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May 23, 2014

Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Submitted via email: rule-comments@sec.gov

RE: Feedback on OFR Study on Asset Management and Financial Stability

Dear Ms. Murphy:

We respectfully submit the enclosed *ViewPoint* entitled, "Who Owns the Assets? Developing a Better Understanding of the Flow of Assets and the Implications for Financial Regulation" as a supplement to the letters we previously submitted. As I mentioned in my remarks during the May 19, 2014 FSOC Asset Management Conference, understanding the distinct roles of asset owners, asset managers, and intermediaries is critical to any discussion on the actual dynamics of asset flows. The enclosed *ViewPoint* explains these distinctions, surveys some of the investment trends among different types of asset owners, and highlights the impact that post-financial crisis monetary policies and financial regulatory reforms have had on the investment decisions of asset owners. The paper also explores the current regulatory paradigm for funds to establish a framework for potential solutions and identifies several recommendations to improve the financial ecosystem for all market participants.

We again thank the Securities and Exchange Commission for providing the public, including BlackRock, the opportunity to comment on the Office of Financial Research Study. We are prepared to assist the Financial Stability Oversight Council and its member agencies in any way we can, and we welcome a continued dialogue on these important issues.

Sincerely,

Barbara Novick
Vice Chairman

VIEWPOINT

WHO OWNS THE ASSETS?

Developing a Better Understanding of the Flow of Assets and the Implications for Financial Regulation

MAY 2014

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Recently, academics and policy makers have focused on the potentially destabilizing impact of pro-cyclical "asset flows".[1] The concern is that the actions of various financial institutions may, on occasion, materially increase systemic risk. A proposed solution is to increase the scope and intensity of financial regulation through the use of the Systemically Important Financial Institution (SIFI) designation. As this discussion has developed, the role of asset owners and asset managers has often been conflated. In practice, asset owners such as pension plans, sovereign wealth funds, and insurance companies have legal ownership of their assets and make asset allocation decisions. Many asset owners manage their money directly, while others outsource management of all or a portion of their assets to external asset managers. A failure to distinguish the roles of asset owners and asset managers has led to policy proposals that, if implemented, will not address the concerns that have been raised. For example, proposals to apply "systemic" designations to large asset managers or to large collective investment vehicles ("CIVs" or "funds") might cause money to move between different managers and different funds but would not address the issue of asset flows into and out of a specific asset class or type of fund. These decisions are controlled by asset owners, not asset managers.[2]

In this paper, we explain the respective roles of asset owners, asset managers, and intermediaries—distinctions that are critical to understanding any discussion of actual dynamics of asset flows. In addition, we highlight the market impacts of post-financial crisis monetary policies and various financial regulatory reforms. In many cases, these policies and reforms have altered the investment and asset allocation behavior of asset owners. We also explore the current regulatory paradigm for funds to establish a framework for potential solutions to the concerns raised specific to asset flows from particular types of funds. Finally, we identify a number of recommendations for improving the financial ecosystem for *all* market participants.

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DIFFERENTIATING ASSET OWNERS, ASSET MANAGERS AND INTERMEDIARIES

ASSET OWNERS

- Legal ownership of assets
- Make asset allocation decisions based on investment objectives, capital markets outlook, regulatory and accounting rules
- Can manage assets directly and/or outsource asset management
- Examples: pension funds, insurers, banks, sovereign wealth funds, foundations, endowments, family offices, individuals

Asset owners can outsource asset management to an asset manager →

ASSET MANAGERS

- Act as agent on behalf of clients (asset owners)
- Not legal owner of assets under management
- Not the counterparty to transactions or to derivatives
- Can manage assets via separate accounts and/or funds
- Make investment decisions pursuant to guidelines stated in IMA or fund constituent documents
- Required to act as a fiduciary to clients

Provide investment advice ↑ *Conduct due diligence* ↑

INTERMEDIARIES

- Provide investment advice to asset owners including asset allocation and manager selection
- Conduct due diligence of managers and products
- Examples: institutional investment consultants, registered investment advisors, financial advisors

The opinions expressed are as of May 2014 and may change as subsequent conditions vary.

SUMMARY OF RECOMMENDATIONS

(Detailed discussion on pages 14-15)

1. Clearly identify the specific risks that need to be addressed.
2. Acknowledge the respective roles of asset owners, asset managers, and intermediaries and design policies consistent with their respective roles and functions.
3. Review (and potentially revise) regulatory, accounting, and tax rules to encourage the desired investment behaviors of asset owners.
4. Focus on investment funds and investment practices in order to improve the overall financial ecosystem for all market participants.
   a. Identify levered vehicles that may magnify risks if forced to sell assets.
   b. Specify guidelines for structuring funds that reduce or minimize "run risk" thus providing better investor protection and mitigating systemic risk.
5. Encourage standardization of issuance in corporate bond markets to improve secondary market liquidity.

Asset Owners

The terms “asset owners”, “end-investors”, and “clients” are often used interchangeably. Asset owners include pension plans, insurance companies, official institutions, banks, foundations, endowments, family offices, and individual investors located all around the world. As highlighted in Exhibit 1, pension funds, insurers and sovereign wealth funds represent total assets of approximately $33.9 trillion, $24.1 trillion, and $5.2 trillion, respectively. Each asset owner has a choice of managing their assets directly, outsourcing to asset managers, or using a combination of direct management and outsourcing. McKinsey & Company estimates that more than three quarters of financial assets are managed directly by the asset owner (Exhibit 2). Many large institutional asset owners invest some or all of their money directly which explains why the largest 20 asset managers have $25 trillion[3] in client assets under management, a fraction of the assets belonging to asset owners. Some of the growth observed in the asset management industry reflects the decision of many asset owners to outsource management of a greater portion of their assets.

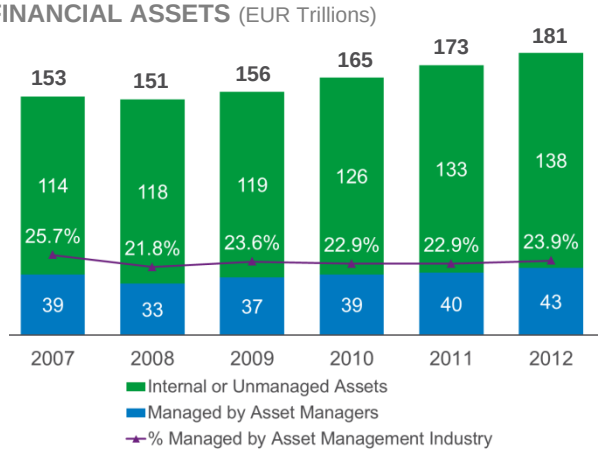
Exhibit 1: ASSET OWNERS

	Assets ($ trillion)
Pension funds	$33.9
Insurers	$24.1
Sovereign wealth funds	$5.2
Banks[a]	$50.6
Foundations / Endowments[b]	$1.4
Family Offices[c]	$0.14 – $0.42
High Net Worth Individuals (HNWI)[d]	$52.4
Mass Affluent	$59.5

Source (unless otherwise noted below): “Asset Management 2020: A Brave New World”. PWC. Data as of 2012. PWC analysis based on data from various sources including Credit Suisse Global Wealth Data Book, SWF Institute, TheCityUK, OECD, and Insurance Europe . Available at http://www.pwc.com/gx/en/asset-management/publications/pdfs/pwc-asset-management-2020-a-brave-new-world-final.pdf. Some assets may be double counted.

a. Represents largest 25 Banks. Source: http://www.relbanks.com/worlds-top-banks/assets. As of 2013.
b. Source: McKinsey & Company. As of 2012.
c. Source: Cerulli estimates for US single-family offices. As of November 2011. Limited data available on family office assets.
d. HNWIs are defined as those having investable assets of US $1 million or more, excluding primary residence, collectibles, consumables, and consumer durables.

Exhibit 2: ASSET MANAGERS’ SHARE OF GLOBAL FINANCIAL ASSETS (EUR Trillions)



Source: McKinsey & Company. “Strong Performance but Health Still Fragile: Global Asset Management in 2013. Will the Goose Keep Laying Golden Eggs?”

Specific asset owners, whether investing directly or through an external manager, have different investment objectives and different constraints. Pension plans, banks, and insurance companies typically strive to generate sufficient income to meet their projected liabilities, whereas foundations and endowments often seek to maximize long-term returns and preserve principal. The projected liabilities of individual pension plans, banks, and insurance companies differ markedly, leading to different investment objectives and different asset allocations. Likewise, different official institutions have very different charters and thus bespoke investment portfolios. Furthermore, most institutional clients are subject to regulatory and accounting rules which further dictate their investment portfolios. And, of course, individual investors may have very different investment objectives even over the course of their own lives (e.g., saving to purchase a home, saving for a child’s education, retirement planning, etc.).

Pension Plans

Pension plans encompass defined benefit (DB) and defined contribution (DC) pension schemes sponsored by public entities and by corporations. The range of plans across various countries makes it difficult to generalize about current asset allocations or future trends. The historical trends in

asset allocation across pensions in different countries are highlighted in Exhibits 3, 4 and 5. In reviewing pension asset allocation trends over the past twenty years, there is a significant shift into so-called "alternative" investments such as real estate, private equity, and hedge funds as well as a liability-driven shift into (longer duration) fixed income. This shift towards alternatives reflects asset owners' dual objectives of increasing return and reducing the apparent volatility in their portfolios which has helped counter-balance, from a return perspective, the effect of moving more assets into fixed income. Nevertheless, expected returns on these pension plans have decreased by about 75 basis points in the US over the past eight years[4] as sponsors have changed both their expectations and their asset mix.

Additionally, regulatory and accounting rules directly affect the design of the overall investment program for pension plans. For example, the recent trend in the US of freezing corporate DB plans (not allowing new participants to enter the plan or, in some cases, discontinuing the DB plan), executing liability-driven investment (LDI) strategies for corporate DB plans, as well as greater use of defined contribution (DC) plans can be tied to Financial Accounting Standard 158 (FAS 158) and International Accounting Standard 19 (IAS 19). These rules have also impacted the asset allocation decisions of corporate DB plans. For example, IAS 19 requires companies to discount their DB pension fund liabilities at AA Corporate Bond yields when valuing the size of the pension fund deficit or surplus on their balance sheet. This change incentivized companies to move out of equities and into corporate bonds to provide a better match for their liabilities in an attempt to reduce the volatility of the pension deficit and potential impact on the sponsor's balance sheet. Similarly, the Financial Assessment Framework (FTK) in the Netherlands linked the discount rate for pension liabilities to the Euro swap curve, which resulted in a 10% reduction of the average allocation to risk assets (equities and property) within two years from when the rule was passed in 2007.[5] It also resulted in an increase in the use of long duration bonds as well as the use of swap overlays for the first time in Dutch pension funds. As should be expected, asset owners redirect their assets in large part in response to changes in the regulatory environment.

US DC plans have undergone a shift in investment options made available to participants away from company stock and a conservative fixed income portfolio to investment options that are diversified baskets of equity and fixed income. This trend reflects the recognition that these plans which began as supplemental savings programs have become the primary retirement program for many employees. Along with this evolution of purpose, these plans have experienced

PENSION ASSET ALLOCATION DATA

Exhibit 3:
2013 PENSION ASSET ALLOCATION BY COUNTRY[a]

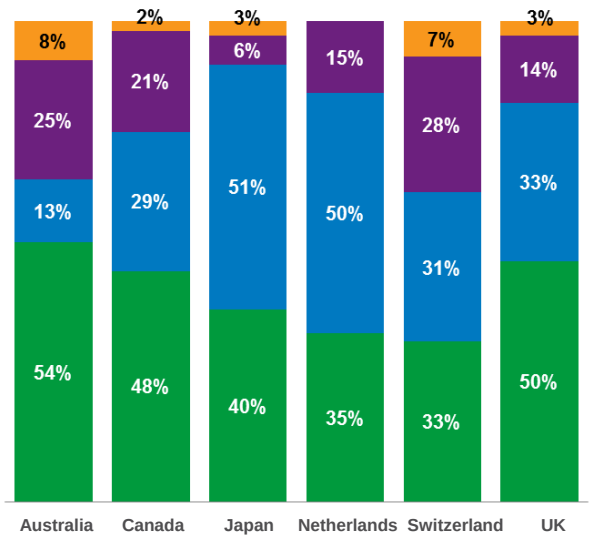


Exhibit 4:
GLOBAL PENSION ASSET ALLOCATION[a]

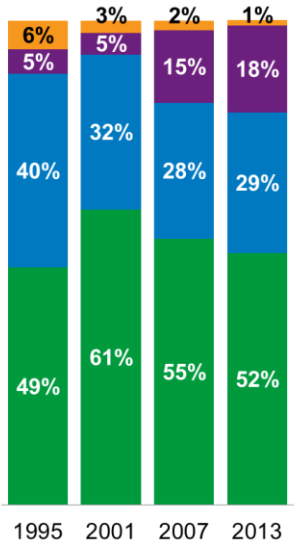
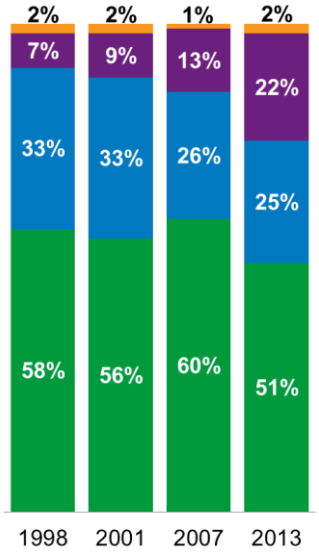


Exhibit 5:
ASSET ALLOCATION FOR TOP 200 US DB PLANS[b]



■ Equity ■ Bonds ■ Other ■ Cash

a Source: Towers Watson "Global Pension Assets Study 2014", January 2014..Available at http://www.towerswatson.com/en-US/Insights/IC-Types/Survey-Research-Results/2014/02/Global-Pensions-Asset-Study-2014. May not sum to 100 due to rounding.

b Source: Pension & Investments. As of September 30, 2013. http://www.pionline.com/article/20140203/INTERACTIVE/140139939/interactive-infographic-pis-top-1000-largest-retirement-funds.

substantial growth in assets, and the Pension Protection Act of 2006 has encouraged the use of multi-sector asset allocation products as a more appropriate investment option, including their use as the default investment for those participants that fail to make an investment election.

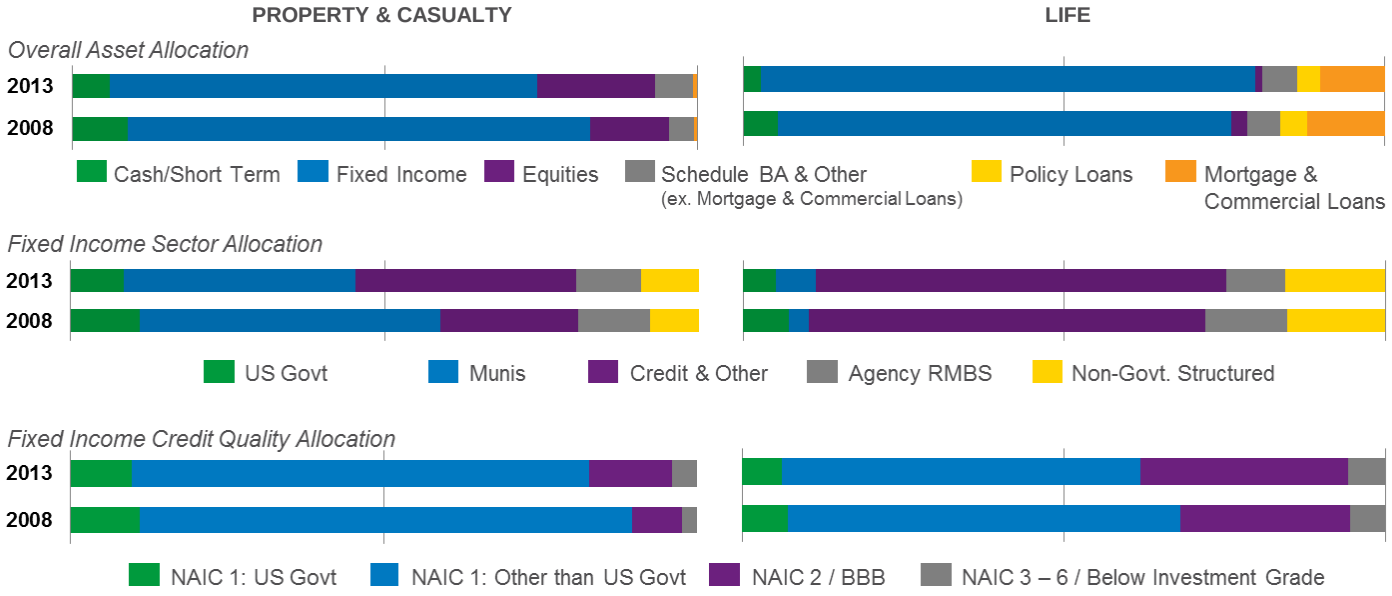
Once defined benefit pension funds settle upon a broad asset allocation in response to their best judgment and regulatory constraints, most pension plans impose policy limits on individual asset classes in response to changes in the market value of their assets. For example, a plan's Chief Investment Officer (CIO) might be directed by the pension's investment policy to maintain an asset allocation within a band of 40% to 60% in fixed income, or 0% to 20% in alternatives. When changes in market values cause a plan to bump up to the outer bounds of these policy limits, the pension will rebalance its asset allocation. Policy rebalancing is counter-cyclical to market movements as plans pare back asset classes or sectors that have appreciated disproportionately and increase investment in sectors whose performance has lagged. Some smaller pension plans lack sufficient internal resources and may outsource the rebalancing function to an external asset manager. For example, BlackRock manages approximately $250 billion in client-directed asset allocation portfolios, almost exclusively for pension plans, whose investment objective is to provide risk-controlled beta exposure to a specified asset allocation benchmark. BlackRock is directed to rebalance these portfolios regularly using a rule agreed upon with the client. In these portfolios, BlackRock does not have discretion to make active asset allocation decisions versus the portfolio benchmarks, and these portfolios are regularly rebalanced to track their benchmarks. This is an example of explicitly counter-cyclical asset flows directed by a client that is executed on their behalf by an asset manager.

Insurers

Insurance companies include property and casualty (P&C), health, life, monoline, and reinsurers. Each type of insurance company has a different business model with specific products from which they project their liabilities. While individual company portfolios differ significantly, the asset allocation of a typical insurance company is heavily weighted towards high quality fixed income securities. These companies try to earn a spread while matching their liabilities and meeting various regulatory and rating agency constraints. Exhibit 6 shows the average allocations for different types of US insurers over time.

P&C insurers rely on investment returns as a critical driver of shareholder returns. Over the past 30 years this was primarily accomplished by holding corporate and municipal bonds with high embedded book yields, and a relatively small allocation to equities for diversification. With yields at historic lows, total investment returns for P&C insurers have been under pressure, driving industry-wide changes in asset allocation to maintain profitability. By 2010, in order to offset declining yields, the majority of P&C insurers had started to look outside the universe of investment grade fixed income. P&C insurers moved down the credit quality spectrum within fixed income, and outside of core fixed income to non-traditional asset classes such as collateralized loan obligations (CLOs), bank loans, equities, and alternatives. Since 2008, P&C insurers have added an additional 5% to BBB (NAIC 2) assets, approximately 2% to high yield, as well as an additional 6% to equity allocations. Allocations to non-traditional assets such as private equity and hedge funds increased by 2% as P&C insurers began to build out their portfolio of alternatives.[6]

Exhibit 6: US INSURANCE INDUSTRY ASSET ALLOCATION TRENDS



Source: SNL. As of December 2013.

The life insurance industry has also suffered from the prolonged low yield environment, as profitability for a life insurer is achieved by earning a spread on the investment portfolio over the cost of its liabilities. In a higher-yield environment, life insurers had historically been able to rely on long duration, high-quality fixed income assets with little to no exposure to alternative asset classes. Given the long-term nature of the business, the life insurance industry was slower to act in response to the low yield environment, but followed similar trends to P&C insurers within fixed income as they looked beyond investment grade fixed income to find additional yield. Since 2008, the life insurance industry has experienced a 6% increase in securities classified as BBB, positioning approximately 38% of the investment portfolio in assets rated BBB and below.[7] In terms of risk assets, life insurers are less able to tolerate both the volatility and high capital charges of an equity allocation and have opted instead for less-liquid, income producing alternatives to help boost returns.

For European insurers, investment trends since 2008 have been similar to those observed among US insurers. Low yields across fixed income asset classes coupled with reduced lending capacity from traditional sources has encouraged life insurance companies to diversify into asset classes such as whole loans, infrastructure debt and commercial real estate debt. Additionally, over this same period, Europe has engaged in a major overhaul of insurance regulation, called Solvency II, which is a framework that combines a regulatory capital requirement based upon economic risk with wide ranging integration of firm-wide risk management. Although the final specification of Solvency II has not been agreed, proposed capital requirements for securitizations remain high relative to corporate bonds. This may limit investor appetite from insurers focused on regulatory capital efficiency.

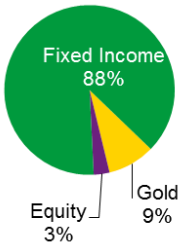
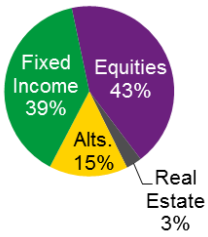
2013 was a challenging year for fixed income investors with nearly every sector within fixed income posting negative total returns. Mounting fixed income losses were offset by investment income driven largely by allocations to income-producing alternatives, as well as allocations to equities. Going forward, P&C and life insurers will likely focus on optimizing their portfolios within the confines of rating agency guidelines and risk-based-capital charges, as well as internal capital restrictions.

Official Institutions

Official institutions include sovereign wealth funds, central banks, national pension schemes, and other financial entities controlled by a national government or governments. Official institutions are not a homogenous group with respect to governance, asset allocation, investment horizons, or transparency. In addition, official institutions are not subject to the same regulatory or accounting rules that apply to other asset owners. There is no definitive source that has accurate data on the investments of all of these institutions. Based on our research and our professional experience working with official institutions, we believe the aggregate pool of investment assets for official institutions exceeds $25 trillion. Exhibit 7 highlights the significant differences observed in the asset allocation of central banks and sovereign wealth funds reflecting the different roles of these respective institutions. Not surprisingly, central bank portfolios are dominated by fixed income with significant allocations to gold and a growing component of equities whereas sovereign wealth funds are diversified across asset classes with increasing allocations to alternative investment strategies.

Over the past few years, several important trends in the asset allocations of official institutions have emerged. The major trends are (i) new allocations to equities, especially passive mandates for both US and global equities, and mandates for emerging markets, (ii) a shift from broad fixed income mandates to more specialized mandates, including mandates focused on mortgage-backed securities, Treasury Inflation-Protected Securities (TIPS), global inflation-linked bonds (GILBs), credit, and Asian fixed income, and (iii) increased allocations to alternative investments, including funds of funds, multi-asset mandates, and opportunistic strategies. While these shifts generate asset flows and manager search activity in the sector, individual institutions can, and often do, execute different strategies—which may not be captured by observed flows, given that many official institutions manage the majority of their assets directly.

Exhibit 7: OFFICIAL INSTITUTIONS' ESTIMATED ASSET ALLOCATION

		Central Banks FX Reserves	Sovereign Wealth Funds
Estimated Outsourced Assets	%	3% - 5%	25% - 30%
	$	$360B - $600B	$1.2T - $1.3T
Estimated Asset Allocation			

Source: BlackRock. All data estimated as of April 2013.

Banks

In aggregate, banks are among the largest asset owners in the world. Banks invest in a broad range of assets. A typical bank holds wholesale and retail loan exposures including commercial real estate loans, syndicated loans to large companies, small business loans, unsecured credit card receivables, home mortgages and more. Banks hold "loan loss reserves" specifically to cover the expected losses on their portfolio which reflect the range of credit quality of

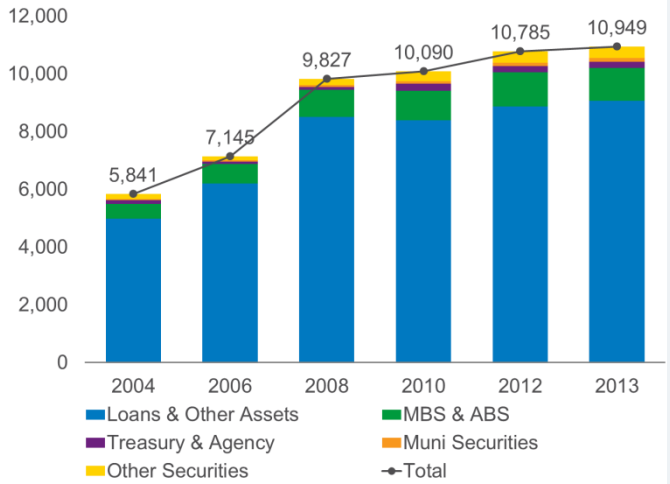
their loans. These assets are held on the balance sheet of the institution, and are financed in part by insured deposits. Banks rely on government guaranteed deposits as a source of funding and US banks have access to the Federal Reserve discount window to meet liquidity needs. As noted above, bank assets reflect a wide range of lending practices, and banks also employ leverage which can amplify positive and negative aspects of their portfolio. As a result, banking regulators require banks to hold capital as a way of protecting customers and the government insurance fund. Over the past few years, banks have been subjected to increasingly stringent capital requirements and other banking regulations. Given the interest rate environment and the regulatory environment, the asset side of bank balance sheets has shifted noticeably. In the US, banks have increased the size of their securities portfolios since the 2008 financial crisis due to both a reluctance to lend and new liquidity requirements resulting from regulation. US banks also increased their allocations to Treasury and Agency securities post-crisis (see Exhibit 8). Additionally, banks have reduced balance sheet leverage. In the US, banks were typically levered fourteen to fifteen times before the crisis; post-crisis, leverage has dropped to approximately eleven to twelve times.[8] Similar trends are evident in Europe, although balance sheet leverage has run historically higher as lower risk weighted assets (RWA) were typically retained on banks' balance sheets. This difference can be attributed in part to: the European adoption of Basel II, which led to banks using their own risk weighting models; a lack of outright leverage constraints; and, notwithstanding the covered bond market, the absence of a government-sponsored enterprise (GSE)-sponsored secondary housing market in Europe. The aggregate leverage ratio of monetary financial institutions in the European Union peaked at sixteen times in the second half of 2007, but as a result of these factors, some European banks exhibited ratios around double this.[9] However, the introduction of the new Basel III leverage ratio requirement and the regulatory trend towards more stringent internal RWA models have served to reduce the general leverage on EU banks' balance sheets.

It is particularly important to clarify the status of banks[10] along the asset owner/asset manager dimension, particularly since banks are in large part at the epicenter of the financial system and therefore have been the subject of a lot of thought and subsequent regulations designed to mitigate systemic risk. Given the long history of micro-prudential regulation, it is natural that the vast majority of regulators now pondering how to design appropriate macro-prudential regulation for the financial system have assimilated the banking model deeply into their thinking. Yet, it is precisely on this axis that banks and asset managers are fundamentally different. Banks gather equity capital from shareholders and, subject to their charters and regulations, raise deposits and invest their combined funds into a collection of balance sheet assets. These assets conceptually and legally are owned by the bank, and the bank garners their full economic returns net of the cost of funding its liabilities. The bank as the asset owner is a principal, not an agent. Due to current regulations, most banks manage their assets directly and do not hire external asset managers as agents to manage assets on their behalf. The nature of any macro-prudential solutions dealing with any systemic risk must, therefore, differ materially.

Individual Investors

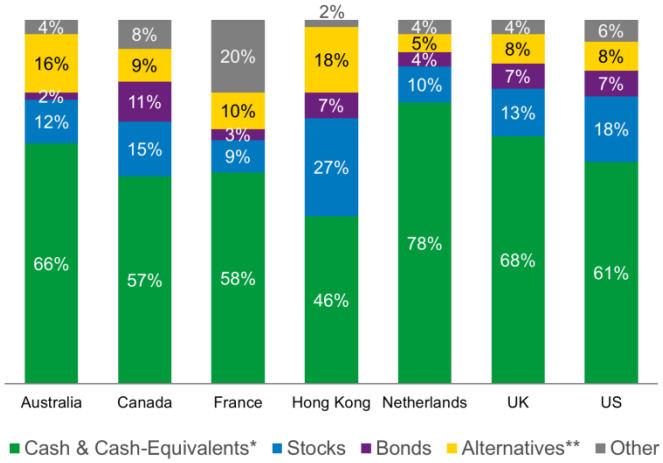
Retail investors encompass a broad range of investor types. Likewise, the investment objectives of individual investors vary widely and include saving for retirement or a child's education, generating investment income, wealth preservation and many more. Further, investment objectives and ability to take on investment risk often change dramatically over an individual's life course. Given the wide

Exhibit 8: ASSETS OF LARGEST US BANKS 2004-2012 (USD Billions)



Source: SNL. As of December 2013. Excludes US entities of foreign banks and Goldman Sachs and Morgan Stanley.

Exhibit 9: ASSET ALLOCATION OF INDIVIDUAL INVESTORS FROM SELECT COUNTRIES



Source: BlackRock 2013 Investor Pulse Survey.
*Includes cash, money market funds, certificates of deposit and similar instruments.
**Alternatives includes property/real estate outside of main residence.

array of investment objectives that individual investors can have, it is difficult to generalize; however certain behaviors can be observed. For example, individual investors often invest a portion of their assets directly in cash, stocks and/or bonds and a portion of their assets in CIVs. According to BlackRock's 2013 Investor Pulse Survey[11], retail investors are particularly concerned about preservation of their principal given the market experience in 2008, and their ability to generate sufficient income in retirement. To that end, the survey found that approximately 60% of individual investors' investable assets are in cash or cash equivalents, with a relatively small proportion dedicated to other types of investments (Exhibit 9). Indeed, the psychological impacts of the financial crisis are still impacting individual investors – with many individuals' asset allocations reflecting continued risk aversion despite steady gains, particularly in equity markets, in recent years. As described later in "The Role of Intermediaries" section, many (but not all) individual investors rely on advice from financial advisors to help them build their portfolio.

Asset Managers

As explained in the previous section, various asset owners often retain external asset managers to invest some or all of their assets. Asset owners that outsource to asset managers often choose different asset managers for different mandates, based on the expertise and performance record of a particular manager in an asset class, sector or investment style. Asset owners may also select different asset managers for the same or similar mandate to diversify performance risks.

Exhibit 10: ASSET MANAGERS COME IN MANY SHAPES AND SIZES

Business Focus	
Retail	Global
Institutional	Americas
Passive	Asia-Pacific
Active	Europe
Alternatives	

Capital Structures Vary
Public
Privately held (including partnerships, LLP, LLC)
Wholly-owned subsidiaries
Mutualized shareholders

Representative Asset Managers with Various Business Models	
Aberdeen	Franklin Templeton
Allianz Global Investors	Invesco
AQR	KKR
BlackRock	Man Investments
Blackstone	PIMCO
Capital Group	T. Rowe Price
Fidelity	UBS Global Asset Management
Fortress	Vanguard

The most important aspect of the asset manager as agent for the asset owner is that asset managers have a duty to act as a fiduciary on behalf of their clients. This means that they must place the interest of their clients ahead of their own. This legal obligation goes to the heart of why asset owners feel comfortable outsourcing the activity. If an asset manager breaches this duty, it may be required to make restitution, be subject to prosecution, incur fines and/or suffer severe reputational damage which can preclude their future ability to grow and maintain their business.

The practices of asset owners necessarily drive the business practices of asset managers. Yet, the business models of asset managers can differ significantly from one manager to another. Some firms specialize in a particular asset class whereas others offer a more diversified set of products. Some firms have a domestic focus based on their national market, whereas others have a regional or global business. Some firms primarily manage traditional long-only strategies whereas other firms focus on alternative investment strategies. Some firms focus on institutional separate accounts whereas others focus on collective investment vehicles. Even the legal entities and their capital structures differ as firms may be organized as partnerships, public companies, subsidiaries of banks or insurers, or even as a mutualized company. Exhibit 10 captures some of this diversity in the asset management industry.

Asset managers act as agents on behalf of institutional and individual investors, meaning they transact for their investor clients, not for themselves. Asset managers neither own the assets that they manage nor are they counterparties to trades or derivative contracts that they enter into on behalf of their clients. Asset managers generate revenue principally from fixed basis point fees on client assets under management. Asset owners can hire asset managers directly or under the supervision of the CIVs management body (e.g. directors, trustees, etc.) such as mutual funds and exchange traded funds (ETFs) that undertake specific investment programs for investors set forth in their constituent documents (i.e. prospectus, offering memorandum, etc.). When institutional investors choose to hire asset managers, they do so by either investing in CIVs, or by appointing an asset manager as their agent to directly manage their assets through a separate account. Importantly, the assets are held by a custodian in the name of the client or fund, not the asset manager.

The terms of separate account relationships, including the investment guidelines, are defined in an investment management agreement (IMA) which is a contractual document between the asset owner and the asset manager. The investment strategy and the investment guidelines to be followed by the asset manager are set out in the IMA or are established by the offering or constituent documents that establish the fund. These guidelines specify the client's desired investment strategy including the allowable sector(s) for investing the assets. Within the framework of the clients'

investment guidelines, the asset manager can make tactical asset allocation decisions. Paradoxically, given the formal legal nature of the IMAs, they can, in aggregate, sometimes lead to rigidity or synchronization in the apparent behavior of asset managers. For instance, many clients create "investment grade" mandates which require that their asset managers must dispose of any non-investment grade holdings according to a specified protocol. Thus, ratings downgrades below investment grade typically create a certain amount of forced selling. In this specific case, the phenomenon is so well-known that many non-constrained investors look upon this forced selling as an investment opportunity.

As described above, different asset owners have different investment objectives and constraints. Under the IMA, the client retains the right to terminate the manager's discretion without penalty or with little or no notice. When clients want to reassign the management of their assets to a different asset manager, investment strategy, or product the change can be implemented quite quickly. In some cases with institutional clients, the asset owner might even choose to hire a transition manager to expedite the process.

Individual investors, whether professionally advised or making their own decisions, are more likely to purchase interests in CIVs, such as mutual funds, ETFs or UCITS, as opposed to investing through separate accounts. CIVs have management bodies (i.e. directors, trustees, etc.) who oversee the funds, and who have the authority to hire or replace a manager, or the underlying investors retain the right themselves. Similar to asset owners investing through separate accounts, CIV management bodies establish the investment guidelines specific to each CIV that the asset manager must follow. The assets in both separate accounts and CIVs are held by a custodian who is selected by the institutional client or the CIV's directors or trustees.

Separate account clients are the asset owners and, therefore, have direct, legal ownership of the assets in the separate account, and CIV investors own an undivided interest in the underlying assets of the fund. In both cases, the investment results of the portfolios belong to the asset owners. Asset managers do not guarantee returns to investors, nor do they provide liquidity for redemptions from CIVs. Andrew Haldane, Executive Director, Financial Stability and member of the Financial Policy Committee, Bank of England noted: "As an agency function, asset managers do not bear credit, market and liquidity risk on their portfolios…Fluctuations in asset values do not threaten the insolvency of an asset manager as they would a bank. Asset managers are, to a large extent, insolvency-remote."[12] Since the assets belong to the clients and the clients control the allocation and reallocation of these assets, bank-centric regulations imposed on either a fund or a manager such as capital,

"As an agency function, asset managers do not bear credit, market and liquidity risk on their portfolios… Fluctuations in asset values do not threaten the insolvency of an asset manager as they would a bank. Asset managers are, to a large extent, insolvency-remote."

– Andrew Haldane, Executive Director, Financial Stability and member of the Financial Policy Committee, Bank of England

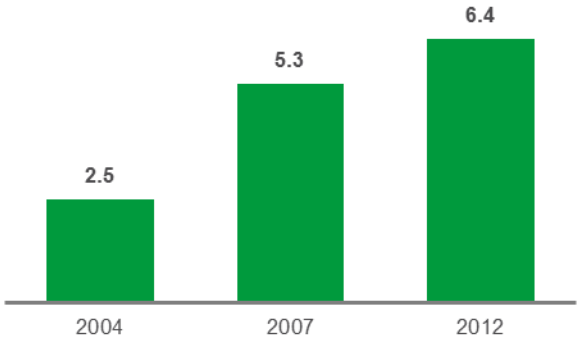
enterprise stress testing, and liquidity coverage ratios would have no effect on addressing the concerns expressed regarding asset flows.

Several commenters have suggested that asset managers develop products that funnel clients into particular investment strategies or sectors.[13] In our experience, while there is certainly some element of "build it and they will come" in the creation of investment management products, in practice, the majority of investment products that capture the bulk of asset flows are developed based on the needs of asset owners and their allocation of assets to these strategies. For example, as discussed above, many asset owners have increased their allocation to alternative investments as a way to increase returns and to build more stable portfolios. Not surprisingly, we have seen an increase in products to meet this demand and thus in assets managed by hedge funds and other alternative investment strategies as highlighted in Exhibits 11 and 12. One area that has garnered attention from regulators is the development of registered funds that employ alternative strategies.[14] This is a relatively small but growing sector with approximately $465 billion in US mutual funds and approximately €155 billion in UCITS (see Exhibits 13 and 14).

Regulation can have a major influence on the investment decisions of asset owners, as some product development will occur in response to demand driven by regulatory change. For example, the Pension Protection Act of 2006 set forth certain types of DC plan investment options, including multi-sector asset allocation funds that constitute qualified default investment alternatives (QDIAs). If a plan participant fails to make an affirmative investment election, the plan sponsor may direct investment of such assets into a QDIA. By following the Department of Labor's QDIA rules, the plan sponsor avoids responsibility for investment decisions, including liability for investment losses. This has prompted DC plan sponsors and plan fiduciaries to increasingly offer these funds to plan participants as investment options, leading to a significant change from DC asset allocations historically. This regulatory protection for plan sponsors provided by the QDIA rules has, in turn, fostered the growth of target date funds (TDFs). Today many US DC plans offer TDFs as an investment option and, in

GROWTH AND ALTERNATIVE PRODUCTS

Exhibit 11: GROWTH IN ALTERNATIVE ASSETS UNDER MANAGEMENT (USD Trillions)

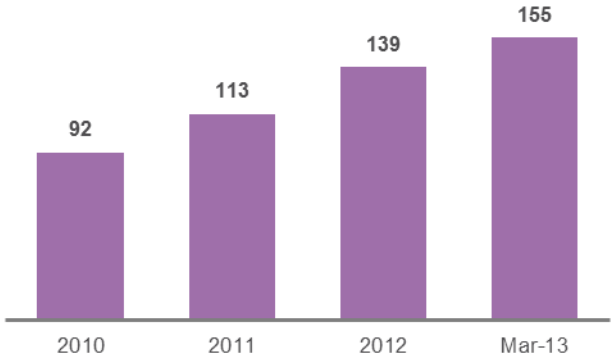


Source: PWC. "Asset Management 2020: A Brave New World". Available at http://www.pwc.com/gx/en/asset-management/publications/pdfs/pwc-asset-management-2020-a-brave-new-world-final.pdf.

Exhibit 12: GROWTH IN HEDGE FUND AUM (USD Trillions)

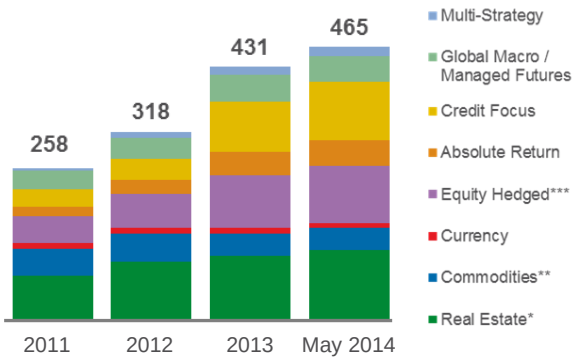
Source: HFR Global Hedge Fund Industry Report. www.hedgefundresearch.com

Exhibit 13: ALTERNATIVE STRATEGIES IN UCITS (EUR Billions)



Source: "Preqin Special Report: UCITS Hedge Funds". June 2013. Available at https://www.preqin.com/docs/reports/UCITS_Hedge_Funds_Report_June_2013.pdf.

Exhibit 14: ALTERNATIVE STRATEGIES IN US MUTUAL FUNDS (USD Billions)



Source: Lipper
* Includes real estate, global real estate, and international real estate categories.
** Includes commodities general and commodities special categories.
*** Includes event driven, long/short equity, dedicated short bias, and equity market neutral categories.

many cases, TDFs are the default investment option for plan participants who fail to make an investment election. According to EBRI/ICI, from 2006 to 2012 the percentage of DC plan participants invested in TDFs has increased from 19% to 41% and, over the same period of time, the percentage of DC assets invested in TDFs has increased from 5% to 15%. Given the growing importance of DC plans in retirement planning combined with the growing popularity of multi-asset class strategies, the growth of TDFs is projected to continue to accelerate. In another example, regulatory focus on fees[15] may encourage an increase in passive investing and the introduction of additional index funds to meet this demand.

The Role of Intermediaries

Relatively little commentary has focused on the role of non-asset manager intermediaries in asset owner portfolios. Investment consultants play a critical role in the allocation and re-allocation of assets. Both institutional asset owners and individual asset owners may use advisory or consultant intermediaries to assist them in various ways. Institutional investment consultants work hand-in-hand with pension plans and other institutional investors providing independent professional advice that augments institutional investors' internal resources and expertise. In many cases, the use of nationally recognized investment consultants, in addition to providing needed valuable services, also provides investment committees and boards with an additional layer of legal protection by demonstrating that they are following a prudent and well-informed process. The services these investment consultants provide include projections of liability streams, design of investment policy statements, asset allocation studies, portfolio construction recommendations, and performance monitoring. In addition, these consultants provide due diligence on asset management firms and on the specific products offered by these firms; they also closely

monitor and evaluate the performance of specific sectors and peer universes. Institutional consultants often maintain proprietary databases of research and recommended "buy" lists. These consultants actively monitor the asset managers and the investment products the consultants are recommending to identify any issues that might cause them to change their recommendation to hire a manager or to shift investment recommendations to "hold" or "sell". Institutional consultants regularly conduct asset manager searches on behalf of their clients, and they maintain statistics on their search activity by asset class.[16] The actions of these intermediaries may directly or indirectly drive correlated asset allocation decisions of their clients. For example, recent press articles have noted increased search activity for alternatives and multi-asset strategies.[17] According to Pensions & Investments, the largest 20 institutional investment consultants advise institutional asset owners on assets of approximately $32 trillion globally, which includes internally and externally managed assets.[18] Exhibit 15 shows the five largest institutional investment consulting firms with global operations ranked by assets under advisement; there are also many well-known national, regional, and specialized firms.

Various financial intermediaries, including banks, insurance companies, broker/dealers and registered investment advisory firms, similarly have research arms that perform due diligence on managers and their products before offering a manager's funds or services to their retail clients, in accordance with FINRA rules on "suitability".[19] In addition, these firms generally have economists and investment strategists that advise retail investors on macro trends and make asset allocation and portfolio construction recommendations.[20] The increase in alternative investments reflects these recommendations. And, of course, traditional retail brokers, now often referred to as financial advisors, regularly advise individual clients on their asset allocation decisions and help them identify appropriate investment options to meet their specific investment needs, oftentimes relying upon research and recommendations from their firms. All of these recommendations materially impact the decisions of asset owners and may significantly impact asset flows across products or asset classes.

Exhibit 15: LARGEST INSTITUTIONAL INVESTMENT CONSULTANTS
by Worldwide Assets Under Advisement

Consultant Name	Worldwide Assets Under Advisement ($ billions)
Mercer	$6,900
Hewitt EnnisKnupp, an Aon Company	$4,683
Cambridge Associates	$4,246
Russell Investments	$2,400
Towers Watson Investment Services	$2,100

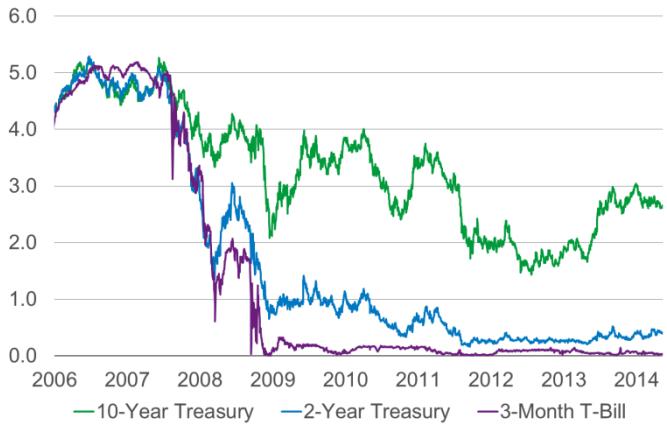
Source: Pensions & Investments. As of 30 June 2013. Available at www.pionline.com

Impact of Monetary Policies and Financial Regulatory Reform

A discussion of asset flows would not be complete without highlighting the importance of both monetary policies and financial regulatory reform, especially following the 2008 global financial crisis. Global monetary policies have held interest rates unusually low for an extended period of time (see Exhibit 16). These seemingly unsustainably low levels of rates have created a fear that monetary authorities will eventually need to hike rates, amplifying the fear of owning longer duration assets. For pension plans and insurance companies, and for retirees on a fixed income, meeting their income needs has become increasingly challenging. As some have reported, these investors are necessarily "reaching for yield" to meet their liabilities or income requirements. Asset owners, in search of higher yields, have increasingly allocated assets into the high yield bank loan markets, taking on credit risk while attempting to minimize their exposure to rising rates. When the time comes, reversing current monetary policies will require a careful transition to avoid disrupting markets. For example, the Federal Reserve Bank's impact on the market when they began tapering of Quantitative Easing (QE) illustrates the importance of taking gradual steps rather than one quick leap.

While the impacts of monetary policy are easy to observe, the impacts of financial regulatory reform are more subtle. Many new rules have been introduced which have changed the shape of the banking and insurance businesses while improving the financial soundness of these companies. For example, the latest round of stress testing in the US and the comparable Asset Quality Review (AQR) in Europe exposed weaknesses in the balance sheets of certain banks, while Basel III will require banks to increase equity to 7% of their

Exhibit 16: US INTEREST RATES



Source: Federal Reserve Bank of St. Louis. FRED. As of May 2014.

risk-bearing assets by 2019 with global banks being required to hold an additional 2.5%. The Volcker Rule, which was enacted as part of the Dodd-Frank Act prohibits proprietary trading by banks. Likewise, the "Liikanen" and "Vickers" reforms in the EU and UK, respectively, set out to achieve similar policy goals as the Volcker Rule. In aggregate these measures are likely to constrain the capacity of banks and broker/dealers to hold inventory on their balance sheets and therefore constrain client-facing market making activity, especially in less liquid asset classes such as emerging market debt and corporate bonds. A recent International Organization of Securities Commissions (IOSCO) report[21] similarly recognizes bond investors are facing higher liquidity risk. IOSCO suggests that firms which regularly issue debt may have an incentive to issue standardized issuances to facilitate electronic trading to overcome this liquidity challenge. BlackRock began highlighting this issue in 2012[22], and has been actively engaging with policy makers on potential ways to standardize corporate bond issuance and improve secondary market liquidity.

Beyond banking reform, financial regulatory reform has impacted various non-bank sectors and products (see Exhibit 17). Demand for high quality collateral will increase as a result of requirements to centrally clear various previously OTC derivatives under the European Market Infrastructure Regulation (EMIR) and the Dodd-Frank Act and through increased collateral requirements for bilateral trades. As noted previously, a greater focus on fee disclosures and calls for greater transparency on the cost of investing[23] may encourage demand for low fee products, which may result in significant inflows to passive index strategies. In Europe, the forthcoming ban on commissions paid to independent financial advisers who operate in an open architecture environment may encourage distributors to move to a commissions-paying closed-architecture model offering a narrower range of products.[24] Further, credit rating agencies (CRAs), and in particular the use of credit ratings themselves, are under scrutiny in both Europe and the US.[25] And, of course, concerns about the impact of certain market finance activity are bringing changes to money market funds, securities lending, repurchase markets, and securitization. Finally, new tax proposals such as a financial transactions tax would have significant impacts on investor behavior if enacted. While many of these reforms have improved the safety of financial markets, there has been little analysis of the cumulative impacts of financial regulatory reform.

Exhibit 17: KEY REGULATORY REFORMS 2008-2014

Major Financial Legislation & Regulation	Key Reforms
Alternative Investment Fund Managers Directive (AIFMD)	Bank Capital & Liquidity Rules
Basel Accords	Bank Stress Testing
Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010	OTC Derivatives Reforms
European Market Infrastructure Regulation (EMIR)	Cash Investing Rules
Markets in Financial Instruments Directive (MiFID)	Private Fund Advisor Registration
Solvency II	Private / Alternative Funds Reporting
Volcker, Vickers, Liikanen	

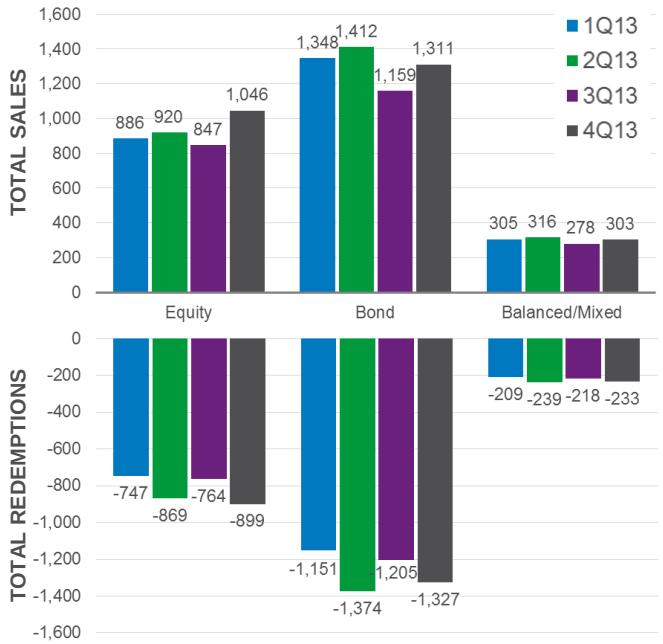
Asset Flows Into and Out of Funds

While asset owners and asset managers are clearly playing very different roles in the capital markets, recent discussions by policy makers focused on "herding" and "run risk"[26] have conflated their two distinct roles. "Run risk" reflects the ability of asset owners to reallocate their capital. As explained previously, asset owners change asset allocations for many reasons on a regular basis which can lead to a shift of money – or asset flows – from one asset class to another, from one investment strategy to another or from one manager or fund to another. Client subscriptions into funds represent the asset owners' decisions to allocate additional assets to a strategy, sector, manager, or product; client redemptions from funds represent a decision by the asset owners to reallocate assets to other strategies, sectors, managers, or products. With respect to "herding," asset owner initiated flows, in aggregate, substantially overwhelm asset managers' discretionary allocation decisions because asset managers can only allocate the assets placed under their discretion within the investment guidelines of a specific client mandate whereas asset owners have complete control of their assets. Moreover, client mandates often preclude investments by asset managers in riskier sectors, such as high yield and emerging markets, which may experience more volatility in prices and flows than investment grade and developed market investments.

Exhibit 18 shows client-driven sales and redemptions (or "gross flows") across equity, bond and balanced mutual funds in 2013. These flows reflect decisions by asset owners to change their asset allocation and/or to make a manager or product change. As a result, within each category, it is common for some managers to experience large inflows even while other managers experience large outflows and for managers to experience large outflows from one product and inflows into another. As Exhibit 18 demonstrates, in 2013, global mutual funds experienced more than $19 trillion in gross flows. These sizable flows were driven exclusively by asset owners. Therefore, any discussion on regulating asset flows across sectors, or into and out of specific funds, must recognize that asset owners control these asset allocation decisions.

As part of this discussion, the regulation of the redemption characteristics of CIVs would benefit from additional review. There exists considerable variation between regulatory

Exhibit 18: GROSS FLOWS IN 2013 FOR WORLDWIDE MUTUAL FUNDS (USD Billions)



Source: ICI Global. Excludes funds of funds to avoid double counting. As of December 2013.

regimes both for different types of CIVs and for CIVs offered to investors in different countries. Whereas separate accounts do not present systemic risk because the sole asset owner of an individual separate account has no first-mover advantage in seeking to sell their holdings, the characteristics of CIVs can sometimes create an incentive to head for the exit at the first sign of trouble. Regulation of CIVs should seek to protect all investors in the CIV while at the same time avoiding circumstances that could lead to "runs" or other behavior that could present systemic issues. As a starting premise, investors in a fund should not be disadvantaged by the asset allocation decisions of other investors in the same fund. A well-structured fund should not create a "first mover advantage" in which one investor has an incentive to leave a fund before other investors in that fund. Importantly, this approach protects all investors while also mitigating the potential for systemic risk by eliminating "accelerants" related to fund redemptions. Securities regulators around the world have recognized the importance of addressing these issues and have developed different regulatory regimes for funds in their jurisdictions that respond to these issues in different ways. Given the increasing number of questions raised around asset flows into and out of CIVs, we recommend that securities regulators review the varying approaches and define "best practices". IOSCO has begun this process and has published three reports on CIVs addressing (i) valuation; (ii) suspensions of redemptions; and (iii) liquidity risk management.[27] This section reviews some of the key distinctions between the approaches taken today by regulators of various CIVs, and suggests a framework for potential future regulation in this area.

…this approach protects all investors while also mitigating the potential for systemic risk by eliminating "accelerants" related to fund redemptions.

Numerous forms of CIVs have been developed to meet the needs of different clients in different regions around the world. These include funds that are publicly offered and widely available to retail investors (sometimes referred to as "registered funds" or "mutual funds") as well as privately offered funds that are available on a more targeted basis to institutional asset owners or a particular subset of investors. ETFs and closed-end funds are variants of registered funds subject to regulation in various jurisdictions, and this regulation is tailored to these products. The term "private fund" encompasses a wide array of investment products, that are offered to institutional investors and sophisticated individual investors, including hedge funds, private equity funds, credit funds, and certain real estate funds.

Each type of CIV is subject to its own specific rules or practices. Key characteristics distinguishing each type of CIV include:

(i) Pricing methodologies for subscriptions and redemptions; examples of pricing methodologies include allocating transaction costs to transacting investor(s), dual pricing, swing pricing, and dilution levies;

(ii) Redemption provisions, including powers granted to the trustees or directors of a fund;

(iii) Limitations, if any, on leverage and illiquid securities, including limits on the use of derivatives as well as stress testing and other risk management and risk monitoring procedures; and

(iv) Disclosures in fund constituent documents as well as communication with investors on investment guidelines, risks and the provisions mentioned above (as applicable).

Exhibit 19 provides points of comparison between the rules governing several different CIVs based on the applicable regulatory regime.[28] Taken together, each vehicle's specific regulations and market practices in these areas enable fund managers to manage to varying degrees the redemption requests and align the interests of both the investors remaining in a fund and the investors redeeming from the fund. While asset owners drive the redemption flows from CIVs, depending on the redemption provisions of the CIV, they may or may not be required to bear the full transaction costs associated with a redemption. In the context of this discussion, the potential systemic impact also needs to be addressed. To the extent that there are significant transaction costs and those costs are not borne by the

Exhibit 19: RULES GOVERNING COLLECTIVE INVESTMENT VEHICLES

	Subscription / Redemption Pricing	Redemption Provisions	Liquidity, Leverage & Risk Management
'40 Act Funds (open-end funds) *Offered in: US* *Primary regulator: SEC* *Publicly available: Yes*	▸ NAV calculated at end of each business day. ▸ Subscriptions / redemptions priced at next NAV calculation after order submitted. ▸ Board can elect to use fair value pricing if market prices are not readily available or do not reflect current market values. ▸ Redemption fees which go back into the NAV on some funds.	▸ In-Kind Redemptions: Permitted subject to certain requirements ▸ Suspension: Prohibited unless a Stop Order from SEC is received. ▸ Often have frequent trading policies in place. These policies can include explicit redemption fees which are disclosed in the fund prospectus.	▸ Illiquid Assets: Max. 15% of NAV. ▸ Leverage: Max. 33.3%; revolver loans/lines of credit with 300% asset coverage of borrowings. ▸ Derivatives: More rules if significant usage including additional disclosure, asset segregation. ▸ Risk Management: No specific requirements.
UCITS *Offered in: Europe, Asia, Latin America, other countries* *Primary regulator: Domestic regulators and ESMA* *Publicly available: Yes*	▸ Multiple methods including dual pricing, swing pricing, dilution levy.	▸ In-Kind Redemptions: Permitted subject to client consent. ▸ Suspension: Allowed in exceptional circumstances with Board and/or regulatory approval. ▸ May restrict redemptions to 10% of NAV on any dealing day.	▸ Leverage: Borrowing max. 10% and only for short-term purposes. ▸ Derivatives: Must adhere to extensive rules. ▸ Risk Management: Stress testing and scenario analysis.
Registered Management Investment Schemes (Registered Schemes) *Offered in: Australia* *Primary regulator: ASIC* *Publicly available: Yes*	▸ The "Responsible Entity" may exercise discretion or make adjustments affecting the amount payable on withdrawal using a formula or method, based on the NAV. ▸ Expected to have anti-dilution measures in place and to disclose them. ▸ Must disclose formula used for calculating withdrawals, which must be based on the value of Registered Scheme assets less liabilities, and can take into account the material costs involved in the disposal of Registered Scheme assets.	▸ The relevant provisions governing redemptions must be set out in the Registered Scheme's constituent documents, including the constitution. ▸ In-Kind Redemptions: Permitted if provided for in the constitution. ▸ Suspension: Permitted in limited circumstances if provided for in the constitution.	▸ Leaves discretion to "Responsible Entity", subject to appropriate disclosure and assuming this is not inconsistent with the Registered Scheme's constituent documents. However, the extent to which non-liquid assets are held will affect whether the Registered Scheme is considered to be liquid or "non-liquid" under the relevant provisions of the Corporations Act 2001.
Collective Investment Funds (CIF) *Offered in: US* *Primary regulator: OCC* *Publicly available: No*	▸ NAV typically calculated at end of each business day. ▸ Subscriptions / redemptions priced at next NAV calculation after order submitted. ▸ For certain CIFs, portfolio transaction costs caused by redemptions can be allocated to a subscribing / redeeming participant.	▸ Suspension: Permitted under limited circumstances if in best interests of remaining investors subject to constituent documents. ▸ In-Kind Redemptions: Permitted subject to certain requirements.	▸ Leverage: Permissible for certain investment strategies, subject to fund guidelines. CIFs typically do not incur indebtedness to finance investments. ▸ Risk Management: Subject to bank risk management oversight and ERISA (if ERISA clients in CIF).
Alternative Investment Funds (AIFs) *Offered in: Europe* *Primary regulator: Domestic regulators and ESMA* *Publicly available: No**	▸ Leaves discretion to the Alternative Investment Fund Manager (AIFM), subject to appropriate disclosure. AIFs sold to retail investors may be subject to additional UCITS-style restrictions.	▸ Leaves discretion to the AIFM, subject to appropriate disclosure. ▸ In-Kind Redemptions: Leaves discretion to the AIFM, subject to appropriate disclosure. ▸ Suspension: Leaves discretion to the AIFM, subject to appropriate disclosure.	▸ Leverage: Enhanced reporting when an AIF has commitments >300% of NAV. ▸ Risk Management: Requires liquidity risk management. process to be in place including periodic stress testing and scenario analysis.

*AIFs are generally not publicly available but can be made publicly available when additional local requirements are met in certain jurisdictions.
Note that the above table is for illustrative purposes and is not exhaustive. Does not reflect rules specific to money market funds or ETFs.
See glossary on page 16 for full names of regulators.

investors initiating the flow, an element of first-mover advantage in the CIV is created. Secondly, but perhaps much more important, by separating out the full cost of exiting, asset owners are able to effectively be protected from the consequences of the market forces during a fire sale. While asset owners might want to rush to the exits, a large bid/ask spread serves as a disincentive which will tend to attenuate such behavior. If all CIVs were broadly structured to make sure that asset owners associated with net flows bore their full cost, whether that be in terms of "herding" into an asset class or rushing out, systemic risks would be mitigated. As discussed under "Recommendations for Improving the Financial Ecosystem", specific rules could be tailored based on the underlying securities or investment strategies of the fund.

Recommendations for Improving the Financial Ecosystem

Asset owners and asset managers share policy makers' concerns about financial stability, and welcome the opportunity to engage in a constructive dialogue on ways to improve the financial ecosystem for all market participants. The following recommendations deserve serious consideration to focus the discussion on potential solutions to concerns raised regarding the risk of systemically risky pro-cyclical asset flows.

1. Clearly identify the specific risks that need to be addressed. The financial crisis highlighted a number of risks and, in response, over the past several years, many changes to financial regulation and to market practices have occurred which taken as a whole reduces systemic risk. These changes range from an increased emphasis and requirements for improved risk management to improvements in liquidity management, enhanced collateral management and counterparty limits, increased transparency, deleveraging of banks and increased capital standards, as well as detailed reporting on private funds, derivatives, and other security transactions. BlackRock supports those changes that have resulted in a sounder financial system, and we are supportive of additional reforms that address systemic risks. New regulations should be targeted to fill in any remaining gaps. In our experience, identifying specific risks or issues enables market participants to work together to design workable solutions.

2. Acknowledge the respective roles of asset owners, asset managers, and intermediaries and design policies consistent with their respective roles and functions. The roles of asset owners and asset managers are often conflated. The primary control over strategic asset allocation decisions rests with asset owners, often in consultation with investment consulting intermediaries. On the other hand, asset managers act as agents for asset owners and have only marginal impact on broad asset allocation decisions. While active asset managers engage in tactical asset allocation and relative value transactions subject to the limits placed upon them by the asset owners, these transactions are necessarily modest relative to the entirety of transactions taking place in the markets by asset owners and governmental entities. This understanding is critical for many of the current policy discussions, including central clearing counterparty (CCP) resolution and recovery proposals, designations of systemically significant non-bank financial institutions, modifications to OTC derivatives contractual provisions, and nascent attempts to control asset flows.

3. Review (and potentially revise) regulatory, accounting, and tax rules to encourage the desired investment behaviors of asset owners. Pension plans and insurance companies tailor their portfolios to optimize the outcome given various rules which may not have been architected with systemic stability as an explicit objective. Changes in the rules necessarily result in different asset flows and resulting portfolio construction. Regulators should aim to find a balance between solvency and maintaining transparency of information while encouraging long-term decision-making. In particular, funding rules should take into account a longer time horizon.

4. Focus on investment funds and investment practices in order to improve the financial ecosystem for all market participants. Both asset owners and asset managers benefit from properly functioning capital markets, and therefore, have an incentive to contribute constructively to policy makers' work on broad market solutions. We recommend exploring two different areas involving CIVs in the context of addressing concerns about asset flows: (i) identifying levered investment vehicles, and (ii) structuring of funds.

Identify levered vehicles that may magnify risks if forced to sell assets: In our response to the recent FSB-IOSCO "Consultative Document on Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions" (the "FSB-IOSCO consultation"),[29] we recommended using leverage as an initial screen to identify funds that should be evaluated further for their potential to present systemic risk. While leverage in and of itself does not equate to dangerous levels of risk, the term structure of leverage can be a key indicator of the risk presented by a leveraged CIV. As such, once this universe of funds is identified using the leverage screen, further analysis should be conducted using factors such as liquidity, redemption provisions, counterparty relationships and volatility.[30] As FSB-IOSCO noted, the potential for forced liquidations and market distortions are amplified by the use of leverage.[31] This is particularly true for those entities with maturity mismatched leverage, as their solvency may be exposed to extreme price moves. Conversely, where a fund has limited, matched and durable leverage, to the extent the fund receives redemption requests, selling down its assets on a one-to-one basis to meet the redemptions

would not create the risk of a fire sale with the attendant risk of creating a cascading downward price spiral.

Specify guidelines for structuring funds that reduce or minimize "run risk" thus providing better investor protection and mitigating systemic risk: As noted earlier in this paper, all funds in the market should be designed in a way that attenuates "run risk" looking at a combination of pricing methodology, redemption features, underlying portfolio management rules, and disclosure. Importantly, these elements should not be considered in isolation but rather should be assessed as a complete package. IOSCO began the process of establishing guidelines for several factors; however, the IOSCO guidelines look at each factor independently. We recommend that regulators use the IOSCO guidelines for suspensions of redemptions, liquidity risk management, and valuation as a starting point to develop more granular guidelines for structuring both registered funds and private funds. By requiring consistent investor protection, such guidelines, when adopted, will also mitigate systemic risk.

- **Classifying funds**. We recognize that all funds are not homogeneous with regards to underlying assets or underlying investment strategies. We therefore recommend considering rules that are tailored to reflect these differences. For example, regulators could establish different rules for: (i) money market funds, (ii) liquid funds, (iii) "less liquid" funds, (iv) hedge funds, and (v) other types of private funds. Using this approach, concerns expressed regarding small cap equities, emerging market debt, bank loans, corporate bonds, liquid alternatives, or other specific asset classes or products could be addressed with solutions tailored to the underlying assets or strategies involved.

- **Addressing transaction costs**. In cases where regulators determine a particular asset class or investment strategy is less liquid, additional measures may be warranted to address the allocation of transaction costs. Again, these measures should not be considered in isolation but should be analyzed holistically in the context of all four structuring features. For example, a fund that incorporates dual pricing probably should not also be required to have a redemption fee as both of these features address transaction cost allocation. Following the market timing scandals in 2003, many mutual funds implemented frequent trading policies, which can include imposing redemption fees or other anti-dilution measures on investors who enter and exit a fund more than a specified number of times over a specified period of time. Where a redemption fee is charged by a fund and, paid to the fund, it is for the benefit of the remaining investors in the fund. In some cases, these fees have been instituted to cover transaction costs associated with selling securities to meet redemptions in less liquid assets. In funds that incorporate redemption fees, these fees are disclosed to the investors in these funds. Today, hundreds of funds incorporate various kinds of redemption fees.[32] In the event that a sizable number of investors want to redeem from a specific fund or asset class, these fees are designed to cover the transaction costs of selling assets to cover redemptions, and provide protection to investors remaining in the fund. Asset owners who invest directly in these underlying asset classes would similarly face transaction costs in the event they were to sell these assets.

- **Additional Ideas.** There are several additional ideas worthy of further exploration. Regulators should consider how asset managers manage fund liquidity. Another idea to consider is standardizing provisions for redemption-in-kind for large redemption requests while exempting smaller investors. Finally, we recommend reducing uncertainty for investors by standardizing Board/Manager powers to close a fund, liquidate a fund, or take other emergency measures to protect investors in a fund.

- **Special issues for hedge funds**. While most of this paper addresses potential risks associated with open-end funds, hedge funds similarly need to be structured to protect investors in a fund from the actions of other investors in the fund. We recommend that securities regulators consider developing guidelines addressing the use of a combination of periodic redemptions (monthly or quarterly), notice periods, investor-level gates capping the amount an investor can redeem on a given redemption date, and "side-pocketing" for funds that invest in illiquid assets. As with open-end funds, these guidelines need flexibility to enable managers to tailor a specific fund structure to reflect the underlying assets and investment strategy of the fund.

- **Special issues for Money Market Funds**. In the aftermath of the financial crisis, a tremendous amount of work has been done on money market funds. Changes have been made to: portfolio credit quality, liquidity within the portfolio to meet redemptions, reporting requirements, stress testing, and Board powers. We anticipate that regulators will complete additional structural changes soon. Taken together, the objective of money market fund reform is to improve the resiliency of these funds, protecting investors and mitigating the potential for systemic risk.

5. Encourage standardization of issuance in corporate bond markets in order to improve secondary market liquidity. Companies currently tend to issue bonds whenever financing needs arise or opportunities present themselves. By staggering issuance schedules and diversifying maturities, companies can minimize risks of refinancing and higher rates when credit markets are expensive or closed. As a result,

secondary market trading is fragmented across thousands of bonds of varying maturities. Even for a single large issuer there can be hundreds of CUSIPs. Standardization, on the other hand, would reduce the number of individual bonds via steps such as issuing similar amounts and maturities at regular intervals and re-opening benchmark issues to meet ongoing financing needs. This would cut down the jungle of bonds and create a liquid curve for individual issuers. Standardized terms would improve the ability to quote and trade bonds leading to enhanced secondary market transparency, liquidity, and access.

Conclusion

The focus on potential systemically significant designations on individual asset management firms or individual large funds is misplaced, especially if the objective is to address systemically destabilizing pro-cyclical asset flows. The drivers of asset allocation, and hence asset flows are the asset owners and their intermediaries, not the asset managers. The issues identified in the various papers that have been published involve investment products and investment practices which require industry-wide solutions, not solutions focused on a handful of individual funds or asset managers. To put this view into perspective, the solution to over-the-counter (OTC) derivatives exposure did not involve regulating the two or three largest swap dealers since the business would either consolidate with these dealers or move to different market participants. Likewise, if adverse structural reforms to money market funds (MMFs) were applied to only a few of the largest MMFs, clients would undoubtedly move their assets to other non-affected MMFs. Not surprisingly, the US regulators (CFTC and SEC) and others (e.g., ESMA through the implementation of European Market Infrastructure Regulation (EMIR) in Europe) comprehensively changed the ecosystem for swap markets by instituting reporting, clearing and mandatory trading on regulated platforms, and we expect that the SEC's final rule on MMFs will apply to all 2a-7 MMFs, not just the largest MMFs or those sponsored by large managers. In considering further reform of "asset management" to reduce systemic risks, policy makers need to understand the respective roles of asset owners and asset managers and then take steps to improve the financial ecosystem for all market participants.

Rather than targeting a small group of large asset managers or a small group of large funds, policy makers need to consider solutions that address asset flows across all funds of a particular category. Concerns about "run risk" are often associated with "first mover advantage" which emphasizes the importance that investor protection rules should play in mitigating systemic risk. Given the diversity of assets and funds, we are not advocates of a "one size fits all" solution.

As noted earlier, the assessment of any individual fund or category of funds needs to look holistically at the provisions that are in place to manage client flows, and how these provisions collectively address investor behavior and investor protection. Ideally, this type of comprehensive fund review can be done collaboratively with regulators and fund sponsors working together to improve the financial ecosystem for all market participants. Obviously, any new regulations addressing these issues need to be applied across all funds in the category; otherwise regulatory arbitrage may cause assets to flow between funds with different characteristics.

ACRONYM GLOSSARY

Acronym	Name
AIF	Alternative Investment Fund
CIV	Collective Investment Vehicle
CIF	Collective Investment Fund
ETF	Exchange-Traded Fund
MMF	Money Market Fund
TDF	Target Date Fund
UCITS	Undertakings for Collective Investment in Transferable Securities
ASIC	Australian Securities and Investments Commission
CFTC	US Commodity Futures Trading Commission
ESMA	European Securities and Markets Authority
FSB	Financial Stability Board
IOSCO	International Organization of Securities Commissions
OCC	US Office of the Comptroller of the Currency
SEC	US Securities and Exchange Commission
CIO	Chief Investment Officer
DB	Defined Benefit
DC	Defined Contribution
IMA	Investment Management Agreement
LDI	Liability-Driven Investing
QDIA	Qualified Default Investment Alternatives

Notes

1. Feroli, Michael and Anil Kashyap, Kim Schoenholtz, and Hyun Song Shin. "Market Tantrums and Monetary Policy". Chicago Booth Research Paper No. 14-09. 28 February 2014; Haldane, Andrew. "The Age of Asset Management". Speech at London Business School Asset Management Conference. 4 April 2014; Shin, Hyun Song. "The Second Phase of Global Liquidity and its Impact on Emerging Economies". Keynote address at the Federal Reserve Bank of San Francisco Asia Economic Policy Conference. 7 November 2013; "Global Financial Stability Report". IMF. April 2014; and "Asset Management and Financial Stability". OFR. September 2013.
2. Elliott, Douglas J., "Systemic Risk and the Asset Management Industry". Brookings Institute. May 2014. Available at http://www.brookings.edu/~/media/research/files/papers/2014/05/systemic%20risk%20asset%20management%20elliott/systemic_risk_asset_management_elliott.pdf
3. Source: Pensions & Investments. As of 31 December 2012.
4. Source: Pensions & Investments. As of 30 September 2013.
5. Source: Dutch National Bank. See www.dnb.nl.
6. Source: SNL.
7. Ibid.
8. Ibid.
9. European Central Bank. Centralised MFI data.
10. For purposes of this discussion, we are explicitly not considering any asset management subsidiaries of a given bank.
11. BlackRock's 2013 Investor Pulse Survey was conducted by Cicero Group, an independent research company. The survey took place from August 24, 2013 to September 16, 2013 and was distributed to 17,567 individuals in 12 countries: US, Canada, UK, Germany, France, Italy, Netherlands, Belgium, Switzerland, Australia, Hong Kong, and Taiwan.
12. Haldane, Andrew G., "The Age of Asset Management?" Speech at the London Business School. 4 April 2014.
13. See for example "Asset Management and Financial Stability". Office of Financial Research. September 2013.
14. Ibid.; and Bowden, Andrew J. "People Handling Other Peoples' Money". Speech at Investment Adviser Association Compliance Conference. SEC. Available at http://www.sec.gov/News/Speech/Detail/Speech/1370541260300. 6 March 2014; and the European Commission's Green Paper, "Undertakings for Collective Investment in Transferable Securities – Product Rules, Liquidity Management, Depositary, Money Market Funds, Long-term Investment", July 2012, which raised questions concerning the continued eligibility of derivative instruments in UCITS.
15. See e.g., 29 CFR § 2550.404a-5 (Department of Labor requires plan fiduciaries to disclose certain plan, fee and investment-related information to participants and beneficiaries in DC plans); 29 CFR § 2550.408b-2 (Department of Labor requires covered service providers to disclosure to plan sponsor clients the fees that they receive and the services they provide); Form 5500, Schedule C (Department of Labor and Internal Revenue Service require plan administrators to report compensation paid to the plan's service providers on an annual basis); Form N-1A, Item 3 (Securities Exchange Commission requires mutual funds to describe fees and expenses in the risk/return summary); Form ADV, Part II, Item 5 (Securities Exchange Commission requires investment advisers to disclosure how they are compensated for advisory services). For the European Union, see e.g. Art. 24(4) to Art. 24(9) of the Market in Financial Instruments Directive II (relate to information to clients on costs and charges of the investment firm, the financial instruments, proposed investment strategies, execution venues and all costs and related charges); At national European level, COBS 6.1A.17R and COBS 6.1A.24R of the FCA Handbook, part of the UK Retail Distribution Review, (require advisers to give the client their charging structure before they provide advice, and to disclose the total adviser charge for the service they provide to that client); and and articles 168a and 168aa of the Dutch Decree on Decree on conduct of business supervision financial undertakings tyo the Dutch Financial Supervision Act ('Besluit gedragstoezicht financiële ondernemingen Wft') (relate to the ban for investment firms in relation to the receipt and payment of fees or other forms of remuneration from and to retail clients with regard to financial instruments).
16. See for example "Global Manager Search Trends: 2012 Year End Report". Mercer. 2013; and "A Tailored Approach: Positioning to Outcome-Oriented Global Investors". February 2014. Casey Quirk. Available at http://www.caseyquirk.com/pdf/21254_CQA_ConsultantSurvey_ForWeb.pdf .
17. See for example: Baker, Sophie. "Mercer: Institutional Searches Moving Away from Traditional Asset Classes". P&I Alternatives Digest. 30 April 2014. Available at www.pionline.com; and Williamson, Christine. "Asset Owners Up Pace of Activity with Hedge Funds". P&I Alternatives Digest. 28 April 2014. Available at www.pionline.com.; Davis, Morgan. "Corporate Pensions to Pump Money into Passive". 13 May 2014. FundFire. www.fundfire.com.
18. Source: Pensions & Investments. As of 30 June 2013. Available at www.pionline.com
19. FINRA Rule 2111 (Suitability).
20. See for example Ortiz, Peter. "Alts to Move From Fringe to Core, Fueling Growth: Cerulli". Ignites. 14 May 2014. Available at www.ignites.com.
21. Tendulkar, Rohini and Gigi Hancock. "Corporate Bond Markets: A Global Perspective". Staff Working Paper of the IOSCO Research Department. IOSCO. April 2014. Available at http://www.iosco.org/research/pdf/swp/SW4-Corporate-Bond-Markets-Vol-1-A-global-perspective.pdf.
22. See "Got Liquidity", BlackRock Investment Institute http://www.blackrock.com/investing/literature/whitepaper/got-liquidity-us-version.pdf, September 2012; and "Setting New Standards: The Liquidity Challenge II", BlackRock Investment Institute http://www.blackrock.com/investing/literature/whitepaper/setting-new-standards-us-version.pdf, May 2013.
23. See e.g., 29 CFR § 2550.404a-5 (Department of Labor requires plan fiduciaries to disclose certain plan, fee and investment-related information to participants and beneficiaries in DC plans); 29 CFR § 2550.408b-2 (Department of Labor requires covered service providers to disclosure to plan sponsor clients the fees that they receive and the services they provide); Form 5500, Schedule C (Department of Labor and Internal Revenue Service require plan administrators to report compensation paid to the plan's service providers on an annual basis); Form N-1A, Item 3 (Securities Exchange Commission requires mutual funds to describe fees and expenses in the risk/return summary); Form ADV, Part II, Item 5 (Securities Exchange Commission requires investment advisers to disclosure how they are compensated for advisory services). For the European Union, see e.g. Art. 24(4) to Art. 24(9) of the Market in Financial Instruments Directive II (relate to information to clients on costs and charges of the investment firm, the financial instruments, proposed investment strategies, execution venues and all costs and related charges). At national European level, see COBS 6.1A.17R and COBS 6.1A.24R of the FCA Handbook, part of the UK Retail Distribution Review, (require advisers to give the client their charging structure before they provide advice, and to disclose the total adviser charge for the service they provide to that client); and articles 168a and 168aa of the Dutch Decree on Decree on conduct of business supervision financial undertakings tyo the Dutch Financial Supervision Act ('Besluit gedragstoezicht financiële ondernemingen Wft') (relate to the ban for investment firms in relation to the receipt and payment of fees or other forms of remuneration from and to retail clients with regard to financial instruments).
24. Markets in Financial Instruments Directive II (MiFID II), Article 24(4) prevents firms providing advice on an independent basis from accepting and retaining commissions, fees or other monetary or non-monetary benefits from a third party such as the product manufacturer. Firms who do not give independent advice still have to meet enhanced suitability requirements when they give advice and disclose the amount of commissions received.

25. In particular, in Europe, while policy makers are driving to an increased use of in-house ratings to mitigate "over reliance on ratings" the situation is complicated by ratings being enshrined in many areas of prudential and conduct regulation. In the US, Section 939A of Dodd Frank directs federal agencies, to review regulations that rely on credit ratings as a standard of measurement and eliminate references to ratings as a standard of creditworthiness. Additionally, Section 939F of Dodd-Frank, or the "Franken Amendment" directs the SEC to study the feasibility of implementing a system whereby a board assigns CRAs to rate structured finance securities and to implement this system unless it finds a more suitable alternative. The SEC's work on this area is still underway.
26. "Asset Management and Financial Stability". Office of Financial Research. September 2013; and Haldane, Andrew. "The Age of Asset Management". Speech at London Business School Asset Management Conference. 4 April 2014.
27. See "Principles for the Valuation of Collective Investment Schemes". IOSCO. May 2013. Available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD413.pdf; "Principles of Liquidity Risk Management for Collective Investment Schemes". IOSCO. March 2013. Available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD405.pdf ; "Principles on Suspensions of Redemptions in Collective Investment Schemes". IOSCO. January 2012. Available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD367.pdf.
28. For comparison purposes, we have focused the discussion on open-end funds and we do not address money market funds or ETFs in Exhibit 19, as these are subsets that often have more specialized rules under commingled fund regulations.
29. See letter to Secretariat of the Financial Stability Board from Barbara G. Novick. 4 April 2014. Available at http://www.blackrock.com/corporate/en-us/literature/publication/nbni-gsifi-fsb-iosco-040414.pdf.
30. Ibid.
31. Ibid.
32. Source: Morningstar Direct. As of April 2014.

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