Redeemed)					-4	2	-2		
Non-SP Portfolio Performance					-8%	-4%	5%	-2%	
NAV/share				91	84	81	85	79	
Share Roll				43	39	41	39	41	
Investor Equity				**3938**	3260	3287	3278	3221	
SP (25%):									
Net Flow Requested: % of Fund NAV (N2)									
Shares Redeemed									
SP Portfolio Performance					-40%	-45%	10%	95%	
NAV/share (N3)				100	60	33	36	71	
Share Roll				13	13	13	13	13	
Investor Equity				**1313**	788	433	476	929	
Total Investor Equity (SP & Non-SP)					4048	3720	3755	4150	
Investor Impacts:									
If no SP re-organization: no cash back until liquidation date								4528	**4528**
Under SP re-organization: non-SP investor liquidity continues (N4)					362	-157	173	4150	**4528**

Maintaining long-term illiquid assets in the SP allows investors to still subscribe/redeem in the liquid part of the strategy. This is not otherwise possible if the overall fund needed to be suspended until liquidation date.

(N1): From a LIFO viewpoint, the fact that shares can continue to be subscribed (Day 5) & redeemed (Day 10) shows that gains can still be made due to the non-SP fund being open
(N2): Although not reflected in the example, SP pro-rata redemptions and/or distributions could be made on a periodic basis to shareholders on the sale of previously illiquid assets
(N3): On Day 3 when the SP is created, 25% of fund equity (ie. illiquid assets) is allocated to a newly created SP share class, with shares allocated pro-rata to existing investors
(N4): Continuous liquidity is a fundamental requirement of UCITS investors, with SP enabling this for a large part of the portfolio. For simplicity, the scenario concludes with a full liquidation of both SP and non-SP portfolios, although not necessary for the non-SP. Maintaining the SP shows that the manager was able to take time in finding a best outcome