THE
INVESTMENT
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Dear Sir/Madam

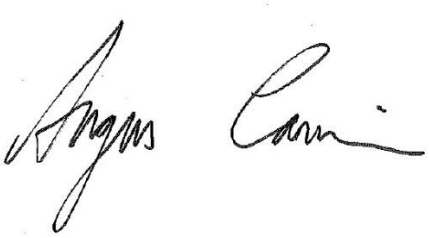
RE: CONSULTATIVE DOCUMENT – ASSESSMENT METHODOLOGIES FOR IDENTIFYING NON-BANK, NON-INSURER GLOBAL SYSTEMICALLY IMPORTANT FINANCIAL INSTITUTIONS (4 March 2015): "CP2"

Please find attached the response of The Investment Association to the above consultation. We are grateful for the opportunity to comment.

The Investment Association is the trade body that represents UK investment managers. We have over 200 members who manage more than £5 trillion for clients around the world.

Our response covers that part of CP2 relevant to our industry, answering questions in sections 2, 6 and 7.

Yours faithfully



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Introduction

The Investment Association welcomes the opportunity to respond to this consultation. We would first like to set out our concerns about the CP2 approach to the asset management industry and financial stability. In doing so, we understand (and welcome) that policy makers (including the FSB and IOSCO) should investigate the financial stability implications of asset management. However, a better approach to financial stability policy than that contemplated by CP2 requires a holistic approach to the markets in which asset managers operate and to their products and activities.

The SIFI framework is inappropriate to asset management

CP2 asks for comment on whether the FSB's SIFI framework should be extended to the asset management industry (both funds and managers). This SIFI framework looks to entities as a source of systemic risk: CP2 refers to it as a "framework for reducing the systemic and moral hazard risks posed by SIFIs[1]." However, it is not axiomatic that entities are the main source of systemic risk concerning asset management. Moreover, neither the first consultative document (dated 8 January 2014) on this issue ("CP1") nor CP2 elaborate on the moral hazard posed by the asset management industry (let alone present evidence of this moral hazard). Indeed, it is counter-intuitive to claim that asset management poses moral hazard, certainly not in the way that banking does, e.g. neither funds nor asset managers have access to the discount window (or the other privileged arrangements that banks have with central banks), nor do investors benefit from deposit insurance. We fail to see how moral hazard considerations justify this policy making concerning our industry.

The FSB's SIFI framework was conceived in the aftermath of the recent financial crisis to address the "too big to fail" issue, in light of the threats to financial stability that crystallised in the banking sector. The entity-level approach of the SIFI framework – with size playing a central role - makes sense for banks. Applying the SIFI framework to asset management assumes as axiomatic that an entity-focused framework is appropriate to our industry and that size – i.e. being too big to fail – is at the core of systemic risk, whereas, on the contrary, we believe that this assumption is incorrect. There are fundamental differences between banking and asset management, which make this assumption and, therefore, CP2's approach to financial stability and asset management inappropriate.

Responses to CP1 – including our own – explained the relevance of the differences between banking and asset management to any analysis of financial stability issues arising in connection with our industry:

- As we said in our response to CP1, deposit-taking entails a promise to repay a defined amount of money (i.e., whatever the customer has deposited) and that is why deposit insurance has a role to play. Confidence in the viability of the banking system arguably depends on such measures relating to the integrity of a claim on individual banks. Many investment managers do not hold client money, and those that do protect the customer's money by segregating it from their own. The fate of the customer's money is independent of the manager's fate; this also necessarily means that the amount of money coming back to the customer will vary - the asset owner bears the market risk, not the manager. In fact, the investor typically commits money to the fund precisely because of that ability for the sum to change in size. Moreover, whilst G-SIB groups often have multiple entities connected

[1]CP2 page 1.

through complex intra-group exposures, there is no similar exposure between the manager and the funds, segregated accounts and mandates it manages, nor between those individual funds and accounts. Finally, there is no substitutability issue (asset management is a highly competitive, diverse business[2]).

- Ours is an agency business, where the assets are not on the manager's balance sheet, but are owned by the investor: even if a manager, as an entity, were to fail, the assets remain segregated and can be transferred elsewhere. Assets in collective funds are typically in the custody of a third party, the custodian or depositary, which is legally and/or functionally independent of the manager.[3] . Institutional assets managed under segregated mandates are also in the custody of a custodian hired by the client ("separate accounts").[4] Transfer of assets in custody upon a failure of the manager – whether fund assets or separate accounts - is a simple and well-tested procedure.

- Asset owners make the strategic decisions on investment, which is their overall asset allocation and which their agents, the asset managers, put into effect. Institutional investors award mandates to asset managers for specific asset classes. Asset managers are responsible for the tactical asset management within such mandates. Hence, in contrast to the dominance of just 30 G-SIBs (at present) of world banking, millions of investors, directly and collectively (in the case of funds) and indirectly (in the case of investment mediated through insurance or pension funds) determine the strategic allocation of their investments according to their multiple and diverse saving priorities.[5]

We also believe that CP2 wrongly makes designation of entities as its first outcome, when policy makers should first identify and assess the relevant potential risks to financial stability that may arise in non-bank activities. In addition, entity designation should be just one possible policy tool to address these risks.

We also believe that designating entities as systemic without consideration of the implications of such designation is inappropriate. In the case of banking (i.e. designating banks as G-SIBs), potential policy tools were well understood – including, for example, additional capital requirements. This is not the case for asset managers and funds: it is far from clear what the appropriate policy measures should be. We find it difficult to justify threatening an entity with designation as systemic without clarity as to what the implications of that might be.

There is a further process issue: asset management is a competitive industry and investors move their money on small cost differences alone. Of course, we accept that addressing financial stability risk might impose additional regulation, but even an early stage of the three "phase" FSB and IOSCO policy process proposed in CP2 (e.g. when funds or asset managers

[2] The irrelevance of the "substitutability" channel of risk transmission to asset management is elaborated upon in our response to Question 6.1.
[3] In the UK the depositary must be both legally and functionally independent of the manager.
[4] Experience of 2007 demonstrated that, where there are large institutional redemptions of shares in funds, these were preceded by active discussions with the asset manager. This ensured that such sales could be managed in a way that ensured the best interests of the sellers and ongoing investors could be maintained.
[5] The BNP Paribas/YouGov study "Risk Analytics –Challenges and Perspectives in A Low Yield Environment" reveals how extensively investment priorities of institutional investors (pension funds, insurance companies, sovereign wealth funds and central banks) vary, even in the current "low-yield" environment.

are added to the pool to be assessed for designation as SIFIs) could precipitate an investor response - i.e. investors will move their money to competitors - in anticipation of the regulatory burden to follow.

These considerations lead us to propose policy-making more rigorous than the SIFI approach to address concerns about financial stability and our industry.

A holistic approach to markets, products and activities

We agree with the FSB and IOSCO that the interaction between asset management and financial stability merits proper investigation. Indeed, our industry shares with policy makers a common interest in protecting from financial instability the financial system, the economy more broadly and participants in our sector of the financial services industry.

Risks to financial stability concerning our industry will manifest themselves in financial markets, as threats to financial stability from market turbulence, malfunction or disorder.[6] Hence the nexus between asset management and financial stability requires addressing the risks to financial stability in financial markets. This requires a holistic approach, focussing on the entire market ecosystem and taking into account:

- Market structure, including the products traded
    - Policy analysis should distinguish market risk from systemic risk. Moves in asset prices – even sudden large falls – generally indicate the market is functioning. Indeed, it is not possible to legislate price stability, so policy making must guard against implicitly targeting the price formation function of markets. There is a fine line between manifestation of market risk and systemic events. Neither CP1 nor CP2 have investigated this.
- Market participants and their behaviour:
    - It is relevant to note that most asset owners buy and sell without the intermediation of an asset manager.[7] Moreover, funds and managers will not behave uniformly (and may behave, in aggregate, in a risk-reducing way), even in stressed markets, owing to their different investment objectives. This also reflects the variety of investment vehicles such as mutual funds, separate accounts, hedge funds, private equity funds, etc.
    - FSB and IOSCO analysis of "fire sale" risk, for example, does not reflect that investor redemptions do not increase significantly in times of market stress.[8] The relative "stickiness" of managed investments (both funds and segregated accounts/mandates) has been a powerful countercyclical force in past market

[6] This is implicit in the analysis in both CP1 and CP2. Such turbulence and disorder needs to be distinguished from market volatility / market risk, which asset managers manage on behalf of their clients on a daily basis.
[7] See McKinsey & Company. "Strong Performance but Health Still Fragile: Global Asset Management in 2013. Will the Goose Keep Laying Golden Eggs?" (page 8 exhibit 2), which estimates that around 75 per cent of assets are not managed by intermediaries (over 2007-2012).
[8] This is true of both retail and institutional investors. Evidence is cited in industry responses to both CP1 and the recent FSOC consultation.

turbulence, including in the recent global financial crisis. CP2 fails to take this into account.

- Market liquidity

    - Policy analysis should factor in short-term and structural influences on financial market liquidity. For example, the extraordinary monetary conditions presently obtaining in many G20 economies – and market expectations of the exit from these conditions - would be highly relevant to the analysis. There is no indication that CP2 takes official sector policies that impact market liquidity – including monetary and macro-prudential policy - into account appropriately.

- Leverage

    - Leverage is a key marker of systemic significance (the need to de-leverage rapidly in a crisis could drive "forced" asset sales). Funds without leverage cannot fail like banks and funds generally employ little or no leverage.[9] The term structure of leverage in a fund is key to the analysis of any systemic risk arising in relation to that fund. Risk emanating from highly levered entities is not limited to large funds. Therefore, attempts to identify highly leveraged funds should not be predicated on assets under management ("AUM") as is contemplated in CP2 (although there should be some *de minimis* floor to size). Rather, leverage should be used as a first screen followed by further analysis of other factors. This approach will avoid missing smaller highly leveraged entities that could create systemic risk and may require a regulatory response targeting a category of market participants, whether funds, managers or other entities (c.f. G-SIFI designation, which is intended to address risks specific to a particular entity).

- Interlinkages between financial markets and with the broader economy

    - Policy analysis on this subject should identify how risks to financial stability propagate to and from market participants through financial markets (including second and subsequent-order effects) and the impact points on general economic activity. We believe that impact on the banking sector and shock-absorption by unmediated asset-owners, amongst other market participants, will merit close analysis.

- Market practice (especially that mitigating risks to financial stability):

    - Asset managers in Europe normally have at least one of the following tools – swing pricing, fees, liquidity pockets/cash buffers, gates, staggering redemptions and applying dilution adjustments – to reduce any "first mover" advantage and to treat all investors – incoming, continuing and redeeming –

[9] EU UCITS legislation and the AIFMD both constrain leverage (in the case of UCITS to 2 times equity – orders of magnitude less than leverage in banking). In this sense, asset management is (predominantly) equity investment, while banking is (predominantly) debt investment.

fairly.[10] This tool box can be enhanced and also acts to mitigate the fire sale risks that concern the FSB and IOSCO in this policy making work.[11]

- Asset managers also employ other tools, which would mitigate risks to financial stability identified in CP2, including fund stress testing.[12]

- Asset managers are highly experienced managers of fund liquidity, particularly for open-ended funds. Data shows that managers increased fund liquidity over the 2008 crisis without any regulatory intervention.[13] It is in the interests of managers (indeed it is a regulatory obligation, because managers must be fair to all unitholders and consider the interests of the continuing investors in the fund) not to move the market against the fund.

- Existing regulation (especially that mitigating risks to financial stability), for example:

  - G20 post-crisis regulatory reform already addresses to a considerable extent potential threats to financial stability from financial markets and their participants. The impact of this reform needs to be factored in to the analysis of financial stability and asset management.

  - Banking – Basel 3 and "too big to fail" (TBTF) measures (recovery and resolution planning) both make banks safer and protect banks from threats arising from those activities that could give rise to inter-connectedness with asset management (e.g. limiting large exposures).[14]

  - Securities financing transactions (SFT) – the FSB is already reforming SFT to make securities financing markets more resilient (minimum haircuts, reporting and disclosure obligations – with EU legislation following). Moreover, banking reform (e.g. leverage ratio, NSFR) will reduce the threat to banking from disruption of SFT markets.

  - Derivatives and securities – enhanced regulation of trading and greater transparency; enhanced regulation of derivatives: mandatory central clearing, reporting and (for non-cleared business) risk-mitigation; improved resilience and regulation of CCPs.

  - MMFs – since many policy makers are concerned about the key role of MMFs in providing short-term finance to banks (via SFT), amongst other aspects of

[10] Industry responses to the recent FSOC consultation (e.g. those of BlackRock and the ICI) explain fund liquidity management practice in detail.
[11] In addition, experience of 2007 demonstrated that where there are large institutional redemptions, these were preceded by active discussions with the asset manager. This ensured that such sales could be managed in a way that ensured the best interests of the sellers and ongoing investors could be maintained.
[12] Note that in the EU the AIFMD requires fund stress tests. We would be happy to discuss fund liquidity management tools in detail with policy makers.
[13] See page 29 of the 19 March Morgan Stanley – Oliver Wyman Wholesale & Investment Banking Outlook.
[14] We are concerned that CP2 does not consider whether the mitigation of risks to financial stability from G-SIBs has shifted risks to financial markets and the ramifications of this for policy making concerning financial stability.

MMFs, FSB and EU/US/other national proposals for MMFs will already address these concerns to a considerable extent.[15]

- Asset management industry regulation – existing regulation of our industry already promotes financial stability. In the EU UCITS laws and the AIFMD regulate such matters as fund liquidity, leverage, limitations to large exposures and asset diversification – all of which promote financial stability (as well as other public policy objectives, such as investor protection).[16]

- It is also important to review the full suite of G20-mandated reforms of financial services to identify adverse consequences for financial stability and factor redress of these into this policy making process. For example, regulatory reform appears to have adversely impacted the liquidity of secondary markets, exacerbating fire sale risks.

- Other relevant public policy considerations:

  - Governments (including the G20) promote saving, particularly for retirement and now more than ever (in the light of demographic change, constrained public finances etc.). The EU is developing a Capital Markets Union to channel savings to companies through capital markets more effectively in an attempt to rekindle growth and reverse unacceptable levels of unemployment. Financial stability-motivated policy measures should be adapted appropriately to these other public policy objectives. CP2 takes no account of other public policy objectives that would otherwise require adjustment of measures taken in pursuit of financial stability.

Evidence-based policy-making

Best practice in policy-making requires that the policy analysis is supported by evidence and grounded in data. However, there is insufficient evidence to support the policy approach in CP2. Moreover, evidence contrary to that policy approach would appear not to have been taken into account in CP2. For example, our data provide evidence that fund investors do not materially increase redemptions during financial crises: there is no evidence from the funds that we cover of "herding" or "fire sales" engendered by significantly higher redemptions than normal.[17] We would be happy to discuss this data in detail with policy makers.

Policy makers themselves admit to the relative paucity of data currently available to inform their analysis. For example, page 4 of CP2 itself admits to "the limitations in obtaining appropriate data/information for assessing systemic risks of NBNI financial entities in a global context" and elaborates on these limitations in section 2. In addition, CP2 page 6 states: "One of the key challenges in assessing the global systemic importance of NBNI financial entities is the difficulty in obtaining appropriate and consistent data/information." [18]

CP2 acknowledges the need for more analysis on page 34 in calling for "further investigation" of the potential for redemption management tools "to mitigate potential systemic risks."

[15] In the USA SEC proposals for prime institutional and other MMFs; in the EU the proposed MMF Regulation
[16]. One objective of the EU AIFM Directive is to mitigate potential systemic risk of unregulated asset management activities.
[17] The Investment Association holds data on monthly flows in and out of UK funds, including over the period of the "dot.com" crash and the recent global financial crisis.
[18] See also page 12.

Andrew Haldane of the Bank of England's paper "The Age of Asset Management" also concedes the "green-field" state of analysis (e.g. on page 12 the author says "We are in the intellectual foothills when understanding and scaling the transmission channels through which asset managers could generate systemic risk)."

The FSB Standing Committee on Assessment of Vulnerabilities (FSB SCAV) tacitly concedes both the need to gather more data on financial stability issues in relation to asset management and the need to anchor the analysis in a wider assessment of financial stability issues in financial markets by initiating work to review "financial stability risks associated with market liquidity in fixed income markets and asset management activities in the current conjuncture."[19]

The industry responses to both CP1 and to the recent FSOC consultation cite evidence rebutting suggestions that asset managers and funds threaten financial stability. Evidence suggests that past major events affecting funds do not impact financial stability, e.g. no traditional asset manager was proven to have caused financial instability in the last financial crisis[20]. Even if past performance is no guide to the future[21], better regulation places the onus upon the policy maker to adduce the evidence in support of the proposed policy. We do not believe that this burden has been discharged by the FSB and IOSCO in relation to the policy proposed in CP2.

We reiterate our call in the response to CP1 for the FSB and IOSCO to collect the necessary data through a single global template, drawing as much as possible on existing locally reported data. Recently the PRA/FCA in the UK have asked for data on liquidity practices, risk management and investor due diligence in relation to bond funds. We welcome this first step, but it is only a first step and has not yet been followed globally.

Conclusion

The SIFI framework is a poor model for policy making to address concerns about financial stability and asset management (asset owners and asset managers), both for focussing on entities and for lacking the features of the overall market ecosystem approach outlined above. The FSB itself has identified a better way to make policy in this field, by:

> "prioritising work to understand and address vulnerabilities in capital market and asset management activities. This will comprise two linked projects. The first will examine the likely near-term risk channels and the options that currently exist for addressing these. The second will consider the longer-term development of these markets and whether additional policy tools should be applied to asset managers according to the activities they undertake with the aim of mitigating systemic risks."[22]

Other policy makers are also rightly moving to focus financial stability policy on the overall market ecosystem, e.g.:

- The IMF's Global Financial Stability Report recent chapter on asset management, which stresses the importance of a products or activities-based approach and asserts that

[19] See the FSB's press release from the Plenary Meeting in Frankfurt on 26 March 2015.
[20] Actual redemptions in the 2008 crisis were muted – declines in AUM largely related to falls in market price. See, for example, the responses to CP1 and the recent FSOC consultation.
[21] As Mr Haldane points out in "The Age of Asset Management".
[22] FSB Chair's Letter to G20 on Financial Reforms – Progress on the Work Plan for the Antalya Summit, 9 April 2015.

investment focus is more important than the size of the fund or the asset manager in gauging systemic risk;

- The FSB's own SCAV has recently initiated work on financial stability and asset management;
- The US FSOC's latest consultation focussed on activities, not entities; and
- The recent views of the Bank of England's Financial Policy Committee[23].

The protection of financial stability would be better advanced by merging the policy work, of which CP2 is the latest iteration, into the more holistic policy-making referred to by Governor Carney and benefiting from the FSB SCAV analysis to come. Therefore, we call for a halt on SIFI designation work, while the FSB and IOSCO take forward this new policy work addressing financial stability and asset management.

[23] For example at its 24 March 2015 meeting the FPC directed the UK authorities to look at risks to financial stability in the UK holistically, considering all risks arising from market illiquidity (including resulting from asset managers' strategies for managing the liquidity of their funds in normal and stressed scenarios).

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.

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

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 do not agree with the justification offered for excluding public financial institutions, sovereign wealth funds or pension funds from an analysis of threats to financial stability. It follows from our holistic approach to financial stability that all market participants must be considered. Indeed, these institutions comprise a significant portion of the 75 per cent of unmediated investment identified by McKinseys.[24] For example, the investment strategy and market actions of these investors - like the investment strategy and the activities of many funds and managers - can significantly mitigate threats to financial stability arising in a financial market: they are generally long-term and counter-cyclical investors. It is, therefore, important to factor their activities into financial stability analysis – not exclude them *ex ante*.[25]

We also observe that the justification for excluding pension funds – "they pose low risk to global financial stability and the wider economy due to their long-term investment perspective" – applies to many investors and, by extension, to an understanding of risks to financial stability from their managers or the relevant funds and segregated mandates. The justification for excluding public financial institutions and sovereign wealth funds – "they are owned and fully guaranteed by a government" – even if true in every case, is irrelevant to the holistic analysis required[26].

Finally, we note that some of these entities have "captive" asset managers. It is difficult to see how an exemption would work in such cases. The potential for competitive distortion with non-exempt asset managers is clear.

We note that CP2 improves on CP1 in avoiding "double designation" of an asset manager subsidiary of a G-SIFI, where the subsidiary is already subject to the financial stability-mitigating measures applied to the group.[27]

We further observe that substantial flows in financial markets have been driven and continue to be driven by accounting (e.g. mark-to-market accounting standards), monetary policy and

[24] See our prefatory comments.
[25] It follows from these observations that public financial institutions, sovereign wealth funds and pension funds should not be candidates for SIFI designation, should the FSB and IOSCO (incorrectly) persevere with the SIFI framework.
[26] Of course, a government guarantee may not circumscribe the activities of the guaranteed entity, including activities identified by CP2 as potentially harmful to financial stability, nor does it prevent default by the entity on its obligations, which may have systemic consequences.
[27] See CP2 page 10

other regulation applying to pension funds, insurance companies and other investors. It is important to understand the impact of such policies on the asset allocation decisions of asset owners, on fund flows and any implications for financial stability (as opposed to market risk).

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.

It is of little help to the understanding of financial stability to investigate the systemic risks associated with the financial distress or disorderly liquidation of an investment fund in isolation from the investigation of all other relevant factors identified in our holistic approach to financial stability. In any event, industry responses to CP1 (including our own) substantially address this question in answering CP1 Question 1-1.

The "exposures/counterparty channel" requires that other market participants have extended financing to the fund(s) concerned or have direct trading linkages to them. To the extent that a fund does not trade with or borrow from other counterparties (e.g. where the fund buys and holds assets to maturity and with minimal or no leverage), the "exposures/counterparty channel" would appear not to be relevant. Clearly the risk is proportionate to the leverage in a fund, so we welcome the increased attention paid to leverage in CP2. We also welcome the acknowledgement in CP2 of existing regulation of leverage in funds[28] and observe that this must be factored into assessment of the financial stability issues.

The analysis of this risk transmission channel should also take into account G20-mandated reforms of the regulation of financial services and other relevant existing measures, designed to mitigate the risks that concern the FSB and IOSCO (e.g. the post-crisis reform of the prudential regulation of banks).

CP2 reveals policy-maker concern that a fund's failure to honour borrowing or trading obligations to a systemic creditor (which will normally be a bank or broker-dealer) could threaten financial stability through the impact on that creditor. This calls for a consideration of the financial stability implications of the creditor failure alongside the financial stability implications of the fund failure. Naturally, such an analysis would factor in the systemic risk reducing measures applicable to the creditor (for example, the suite of policy measures targeting G-SIBs). In other words, entire market ecosystem analysis is required, not an assessment of the financial stability threats posed by funds in isolation, which is a key feature of the CP2 SIFI-based approach to policy-making.[29]

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[28] UCITS funds are not generally permitted to be leveraged in excess of their net value, using the "commitment method". The exception being certain "sophisticated" funds, where a detailed derivatives risk management plan is required including using Value at Risk to monitor derivative positions (in any event the VaR limit is 2 times benchmark and no more than 20%). The leverage of a non-UCITS fund, whilst it may be greater, is already reported under AIFMD. There are similar requirements in the US, where alternative funds report data under Form PF, permitting the perceived systemic risk to be monitored globally.

[29] The US GAO report into LTCM cited on CP2 page 32 supports our position. In observing that "the banks and securities and futures firms that were [LTCM's] creditors and counterparties failed to enforce their own risk management standards" the GAO draws attention to the key role of these creditors and counterparties and, by implication, the regulation of these creditors and counterparties.

We have little to add to the comments already made by industry respondents (including our own) to CP1 on the "Asset liquidation / Market channel", with its focus on fire sale risks. Again we note the relevance of leverage: the need to de-leverage rapidly in a crisis could drive the "forced" asset sales that so concern policymakers. However, we do not believe that policy makers have satisfied the burden of establishing their case with sufficient confidence that policy measures could properly follow. The papers cited in CP2 in support of the contention that asset fire sales by funds threaten financial stability are insufficient evidence in support of that proposition. Moreover, countervailing evidence is either ignored or not given due credit.[30] Finally, this market transmission channel must be considered in tandem with the other relevant factors identified in our holistic approach to financial stability. The analysis in CP2 is undermined by the failure to do this.

As well as rightly noting the relevance of leverage, CP2 notes the relevance of redemption management tools (like fees and gates), calling for "further investigation" of these tools.[31] We welcome this focus on fund liquidity management (and the implicit support to a holistic analysis incorporating liquidity management tools).[32] We stand ready to assist policy makers in this.

Our response to CP1 addressed the "critical function and service/substitutability channel". We do not consider this transmission channel to be material to the assessment of financial stability risks and our industry. In particular, we regularly measure the converse of substitutability, i.e., concentration, in UK-based (collective) fund management. Specifically, we calculate the Herfindahl-Hirschmann Index number, as it relates to market share. As of end 2013, this stood at a very low figure of 420, little changed since 12 months earlier (418). With a maximum possible score on the HHI scale of 10,000, and the threshold for moderate concentration standing at 1,000, the UK collective fund management industry is clearly one with strong evidence of robust competition.

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?

Although policy makers should pay particular attention to any fund, whose asset holdings or trading activities are significant relative to the market segment, particularly in less liquid markets, there is no evidence that "significance" in the sense of Question 6-2 translates to systemic threat. One cannot determine the extent to which risks to financial stability are heightened in isolation from the other relevant factors identified in our holistic approach to financial stability. Any assessment of risk that is limited to analysis of a particular fund, whether its asset holdings or trading activities are significant relative to the market segment or not, will be incomplete. To the extent that an individual fund's asset holdings or trading activities might reasonably be seen as significant in a relative sense, the market segment or asset class concerned tends to be niche, not systemically significant.

[30] Again, we draw your attention to the FSOC responses, e.g. that actual redemptions in the 2008 crisis and 2013 were muted – declines in AUM largely related to falls in market price.
[31] CP2 page 34.
[32] The IOSCO Principles of Liquidity Risk Management for Collective Investment Schemes (4 March 2013) should inform the analysis of fund liquidity.

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?

We do not have evidence of either an individual fund or industry-wide behaviour, which contribute to broader market contagion. However, we reiterate that the term structure of leverage in a fund is key to the analysis of any systemic risk arising in relation to that fund.

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?

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.

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).

Our introductory remarks explained the basis for our rejection of CP2's entity-focussed approach to financial stability issues. Accordingly, any thresholds or filters for entities would be arbitrary and subject to arbitrage (which would merely shift risk within the system).

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.

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.

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).

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

In view of our opinion that the policy development methodology of CP2 is misconceived, we shall confine ourselves to some observations relating to questions 6-7 – 6-11. In particular, the indicators set out in section 6.4 concern five "impact factors", which CP2 appears to consider sufficient for determining "the global systemic significance of investment funds". Our

prefatory comments explains our view that the analysis needs to be broader and more sophisticated to capture appropriately risks to financial stability in relation to our industry.

An overall market approach to financial stability should incorporate analysis of the price-signalling function of markets, including allowing for crystallisation of market risk and investment risk - and associated price fluctuation. As our introductory comments explained, it is not possible, nor would it be desirable, to legislate price stability.

We observe again that CP2 incorrectly presumes that indicators of relevance to the assessment of whether a bank is a G-SIB should be relevant to the analysis of financial stability and our industry. Our prefatory comments explained the fundamental differences between asset management and banking, including that ours is an agency business.

We recommend that the FSB and IOSCO give due consideration to the treatment of leverage under the EU AIFMD (which treats leverage greater than 3 times as significant) in financial stability analysis. While GNE does not provide a measure of risk and there are alternatives that would do so, we do understand that GNE is a number that will be easier to compute and that the notional is a number that will (with few exceptions) remain stable throughout the life of the derivative contracts, hence its common use as a proxy for market size. But we do encourage the authorities to look at measures of risk rather than what is a misleading measure, given that GNE only covers of total activity.

We note that impact factor 6.4.5 (global activity) is particularly unhelpful to an assessment of systemic risk. First, the very global financial activity identified by CP2 as a concern would generally indicate compliance with the fund diversification requirements in local law, as well as prudent investment practice. The justification for indicator 5-1 (number of jurisdictions in which a fund invests as an indicator of cross-jurisdictional activities (global activity)) offers no evidence in support and seems counter-intuitive. It is also contrary to CP2's reasoning on impact factors 6.4.1 (size) and 6.4.2 (interconnectedness): policy makers would prefer globally diversified investment over investment concentrated in "the securities or other assets of only a few jurisdictions" - the more so, the larger the fund in relation to the market segment concerned.

It is true that some indicators will be difficult to use due to the difficulty in obtaining data, e.g.:

- Indicator 2-7: identifying the nature of investors in open-ended funds will be difficult
- Indicators 3-1 and 3-2: the overall daily trading volume of a market segment will be difficult to obtain for many asset classes, due to OTC trading, in particular in bond markets
- Indicator 3-3: the size of the underlying market will be difficult to obtain

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.

There are no other activities or services conducted by asset managers that are relevant for an analysis of financial stability issues. We note that managers active in the securities lending

markets will respond to CP2 concerning this activity.[33] However, we observe that to the extent securities lending activity creates vulnerability at the fund level, the FSB itself has a sister policy process for addressing systemic risks in securities financing, which has already lead to national regulation.[34]

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.

We do not believe that the default of an asset manager in itself could be systemic (we are not sure what CP2 means by "distress" at an asset manager, but the recent events at PIMCO – which have proven not to threaten financial stability – seem as "distressing" as anything that might happen to a manager short of failure). Failure of the manager neither:

- imperils the assets (which are segregated and safeguarded under existing legislation in many G20 members), nor
- threatens continuity of the core asset management service (the portfolio management service is readily substitutable and support services are with third parties (custodians/depositaries, valuation agents etc.).[35]

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?

Our response to Question 6-1 noted that it is of little help to the understanding of financial stability to investigate the systemic risks associated with the liquidation of an entity (in this case the asset manager) in isolation from the investigation of all other relevant factors identified in our holistic approach to financial stability. Moreover, since any liabilities of potential relevance to the exposure/counterparty channel are not the manager's, but sit at the fund level, we think it is particularly misconceived to ground an assessment of systemic risk in an analysis of the exposure/counterparty channel for asset managers.

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?

[33] Based on responses to the recent FSOC consultation we endorse the comments of managers, such as BlackRock.
[34] The FSB's "shadow banking" work stream 5. G20 implementation to date includes the EU Securities Financing Transaction Regulation (currently approaching finalisation in the EU legislative process).
[35] Note that EU law requires managers to hold capital against operational risk, which can be utilised upon failure of the manager to expedite orderly transfer of service.

See the response to 7-3. The transfer of SMAs occurs regularly according to well-established market practice[36]; there is no reason to expect – nor any past evidence that - a transfer arising because of reputational or operational risks at the asset manager would differ from current practice.

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?

See the response to 7-3. In addition, we note the ready substitutability of all services offered by the asset manager.

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).

Our introductory remarks explained the basis for our rejection of CP2's entity-focussed approach to financial stability issues. Accordingly, any thresholds or filters for entities would be arbitrary and subject to arbitrage (which would merely shift risk within the system).

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?

Consistent with the holistic approach to financial stability we advocate in our prefatory comments, a set of indicators that presumes managers can be systemic is misconceived.

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.

See our response to Question 7-8. Note also that indicator 3-2 is inappropriate as it is not possible to know the total AuM invested in a specific strategy by all managers.

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?

See our response to Question 7-8.

[36] If the client decides to transfer the mandate, they are likely to appoint a transition manager, who will decide the assets to be sold, returned to the client or transferred to the management of a new asset manager.