## EFAMA Response to the 2nd FSB / IOSCO Consultative Document
## Assessment Methodologies for Identifying NBNI G-SIFIs
## Proposed High-Level Framework and Specific Methodologies

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## Preliminary comments

EFAMA and its Members appreciate the opportunity to comment on the second FSB/IOSCO consultative document in the context of the current global debate around the alleged "systemic" nature of the asset management industry. EFAMA is the representative association for the European investment management industry. We represent through our 26 national association members, 63 corporate members and 25 associate members about EUR 17 trillion in assets under management, of which EUR 11.3 trillion managed by 55,600 investment funds at end-December 2014. Over 36,100 of these funds are UCITS (Undertakings for Collective Investments in Transferable Securities) funds, as regulated under the relevant EU UCITS directive of 2009[1].

Before addressing the relevant questions, we note with regret that few of the objective arguments presented by our industry in response to the first consultative document of January 2014 have been appropriately reflected in this second consultation. Instead, this second consultative document still shares many of the same ambiguities and misconceptions of the first. As a result, it is our view that the debate within the FSB/IOSCO – and specifically within WS3 continues to disregard key facts and appears – quite worryingly – purely "result oriented" for the purpose of meeting a general G20 mandate. As such, we would note that this mandate – worded only very broadly in G20 summit *communiqués* since 2009 - does not expressly bind the FSB/IOSCO to identify and designate asset management entities among other global systemically relevant financial institutions, leaving room for interpretation as to whether an entities-based approach continues to appear sensible and justifiable in light of our industry's responses to the previous, as well as to the present, consultative document.

[1] Please refer to Directive 2009/65/EC of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities.

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Moreover, we note that the growing attention around the presumed systemic nature of asset management entities is being increasingly led by multilateral institutions (e.g. the IMF[2] or the BIS[3]) and prudential, central bank regulators (e.g. the Bank of England[4], the ECB, or the U.S. Federal Reserve), whose mandate is not to directly supervise non-bank, non-insurance (NBNI) entities like asset managers or their funds. Although we recognise the important role of these institutions in monitoring the build-up of system-wide risks across financial markets beyond the remit of credit institutions, we caution that their analysis and consequent recommendations may not always be accurate, or reflect sufficient knowledge of the asset management industry and its extensive regulation[5]. We understand this is in part also due to the fact that these institutions do not directly collect the often sensitive, supervisory data that is reported to securities regulators, although would observe that it is only on the basis of such evidence that many of the theoretical assumptions around the systemic nature of funds and their asset managers would need to be tested. Specifically, EFAMA does not support the persisting "bank-centric" views in the document around "distressed" markets and contagion channels, around investor behaviour (despite the repeated explanations illustrating the fundamental differences with bank customers), and around fund and asset management company liquidations.

In addition, we note that new institutions, which have been created to identify and monitor the build-up of systemic risk (e.g. the FSOC in the U.S. and the ESRB in Europe), have drawn conclusions sometimes at odds with views of national securities regulators[6], failing to adequately consider:

(i) The true "agency" nature of the asset management industry and its time-tested tools to protect the interests of its clients - particularly those methods intended to manage liquidity risk for open-end funds (e.g. active cash provisioning, stress-testing, "swing-pricing", etc.) - as well as to limit exposures to counterparty and broader market risks;

(ii) A considerable body of detailed rules and regulations designed specifically for asset management entities, established both before and refined post-2008, and aimed expressly at preventing the build-up of systemic risks[7], as well as to protect and enhance investor confidence; and

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[2] In this regard, please refer to the IMF's recently published chapter "The Asset Management Industry and Financial Stability" in the IMF's own *Global Financial Stability Report: Navigating Monetary Policy Challenges and Managing Risks*, published in April 2015 and available at: http://www.imf.org/External/Pubs/FT/GFSR/2015/01/index.htm

[3] See J. Caruana, "Financial Reform and the Role of Regulators: Evolving Markets, Evolving Risks, Evolving Regulation," speech at GARP 16th Annual Risk Management Conference on 24 February 2015; available at http://www.bis.org/speeches/sp150225.htm.

[4] See A. Haldane, "The age of asset management", speech at the London Business School on 4 April 2014; available at: http://www.bankofengland.co.uk/publications/Pages/speeches/2014/723.aspx

[5] As an example, please refer to S. Collins and C. Plantier, "The IMF Is Entitled to Its Opinion, But Not to Its Own Facts" in *ICI Viewpoint* (10 April 2015); available at: http://www.ici.org/viewpoints/view_15_imf_gfsr. Another reference from the two authors is "The IMF Makes All of OFR's Mistakes—And More" in *ICI Viewpoint* (10 October 2014); available at: http://www.ici.org/viewpoints/view_14_imf_report

[6] As an example, please refer to the letter from U.S. SEC Commissioner Daniel M. Gallagher around the conclusions of the U.S. FSOC OFR Study on Asset Management Issues, dated 15 May 2014; available at: https://www.sec.gov/comments/am-1/am1-52.pdf

[7] Relevant for the prevention of systemic risk, please consider the continuous references thereto under numerous article of the EU Directive 2011/61/EU of 8 June 2011 on Alternative Investment Fund Managers Directive (AIFMD), in particular Article 3(3) letter d): "Member States shall ensure that AIFMs referred to in paragraph 2 at least: (…) regularly provide the competent authorities of their home Member State with information on the main instruments in which they are trading and on the principal exposures and most

(iii) The extensive regulation ushering structural changes to the banking industry (e.g. Basel III capital requirements and treatment of banks' "large exposures") post-2008, as well as through the creation of new market infrastructures like central counterparties – or CCPs – responsible for the centralised clearing of entire classes of OTC derivatives, particularly when illustrating contagion channels.

As a result of these profound changes, a new operational and securities trading environment has *de facto* emerged, one where leverage has been significantly reduced by scaling back banks' balance sheets and limiting large exposures through exacting capital charges, where counterparty risk is channelled to well-capitalised CCPs, in turn required to adopt several risk-mitigating techniques, and where the creation of trade repositories is intended to provide market regulators greater information as to the build-up of risks in derivative markets compared to what was beforehand available.

As more data becomes available to securities regulators under many of the recently introduced rules set to enhance reporting requirements – for funds/asset managers, as well as for other entities – a more balanced, objective and informed assessment will be able to take place. In this regard, EFAMA would call for the ongoing IOSCO/FSB NBNI G-SIFI identification and designation process to momentarily "pause" until better evidence can be gathered and studied for the purpose of forming a more comprehensive view of the current market ecosystem, able to crystallise specific risks, and ultimately, draw evidence-based conclusions. In fact, a *conditio sine qua non* for the envisaged methodology and yearly designation process to work is that, looking forward, market regulators also be endowed with sufficient means and resources to not only effectively overcome existing "data gaps", but to understand and elaborate data, and subsequently, draw meaningful conclusions as to whether a NBNI entity truly deserves to be designated as "systemic"[8].

As a corollary to more robust data, we also see a better potential to address some of the parallel concerns that have emerged more recently in the IMF's *Global Financial Stability Report* of 2015, particularly with regard to large fund flows into and out of emerging market countries that, under certain conditions, may give rise to contagion effects with adverse impacts on the receiving economies. Although we value attempts made by the referenced academic literature in analysing the role of funds played in the transmission of shocks through the sudden reversal of flows from emerging markets, we contend that such dynamics are more the outcome of unsustainable monetary policies, macro-economic imbalances and balance-of-payment conditions, rather than of underlying changes in market sentiment determining the flows[9]. In this regard, the considerable literature around the causes of

important concentrations of the AIFs that they manage in order to enable the competent authorities to monitor systemic risk effectively; (…)"

[8] In this last regard, we greatly welcome the U.S. FSOC's announced changes of February 2015 to its designation process, permitting greater engagement with parties concerned by a potential "SIFI" designation, as well as the parties' primary market regulator, and thereby making a systemic designation based merely on conjectures less likely.

[9] Most scholars would agree that at the root of the emerging market crises of the late 1990s lay currency crises that were sparked by the collapse of various types of fixed or semi-fixed exchange rate pegs. Contingent events like these were typically preceded by the build-up of large economic imbalances in the form of current account and/or large fiscal deficits leading to the accumulation of public and foreign liabilities - largely denominated in a foreign currency – that needed to be continuously financed. Adding to the stock of problems, the relevant literature has also pointed to growing doubts – particularly in the foreign investment community - about policy-

emerging market financial crises – e.g. the Mexican one of 1994, the East Asian ones of 1997, the Russian one of 1998 and the Argentine one of 2001 - bear testimony precisely to the above considerations. We understand, however, that the focus of this second FSB/IOSCO consultative document is to address "systemic risk" more broadly from a financial market perspective, compared to the emerging market country-focussed appreciation of the IMF analysis, and will hence refrain from elaborating further.

In addition to these opening remarks, EFAMA wishes to make the following important considerations around the FSB/IOSCO intended approach and assessment process:

- The logic and intended purpose of the FSB/IOSCO exercise is flawed by the fact that the "incremental policy measures" intended to accompany the actual designation of a NBNI entity remain to this date unknown. Although we are conscious of the FSB's recovery and resolution requirements under its 2011 *Key Attributes of Effective Resolution Regimes for Financial Institutions* (as revised in October 2014), we are wary of any intended measures "incremental" to those already in place for asset management entities, and in particular, the very comprehensive regime foreseen under the AIFM directive in Europe, as only one example[10]. In this regard, we renew our suggestion that WS3 duly consider the extent to which existing legal requirements already address many of the alleged risks described in both FSB/IOSCO consultative documents. The eventual designation through the IOG of an entity, as described in the opening sections of the consultative document, should not be a "done deal" and occur only once clear risks have been convincingly identified and existing requirements proven as insufficient;

- EFAMA and all of its Members strongly disagree with the scope of the assessment in that it is intended to measure the mere *impact* of an entity's failure on the global financial system, rather than the *probability* of such a failure occurring, which in our view would be more logical and sensible as the latter approach would to a certain extent at least be quantifiable. The current FSB/IOSCO approach is flawed in that it pretends to draw policy conclusions, possibly accompanied by very "material" policy measures for future designated firms, based entirely on conjectures that are forward-looking and hence unsubstantiated by evidence;

- Regarding the broad notion of "systemic risk" as defined by the FSB in numerous publications - i.e. "the risk of disruption to financial services that is (i) caused by an impairment of all or parts of the financial system and (ii) has the potential to have serious negative consequences for the real economy" – we observe that throughout the narrative of the consultative document, this notion is wrongly conflated with ordinary "market risk" or confused with "volatility". Far from being indicators of systemic risk, the latter are in fact inalienable features of modern-day financial

makers' ability to service growing debt burdens by generating large enough primary surpluses, as well as to significant microeconomic distortions in the form of poor banking regulations or explicit government guarantees that encouraged excessive borrowing (especially in foreign currency, thus tying debt repayment to the fortunes of the chosen currency peg). For an accurate analysis of the underlying causes and history behind recent emerging market crises, please consider the work of N. Roubini and B. Setser *Bailout or Bail-ins? Responding to Financial Crises in Emerging Economies* (2004).

[10] Please refer to Directive 2011/61/EU of 8 June 2011 on Alternative Investment Fund Managers, in particular Article 24 thereof, the relevant clauses of the implementing Regulation (EU) No 231/2013 of 19 December 2012, as well as the extensive reporting template as finalised by ESMA in November 2013.

markets and the outcome of choices based on a risk/reward analysis performed by millions of investors, which is in turn reflected in asset prices that adjust based on fundamental demand/supply dynamics;

- Although we understand the political relevance of the G20 mandate bestowed upon the FSB/IOSCO to identify NBNI G-SIFI entities and welcome the opportunity in this (as in the previous) consultation to explain the nature of the asset management business, we are deeply concerned by the fact that the work of WS3 appears necessarily to lead to the designation of a handful of asset management entities, primarily to ensure "consistency" with the FSB's existing frameworks for banks (G-SIBs) and insurance companies (G-SIIs). Such an approach furthermore does no justice to the fact that certain activities or "critical functions", against which only asset management companies would allegedly be assessed under the proposed methodology, are carried out by other financial market players at large (including "sell-side" firms and asset owners that manage their assets in-house). In this regard, we suggest WS3 turn to its earlier *Policy Framework for Strengthening Oversight and Regulation of Shadow Banking Entities* of August 2013, reflecting a more holistic and sensible approach to the identification and estimation of financial market risks arising out of five key economic "functions" or activities, instead of focussing on individual entities. The latter approach would in our view simply "shift" financial risk away from the designated entities and end-up concentrating it with new categories of entities elsewhere[11]. We therefore encourage the Members of WS3 to consider what specific risks – if any – would arise from the presence of funds and their asset managers as actors in today's financial markets, as opposed to a situation where these actors did not exist. In other words, what additional risks does the service of professional portfolio management pose to the financial system, and would these risks be more contained in a hypothetical circumstance where all investors (from households, to corporates, to pension funds, etc.) managed their investments directly? We believe the reply to such question should guide the FSB/IOSCO assessment going forward in better isolating if – and if, how – asset managers and their funds contribute to systemic risk[12];

- Finally, EFAMA is not alone in expressing its deep apprehension over the sequencing of the FSB/IOSCO designation process with the concomitant "SIFI" designation process led by the U.S. FSOC in line with Section 113 of the Dodd-Frank Act in the U.S. Considering the significant overlap between the present FSB/IOSCO consultation process and the FSOC's *Notice Seeking Comment on Asset Management Products and Activities* that closed on 25 March 2015, we call on those key decision-makers involved to coordinate both processes going forward. Lingering uncertainty as to the identity of designated firms and corresponding requirements – with the chance that in the U.S. designated firms will in theory no longer be supervised by their primary securities regulator (U.S. SEC) and receive "bank-like" capital treatment under the authority of the U.S. Federal Reserve –

[11] In recent exchanges with WS3 representatives, EFAMA certainly welcomes the creation of a parallel working group whose intent, we understand, would be to focus precisely on such "market-wide" risks that correctly transcend the activities of individual entities as in the present FSB/IOSCO analysis.

[12] We invite WS3 Members to also refer to the following pertinent opening summary of the aforementioned chapter from the IMF *Global Financial Stability Report* of April 2015 (page 93): "However, the analysis shows that larger funds and funds managed by larger asset management companies do not necessarily contribute more to systemic risk: the investment focus appears to be relatively more important for their contribution to systemic risk."

has the potential to only lessen regulators' credibility in the eyes of our industry. As explained above, the fact that WS3 has until this point in time been unable to suggest – even broadly – what types of incremental measures are being contemplated and in the uncertainty as to whether decisions affecting the allocation of a G-SIFI fund/asset manager's client assets may in the future fall under the authority of central bank supervisors, makes a constructive reply to this second consultative document genuinely challenging. Were the latter scenario to materialise, not solely would the global asset management industry (and direct supervision over it) risk being split into two, i.e. systemically designated firms supervised by central banks vs. non-designated firms supervised by their primary regulator, but also imply the near certainty of considerable competitive harm to designated firms once their client base – keen to preserve its freedom to control its assets - would choose to redirect them to non-designated and market-supervised entities.

In light of the above remarks, EFAMA and its Members call on WS3, as well as the higher ranking decision-making bodies within the FSB and IOSCO, to consider our industry's replies to this second consultative document carefully, acknowledging the limits of their analysis this far and the far-reaching, material implications of their work going forward. We would invite these bodies to amend their current approach and review their timelines accordingly, knowing that a more balanced and better calibrated assessment is possible on the back of better data awaited under the recently enhanced and industry-wide reporting requirements.

## High-level framework for identifying NBNI G-SIFIs

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

As emphasised above, in line with our suggested holistic approach when attempting to assess systemic risk by looking at the broader financial market and not solely at asset management entities, EFAMA believes that entities such as public financial institutions, sovereign wealth funds and pension funds should be taken into consideration for the reason that these institutions do make investment decisions and are often the driving forces behind the actions of individual asset managers. The above institutions are asset owners in their own right, managing according to some recent studies between 60% (IMF) to 75% (McKinsey & Company) of global financial assets[13]. For this reason, considerations around the systemic stability of financial markets should not discount the important role of the above direct asset owners, especially in light of their considerably large and strategic asset re-allocations.

Also, a categorical exclusion of the three types of entities mentioned above – in the absence of proper reasoning – would appear arbitrary in light of the fact that the FSB/IOSCO draft methodology continues to consider “size” – expressed in terms of AuM - as the main indicator of systemic vulnerability. With sovereign wealth funds and public pension funds each typically managing hundreds of billions worth of assets directly - amounts which are considerably greater than the AuM of even the largest fund managed on an agency basis – we do not believe the proposed approach to exclude them sits well with identifying systemically important entities.

**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.**

Please refer to our reply above.

**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.**

As suggested in our reply to Question 2-1 above, a holistic assessment of system-wide financial risks should not exclude individual entities as a matter of principle. Considering the asset management industry, EFAMA supports the proposition that all concerned actors – whether direct asset owners or agents managing their clients’ funds – be at least preliminarily considered for the purpose of identifying relevant systemic risks before the elaboration and refinement of the designation metrics, as presented

[13] Please refer to the cited IMF *Global Financial Stability Report* of 2015 and the relevant report by McKinsey & Company “Strong Performance but Health Still Fragile: Global Asset Management in 2013. Will the Goose Keep Laying Golden Eggs?” Please note that the percent of externally managed assets is lower than the IMF’s calculation since this calculation includes loans in total global financial assets.

in the FSB/IOSCO draft methodology[14]. Once such risks have been identified, only then should regulators take stock as to whether existing safeguards – whether of a legal or of an operational nature – adequately address and contain the identified risks, or in other terms, more appropriately estimate the *probability* that such safeguards may not prove sufficient.

On the back of these legal and operational safeguards, as inscribed in binding EU legislation and implemented across a union of 28 Member States, EFAMA, in view of its membership, would advocate that UCITS fund structures and low-leverage "alternative investment funds" or AIFs (i.e. with a leverage factor of less than three-times their NAV), as identified and strictly disciplined under the relevant pair of UCITS and AIFM directives respectively, be excluded from the definition of NBNI G-SIFIs as presently envisaged by the draft methodology. On the basis of their very similar statutory requirements and applicable regulatory regime as highlighted across a number of industry (including our Members') replies to the recent FSOC *Notice* in the U.S., we would also exclude mutual funds registered under the U.S. Investment Company Act of 1940 ('40 Act mutual funds) from further consideration.

## Investment Funds

Before responding to the relevant questions, EFAMA acknowledges that the simplified categorisation in the consultative document between "traditional" and "private" funds does not exist in an EU legal context and thus will lend itself to broad interpretations by European national supervisors during the eventual further assessment phase. Nevertheless, for the purpose of the FSB/IOSCO current policy exercise, we would not oppose such broad categorisation, provided the following considerations be borne in mind:

(i) Regarding the notion of "traditional" funds as used throughout the consultative document, we understand this notion to fairly coincide with European UCITS collective investment schemes, as regulated under the relevant EU UCITS directive and characterising the bulk of the retail offer in Europe and some 70% of total AuM managed out of Europe. Even if of second-order importance, we wish to add that the focus of any assessment methodology should apply at the level of a single fund, or - for the common "umbrella" UCITS fund structures in Europe – at the level of the individual sub-fund. Given their well-regulated and highly conservative product design, UCITS funds may be easily likened to U.S. mutual funds covered by the Investment Company Act of 1940 (i.e. '40 Act mutual funds); and

(ii) Conscious of the notion borrowed from the U.S. regulatory regime under the 2010 Dodd-Franck Act, a "private" fund may not entirely overlap with the existing EU legal categorisation. We wish to note in this regard that such notion in Europe would generally comprise both open- and closed-end, including hedge funds, private equity vehicles, real estate funds, funds of funds, commodity funds, infrastructure funds, institutional index funds, LDI pension funds and others, depending also on the classification applied in specific EU jurisdictions. Grouped

[14] We note that the IMF has also adopted an analogous approach in the introduction of its relevant chapter of its April 2015 *Global Financial Stability Report*.

together, these vehicles may be broadly classified as AIFs under the AIFM directive, with some among them also being offered to retail investors and bearing features akin to UCITS funds.

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

The exposures/counterparty channel

Of the three propagation channels defined in the consultative document, we deem the summary description of the counterparty risk channel to better reflect – albeit simplistically – the potential effects of a fund's liquidation on one or more counterparties. The notorious failure of Long Term Capital Management's flagship fund in 1998 remains perhaps the clearest example of how large amounts of synthetic leverage were amassed concomitantly with poor risk management on behalf of a circle of creditor institutions acting as the fund's prime brokers[15]. In the aftermath of the more recent global financial crisis, it is of fundamental importance that global regulators and standard setters systematically reappraise counterparty risk in light of the far-reaching financial reforms that have taken place and are being implemented across the world's more developed financial markets. More specifically, EFAMA wishes to stress the mandatory move of a significant part of OTC derivatives trading onto central clearing platforms, the additional capital charges imposed on bank institutions as funds' traditional counterparties under the Basel Committee's supervisory framework for measuring and controlling "large exposures" of April 2014[16], but ultimately also the extensive regulatory frameworks that already apply and are specific to asset management entities. Although we definitely welcome the references to these frameworks in section 6.2.1 of the consultative document, what has not been adequately captured in its narrative is a deeper appreciation of these frameworks as to their intended effects. For instance, it must be clarified that in Europe, as elsewhere, it is not only traditional funds that are subject to regulatory limitations and reporting requirements as to their use of leverage, but private funds as well to the extent that some of these fall within the scope of the EU AIFM directive covering – apart from hedge funds and private equity funds - also real estate funds, funds of funds, commodity funds, infrastructure funds, institutional index funds, LDI pension funds and others also depending on one specific EU jurisdiction.

With respect to the hypothetical risk of a fund's synthetic leverage levels growing un-checked – as the FSB/IOSCO suggest in the closing paragraph of section 6.2.1 - through the use of non-centrally-cleared OTC contracts, we contend that such risks will gradually subside, as more types of OTC contracts - via which synthetic leverage is typically obtained - will be cleared through CCPs in line with requirements

[15] For a detailed account of the trading strategies and events that led to the ultimate liquidation of Long-Term Capital Management L.P. (LTCM) and its flagship fund Long-Term Capital Portfolio L.P., please refer to the business case study Long-Term Capital Management L.P. (Parts A to C) prepared by Prof. André F. Perold at the Harvard Business School (1999).

[16] Such framework has been transposed into a binding EU act - Regulation (EU) No. 575/2013 on prudential requirements for credit institutions and investment firms (CRR) - calling on the European Banking Authority (EBA) to issue further guidelines on setting limits on institutions' exposures to non-bank entities.

under the EU EMIR regime[17]. What is more important, however, is that with the extensive reporting requirements foreseen in the EU context under the relevant AIFM directive, there is hardly any scope for leverage levels to grow un-checked beyond the allowed limits (i.e. for AIFs, such limit would correspond to 300% of the fund's NAV and beyond which a fund is considered to be leveraged on a "substantial basis", triggering the enhanced reporting regime on which we elaborate in our answers further below – see footnote 36).

<u>The asset liquidation/market channel</u>

Considering the asset liquidation/market channel, we recognise the value of WS3 only looking at those open-end vehicles offering liquidity on demand features. Unfortunately, however, the consultative document erroneously still discounts the importance and availability of liquidity management tools as defined and described at length in our and in our Members' respective replies to the first FSB/IOSCO consultation of January 2014. A passage from section 6.2.2 of the second consultative document is particularly telling in this regard, suggesting that because these tools are "infrequently used", their effectiveness is cast into doubt and thus "warrants further investigation"(!). On the contrary, we must clarify that the reason for why measures such as redemption fees, gates, temporary suspensions, etc. are seldom, if ever, used is precisely because funds' core risk management functions have proven very effective at matching assets and liabilities, including throughout periods of past and more recent market turmoil, in line with managers' fiduciary duties towards their clients. In need for concrete examples, we invite WS3 to thoroughly consider the significant outflows out of what was, at least until early 2013, the world's largest mutual fund – the PIMCO Total Return Fund (PTTRX) – with substantial exposures across a very large maturity spectrum of the U.S. fixed-income market. In light of the FSB/IOSCO's persistent focus on individual entities, instead of on a more objective and aggregate approach based on global asset class valuations and how changes in these may shift investor appetites, we would invite WS3 to refer to PIMCO's informative response to this consultation to best appreciate how redemption requests totalling hundreds of USD billions since May 2013 have been managed in the midst of destabilising events, from fears around possible interest rate increases over the medium-term by the U.S. Federal Reserve (i.e. the "taper tantrum"), to departures of "star managers" and co-founders (i.e. William H. Gross), as well as of large, historic institutional clients (e.g. the Californian Pension Fund Orange County Employees Retirement System)[18]. These events demonstrate how, even for the world's largest bond fund, reputational risk of the sort making financial press headlines is by no means a trigger for asset liquidations of systemic proportions as somewhat superficially assumed in the consultative document – see number (iv) under section 6.2.2.

Another evident misconception we wish to redress in the consultative document is the likelihood of "fire sales" materialising in the presence of concentrated and relatively illiquid portfolio holdings, accompanied by the "first-mover" incentives of clients to avoid losses. As an initial consideration, we would underscore the key principle underpinning all investment management decisions: the principle of risk-spreading, or more plainly, "diversification". For all traditional and private collective investment

[17] In Europe, the relevant regulatory framework is the European Market Infrastructure Regulation (EMIR) - Regulation (EU) No. 648/2012 - of 4 July 2012 on OTC derivatives, central counterparties and trade repositories, accompanied by a raft of implementing measures entrusted to the European Securities Markets Authority (ESMA).

[18] Please refer to the article "Orange County Employees Retirement System dumps Pimco", as reported in the *Financial Times* on 12 April 2015.

vehicles alike, portfolio diversification lies at the core of risk management and, in virtually all jurisdictions which have adopted a legal framework for our industry, diversification forms the object of mandatory legal requirements. In Europe, EFAMA must (again) stress the explicit diversification requirements of the UCITS directive that managers must to adhere to at all times once authorised to manage a UCITS vehicle on behalf of clients. These are expressly laid out in Article 52 *et seq*. of the directive, accompanied by clauses limiting the build-up of leverage to twice the value of NAV, as well as limits for OTC derivative and for other "efficient portfolio management" (EPM) technique exposures to counterparties[19]. Implemented in combination and where properly supervised by the competent markets' supervisor, these strict clauses materially impede any concentration of the sort described under section 6.2.2 of the consultation.

For private funds falling within the remit of the AIFM directive and catering for the most part to the needs of large, professional clients, diversification rules are less prescriptive, with mandatory disclosures to clients only on main concentrations. Nevertheless, a private fund or AIF manager in Europe will need to respect the contractual limits of a customised investment mandate with its professional clients, or otherwise, be in breach of its fiduciary duties, with possible indictments before courts and dire consequences in terms of reputation. Also, many AIF investments are characterised by statutory initial lock-up periods by virtue of their less liquid holdings or investment strategies that target returns over longer holding periods, combined with infrequent redemption periods (from quarterly to semi-annually or even annually), as well as opportunities for (institutional) investors to redeem in-kind. Another critical feature and differentiator between the traditional vs. private (or broadly, UCITS vs. AIF) in Europe frameworks are the requirements for funds of the latter category to foresee and conduct ongoing stress-tests to manage an AIF's liquidity profile with its redemption policies, as prescribed under Article 16 of the AIFM directive and detailed in accompanying implementing measures[20].

Moreover, it is important for WS3 Members to fully appreciate the composition of a private fund's liability side, made up essentially of large institutional clients, which in turn have to finance long-term liabilities (e.g. insurance and pension fund providers) and are thus certainly able to withstand any of the sudden or short-lived market corrections – whether due to the fundamental re-pricing of an asset class or to erratic events in the form of a "flash crash" – imagined in the consultative document's narrative[21]. Were we to assume that at some point in time, a specific asset class were to suddenly fall out of favour with these investors due to an extraordinary exogenous cause, their investment advisors would hardly recommend their managers to "dump" sizeable proportions of a portfolio in a falling market in response to rising redemption demands. Given prevailing liquidity conditions at one time, institutional investors tend to resist short-term impulses to sell in light of their long-term investment horizons, knowing also that, as bid-offer spreads typically widen in a falling market, having their portfolio manager sell a specific asset at prices potentially far below what investors believe to be its

[19] Please refer to Section XII of the ESMA *Guidelines on ETFs and other UCITS issues* of 2012 (as amended in August 2014); available at: http://www.esma.europa.eu/system/files/esma-2014-0011-01-00_en_0.pdf
[20] In this regard, we invite WS3 to consider the far-reaching requirements of Article 48 & 49 of the implementing regulation (EU) No. 231/2013 with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision.
[21] In this regard, EFAMA welcomes the inclusion of the new indicator "Nature of investors in the funds", relative to the "Interconnectedness" impact factor, in the revised draft methodology.

true long-term value would be self-defeating. If however the asset owner decides to redeem its assets, either traditional or private fund managers can always count on a broad array of tools to manage liquidity, either alone or in coordination with their primary supervisors. In this last respect, we wish to remind WS3 to turn to its earlier *Policy Framework for Strengthening Oversight and Regulation of Shadow Banking Entities* of August 2013, expressly recommending a dedicated policy tool-kit to stem these market channel transmission risks arising from one out of five economic functions, i.e. that of the *management of collective investment vehicles with features that make them susceptible to runs*. We are confused in this regard, as WS3 does not seem to be drawing from some of its most recent and valuable work on identical themes. For further considerations around the likelihood of large asset liquidations and their effects on asset prices, please refer to our responses to Questions 6-2 and 6-3 further below.

<u>The critical function or services/substitutability channel</u>
The notion of "critical function" or of "services", as defined in section 6.2.3 of the consultative document, remains unclear. The reader is left wondering whether the co-drafters actually intend a very bespoke investment strategy that would necessarily be unique to one or very few clients - thereby largely excluding the possibility of it generating "crowded trades" that could in the FSB/IOSCO line of reasoning even exacerbate downward price spirals – or whether the critical function or services would be something essentially different from "plain vanilla" investing when referring to a fund becoming a "source of liquidity".

Whatever the notion of "critical function" or "services" and in line with our previous reply, we would categorically exclude any concern tied to any one single fund able to "corner" a market by, for instance, purchasing a substantial portion of the outstanding stock of one given security, or by taking a pure one sided-view of a given market by amassing huge derivative positions. Not only would such concentrations be illegal under traditional, UCITS fund rules in Europe, but also fly in the face of sound risk management (which would command the portfolio manager to hedge by also taking on an opposing position) to threaten the very survival of the fund, as well as the reputation of its manager. In addition, WS3 should bear in mind that under the EU Transparency directive[22], voting rights above a certain level are required to be disclosed, including positions held via derivatives, and that the relevant EU Market Abuse Regulation (MAR)[23] would furthermore prevent all market participants from taking abusive positions in the markets.

It is also logically difficult to understand how highly-specialised funds, allegedly "making markets" in thinly traded securities, could possibly be at the origin of systemic risk propagation. EFAMA would therefore recommend regulators to re-consider the high degree of substitutability that exists in the asset management industry as explained in the numerous stakeholder responses – ours included - to the earlier FSB/IOSCO consultation. As more data regarding private funds becomes available to securities regulators via the enhanced reporting requirements of the AIFM directive in Europe (or form-PF in the U.S.), a more granular picture as to a fund's participation or "foot-print" in a relevant market should emerge to dispel remaining doubts. It is of paramount importance that securities

[22] Please refer to Directive 2001/34/EC of 28 May 2001 on the admission of securities to official stock exchange listing and on information to be published on those securities (as amended).
[23] Please refer to Regulation (EU) No 596/2014 of 16 April 2014 on market abuse.

market regulators be able to draw objective and meaningful conclusions from this data sooner rather than later.

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

With the European asset management industry representing an estimated mere EUR 11.3 trillion (USD 12.6 trillion) between UCITS and non-UCITS[24] out of some USD 225 trillion of globally investable assets as of end-2014, fears of any one fund "cornering" a relevant market have plainly no substance. According to the aforementioned McKinsey & Company survey, it is estimated that 75% of the world's financial assets are managed directly by the asset owner[25], with the remaining approximately 25% managed by asset managers in separate accounts (approximately 10%) and funds (approximately 15%).

Regarding some of the concerns made under section 6.2.2 of the consultative document, particularly those relating to the possibility that concentrated selling in certain market segments, e.g. emerging market debt, may propagate contagion and provoke domestic market instability, EFAMA would note that evidence seems to suggest otherwise. According to a recent study[26], on the basis of BIS debt statistics, the total amount of outstanding emerging market debt totalled approximately USD 12.9 trillion (or some 14% of global outstanding debt) as of end-2013. Of this stock of emerging market debt, 80% was found to be exchanged only domestically in countries where foreign direct investment was either highly regulated or restricted (e.g. in China, where foreign investments are restricted to quotas available through the QFII and RQFII licenses and tied to a very gradual liberalisation of the Chinese domestic currency), thereby leaving approximately USD 2.7 trillion of emerging market debt to satisfy foreign demand[27]. As visible in the pie chart below, this decisively smaller investable amount is presently held by a variety of different portfolio investors, among which, emerging market debt-dedicated traditional funds, hedge funds, sovereign wealth funds, local insurance and pension funds (held directly) and central banks.

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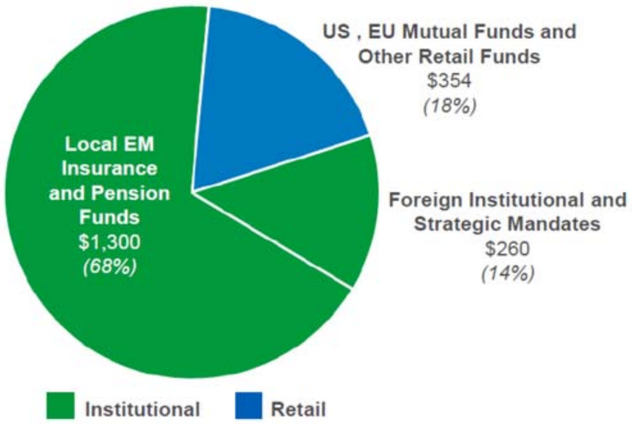
[24] To these, please also consider some EUR 9.9 trillion invested in discretionary mandates according to EFAMA estimates for end-2014. For further figures, please refer to the EFAMA *Asset Management in Europe*, 8th Annual Review (April 2015).
[25] Please refer to *Strong Performance but Health Still Fragile: Global Asset Management in 2013. Will the Goose Keep Laying Golden Eggs?*, McKinsey & Company (2013).
[26] Please refer to the relevant chapter by J. Shen "Emerging Markets Debt (EMD) and EMD Funds" in "Who owns the assets? A Closer Look at Bank Loans, High Yield Bonds and Emerging Markets Debt", BlackRock *Viewpoint* (September 2014); available at: http://www.blackrock.com/corporate/en-us/literature/whitepaper/viewpoint-closer-look-selected-asset-classes-sept2014.pdf
[27] The author also notes that the progressive enhancement of domestic credit quality has also increased foreign participation, despite the aforementioned limits, from USD 894 billion in 2008 to USD 1.7 trillion in 2013. In addition, bouts of volatility that have accompanied the global financial crisis since late 2008 have proven to be manageable.

**Chart I**: Break-down of global EM debt ownership between domestic and foreign holders



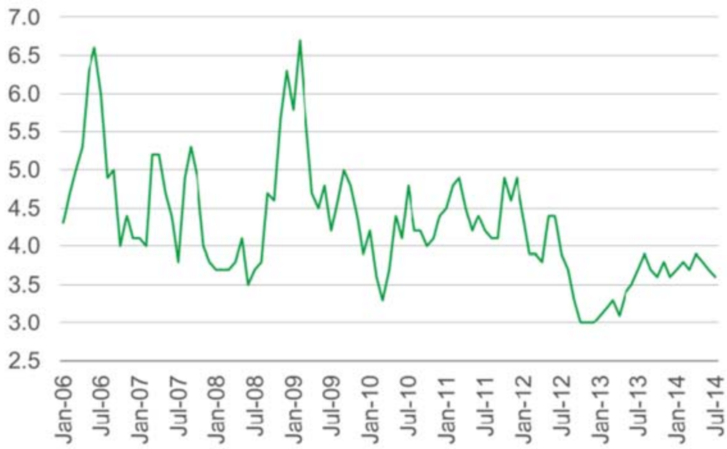

Source: "Emerging Markets Outlook and Strategy for 2014," JP Morgan, November 25, 2013. JP Morgan estimates, official sources, EPFR, Bloomberg.

Wanting to observe a break-down of the above portfolios in the aggregate, a majority of the assets is held in investment grade debt which in turn reflects the composition of the main emerging market bond indices[28] and for over two-thirds denominated in hard currencies, with cash and developed market bonds accounting for the rest, so as to ensure sufficient liquidity. Diversification is further guaranteed by holding issues spanning across 12-20 countries, as well as across different maturities, thereby further limiting duration risk[29], and avoiding concentrations to single names or illiquid securities. Of key importance, in our view, is also the active management of the portfolios' cash balances (oscillating between 3% and 6.8%), depending on the market environment, as depicted in the chart below. Worthy of notice is the fact that over the broad period 2006-2014, spikes in portfolios' cash reserves are explained by the fact that portfolio managers have anticipated greater redemption demands in concomitance with periods of market turmoil (as clearly visible in the steep upward trend in the second semester of 2008, in the first of 2010 with the start of the Euro crisis and – albeit more timidly - over the first semester of 2013 with the start of the "taper tantrum").

[28] The most common are JP Morgan's EMBI, CEMBI and BGI-EM.

[29] The latter opportunity reflects a positive development and is in part the result of the policy enhancements introduced as a response to the numerous financial and currency crisis of the 1980s and 1990s, where these include more independent central banks, inflation targeting, flexible currency arrangements and, most importantly, the lengthening of the term structure of local interest rates improving the ability to issue and hold longer-term bonds.

**Chart II**: Cash reserves as % of EM debt portfolios held on balance for the period 2006 – 2014 on aggregate




Source: JP Morgan. As of July 2014.

In line with our above considerations, we certainly exclude that a traditional European UCITS fund could find itself in a situation where it would be a "very large and a significant investor" in one specific asset class, as a result of the strict diversification and eligible asset rules applied by supervisors to its portfolio. Moreover, systemic risk transmissions via the market channel from an individual fund are sufficiently tempered through the use of liquidity management tools available to portfolio managers when needing to govern unanticipated spikes of redemption requests, either alone or with supervisors' approval. We describe some of these tools in greater depth in the paragraphs below.

Already in the ordinary course of business, among the available tools, several regulators in Europe – including those in two of Europe's largest fund domiciles (Ireland and Luxembourg) - allow UCITS funds to use "swing-pricing" as a mean to avoid any dilution of the value of the portfolio as a result of redemption requests. In sum, it consists of a mechanism by which investors buying or selling UCITS shares at a volume that could materially impact remaining investors would bear the trading costs incurred (at least in part), rather than forcing remaining shareholders to bear those costs on their behalf.

An alternative mean to address the FSB/IOSCO concerns around asset liquidations tied to a "first-mover" advantage, also used by both UCITS and AIF managers, is bid/ask "dual pricing". Under this approach, funds are "dually-priced", i.e. funds publish and investors buy or sell their fund shares at separate redemption and subscription prices (bid/ask). Assets held by the fund are priced on a mid-market basis which is used to obtain a mid-NAV per unit/share. A "crossing" mechanism allows subscriptions and redemptions to be matched as the portfolio manager trades, where transaction costs are added to the NAV to obtain the subscription price and then deducted from the NAV to receive the redemption price as applicable. Hence, the mechanism is designed to pass actual transaction costs as closely as possible to transacting investors, thus protecting existing/remaining investors from dilution caused by the relevant manager trading components of the portfolio. In our view, these mechanisms already sufficiently the risk of a "run" as described under section 6.2.2 of the consultative document[30].

Besides the two mechanisms described above, the effects of asset liquidations in the market may be contained through the imposition of further measures. For instance, in Europe, depending on the relevant EU jurisdiction, a UCITS manager has the authority to suspend dealing in the fund when redemption requests exceed a specific level, e.g. in excess of the 10% of NAV on any business day, or when in the interest of fund investors. Typically, such decisions are also taken in coordination with the domestic competent market supervisor.

For analogous reasons, many of the above considerations apply to private funds as well. Although less diversified by vocation and pursuing a whole range of active investment strategies geared towards returns above the market average (or "alpha"), concentrations in the form of less liquid portfolio holdings may typically be more common, although some AIFs (e.g. hedge funds) do place limits on their allocation to illiquid securities to avoid a portfolio-level mismatch with the redemption features of the fund. Apart from such self-imposed limits – albeit always in line with the requirements of their respective mandates and by no means large enough to consolidate a dominant position in any market - the EU AIFM framework further provides for (i) mandatory stress-testing of liquidity conditions to be conducted on an ongoing basis, and (ii) enhanced reporting requirements where the exposure of the AIF exceeds three times its NAV (i.e. the AIF is leveraged on a "substantial basis" according to the EU AIFM directive). These additional two important factors would respectively allow private fund managers to avoid forced asset sales and amplify distress, while in parallel allow supervisors to monitor the build-up of excessive exposures. Bearing these regulatory limits in mind, together with the reputational fall-out for an individual manager for not adequately managing its liabilities, EFAMA would observe that in today's market environment the notion of "a highly leveraged investment fund" is grossly exaggerated – see number (ii) under section 6.2.2 of the consultative document.

AIFs also foresee redemption provisions, including notice periods and conditions for suspension as explained in detail in the AIF's offering documents. For instance, in response to the arguments put forth in the consultative document for AIFs that invest in illiquid securities or liquid securities that may "suddenly" become illiquid, EFAMA would argue that a typical AIF (e.g. a hedge fund), offers monthly or quarterly redemptions combined with an extended prior notice period that generally ranges between ten and ninety days. In addition, as one of our Members has observed, many hedge funds now apply "investor-level gates," where each investor is allowed to redeem only a certain percentage of their investment on each redemption date versus "fund-level gates" that apply when aggregate withdrawal requests are received for more than a certain percentage of the fund's total assets[31]. Further countermeasures can be employed to protect remaining fund investors, were an AIF to experience significant withdrawal requests. One such tool is a so-called "side pocket" where illiquid assets are warehoused into a separate structure, away from the main fund. When a "side pocket" is

[30] For a numerical example applied to one redemption scenario, please refer to "Fund structures as systemic risk mitigants", BlackRock *Viewpoint* (September 2014).

[31] Investor-level gates are often used in lieu of fund-level gates because the latter provide greater incentives for investors to redeem if they believe many other investors in the fund will redeem. Typically, investor-level gates are set to allow an investor to redeem no more than 10% to 50% of the investor's investment in a single redemption period.

employed, redeeming investors can only receive cash from their pro-rata stake in the non-"side-pocketed" assets. Another mechanism is distribution-in-kind, where assets are distributed to redeeming shareholders on a pro-rata basis through a variety of mechanisms, albeit this latter tool is typically available only to institutional investors.

In sum, we do not consider any European UCITS or AIF fund to have concentrations large enough to be sanctioned as a "dominant player" in any individual security or asset class, given the size and breadth of today's global markets. Above we have exposed the applicable European legal framework that - where correctly supervised - *de facto* prevents any fund from amassing illiquid positions in a manner that would make honouring redemptions impossible. As a further line of defence, an open-end fund's risk management function is always responsible for maintaining a certain percentage of the fund's NAV in the form of cash and cash equivalents (i.e. the cash ratio). Evidence suggests that in times of market stress, when outflows may become more pronounced, a fund's cash balance may actually rise to meet growing redemption requests, acting as a built-in stabiliser (see Chart II above). In this regard, we strongly dispute the idea that in order to raise additional cash, a fund would necessarily be forced to sell-off the more liquid components of its portfolio, thereby triggering – according to the FSB/IOSCO reasoning – the same reactions between other funds with similar asset exposures and liability profiles – see number (i) under section 6.2.2. First, such a scenario would fundamentally compromise the investment strategy agreed with a client and contravene the manager's duty to be adequately invested at all times, where in case of negative performance, the latter also risks a revocation of its mandate and transfer of client assets to a competitor. Second, for private funds in a European context, were the fund's cash ratio to dwindle as a result, for instance, of an incorrect estimate by the fund's internal risk management functions, additional liquidity can be raised in the market via ordinary repo channels, thereby avoiding the effects of having to rely on forced liquidations to raise funds[32].

One final aspect we wish to confute is the assumption that a sudden termination of a large securities loan may force a manager to immediately have to raise cash to return cash collateral to the securities borrower – see number (iii) under section 6.2.2. When lending securities to a borrower and receiving cash collateral in return, the reinvestment of such cash collateral is primarily and prudently re-invested into money market instruments and thereby recallable over a very short time span. In Europe, for UCITS funds, cash collateral re-investment is also required to adhere to the following provisions of the relevant ESMA 2012 *Guidelines*, stating that cash collateral received be:

- Placed on deposit with credit institutions which are repayable on demand or have the right to be withdrawn, and maturing in no more than 12 months;

- Invested in high-quality government bonds;

- Used for the purpose of reverse repo transactions provided the transactions are with credit institutions subject to prudential supervision and the UCITS is able to recall at any time the full amount of cash on an accrued basis;

[32] For UCITS funds, on the other hand, recourse to the repo channel to finance redemptions is not an available option as the ESMA *Guidelines on ETFs and other UCITS issues* of 2012 (as amended in August 2014) only allow the re-investment of cash collateral in accordance to the conditions under paragraph 43, letter j) of the Guidelines.

- Invested in short-term money market funds as defined in the relevant ESMA Guidelines[33].

Although no comparable requirements exists for AIFs, it is our understanding that cash collateral is re-invested no differently, in line also with the standard prescriptions of privately negotiated Global Master Securities Lending Agreements (GMSLAs), defining the contractual rights and obligations for both parties, the collateral call conditions, the treatment of income payments from the lent securities, etc., and including a Schedule detailing eligible forms of collateral[34].

**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 are uncertain as to the exact meaning of "industry-wide", or in other terms, is WS3 looking to define "industry" on the basis of the management of an individual asset class (e.g. fixed income, equity, money market, etc.), or does it intend the asset management industry more broadly, if not the whole financial industry, including investors that are not part of the "buy-side"? *Per se*, an individual fund is certainly distinct from other comparable investment vehicles, in terms of portfolio composition (i.e. no two funds are identically invested in the exact same portfolios at any one time), liability composition (i.e. no two funds have the same investors at any one time), or in terms of management style (i.e. no same manager will manage two portfolios in exactly the same way). The obvious reply to the above question is that each individual portfolio would be affected by liquidation demands in very different ways, each distinct from other behaviours occurring in the broader markets.

Contrary to the perception of funds aggravating or leading to "one-sided markets" acting *in tandem* with other, potentially even "sell-side", actors, evidence (see Chart III below) suggests that investors may actually buy into falling markets as affected securities become cheaper. This is demonstrated by the fact that both inflows and outflows have occurred simultaneously, with portfolios managers actually adding cheaper securities to their portfolios, albeit always in line with their fiduciary duty to guarantee clients the desired level of exposure. Regulators should therefore acknowledge that there often are profit opportunities for investments in securities that appear to be momentarily out of favour with investors, either because perceived to be over-valued or excessively risky. Where fund investments are "sticky" and target income distribution over the long-term, as is the case for most of invested global and European AuM – where in the latter case households account for some 26% and large institutional investors - from insurance companies to pension funds to others - for some 74% of all investment fund ownership[35] - occasional bouts of market illiquidity, possibly accompanied by higher asset price volatility, should not be a cause for concern; or in other terms, a recurring "bear market " is <u>not</u> synonymous with systemic "contagion". Asset classes are therefore only bound to re-

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[33] See *ibid*.

[34] For more information, please refer to the version of the GMSLA template as administered by the International Securities Lending Association (ISLA); available at: http://www.isla.co.uk/images/PDF/MasterAgreements/GMSLA_2010_amendments_July_2012.pdf

[35] Source: EFAMA *Asset Management in Europe – 8th Annual Review* (April 2015); available at: http://www.efama.org/Publications/Statistics/Asset%20Management%20Report/150427_Asset%20Management%20Report%202015.pdf

price at lower values, offering investors who choose to hold onto their positions the opportunities to profit from a future upside appreciation.

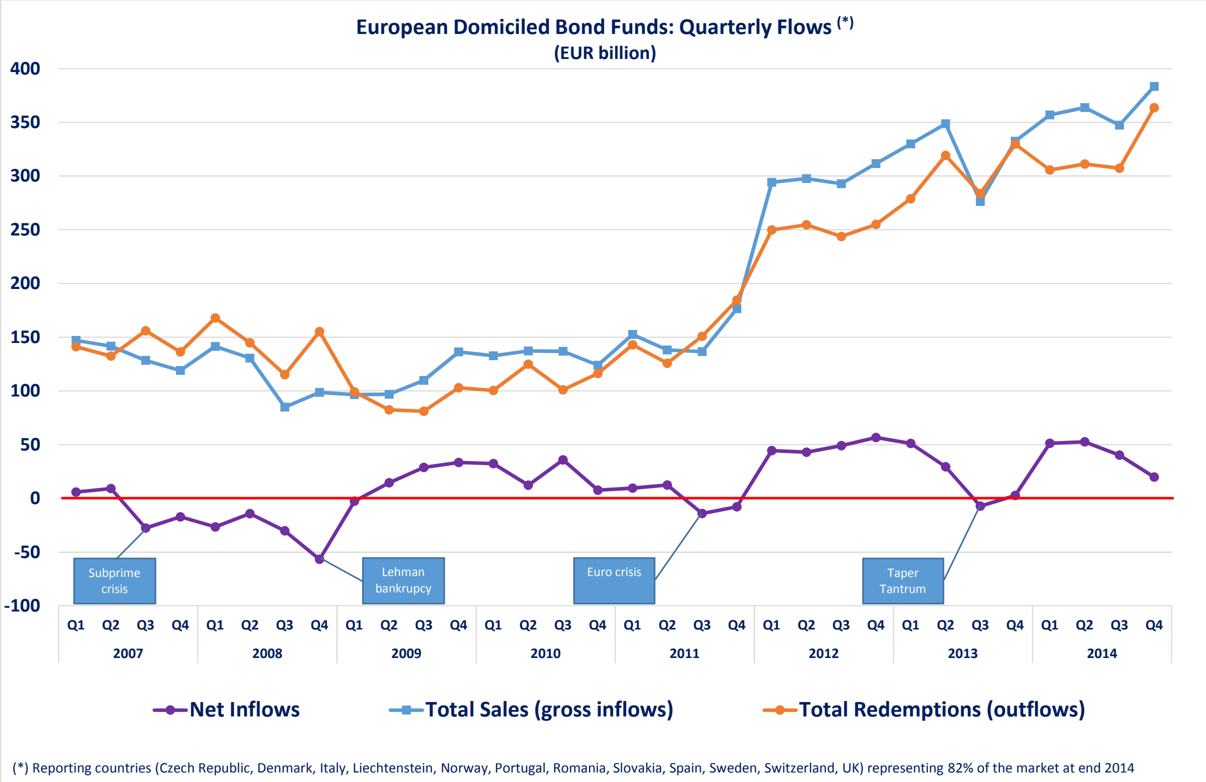
The chart below provides evidence of how bond fund investors have actually acted as "counter-cyclical" forces by buying assets in response to external market shocks and thus leaning against precipitating market trends. It shows quarterly total sales, total redemptions and net inflows (i.e. total sales minus total redemptions) in EUR billions of all European domiciled bond UCITS funds. Three important observations can be made in this regard:

(i) For most of the period under review (2007-2014), investor demand for bond funds has been positive, reflecting the attractiveness of sovereign bonds as "safe -haven" assets and of corporate bonds once investors began seeking higher income in an increasingly low-rate environment. Institutional clients such as pension funds and insurance companies have been forced to take greater exposure to asset classes such as high-yield bonds to meet their obligations;

(ii) Equally important is the fact that inflows and outflows tend to move in parallel. This is also true in periods of market stress, including during the fourth quarter of 2008, during which the rise in redemptions (to approx. EUR 150 billion) was partially offset by an increase in sales (to approx. EUR 100 billion). This observation thus contradicts the view expressed in the consultative document that markets – even during the global financial crisis in Q4 2008 - are "one-sided" in times of turmoil;

(iii) The important role played by gross inflows mitigating the effects of gross outflows is also visible when confidence in the integrity of the Euro area declined dramatically in the lead-up to the Q3 of 2011, and when speculation increased in the spring of 2013 around the fact that the U.S. Federal Reserve would begin easing its assets purchases later that year (i.e. the "taper tantrum" episode). During both of these episodes, net outflows from European bond funds remained very limited (i.e. approx. EUR 11 billion in Q3 of 2011 and EUR 7 billion in Q3 of 2013, owing to persistent gross inflows (i.e. approx. EUR 137 billion in Q3 of 2011 and EUR 276 billion in Q3 of 2013).

**Chart III**: European Domiciled Bond Funds: Quarterly Flows (in EUR billion)




Source: EFAMA

**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?**

As stated above, EFAMA does not agree with the designation of entities as the starting point for reducing systemic risk in financial markets and especially not a designation based on “size” as a primary filter. Moreover, the proposed threshold for private funds in terms of USD 400 billion in GNE remains purely arbitrary, as are the dual options presented for traditional funds. EFAMA would therefore support neither, arguing instead that both types of funds exceeding a 3:1 leverage to NAV factor - as calculated on the basis of the “commitment approach” under the EU AIFM directive - be considered for further assessment[36]. Consequently, this would imply that most traditional funds in Europe, which are UCITS and to which a leverage cap (2:1 leverage to NAV factor) applies under the relevant directive, deserve to be appropriately scoped out. Should WS3 nevertheless wish to consider applying additional

[36] The choice of a 3:1 leverage to NAV factor would in our view be appropriate and moreover coincides with a fund that under the EU AIFM framework employs leverage on a “substantial basis”, calling forth the enhanced reporting requirements under Article 24(4) of the relevant directive. These include the reporting of the overall level of leverage employed by each managed fund, a break-down between leverage arising from the borrowing of cash or securities and leverage embedded in financial derivatives, as well as the extent to which the fund’s assets have been reused under leveraging arrangements, to the competent authorities of the home Member State. Such information shall also include the identity of the five largest sources of borrowed cash or securities for each of the funds managed, and the amounts of leverage received from each of those sources for each of those funds.

thresholds for traditional funds, we would consider these to be of second-order importance and recommend that at least a unique materiality threshold be used for simplicity.

As important, EFAMA decisively opposes the continuing use of the notion of Gross Notional Exposure (GNE) as a threshold and size indicator. It is fundamentally flawed in that it fails to account for offsetting hedging transactions able to limit – if not completely annul – a fund's investment exposure to the broader market. The notional amount of a derivative contract does not equate to a true economic exposure, given that it only represents the present market value of the underlying asset the moment the trade is executed. Once this has occurred, the trade generates a positive or negative exposure for the parties, resulting from the mark-to-market valuation of the underlying and calling for collateral to be exchanged accordingly, i.e. from the party that is "out of the money" to the counterpart that is "in the money". In this manner the trade is re-set to zero on a daily basis along the entire duration of the contract until its expiry/termination date when collateral is returned. Throughout this period, and by virtue of the continuous marking-to-market that in turn provokes the exchange of collateral between the parties (e.g. a fund and its prime broker), the value of the trade remains at zero.

Also, for every additional trade that one party executes with the same counterparty, GNE would not account for the benefits of trade reconciliations between each counterparty's respective list of trades, i.e. instead of adding-up and netting-out positive against negative exposures at the pre-agreed time intervals and setting-off collateral in either one or the other direction, measuring GNE would only result in one inflated figure derived from the sum of the notional amounts. Furthermore, when willing to exit a position before a given expiry date and given the higher costs for early termination under the relevant ISDA Master Agreement clauses, it is common for one party to a derivative contract to exit a position by entering into an offsetting trade with another counterparty instead. In this case, the GNE metric would add-up two notional amounts, where in fact the exposure would be zero - please refer to the example in the relative footnote[37]. Assuming a fund has a positive exposure from the moment it enters a trade and that this exposure equals the notional, as in the consultative documents' narrative, is therefore factually incorrect (!).

As an alternative, for lack of a better globally accepted and consolidated measure, we recommend that WS3 consider the commitment approach to measure leverage - as defined under the EU AIFM framework - for the purpose of identifying a material threshold useful for the "Stage 0" preliminary assessment described in the consultative document. In essence, it requires the asset manager to calculate the sum of the absolute values of all positions, with each derivative position converted into its equivalent position in the underlying assets, using the conversion methodologies specified. We are conscious of the fact that the work of WS3 is global in nature and that the future NBNI G-SIFI assessment methodology will have to apply across several jurisdictions, each with its own rules and regulatory peculiarities. In this regard, our proposed solution for an alternative and more indicative

[37] We invite WS3 to consider the following example: supposing hedge fund X wished to exit a position and, given the relative higher early termination costs involved, chooses instead to enter into an off-setting contractual obligation with another counterparty. In other words, instead of terminating a USD 100 million 10-year IRS swap in which fund X received a fixed rate versus paying Libor, it could find the best offer to execute a new USD 100 IRS swap in which it would reverse the payment of the previous two legs, i.e. receive Libor and pay fixed. Once completed, the fund's economic exposure to interest rate risk is zero, albeit its GNE would add-up to USD 200 million.

measure of fund leverage does not pretend to be "EU-centric". Whether our proposed measure comes under the name of "commitment approach", or something different, its value lies in the fact that it fundamentally accounts for offsetting trades. As also confirmed by a number of our global Members, we deem that most jurisdictions are presently capable to collect or extract such information on the basis of the reporting requirements in force. As part of the global industry that we as EFAMA regionally represent, we fundamentally oppose the persistence of GNE as a size measure on grounds that it defeats the draft methodology's intended purpose.

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

As anticipated in our answer to Question 6-4 above, we do not support the FSB/IOSCO approach to determine the perimeter for a first batch of assessable entities based on the pure size of a fund's AuM, or on the total AuM entrusted to an individual asset management company, or the on the latter's total balance sheet assets, as we shall argue further below in this regard. Understanding that WS3's focus is to identify sources of potential systemic risks, we recommend that size be firstly considered in terms of leverage, the definition of which by WS3 – as a combination of balance sheet and synthetic leverage – we can broadly agree with. Important is nevertheless to clarify that where external party financing occurs – whether through balance sheet activities or through derivatives – what technically qualifies as "leverage" is <u>only</u> the positive exposure that is left un-collateralised and thus unsecured. In the hypothetical event of a firm's bankruptcy, or of a fund's liquidation more specifically, where all liabilities can be met by employing available equity capital, leverage, more correctly, does not materialise. Regulators are in a prime position to fully appreciate the extent to which collateral requirements have been significantly improved and standardised, with secured financing now being the norm across the entire financial industry in the aftermath of the 2008 global financial crisis.

In line with our replies above and given that we do not consider size alone in terms of simple AuM (whether net or gross) to be a relevant factor in gauging systemic importance, were WS3 to persist with its present approach, of the two options proposed, we would favour Option 1 as the "least bad" and discard Option 2 as impossible to implement in light of the unquantifiable notions of "dominant player", "substitutability ratio" or "fire sale ratio". Under such circumstances and at odds with the degree of supervisory judgement allowed for under section 3.2 of the consultative document, we would at least request that the chosen threshold be applied consistently across global jurisdictions for the sake of (legal) certainty.

A further important consideration that deserves to be made as to why size expressed in terms of AuM is not a desirable indicator for traditional funds - both from and industry and investor perspective – relates to the economies of scale tied to the management of larger funds. In this regard, EFAMA, together with the broader European asset management industry, have in the past convincingly supported the European Commission's proposals to address the proliferation of small-sized UCITS funds through the facilitation of fund mergers and asset pooling via master/feeder structures. Such proposals eventually led to the recast of the UCITS directive (what ultimately turned out to be dubbed

"UCITS IV" when published in July 2009)[38]. For the same purpose, separate share classes in one same fund (or sub-fund) were formally recognised, offering investors not only a more customised investment offer and greater diversification, but substantial cost savings in terms of lower administration and transaction costs from a larger asset pool. On their part, managers have reaped substantial economies of scale by managing larger funds that allow them to mutualise costs by avoiding the launch of several and separate individual funds, each requiring separate filings for regulatory approval, together with the accompanying set-up and marketing costs. Risking to raise an issue that may appear removed from the FSB/IOSCO considerations around systemic risks, EFAMA would also like to defend "size" on more commercial and competitive grounds for regulators to better appreciate the natural drivers that underlie it. In this respect, particularly for the European fund industry in the backdrop of the current worldwide competitive landscape, larger funds (i) allow investment management companies to remain competitive in their offer, while helping to resolve the problem of excessive fund fragmentation that is particularly noticeable in Europe; and ii) to offer shares outside the fund's base currency area to meet new demand in third-country (non-EU) jurisdictions.

We deem these considerations to be important and would call on the FSB/IOSCO to be mindful of them in light of their work going forward.

**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).**

Please refer to our response to Question 6-5 above.

**Q6-7. Please explain any proposed revised indicators set out above that, in your view, are not appropriate for assessing the relevant impact factors and its reasoning.**

As anticipated in our reply to Question 6-4 above, EFAMA has strong reservations with regard to the arbitrary nature and purpose of the size indicators, both for traditional and private funds. We also see a substantial overlap between the first three indicators of the "interconnectedness" impact factor, as all three propose to gauge leverage in different ways. Concerning the third indicator, we insist that GNE not be used and invite WS3 to consider a measure identical, or analogous to the commitment approach defined under the EU AIFM framework. Alternatively, the relevant GNE figure must be related with the collateral posted by the investment fund, in place of the fourth indicator, where total posted collateral is measured against the NAV.

[38] For further information, please refer to the European Commission's relevant impact assessment analysis underpinning the "UCITS IV" proposal; available at: http://ec.europa.eu/finance/investment/docs/ucits-directive/ia_report_en.pdf

**Q6-8. What alternative indicators should be added and why would they be more appropriate? For example, do you see any benefits in adding price-based indicators? If so, please explain the rationale for inclusion and possible definitions of such indicators.**

We would invite WS3 to provide further details as to what is intended with "price-based 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.**

Concerning data, EFAMA and its Members' primary concerns are the degree to which securities regulators, as direct supervisors for the asset management industry, are able process the enormous quantities of supervisory data that managers and their funds have begun to report under the enhanced requirements stemming from recent legislation, for instance under the Form PF in the U.S. or under the ESMA consolidated reporting template for AIFMs. Processing data remains, however, only a first step, with its opportune selection and elaboration being a necessary second one to transform it for the purpose of quantifying some of the proposed indicators. We realise the practical difficulties market supervisors may confront within WS3 to produce detailed data at a moment when most of it is being filed by firms for the first time. For this precise reason, EFAMA would suggest that the assessment methodology for NBNI G-SIFIs be tested only once the national authorities in charge of conducting an in-depth analysis of the "Stage-0 lists" are confident that data to assess or construct each indicator is available.

Moreover, by observing specific indicators out of any of the following: "ratio of GNE to the NAV of a fund"; "ratio of collateral posted by the fund to its NAV"; "daily trading volumes of certain asset classes compared to the overall daily (total) trading volume"; "ratio of posted collateral that has been re-used"; "proportion of an investment fund portfolio using HFT"; and "the ratio of unencumbered cash to GNE", there is almost a presumption that market supervisors will need to be placed in a condition to monitor market developments, and especially some of the concerned funds' largest trading positions, almost in real-time. The extent to which this is possible – i.e. calling for multiple departments within a supervisory agency to cross their market data across exchange-traded volumes (inclusive, where possible, of dark pool liquidity), large portfolios in concomitance with collateral movements, and including information from trade repositories – unfortunately still hangs in the balance[39].

As more relevant funds' and markets data becomes available to these regulators, and provided that their respective governments considerably extend their allotted resources over the longer term, conclusions around the systemic nature of financial market actors, funds and their asset managers included, should certainly provide better estimates. In conclusion, we can only encourage market regulators to make full and effective use of the exhaustive information that not solely asset management firms, but many other relevant and potentially systemic market actors and/or

[39] The challenges that market supervisors presently face in terms of access to market data that is timely, accurate and complete, as well as those tied to its collection and analysis, have been recently summarised in a recent speech by SEC Commissioner Luis A. Aguilar; available at: http://www.sec.gov/news/speech/preparing-for-regulatory-challenges-of-21st-century.html

infrastructures, are bound to report either by way of recent regulation or even on demand. Potential "incremental" measures in the form of additional or more enhanced reporting requirements would – in the absence of the expanded capacity cited above – risk serving little or no purpose.

**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).**

Please refer our reply to question 6-4 above.

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

From a European regulatory perspective, EFAMA would support that both types of exposures be measured together, in line with the relevant provisions applicable to UCITS under the aforementioned 2012 ESMA *Guidelines* (as revised in August 2014), where risk exposures to a counterparty arising from OTC financial derivative transactions and "efficient portfolio management techniques" (or EPMs, including repo/reverse repo and securities lending) should be combined when calculating the counterparty risk limits prescribed under the UCITS directive. Moreover, these rules are important as they expressly define collateral quality based on a series of parameters, including liquidity, valuation, issuer credit quality, correlations, collateral re-investment policies, stress-testing policies, etc.[40]

## Asset Managers

EFAMA and its Members wish to strongly reiterate their opposition to the inclusion of asset management companies in the scope of this second consultative document – regardless of whether they are already owned or controlled by previously designated systemic banks (G-SIBs) or insurers (G-SIIs) - and regret that WS3 has apparently not given sufficient attention to the relative justifications in the several industry responses to the earlier consultative document of January 2014. In many ways, the continued emphasis around the supposed systemic nature of asset managers as a result of their "core" and/or "non-core" activities, is in our view a regrettable "step back" with regard to the FSB/IOSCO prior analysis of the first consultation and one we wish to counter with renewed emphasis. Before turning to consider each of the three individual contagion channels, we wish to remind WS3 of the following:

- The essential nature of asset management is one of an "agency" business, where assets are professionally managed by an individual investment manager or management company (hereafter "the manager") on behalf of and in the sole interest of its clients. The latters' relationship with the manager is formalised contractually in a mandate, known generally as an investment management agreement, with the fund's assets becoming legally segregated from the balance sheet of the manager and entrusted to a custodian (typically a credit institution bearing an *ad hoc* license) who registers them in its records in the sole name of the fund. In this manner, the fund's assets are

[40] Please refer to the *ESMA Guidelines on ETFs and other UCITS issues* of 2012 (as amended in August 2014), paragraph 43 *et seq.*; available at: http://www.esma.europa.eu/system/files/esma-2014-0011-01-00_en_0.pdf

made entirely "bankruptcy remote" and thus are in no manner affected by the business (mis)fortunes or reputation of the manager. Ongoing speculation around the transmission of risk from the manager to the fund or vice-versa – as in a number of passages in the narrative under section 7 of the consultative document – therefore continues to be factually incorrect;

- Around client and manager revolves a universe of key services providers, both in-house and/or outsourced, depending on the legal and operational structure of the manager and necessarily including one or more custodians/trustees (each heading a network of sub-custodians and ultimately comprising a central securities depositary or CSD), one or more prime brokers, fund administrators, transfer agents, legal counsel, auditors, pricing vendors, etc. Importantly, the individual investment manager is also responsible before the board of directors for each individual fund he/she manages. The board, typically comprising both interested and independent members, oversees a fund's operations and ensures compliance with corporate policies. In this respect, it must be therefore recognised that one individual manager does not purely act alone when directing investment flows within the perimeter of the investment mandate. In other terms, there is no opportunity for a typical Chief Investment Officer (CIO) to act alone and solely on the basis of his/her convictions as to the direction of the value of a particular asset class. In practice, fund allocations typically see the concourse of several actors, from the initial client (possibly advised by an external investment consultant), to the individual portfolio manager, from members of the fund board (although more remotely) to teams of specialised analysts, economists, traders, etc.[41] Viewed as a whole, such collegiality is "hard-wired" into the investment process and represents yet another barrier against any hasty retreat from any specific asset class in light of contingent market developments, let alone a "fire-sale";

- Given the highly competitive nature of the global asset management industry, funds are regularly liquidated and their fund managers regularly go out of business for reasons that may be entirely un-related to their individual decisions or actions. For instance, global shifts in investor sentiment due to exogenous events like an expected change to a large national central bank's monetary policy or inflation expectations, better growth prospects in one region of the globe, investors' favouring one specific type of investment product over others (e.g. index-trackers over actively managed funds), etc., will necessarily bring clients to re-orient their investment preferences toward asset classes offering higher return opportunities, or better diversification prospects, be they fixed income, equity, currencies, commodities, real estate, luxury goods, etc. Under a new "paradigm", a manager may continue to compete, for instance by extending its product offer to existing and possibly new clients, or alternatively, gradually liquidate its funds by returning assets to its clients, or be acquired by, or merged, with a competitor. In these cases, transition managers play a key role by assisting clients in re-balancing their portfolios and appointing competing asset managers under new mandates;

[41] For an insightful view into the investment process of a global asset management firm, please consider *PIMCO's Time-Tested Investment Process: What and How we Think*; available at: https://investments.pimco.com/MarketingPrograms/External%20Documents/PIMCO_Time_Tested_Investment_Process_What_and_How_We_Think_PB200.pdf

- Events like the liquidation of an asset management company have never until this day been at the root of a global systemic event – only spikes in market volatility at the most - and we maintain they hardly will where asset management firms and their funds are well supervised. We would also like to remind WS3 that most of the observed "failures" of asset management companies over the past several decades have all been either caused by, or related to, gross forms of market misconduct. For these reasons and in light of the previous considerations, EFAMA would underscore the fact that until now the global regulatory response to the 2008 financial crisis has been largely one-sided, i.e. with excessive emphasis placed on new rules and rule-making powers for regulators, while downplaying the importance effective supervision and tougher enforcement, which should in our view also play a key role in preventing future systemic risks.

**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.**

The ancillary activities or services alongside core portfolio management, as correctly exemplified in the introductory section 7.1 of the consultative document, very much depend on managers' preferred business models and partly also on clients' demands, although always to the extent that the regulatory framework in force allows.

Particularly with regard to securities lending as one featuring more prominently among the "critical functions" identified in the consultative document, EFAMA would firstly note that securities lending is in Europe an "efficient portfolio management" (EPM) technique as defined by ESMA and strictly regulated under the 2012 *Guidelines on ETFs and other UCITS issues* (as revised in August 2014). Secondly, it is a technique employed by many different types of institutional investors, including various collective investment vehicles, insurance companies, pension funds, corporations, foundations, national central banks, and possibly others. As such, it logically does not make asset managers unique and may thus not be construed as a potential systemic indicator only for the latter category. Thirdly, securities lending undertaken on behalf of fund clients is for the most part administered directly by the fund's custody bank under a selected securities lending programme, which may also be provided by third parties. Only a few large managers are able to establish their own securities lending business that they carry out for their clients on an <u>agency</u> <u>basis</u>. For these reasons, the few sizeable asset management companies that intermediate securities loans on behalf of their clients, should not be singled out on the basis of this non-core activity, especially where such offer – as we shall illustrate in our reply to Question 7-5 below – is concentrated in the in the hands of other institutions, i.e. global custodians.

**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.**

For reasons highlighted in our preliminary remarks to this section and throughout our reply to the first consultation on this matter, we invite WS3 Members to cease assuming that the difficulties and eventual prospect of an asset manager exiting a business can be categorised as systemic. For reasons tied to an extremely competitive global landscape and on the basis of the fact that an asset management company does not operate its own balance sheet – infinitely smaller when compared to that of any mid-sized bank, not to mention those of the 29 G-SIBs already designated under an analogous process – for proprietary reasons, we deem this question without substance.

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

For the same reason exposed in our answer to the question above, we confute the notion that an asset manager can also become "a counterparty" and a contagion channel to other market participants. We moreover continue to be extremely wary and concerned about such assumptions, which tend to prove that WS3 is attempting to fit what is a "banking methodology" to a completely different industry.

Another clear misconception under section 7.2.1 of the consultative document is that asset managers investing seed money at the launch of one or more funds would transmit their own investment losses over to another counterparty. In this regard, we understand WS3 is considering a scenario where typically a private individual endowed with an entrepreneurial spirit and with a small fortune to invest – better known as a "sponsor" – would commit seed capital to launch a private fund in the typical form of a private partnership and assume the functions of general partner. In such circumstances, with the asset manager being an individual, or even a legal person, the negative performance and eventual liquidation of the fund (or funds), would merely add up to the loss of the partner's equity (along with that of other co-investors or limited partners) and which is certainly negligible if related to the exponentially larger sums needed to provoke even a minimal market impact. We also do not see how, in this example, committing seed capital would be different from managing money placed into any other form of investment.

As to securities lending and related indemnification programmes, EFAMA wishes to stress that actual indemnification is only eventual and would materialise only once the lending firms' prior safeguards have proven insufficient. These include selective due diligence on the counterparty borrower's creditworthiness, over-collateralisation with collateral marked-to-market daily, applied haircuts on non-cash collateral, and where the indemnification does <u>not</u> cover the full exposure of the loan, but rather the shortfall between the value of the received collateral and the replacement cost of the lent instruments. We deem balance sheet exposure for the asset management company to be minimal and prudently backed either by reserves of unencumbered cash and/or by standing multi-year credit facilities. For additional details, we invite WS3 to consider the replies of some our corporate Members which additionally offer securities lending programmes.

**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?**

Reputational risks are entirely idiosyncratic by nature and do not represent a broader market problem in any way. Additionally, they remain unquantifiable because of their behavioural component and are thus not a reliable indicator of systemic risk, which would necessarily also depend on a myriad of contingent factors that remain impossible to fathom. Experience has proven that these are manageable and do not trigger mass redemptions. Across a history of fund and asset management company closures over the past 25 years, the large majority of cases impacting the reputation of an asset management firm originated from various forms of market misconduct, and most notably, fraud, breach of client guidelines, market timing and insider trading[42]. Whatever the cause, none of the above cases generated redemptions large enough to even be barely visible in the broader market. In conclusion, we would argue that reputational concerns are best and more appropriately addressed via the speedy and effective enforcement of applicable securities laws and *in tandem* with judiciary powers able to uphold due process. In light of the growing concerns it raises across the financial industry (but not only) and conscious of IOSCO's important work in this regard, we would also include the vulnerability of a firm to cyber-crime as being a potential threat, although wish to reiterate that adequate prevention and effective enforcement remain the sole methods to tackle what fundamentally remains criminal conduct.

Operational risks, similarly, would not immediately set-off a market reaction that would prove to become unmanageable, as (i) they would not be immediately communicated to the outside world or to investors until eventually only later and once the root of the problem has been identified and fixed; and (ii) would imply an immediate remedy through a mandatory recovery or back-up plan. We would therefore not consider these events to be of any systemic importance.

**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?**

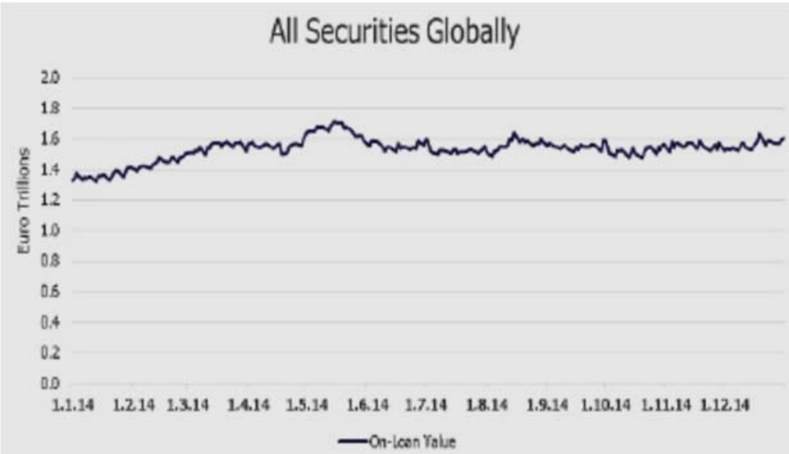
The FSB/IOSCO should consider that asset managers adhere entirely to their "core" function, i.e. managing client portfolios in conformity with the investment mandate. Ancillary or "non-core" services, as exemplified by the consultative document's narrative, are not provided by asset management companies – even the larger ones – by default. Such offer is left to the appreciation of the company's management, compatibly with the business model the company chooses to operate, in light of client demand, and with the alternative available option of out-sourcing. In any event, WS3 should in addition be mindful of the fact that applicable EU directives establish a closed list of permitted "non-core" activities for authorised asset management firms. For instance, the AIFM directive confines non-core activities to (i) investment advice; (ii) safe-keeping and administration in relation to shares or units of collective investment undertakings; and (iii) reception and transmission of orders in relation to financial instruments. Referring once again to the securities lending example, as the most prominent among the "non-core" services offered to clients according to the consultative document, there are globally only very few asset management companies that provide the service of agent lender for their clients. For the most part, the relevant or even "dominant" market specialists of the securities lending business are global custodians (e.g. State Street Bank and Trust Company, Bank

[42] For further information, please refer to Exhibit B of the BlackRock reply to the first FSB/IOSCO consultation on the assessment methodologies for NBNI G-SIFIs, as submitted on 4 April 2014; available at: http://www.blackrock.com/corporate/en-us/literature/publication/nbni-gsifi-fsb-iosco-040414.pdf

of New York Mellon, J.P. Morgan Chase, and Citigroup to name only the largest). On the basis of estimates provided by the International Securities Lending Association (ISLA), as of mid-May 2015 global custodians accounted for some EUR 6.8 trillion (i.e. 48%) out of a total of EUR 14.3 trillion of securities on-loan globally, drawn from an available lending pool made available by institutional and other long-term investors within securities lending programmes and offered to market. The offer which is intermediated by global custodians rises to 57% where the latter open their securities programmes also to third parties (i.e. asset managers for which they do not exercise custody functions). According to the same estimates, large asset management companies - acting as agent lenders and with sufficient scale to run lending programmes – would account for roughly 16% of the abovementioned global intermediated figures, on par with direct lenders (i.e. global banks) which lend as principals[43].

Another pertinent observation may be made in relation to the size of the global securities lending market, valued at EUR 12.5 trillion at end-2014. Compared to its overall size, the amount of securities demanded (expressed as an on-loan balance) at the same date stood at a mere EUR 1.7 trillion, reflecting a significant over-supply in the global relevant market. As a result, the disappearance of any one single lending provider – whether acting on an agency or principal basis – would reasonably not, in light of the prevailing offer over a vastly smaller demand, have any effect[44]. In sum, on the basis of available data from ISLA, one concludes that securities lending, even if being intermediated by a sizeable asset management company, as an additional activity alongside core portfolio management, remains merely a function that by no means should be deemed "critical". The types of concerns illustrated in the section 7.2.3 of the consultative document - especially with regard to the more prominent "non-core" function of securities lending – prove therefore unfounded.

**Chart IV**: Amount of on-loan balances available globally




Source: DataLend & ISLA 2014

Concerning the hypothetical assumption that an asset manager could have acquired a "unique expertise" in the form of a niche investment strategy, we have trouble understanding how such a

[43] For the sake of completeness, securities lending is regularly also provided via international central securities depositaries or ICSDs (i.e. Euroclear Bank and Clearstream International), or at local CSDs, although with a decisively different and specific intent, i.e. that of covering regular settlement failures over a period usually no longer than two days.
[44] Please refer to the ISLA *Securities Lending Market Report* (December 2014), in particular page 6 thereof.

unique investment strategy could attract enough assets to render the funds managed sizeable and systemically important, while continuing to be considered a niche strategy. Success breeds imitators and eventually other market participants – including those that take the other sides of these funds' trades – will develop an understanding of the expertise, at which point the strategy will no longer be unique. We therefore note an evident contradiction between being at one time a "unique" manager (with a "secret sauce" for supposedly stellar returns over a given period) and being substitutable.

**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.**

EFAMA definitely welcomes the fact that more detailed (supervisory) data will be collected for the purpose of implementing the methodology. What we fail to understand, regrettably, are the evident contradictions in the narrative of the consultative document, especially in section 7.3 thereof, where on the one hand WS3 rightly acknowledges the legal and operational separation between funds and asset management company, albeit denies this truth with passages like the following: "Nevertheless, certain risks generated at the asset managers' level might also be transmitted through the investment funds that it manages. In such a situation, the amount of AUM of the asset manager might also be relevant."(!)

The difficulty we see with the second AuM threshold is both conceptual and practical. Conceptually, for reasons explained throughout this response so far, the hypothetical systemic importance of a fund manager cannot emanate from the size of its AuM. From a practical perspective, systemic exposures – if any – emanate from the assets, which are strategically controlled by the managers' clients and where the latter are always free to channel their investments elsewhere. As to the first threshold – i.e. balance sheet total assets – WS3 correctly assumes that an asset manager's balance sheet is small compared to that of other financial market players. This, however, would not rally our favour for the inclusion of asset management companies in the scope of the draft methodology. Rather, we insist that WS3 begin in earnest to consider shifting away from the entities-based emphasis of the present exercise until now. We therefore consider an assessment on the basis of USD 100 billion balance sheet total for asset managers to be, as well as of USD 1 trillion in AuM, misguided for the ultimate objective of this exercise. Finally, the justification by WS3 for determining such threshold amount, i.e. for mere consistency purposes with the accompanying methodologies, remains a poor one, as fundamentally, finance companies and market intermediaries could not be more different from asset managers.

**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).**

Please see our reply to Question 7-6 above.

**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?**

Please see our reply to Question 7-6 above.

**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.**

Please see our reply to Question 7-6 above.

**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?**

In line with our preliminary remarks to this section, EFAMA considers the inclusion of asset managers within the scope of the methodology to be erroneous and entirely misguided.

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Brussels, 29 May 2015
[15-4064]