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Secretary-General
Financial Stability Board
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SWITZERLAND

Date: 21 September 2016

Dear Sir

IA Response to the FSB Consultative Document “Proposed Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities”

The Investment Association is grateful for the opportunity to respond to your consultation paper “Proposed Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities” (“the CP”).

Preliminary comments

We would like, first, to commend the change of approach from the FSB’s previous consultation (of 4 March 2015) to financial stability and asset management (“FSB CP2”). We welcome the focus on “market-wide activities-based policies”, which is consistent with the approach to policy making that we advocated in our response to FSB CP2.

We particularly commend the FSB for giving IOSCO such an extensive mandate in the proposed policy recommendations (“PPRs”) set out in the CP. We urge the FSB to continue to ensure a leading role for IOSCO in the finalisation of policy to deliver the G20’s mandate concerning asset management, markets and financial stability.

We note with concern the references to the NBNI G-SIFI work on which the FSB has previously consulted. We are not aware of any new developments, whether in data, research or market developments, to change our views substantially from those provided in our

previous consultation responses¹, notably that the NBNI G-SIFI approach is fundamentally misconceived, at least insofar as asset managers are concerned.

Yours Faithfully

A handwritten signature in black ink, appearing to read "Angus Canvin". The signature is written in a cursive, flowing style.

Angus Canvin
Senior Adviser

¹ Please see our responses to the first and second joint FSB-IOSCO consultation papers on this subject.

ANNEX I

CONSULTATION RESPONSE

ABOUT THE INVESTMENT ASSOCIATION

The Investment Association is the trade body that represents UK investment managers, whose 200 members collectively manage over £5.7 trillion on behalf of clients.

Our purpose is to ensure investment managers are in the best possible position to:

- Build people's resilience to financial adversity
- Help people achieve their financial aspirations
- Enable people to maintain a decent standard of living as they grow older
- Contribute to economic growth through the efficient allocation of capital

The UK is the second largest investment management centre in the world and our members manage 37% of all European assets under management (AuM).

More information can be viewed on our [website](#).

INTRODUCTION

The CP concerns "structural vulnerabilities associated with asset management activities", proposing PPRs for four of the five areas identified by the FSB in September 2015 for further analysis. The FSB asks whether there are additional structural vulnerabilities associated with asset management activities that the FSB should address. We do not believe so.

The FSB also asks whether there are alternative or additional approaches to the structural vulnerabilities identified. We cover these in our comments on each of the structural vulnerabilities below. Finally, the FSB enquires as to the practical difficulties and unintended consequences associated with implementing the PPRs. Again, we answer this in our comments below.

We take this opportunity to make some general observations concerning "financial stability risks from structural vulnerabilities associated with asset management 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, above all, because asset managers are fiduciaries, the investors, whose money our members manage.

Risks to financial stability concerning our industry will manifest themselves in financial markets, as threats to financial stability from market turbulence, malfunction or disorder. 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 all the relevant factors, including:

1. **The distinction between investment or market risk and 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.

2. **All market participants and their behaviour:** the CP acknowledges that most investors are not intermediated by an asset manager.² Likewise, third party asset managers do not control their clients' decisions to shift assets from one asset class or fund to another, nor do they control their clients' investment objectives or constraints, or the asset owner's decision to employ leverage on their own balance sheets. Similarly, while some asset managers may offer ancillary services (e.g., custody, order management systems, risk analytics, securities lending agent, etc.), there are a multitude of other types of entities providing these services. 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. and the fact that, in general, funds comprise multiple underlying investors, each with their own different investment objectives and time horizons.
3. We do not believe that the FSB will address structural vulnerabilities in the financial system, if it limits the focus of policy making to those investment activities and ancillary services performed by third party asset managers, as opposed to all such activities taking place across the financial system. The challenge of obtaining relevant information concerning asset owners managing their assets directly and ancillary services that are not performed by a third party asset manager should not be an excuse for incomplete, and, therefore, flawed, policy-making. Simply because third party asset managers are already subject to extensive disclosure and reporting requirements regulation does not mean that they pose greater risks to the financial system. We suggest that systemic risk might be of greater concern in the less regulated and transparent areas of the financial system. Therefore, we advise against a narrow focus on only those areas where data is readily available.
4. As currently proposed, the CP would exempt from the scope of recommendations: (i) ancillary services that are provided by entities other than large, complex third party asset managers, (ii) securities lending agent activities and indemnification not performed by third party asset managers; (iii) sovereign wealth funds and, (iv) pension funds. In order to reduce risk, it is necessary to take a holistic approach that encompasses the investment activities (including the ancillary services necessary to perform those activities) of all asset owners and all asset managers across the financial market ecosystem.
5. **Official sector policies impacting market function:** 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 the FSB's work on structural vulnerabilities takes official sector policies that impact market liquidity – including monetary and macro-prudential policy - into account appropriately.

² See page 7 of the CP, where IMF data is quoted. Our response to FSB CP2 cited McKinsey and PWC analysis, which suggested that non-intermediated investment constituted an even larger majority of all investment in financial assets – see footnote 15 for further detail. Whilst such major discrepancies in the understanding of the ownership of financial assets persist, it is difficult to see how policy making in this area that meets better regulation standards (such as being based on reliable data) can usefully proceed.

6. **Existing regulation** (especially that mitigating risks to financial stability), for example:
- a. *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 has yet to be factored in to the analysis of financial stability and asset management.
 - b. *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).
 - c. *Securities financing transactions (SFT)* – the FSB is already reforming SFT to make securities financing markets more resilient (minimum haircuts, reporting and disclosure obligations). Moreover, banking reform (e.g. leverage ratio, NSFR) will reduce the threat to banking from disruption of SFT markets.
 - d. *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.
 - e. *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 MMFs, FSB and EU/US/other national proposals for MMFs will already address these concerns to a considerable extent.
 - f. *Asset management industry regulation* – existing regulation of our industry already promotes financial stability. Structural vulnerabilities within asset management activities are not new to the regulatory environment. There are already initiatives in place to manage some of the key potential vulnerabilities identified by the FSB, for example liquidity and leverage are dealt with under the EU’s UCITS directive and AIFMD.
 - g. *Cumulative impact of regulatory reform* - 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, work continues on how regulatory reform might adversely impact the liquidity of secondary markets, exacerbating fire sale risks.
7. **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. The CP appears not to take account of other public policy objectives that would otherwise require adjustment of measures taken in pursuit of financial stability.

It follows from this holistic view that we are concerned that the FSB has chosen to exclude a significant part of the ecosystem – pension funds and SWFs – for the time being. We believe that it is not possible to understand fully the nexus between asset management and financial stability without considering the behaviour of the industry’s institutional clients, particularly pension funds. In both Defined Benefit (DB) and Defined Contribution (DC) pension plans strategic asset allocation decisions are most frequently (though not exclusively³) taken by plan fiduciaries and their advisers, the investment consultants, rather than asset managers. Excluding the investment behaviour of these actors from the FSB’s

³ DB pension plan trustees sometimes outsource all investment decisions to a fiduciary manager. Such a service can be provided by a consultant or an investment manager.

current analysis and deferring to a later date therefore ignores a significant driver of investment behaviour.

Furthermore, we note that the FSB's future work intends to focus on DC plans rather than DB on the assumption that the former may exhibit similar characteristics to mutual funds. We think excluding DB plans from the work would be a significant omission.

First, the sheer size of the DB sector alone warrants attention - in the UK corporate DB plans currently hold £1.4 trillion of assets⁴, while funded public sector plans hold another £200 billion+ in assets⁵. Secondly, macro-trends have driven many DB schemes to invest in similar ways – the interaction of mark-to-market accounting of assets and liabilities with scheme funding requirements has driven schemes to shift in large numbers from equities to fixed income⁶. This structural shift in DB asset allocation has almost certainly been a partial contributor to, as well as a result of, low bond yields – the interaction of mark-to-market valuation of liabilities with a desire by corporate sponsors to stabilise deficits has led to a self-reinforcing spiral of falling bond yields further driving up demand for bonds, which in turn pushes down bond yields further, increasing demand for bonds and so on. DB plans frequently review their asset allocation decisions and it is clear that such behaviours have significant implications for the stability of the financial system – yet their dynamics are less to do with asset management activity than with the regulation of DB pension funds and the incentives faced by their corporate sponsors. We therefore strongly urge the FSB to factor in the impact of this important class of investors in its analysis of structural vulnerabilities from asset management.

Turning to DC plans, we think these are less important for questions of financial stability. UK regulation in force since 2012 requires all workplace DC pension plans to offer their participants a default investment strategy and evidence suggests that membership of these default strategies is very high, at between 85-99% of members⁷. This is important since these members tend to be very inert in their investment behaviour, a point which generalises to other DC plan participants. Research by the ICI⁸ in the US found, for example, that over the period 2008-2015, on average each year 11% of DC plan participants changed the asset allocation of their account balances and only 8% of participants changed the asset allocation of new contributions each year. In 2008, one of the most turbulent years on financial markets in recent times, these figures were only 14.4% and 12.4% of plan participants respectively. This evidence suggests that DC plan participants do not shift asset allocations frequently or in concert. Furthermore, unlike mutual funds which can see money redeemed and disinvested at any time, DC pension plan design typically locks savings away until retirement, reducing investors' incentives to act, as they cannot in any case access their money. At best they can shift it between different asset classes within the pensions wrapper. Taking this together we do not agree that DC plans share characteristics of mutual funds.

LIQUIDITY CONCERNS

The CP claims that the potential "mismatch in open-ended funds between liquidity of fund investments and daily redemption of fund units" is a "key structural vulnerability". We believe that there is no evidence that such a "mismatch" threatens financial stability. Our response to FSB CP2 noted the absence of evidence of such threats to financial stability and

⁴ Pension Protection Fund, [PPF 7800 Index, August 2016](#)

⁵ Local Government Pension Scheme, [2015 Annual Report](#)

⁶ According to the UK's Pension Protection Fund, in aggregate corporate DB plans went from an asset allocation of 61.1% equities, 28.3% fixed income in 2006 to 33.0% equities and 47.7% fixed income by 2015. Source, Pension Protection Fund, [Purple Book 2015, chapter 7](#).

⁷ Pensions Policy Institute, *The Future Book: 2015 edition*

⁸ ICI Research Report, *Defined Contribution Plan Participants' Activities, 2015*

observed how open-ended funds have proved resilient to past financial crises.⁹ For example, IOSCO's 17 December 2015 report on liquidity management by funds supports this view, noting how the use of liquidity management tools, whilst affecting the funds concerned, did not appear to have wider adverse systemic impacts.¹⁰

The FSB's analysis fails to take into account all relevant factors, such as the diversity of a fund's investor base, the composition of investible assets within a broad asset class (like fixed income, e.g. by issuer, by maturity, sector-specific vs. multi-sector, index vs. active, etc.), the availability of liquid derivatives as a cheaper alternative to underlying cash markets, the use of ETFs as additional sources of liquidity¹¹, to name only the most pertinent factors¹².

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 – fairly. This tool box also acts to mitigate the potential fire sale risks that concern the FSB.¹³ The joint EFAMA-ICMA April 2016 paper “Managing fund liquidity risk in Europe” sets out in detail how asset managers use such tools – and other means – to manage fund liquidity risk of the sort that concerns the FSB.¹⁴ It also explains how existing EU legislation – in particular the UCITS directive and AIFMD – addresses the same liquidity concerns, which the CP raises.

Indeed, the tools that managers use to manage subscriptions and redemptions, including unexpected surges in these, also manage perceived liquidity “mismatches” through linking sales or purchases of fund assets with the price or value of the units concerned and the timing of redemptions (or subscriptions).

The toolkit

Redemption fees, dilution levies and dilution adjustments, gating, deferred redemptions and notice periods are specifically designed to deal with redemption surges, by enabling the settlement of redemptions fairly as between remaining investors and the redeeming investors. It is important that local law allow the use of these tools for authorised funds. In addition, the FSB, IOSCO and national authorities could assist in minimising obstacles to the use of these tools. First, at present some regulators and supervisors stigmatise the use of these tools. The global standards that emerge from this policy-making should proscribe regulatory or supervisory action that stigmatises the use of these tools. We would be happy to elaborate on this subsequently in our engagement with the FSB and IOSCO.

Practical impediments to the use of these tools should also be tackled. For example, it is costly for transfer agents and platforms to update their systems to cope with these tools and they are reluctant to invest in significant system updates, which they may never or very rarely have to use. As dealing processes become more automated, it is not possible for transfer agents and platforms to use manual processes to apply these tools; their volumes in

⁹ We noted the limited exception of certain MMFs during the global financial crisis.

¹⁰ See [Liquidity Management Tools in Collective Investment Schemes: Results from an IOSCO Committee 5 survey to members](#)

¹¹ Data on high yield ETF trading volumes in the aftermath of the Third Avenue Management Company episode in December 2015 demonstrates that these ETFs experienced significant trading (according to estimates, on 11 December 2015, high-yield bond ETFs traded an estimated USD 6.1 billion on exchanges *vis-à-vis* some USD 9.5 billion in the primary market). ETFs provide greater market liquidity by attracting some trading away from high-yield cash markets, thereby dampening the overall market impact of reactions to certain announcements. For a detailed study of the Third Avenue case, please refer to a Special Report prepared by Blackrock and shared with the U.S. SEC, *High Yield Case Study: Post Closing of the Third Avenue Focused Credit Fund* of January 2016; available at: <https://www.sec.gov/comments/s7-16-15/s71615-86.pdf>

¹² See *Viewpoint* prepared by Blackrock, *Breaking down the data: A Closer Look at Bond Fund AUM*, as published in June 2016; available at: <https://www.blackrock.com/corporate/en-il/literature/whitepaper/viewpoint-breaking-down-the-data-bond-fund-aum-june-2016.pdf>

¹³ 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.

¹⁴ See EFAMA-ICMA “[Managing fund liquidity risk in Europe](#)”

most cases are too large. IOSCO might usefully focus on these operational and other practical issues in the next phase of this policy work.

To combat first mover advantage the timely application of liquidity management tools is very important. If they can be implemented as soon as it is evident that the fund's liquidity is going to be affected by the placement of a significant level of redemptions this should combat first mover advantage. Our Managing Large Redemptions Working Group continues to work with our members, along with their delegates and distributors, to prepare for the use of tools they feel are appropriate for their funds. We would be happy to share the outcomes of this work with policy makers.

It should be noted that the fact that a tool is rarely deployed (e.g. gates) does not mean that the tool is flawed; rather, the use of other tools or liquidity risk management techniques may be sufficient to deal with the situation.

Manager's discretion

We have a wide representation on our Managing Large Redemptions Working Group from large to small asset management houses, transfer agents, platforms and depositaries. This group is of the view that one solution does not fit all. Even for the same types of funds fund managers have different views on what type of liquidity risk management tool would be best for them to use. Managers should employ the tool that is most appropriate for the fund and the unitholders. A fund with a large retail base, which mostly invests direct with the fund manager through their transfer agent, may find that the most appropriate tool may be different to that for a fund investing in similar assets, but with few unitholders each with large holdings in the fund.

Our work has confirmed our view that the fund manager is best placed to manage any liquidity issues, including the decision whether and how to deploy a risk management tool. This has implications for any eventual recommendations concerning tools. First, the use of all tools should be at the discretion of the manager and no mandatory use of tools should be prescribed. Secondly, regulators should not have the power to supplant the manager and mandate the use of a tool. Aside from being less well-placed to manage risk in the fund than its manager, regulators with such a power might be subject to inappropriate pressure to exercise the power.

Other liquidity risk management techniques

Internal governance, such as systems and controls, are key to ensuring good risk management, including management of the risks described in the CP. For example, the asset manager's internal governance should ensure that risk managers can act as a robust counterweight to the portfolio manager and sales staff. The firm's culture is key in this regard. In addition, the fund's controlling body/board of directors should be appropriately involved, e.g. through reporting to boards on fund liquidity/illiquidity.

Day-to-day liquidity risk management techniques, such as liquidity pockets, cash buffers, and meeting redemptions out of subscription cash, also assist the manager to deal with redemption request surges. Managers are assisted in their risk management by an understanding of the propensity of their investors to redeem (and of potential clients to subscribe for units). A retail UCITS fund with a widely dispersed investor base will exhibit different challenges than a fund, where one institution has a large unitholding. The use of platforms, nominee accounts or other market features that prevent the manager knowing the ultimate beneficial owners of the units poses challenges to this aspect of liquidity risk management. Future IOSCO work on the CP recommendations might look to reduce these challenges.

Stress tests

Stress testing by the manager at fund level is part of prudent fund risk management and normal market practice. Indeed, in the EU the AIFMD already requires fund stress tests. However, a robust system-wide stress test would need to take into account the potential

actions of all market participants, both non-intermediated investors¹⁵ as well as all types of managed investment (such as comprehensively regulated investment funds and segregated mandates). It would need to account for the feed-back effects on one participant of the actions of another participant and so on in increasing orders of complexity. However, we doubt that policy makers currently have the information or tools to conduct such a system-wide stress test.

Disclosure to investors

We agree that there should be greater clarity on the circumstances under which fund managers may use extraordinary liquidity risk management tools, so investors understand how and when such tools might be used. It is important that investors understand that these tools are for their own protection. However, we caution against disclosure that misleads investors by overstating the possibility that these tools may be used. This is true also of disclosure of the potential mismatch in open-ended funds between liquidity of fund investments and daily redemption of fund units. The disclosure of such a tail event risk should not overshadow disclosure of the key risk to investors: investment risk.

Furthermore, any disclosure additional to what national and regional laws already require should be designed to inform investors and not to be satisfied as a compliance, or "tick box", exercise.

Finally, it should go without saying that disclosure concerning liquidity risk to investors will differ substantially from reporting to authorities, with the latter likely to be much more detailed and quantitative.

UK commercial real estate (CRE) funds

In the aftermath of the UK referendum on whether to leave the EU several open-ended CRE funds suspended redemptions by investors. Although it is too early to draw firm conclusions, at this stage we note:

- The use of suspension mechanisms functioned effectively as intended, protecting the interests of investors and preventing widespread distressed selling. Already most suspended funds have "re-opened" for redemptions, as the suspension has fulfilled the prudent risk management objectives of the managers concerned
- This forestalled any major impact on the UK CRE market, let alone other property markets or financial markets; no threat to financial stability has materialised
- There is no evidence that investors in suspended CRE funds redeemed investments in other funds as a consequence, certainly not in an amount that propagated the unusual surge in redemptions beyond the UK CRE asset class: there was no contagion, even within the managed fund sector, let alone to other financial markets or other participants in financial markets.

We propose to commission an independent study of the UK CRE fund case, whose findings we propose to share with policy makers.

ETFs

We do not believe that there is need for additional Recommendations tailored to ETFs. Nearly all ETFs offered and traded in Europe are authorised as UCITS, conforming to the UCITS directive's own prescriptive liquidity risk management requirements, as well as to the more recent ESMA 2012 *Guidelines on ETFs and other UCITS issues* (as revised in 2014). These ESMA *Guidelines* permit ETF

¹⁵ Asset owners that invest directly account for the bulk of most securities markets: 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). We note that the CP estimated that in 2014 60 per cent of global financial system assets are not managed by intermediaries (see page 4).

investors to redeem directly from the ETF fund provider under certain circumstances¹⁶ (instead of from the authorised participant (or “AP”) only, as is ordinarily the case). Such circumstances would be extremely rare, as typically ETF providers may count on multiple APs to continue to provide liquidity. In the event of there being only one AP, investors who have acquired their units or shares on the secondary market would, under ESMA’s rules, be allowed to sell them directly back to the UCITS ETF (rather than to the AP in its market-making role).

LEVERAGE

The IA supports the FSB’s three recommendations on leverage.

Definition of Leverage

There is currently no consistent definition of leverage globally. For example, mutual funds in Europe, Asia, and the US utilise different regulatory approaches to defining, measuring and/or limiting leverage in collective investment vehicles. Even the definitions and the rules on the uses of derivatives differ, sometimes within one regulatory framework. As the FSB is no doubt aware, in accordance with the UCITS directive or the AIFMD EU funds use the commitment approach, a Value at Risk (VaR) based approach and/or the “gross notional exposure” (GNE) to leverage, depending on fund profile. Note that there are differences in the calculation for the commitment approach for UCITS and AIFMD, which would result in different figures for UCITS commitment leverage and AIFMD commitment leverage for the same fund.

Our members believe that managers must be able to choose the most appropriate measure of leverage for their funds. This means that “consistent” must not be conflated with a single measure of leverage. Rather, measures of leverage that accurately calculate the true economic exposure of the fund as a proportion of the value of the fund must be the basis both of a manager’s management of leverage in its fund and the data used by authorities concerning leverage. The appropriate measure of leverage will depend on such factors as: the nature of the exposure (actual, through the obtaining of credit, or synthetic, through derivative exposure of the fund) and the extent of any off-set, such as collateralisation or margin.

Moreover, “gross” levels of leverage do not give a true indication of risk exposure in respect of derivatives. These merely add up the absolute notional exposure of each derivative, and do not indicate how these interact with exposures from other derivatives or assets in the fund. By way of example, if a fund has a dollar asset worth \$100,000, and purchases a \$100,000 Forward FX contract at GBP/USD 1.30, the forward FX will have a notional value of £77,000, however the risk exposure of the FFX would be nil, as it would merely be hedging the currency value of the USD asset – at the end of the contract period, the forward FX will merely be used to adjust the value of the USD asset in sterling terms.

Gross leverage measures can only have a limited application for macro-supervisory purposes (gross will tell you how much derivatives are being used in the financial system), because they do not give a true measure of risk. The Commitment approach, which allows hedging and netting positions to be removed from the notional exposure, gives a more accurate measure of risk. In particular giving gross leverage disclosures to investors can be misleading, as they may be led to believe that derivatives use in funds is leading to gearing effects, where this is not the case.

We encourage the FSB and other policy makers to engage actively with the asset management industry to establish clear definitions and rules that can be applied to different types of funds and strategies.

¹⁶ For example, where the stock exchange value of the units or shares of the UCITS ETF significantly varies from its net asset value (NAV) and where an AP is no longer able or willing to act as a market maker.

Leverage Data

We agree with the FSB that the lack of consistent and accessible data on leverage acts as a barrier to assessing whether funds' use of leverage could contribute to global financial stability risks. The proliferation of templates, formats and definitions, as well as issues associated with data confidentiality and data sharing, reduces the ability of regulators to share data on a cross-border basis and limits their ability to compare information and discern global trends regarding the build-up or concentration of risk. The current process leads to duplication and inconsistency in reporting by firms, as well as operational complexity, with many processes requiring manual intervention.

We support the FSB's Recommendation 12 that IOSCO collect aggregated data on leverage across its member jurisdictions based on simple and consistent measures. Whether monitoring for potential systemic risk or testing compliance for investor protection, consistent data is essential. Different jurisdictions request similar data (i.e., position sizes, counterparties, etc.), but require reporting of such data in different forms. Harmonising data reporting with agreement on definitions, data elements, and reporting formats and methods would address this problem.

We agree with the FSB's call for improved systems for aggregating and analysing information provided to regulators. We recommend consolidating regional reporting hubs to help achieve global harmonisation of fund data collection, with appropriate cyber security safeguards and adequate protection of client data. For example, within the EU, there is much work to be done on coordination of a common European standard and the development of a central European data reporting hub. This could work not only for AIFMD but also for the reporting of key data on liquidity and leverage in UCITS.¹⁷

Disclosure

Our members support disclosure to investors in all funds on the use of leverage and derivatives. Investors should be informed on the investment strategies in place or potentially in place, the types of financial instruments being used to implement these strategies and the risks associated with the strategies and/or the financial instruments.

OPERATIONAL RISK

The CP raises concerns about transferring investment mandates or client accounts. We see these concerns as theoretical and the CP presents no evidence that structural vulnerabilities exist or have threatened financial stability. In fact, investment mandates are transferred regularly, in stressed market conditions (such as during 2007-2009) and in more normal market conditions. The closure of mutual funds is not an unusual occurrence – according to ICI, 462 US mutual funds were liquidated or merged into other funds during 2015. Likewise, hedge funds are launched and closed on a regular basis. According to hedge fund research, 291 hedge funds closed during the second quarter of 2016 alone, down from 305 closures the previous quarter.

We do not believe that the default of an asset manager in itself could be systemic (the recent events at PIMCO – which have proven not to threaten financial stability – seem as challenging as anything that might happen to a manager short of failure). Failure of the manager neither:

¹⁷ We observe in passing that the EU's scheduled review of the AIFMD in 2017 is an opportunity to improve leverage reporting for AIFs.

- 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.).¹⁸

Segregated account assets are on the balance sheet of the client and are held at a custodian selected by the client. In the event of an issue with a manager, the client can take the assets in-house or they can select a new external manager. Often, the client engages a “transition manager” to manage the transition from the former manager to the new manager, which further reduces the scope for operational difficulties. These transitions do not require the sale of portfolio assets. In the EU the investor or client’s assets are either required to be legally isolated from the manager and held with a third party depositary¹⁹, so that the assets are “bankruptcy-remote” from the manager, or, in the case of assets managed under a segregated mandate, the market practice is for the assets to be legally isolated from the manager and held with a third party custodian. In these circumstances, transfer of the investment mandate or client accounts then amounts to notifying the depositary or custodian that the former manager has been replaced by the new manager, which, in practice, may amount to no more than an electronic account entry.²⁰

The CP also alleges that an asset manager’s difficulties might threaten financial stability, if it provides “critical services to other financial institutions.” There are hundreds of different vendors to asset managers offering a range of data, systems, and services. All asset managers, including both external and in-house managers, use some third party services. In addition to third party vendors, there are a variety of financial market infrastructures that all market participants rely on, including exchanges, central clearing counterparties, electronic trading and affirmation platforms, and trade messaging systems such as SWIFT. These financial market infrastructures are the real systemic nodes of financial markets.

Asset management is a highly competitive, diverse business: there is no substitutability issue. Moreover, there is no evidence that any manager provides a “critical service” in the sense used in the CP.²¹ We endorse BlackRock’s comments made concerning its “Aladdin” service in its response to this CP.

Whilst there is no evidence that an asset manager provides a service so critical, that difficulties at the asset manager might threaten financial stability, policy makers, including the FSB, have correctly identified financial market infrastructures, such as CCPs, as systemic and initiated policy making to address their real risks to financial stability. We support this policy making.

In equating the size or complexity of an asset manager with the threat to financial stability (e.g. recommendation 13), the CP follows the NBNI G-SIFI approach, which we reject as fundamentally misconceived, at least insofar as asset managers are concerned.

Recommendation 13 proposes “comprehensive and robust risk management frameworks and practices”. We suggest recommendation 13 call for risk management that is appropriate to the business concerned and fit for the purpose of managing operational risk and facilitating transfers of investment mandate and client accounts. Furthermore, IOSCO should

¹⁸ 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.

¹⁹ UCITS Article 22 and AIFMD Article 21.

²⁰ Of course, the possibility remains to return the assets *in specie* to the investor or client, at least for segregated mandates from professional or institutional investors.

²¹ We imagine that policy makers have in mind the banking situation, where certain banks may provide “critical services” in the sense that the failure of the bank concerned would threaten the availability of that service, which itself would destabilise the financial system. There is no evidence that asset managers provide services that are critical in a similar way. Indeed, the nature of asset management makes it counterintuitive to posit the existence of such criticality in what asset managers do.

complete the policy making in respect of this policy recommendation given its mandate and understanding of asset management firms' BCP arrangements.

The CP suggests operational difficulties with derivative positions when client accounts are transferred from one asset manager to another. The use of central clearing as a result of OTC derivatives reforms has contributed to more seamless transitions of derivatives positions.

Exchange traded derivatives are held at CCPs in client designated accounts, which can be transferred easily and quickly from the control of one manager to another. This is particularly true when the same clearing member is used by both the new and existing asset manager. Transitioning OTC derivatives contracts presents more operational challenges; such transitions can be managed, though they may take longer to accomplish. The terms of OTC contracts may be negotiated by the asset manager on behalf of a number of clients. Thus, transitioning these contracts may be more expeditiously accomplished by unwinding contracts rather than amending agreements to reflect contract terms available to the new asset manager. The positions are then re-established under new arrangements. Continued focus on standardisation of contract terms will help ease the process of transferring derivatives positions from the trading control of one manager to another.

SECURITIES LENDING

The CP suggests that securities lending could be a source of potential structural vulnerabilities. In particular, the FSB is concerned with financial stability risks arising from securities lending *per se* and with risk associated with agent lender indemnification. The CP rightly acknowledges that there has already been significant regulatory reform to address financial stability risks arising from securities lending *per se*, notably in the FSB's own standards concerning securities financing transactions, which has addressed identified risks to financial stability, with the exception of agent lender indemnities, and in the EU Securities Financing Transactions Regulation (SFTR). In this regard, we note that market practice is not to permit collateral re-use by the asset manager agent lender, which prevents the creation of "collateral chains" through re-hypothecation.

For over two decades lending agents (custodial banks, asset managers, and private securities lending companies²²) have provided certain clients indemnification against "borrower default." The potential liability under the arrangements is limited to the event that the borrower fails to return the securities that have been lent AND the collateral amount pledged is insufficient to cover the cost of replacing the securities.

Market practice requires daily marking-to-market of collateral and over-collateralisation of the value of the securities lent. This over-collateralisation provides a "safety cushion" in the event a borrower fails to return the security that is out on loan. It also diminishes the contingent liability associated with the indemnity.²³ Consequently, securities lending indemnities are very rarely exercised and nothing in the past history of their exercise suggests that exercise of such indemnities could threaten financial stability.²⁴

The consultation suggests that there is an "unfair" discrepancy between regulation of banks as lending agents versus asset managers, which may create regulatory arbitrage. This reasoning ignores key differences between banks and asset managers as lending agents:

²² Note that these agent lenders have different securities lending business models, so that an indemnity from a custody bank and an indemnity from an asset manager may not result in the same – or any - risk to the asset manager.

²³ Accounting standards generally require disclosure in the financial statements of the agent lender's contingent liability related to its securities lending indemnification.

²⁴ We draw your attention to ICI's and to BlackRock's responses to this CP for further information on this point.

- asset managers do not rely on wholesale funding nor do they rely on publicly insured deposits to support their liquidity, and
- asset managers do not have the same access to central bank balance sheets, i.e. the discount window.

There is no indication that clients of agent lenders consider regulatory capital requirements related to indemnification when selecting a lending agent. The provision of indemnification is only one component of decision to select a lending agent. We understand that current market practice is that, even in the case where clients require indemnification, they do not normally ask for information about regulatory capital requirements associated with indemnification liabilities. Instead, clients focus on the creditworthiness / credit risk of the lending agent. This necessarily entails a consideration of the availability of assets to cover contingent liabilities.

Creditworthiness may be enhanced by greater available assets to cover liabilities. This incentivises prudent capital management for competitive purposes, regardless of regulation.

ETFs

Annex 3 discusses “liquidity transformation” of ETFs, including an eventuality without historical precedent – an “extremely stressed market environment where no AP [authorised participant] is left functioning.” We note that ESMA has issued guidelines that address direct redemptions by investors in the absence of any AP, which we discuss in further detail in the “Liquidity” section of this response.²⁵

Ireland has implemented the ESMA guidelines by providing for the Manager to buy back shares from non-AP investors where the Manager determines in its sole discretion that the NAV differs significantly from the value of a share traded on exchange, e.g. where no AP is acting or willing to act as AP for an ETF. We suggest that this should guide any eventual IOSCO standards on this area.

²⁵ See https://www.esma.europa.eu/sites/default/files/library/2015/11/esma-2014-0011-01-00_en_0.pdf