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Systemic Risk and Asset Management:
Improving the Financial Ecosystem for All Market Participants
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I. Introduction

In the wake of the 2008 financial crisis, global policy makers have been focused on reducing systemic risk. As part of these efforts, the G-20 called for the identification of global systemically important financial institutions (G-SIFIs), which it defined as globally important "institutions whose distress or disorderly failure, because of their size, complexity and systemic interconnectedness, would cause significant disruption to the wider financial system and economic activity."[1] Similarly, the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) established the Financial Stability Oversight Council (FSOC) to bring together the principal financial regulators in the United States, and among other responsibilities, charged it with identifying systemic risks to US financial stability, particularly those that could arise from the failure of a large, interconnected financial institution.

While a number of banks, insurance companies, financial market utilities and non-bank financial institutions have been designated by the various bodies involved, policy makers have now begun to consider whether asset managers and/or funds pose risks to the financial system. To that end, in 2012, the FSOC asked the Office of Financial Research (OFR) to analyze what threats, if any, asset managers pose to US financial stability and whether such potential threats can be mitigated by subjecting asset managers to prudential standards and supervision by the Federal Reserve Board of Governors (the Federal Reserve), or whether these potential threats are better addressed through other regulatory measures.[2] Similarly, the G20 asked the Financial Stability Board (FSB) in conjunction with the International Organization of Securities Commissions (IOSCO) to develop methodologies to identify non-bank, non-insurance financial institutions that could be systemically important; depending upon the final methodology, this could potentially include asset managers or funds.

By now, with the publication in September 2013 of the "Study of Asset Management and Financial Stability" by the OFR and the issuance of the consultation on "Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions" in January 2014 by the FSB and IOSCO, it is apparent that SIFI identification frameworks are not easily applied to asset managers. The asset management business model is an "agency" model which is fundamentally different than that of other financial institutions that act as principals. Asset managers act as agents on behalf of clients rather than managing assets on their own balance sheet. As a result, asset managers are neither the owner of the assets that they manage nor the counterparty to trades or derivatives. In addition, asset managers are much less susceptible to financial distress than banks, making asset managers highly unlikely to "fail" in the sense of a bank failure. Asset managers do not fund their business using the short-term credit markets and therefore, they are not exposed to the type of liquidity squeeze that banks and broker-dealers may encounter. Likewise, asset managers' revenue is generated principally from fees on assets under management and asset managers have the ability to significantly adjust expenses if revenues decline. Larger asset managers are further protected in that their revenues tend to be diversified by some combination of product, client type, and geography making them less susceptible to issues in any one area. Importantly, even if an asset manager does go out of business, the resolution process is straightforward in that clients can reassign their assets to

1 "Policy Measures to Address Systemically Important Financial Institutions," Financial Stability Board (FSB) (November 4, 2011) (available at <https://www.financialstabilityboard.org/publications/r_111104bb.pdf>).

2 Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 77 Fed. Reg. 21637-21644 (Apr. 11, 2012).

another manager and the remaining assets and liabilities of the manager itself can be resolved easily. Like any other service organization, asset managers go out of business regularly with no systemic implications.

The focus on potential SIFI and/or G-SIFI designations on individual asset management firms is misplaced. The issues identified in the OFR paper as well as the issues identified by the FSB involve investment products and investment practices which require industry-wide solutions. To put this in 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 simply move to different market participants. Likewise, if structural reforms to money market funds (MMFs) were applied to only a few of the largest MMFs, clients would move their assets to other non-affected MMFs. Not surprisingly, the US regulators (CFTC and SEC) and others e.g. 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, regulators should take a similar approach to improving the financial ecosystem for all market participants rather than focusing on a handful of large firms or funds. This paper explains what asset management is, how asset managers differ from other types of financial institutions, and provides several recommendations on how regulators can use their existing powers to reduce systemic risk by focusing on system-wide solutions for investment products and investment practices. Note that the examples used are not meant to be a comprehensive list, but rather provide a framework for approaching asset management issues.

II. What is asset management?

Asset management is portfolio management and trading of securities to achieve a specific investment objective for the benefit of investors such as pension funds, corporations, charities, educational establishments and individual investors. There are more than 500 managers with over $5 billion assets under management (AUM)[3], over 7,500[4] US mutual funds plus thousands of other public and private funds around the world, which represents significant diversity of investment thought processes and execution strategies.

An asset manager acts as an agent on behalf of its clients, meaning it transacts for its investor clients, not for itself. The asset manager is hired by investors directly or by the directors/trustees of commingled investment vehicles such as mutual funds and exchange traded funds (ETFs), in each case entering into an investment management agreement (IMA) that establishes the relationship between the asset manager and the client. 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. Importantly, assets of each client and of each fund are held by a custodian, not by the asset manager.[5]

Asset managers are subject to comprehensive regulation wherever they conduct their business. These regulatory regimes require managers to establish and maintain comprehensive risk management and compliance policies and procedures regarding the management of client accounts, and to keep and make available to regulators extensive records regarding their operations and transactions on behalf of clients. In the US, the SEC is the primary regulator of

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3 The P&I/Towers Watson World 500: World's largest money managers, Pensions and Investments (November 11, 2013, 12:01 AM), <http://www.pionline.com/article/20131111/INTERACTIVE/131109935/the-pitowers-watson-world-500-worlds-largest-money-managers>.

4 Investment Company Institute, 2013 Investment Company Fact Book: A Review of Trends and Activities in the U.S. Investment Company Industry, at 18 (53d ed. 2013).

5 While some asset managers use affiliated custodians, the custodians have direct obligations to the client to hold and safekeep assets. A small subset of funds, primarily those that employ long/short strategies may have some assets held by their prime broker.

asset managers that are registered as investment advisers. Asset managers that operate as trust banks or through bank trust departments are overseen by the Office of the Comptroller of the Currency (OCC) if federally chartered, and by state banking authorities if state-chartered.[6] In the EU, the management of separate accounts is comprehensively regulated under the EU Markets in Financial Instruments Directive (MiFID), and the management of pooled funds is regulated under the Directive for Undertakings for Collective Investment in Transferable Securities (UCITS), which governs retail mutual funds, the Insurance Mediation Directive, which covers funds structured as unit-linked insurance vehicles, and the Alternative Investment Fund Managers Directive (AIFMD) which covers all other investment funds managed by European asset managers.[7] In some cases, EU legislation may be supplemented by additional national requirements. Supervision of consistent implementation of EU legislation by national member states is undertaken by the European Securities and Markets Authority (ESMA), which has the power to issue binding technical standards as well as additional guidelines.

III. What distinguishes asset managers from other types of financial institutions?

While part of the financial services sector, asset managers are characterized by a business model that is fundamentally different than that of other financial institutions, such as commercial banks, investment banks, insurance companies and government-sponsored entities. Asset managers are different than most other financial firms in that they act as advisors or agents on behalf of their clients; asset managers are not investing on their own behalf. Asset managers do not act as lenders or otherwise provide credit to individuals or corporations, nor do they perform clearance, custody or related functions. In addition, asset managers do not act as counterparties in derivatives, financing or securities transactions, and they do not cross-hold debt or equity with their funds or other institutions. When a manager transacts in the market, the obligations under the trade (e.g., settlement, posting of margin) belong to the manager's client and are not obligations of the manager itself.

Contrast this with banks, broker-dealers and insurance companies. Although they promise the return of their customers' funds and assets, these entities *use customer assets in the ordinary conduct of their businesses*.[8] The need to protect customers from a complete loss when these entities fail has led in some countries to specialized protection regimes (e.g., deposit insurance up to specified amounts; SIPC for U.S. brokerage customers; state guaranty funds for U.S. insurers). In addition, the need to untangle these customer assets from the claims of other general creditors with lesser priorities has led to the creation of specific bankruptcy and insolvency schemes for banks, brokers and insurers.

The difference between the balance sheet assets of an asset manager and assets under management are often conflated. As explained above, assets under management (AUM) belong to clients and are not part of the asset manager's balance sheet. Therefore, the AUM, or client assets, are not part of any liquidation or potential bankruptcy process associated with an asset manager and its creditors.

6 Asset management activities of state-chartered banks are also subject to examination and oversight by the Board (if the bank is a member of the Federal Reserve System) and/or the Federal Deposit Insurance Corporation (FDIC) (if the bank is a non-member FDIC insured institution).

7 Asset management firms themselves are individually authorized and supervised by national competent authorities such as the Financial Conduct Authority or Prudential Regulatory Authority in the UK, the German Federal Financial Supervisory Authority, the French Autorité des Marchés, the Central Bank of Ireland and the Luxembourg Commission de Surveillance du Secteur Financier. Legislation equivalent to that in the EU exists in Switzerland and Swiss managers are subject to authorization and supervision by the Swiss Financial Market Supervisory Authority.

8 US securities regulations and client money rules in other countries require segregation of client assets from the assets of the broker-dealer, but permit the use of those assets in certain circumstances, such as when the client uses margin accounts or otherwise becomes a borrower from the broker-dealer.

For these reasons, asset managers – unlike banks, thrifts and federal credit unions – do not have government insured or guaranteed deposits, nor do they have access to the Federal Reserve discount window. Banks accept deposits that, in the US, are then insured by the FDIC and, in the European Union (EU), are obliged to participate in national Deposit Guarantee Schemes. Asset managers, meanwhile, clearly disclose to clients that investment performance is not guaranteed by the manager, the government, or any other party. This distinction was critically important in shielding asset management firms from much of the turmoil that occurred during the financial crisis of 2008.

Because asset management firms are not direct market participants, and do not invest for their own account, they do not assume high levels of balance sheet risk. Conversely, other financial companies engage in activities involving balance sheet risk. For example, investment banks act as principal in trading, market-making and prime brokerage; finance companies access the capital markets for funds and essentially re-lend these monies; and insurance companies provide long-term financing for real estate and other hard assets as part of their asset-liability management. The balance sheet of an asset management firm comprises working capital, an investment portfolio related to seed and co-investment capital, property, premises and equipment; thereby requiring a modest amount of capital. An asset manager's balance sheet is very small compared with that of a bank and its balance sheet is not leveraged. As a result, if an asset manager were to go out of business, the resolution of the assets and liabilities of the firm would be very straightforward and would have no impact on client assets or on broader markets.

Importantly, end-investors primarily bear the risk of adverse market movements, not the asset manager itself. Investors that hire asset managers or invest in funds understand and accept that they are exposed to the risk of their assets falling in value. While asset managers strive to generate positive performance for clients, asset price deterioration in a given fund or client account has little direct impact on the asset manager. Of course, because asset managers normally charge fees based on the size of their AUM, reduced AUM due to market movements or client withdrawals results in reduced revenue. However, larger asset managers have strong cash flow from diversified investment management revenue sources representing various asset classes (e.g., equity vs. fixed income) and investment strategies (active vs. passive). In addition, revenue reductions can be substantially offset through adjustments in the manager's operational expenditure, headcount and variable employee compensation in order to maintain positive net income.

IV. Improving the Financial Ecosystem

The financial crisis highlighted a number of risks and, in response, over the past several years, many changes to global regulation and to market practices have occurred which reduce systemic risk. These changes range from an increased emphasis on 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. Some of these changes are due to broad legislative initiatives such as the Dodd-Frank Act and EMIR, some are the result of targeted regulations, and the remainder reflects changes due to market forces. As an asset manager, BlackRock supports those changes that have resulted in a sounder financial system, and we are supportive of additional reforms that address systemic risks. We have identified several areas where regulators can use current powers and tools to improve the financial ecosystem: cash management products, securities lending, liquidity in fixed income markets, ETFs, central clearing counterparties (CCPs), and harmonization of global data reporting. As noted earlier, solutions should be developed that can be applied consistently across market participants in all regions; otherwise, activity will simply shift from one market participant to another without actually addressing the issue under consideration.

Cash Management Products

Money market funds (MMFs) have been a topic of discussion – and often disagreement -- among policy makers and market participants since the 2008 financial crisis and historic "breaking of the buck" by The Reserve Primary Fund. The result has been a series of reforms that tightened standards and enhanced protections for MMF investors, including the SEC's Rule 2a-7 reforms in 2010, the ESMA "Guidelines on a Common Definition of European Money Market Funds" in 2010 and OCC reforms for short term investment funds (STIFs) in 2012. These reforms introduced more conservative maturity and liquidity requirements, stress testing, and greater transparency and disclosure, among other requirements. Policymakers are pursuing further structural reforms in the belief that additional changes are necessary to protect the financial system. The SEC issued its proposal for further reforms in June 2013 and the European Commission issued its proposed Money Market Fund Regulation (MMFR) in September 2013.

BlackRock has been actively engaged in the dialogue on MMF reform for several years. Throughout, BlackRock has been a proponent of a solution that preserves the benefits of MMFs for investors and provides a mechanism for managing mass client redemption and minimizing the risk that a "run" on a single fund triggers a systemic run. MMFs play a unique role in the economy by providing short-term funding to commercial and municipal borrowers through purchases of commercial paper and other short-term debt while providing short-term investments and liquidity to a broad array of institutional and retail investors. Subsequent to the SEC proposal, we surveyed MMF investors and provided feedback on the various proposals and open questions.[10] We also participated in a letter that was submitted to the SEC jointly by nine MMF managers regarding a proposed alternative definition for "retail" MMFs.[11]

We believe the optimal outcome of these proposed reforms will be an even playing field across comparable products that are regulated by separate regulators. For example, in the US, while the SEC and OCC have implemented the reforms noted, changes to the investment standards and rules applicable to cash funds managed by state chartered institutions is yet to be enacted at either the Federal or state level. In this case, we would encourage the FSOC to work with the FDIC, the Federal Reserve and state bank regulators to create a more harmonized environment. As this example shows, harmonization across comparable cash products would protect investors and prevent regulatory arbitrage. We encourage regulators to consider global harmonization of final rules wherever possible.

Securities Lending

Securities lending is an established practice in global financial markets that provides liquidity to markets while also generating additional returns to investors who lend securities.[12] The availability of securities through lending arrangements is widely viewed as providing liquidity to the markets.[13] The extra return is a function of the "intrinsic value" of the securities, which

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10 Letter from Barbara Novick to Elizabeth M. Murphy, "Feedback on OFR Study on Asset Management and Financial Stability," on Nov. 1, 2013 (available at <http://www.sec.gov/comments/am-1/am1-14.pdf>).

11 Letter from BlackRock, Inc., Fidelity Investments, Invesco Ltd., Legg Mason & Co, LLC and Western Asset Management Company, Northern Trust Corporation, T. Rowe Price Associates, Inc., Vanguard, and Wells Fargo Funds Management, LLC to Elizabeth M. Murphy. "Money Market Fund Reform; Amendments to Form PF (Release No. IC-30551; File No. S7-03-13) on Oct. 31, 2013 (available at http://www.blackrock.com/corporate/en-us/literature/publication/mmf-retail-definition-joint-letter-sec-103113.pdf).

12 In May, 2012, BlackRock published a *ViewPoint* entitled *Securities Lending: Balancing Risks and Rewards*. In this publication, we explained the benefits of securities lending to markets and to investors while also highlighting the risks associated with this investment practice and offered several recommendations for the enhanced regulation of securities lending. This publication is available at <http://www.blackrock.com/corporate/en-us/literature/whitepaper/balancing-risks-and-rewards-may-2012.pdf>.

13 *See, e.g.,* Dreff, Nadja, "The Role of Securities Lending in Market Liquidity", Financial System Review (June 2010), Bank of Canada; Dive, Matthew, "Developments in the Global Securities Lending Market", Quarterly Bulletin (Q3 2011), Bank of England.

factors into what a borrower is willing to pay to borrow the securities, as well as (primarily in the US market) by reinvestment of any cash collateral received, resulting in enhanced returns to investors.

Securities lending involves a loan of securities to a third party (the borrower), who gives the lender collateral (in the form of cash, shares, or bonds) in an amount equal to the value of the loaned securities plus an additional margin above that amount. The borrower compensates the lender for the securities loan either through a payment or allowing the lender to keep part of the collateral reinvestment return. The lender receives at a minimum the same economic exposure to a security on loan, including any dividends or distributions, as if the loan had not occurred, although the lender must recall shares in order to vote proxies. The market for securities lending is driven by demand from large banks and broker-dealers and their clients, including hedge funds. Investors are, directly or indirectly, the lenders of securities and they lend securities to achieve enhanced returns on their portfolios. Lenders are typically large institutional investors, including pension funds, foundations and endowments, sovereign wealth funds, mutual funds, bank maintained collective trust funds, UCITS funds and similar investment funds. Borrowers are typically large financial institutions, such as broker-dealers, investment banks, and market makers, including those who act as prime brokers. While hedge funds are among the largest end-borrowers of securities, they generally borrow from their prime brokers rather than directly from the investors or their agents. The processes associated with securities lending are managed by a lending agent, who is generally compensated by the lender by receiving a percentage of the return generated from the transaction. Most custodian banks offer lending agent services.

Like any investing activity, securities lending entails risks that must be managed. Key risks include counterparty credit risk, cash collateral reinvestment risk, non-cash collateral risk, and operational risk. During the financial crisis, issues surfaced related to cash collateral reinvestment strategies which have triggered increased scrutiny of securities lending by the SEC, ESMA and others. Each of the potential risks associated with securities lending can and should be addressed and monitored in a well-managed securities lending program.[14]

For regulatory reasons, cash collateral is the predominant form of collateral in the US market. When the lender receives cash as collateral, this cash is reinvested. The lender's objective is to generate income. However, the lender is also exposed to investment risk including the potential loss of principal. Concerns regarding cash collateral reinvestment have been raised by the OFR. The management of cash collateral pools in securities lending provides an excellent example of how regulators can create a harmonized regulatory environment to address investment products or practices that may present risks. The management of cash pools is already subject to oversight by multiple regulatory bodies who are working independently to address a variety of concerns arising from the financial crisis, including the guidelines that apply to stable NAV cash funds. As described above, the SEC issued reforms for Rule 2a-7 MMFs in 2010 and the OCC issued reforms for STIFs in 2012 – both sets of reforms enhanced liquidity and maturity requirements. We believe these reforms have gone a long way to address the concerns of policy makers. However, as noted earlier, we would encourage the harmonization of investment standards and rules regarding cash management applicable to state chartered institutions (including custodians that engage in securities lending).

Regulators could also require disclosure in the form of non-public reporting by lenders and borrowers in order to monitor the markets. The exact information to be gathered, the frequency and the format of the information should be agreed between regulators and the industry globally to make the information most useful to regulators and the process workable for the industry.

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[14] "*ViewPoint* Securities Lending: Balancing Risks and Rewards," BlackRock (May 2012) (available at http://www.blackrock.com/corporate/en-us/literature/whitepaper/balancing-risks-and-rewards-may-2012.pdf).

Finally, securities lending risks need to be actively monitored and addressed by both the lenders and their lending agents. Given the global nature of securities lending and the interest by regulators in multiple jurisdictions, we recommend an internationally coordinated approach to establishing standards and regulations. In considering new regulations for securities lending, regulators need to balance the benefits to the markets and to investors with the need to mitigate risks. It is also critical to understand that the securities lending market includes multiple participants, including lenders, borrowers, custodial and non-custodial lending agents, tri-party collateral agents, prime brokers and exchanges. Asset managers act as lending agent for a small subset of the total volume of securities lending transactions; most securities lending activity is conducted by custodial lending agents. As a result, regulating selected market participants, rather than seeking to change practices across all market participants, will not address potential systemic risks associated with securities lending.

Liquidity in Fixed Income Markets

A structural shift is underway in the corporate bond market. The cumulative impacts of regulation, including bank capital rules like Basel III, have reduced banks' appetites for using their balance sheet to take on risk. As a result, as of February 2014, primary dealers' inventories of US corporate bonds have plummeted 73% from a high of $235 billion in 2007.[15] This dynamic has been somewhat obscured by record issuance levels and positive price performance. However, we believe it is important to address this issue as reduced liquidity translates to wider spreads, higher transaction costs, and ultimately diminished returns for investors.

The corporate bond market is highly fragmented as corporations issue various bonds over time with different maturities, different coupons, and other features. Bond investors must sift through thousands of issues even for the top 10 corporate issuers, as Figure 1 shows. We believe a more standardized corporate bond market would result in enhanced market liquidity. Corporations would issue bonds at set maturity intervals by reopening benchmark issues to cut down the number of individual bond issues. This approach would create a liquid curve for large and frequent issuers. In parallel, the standardization of derivative markets would lower the overall cost of hedging for these issuers.

Figure 1:
Bonds and Shares Outstanding of Top US Investment Grade Bond Issuers

Issuer	Bonds in Barclays US Corporate Index	Share of Dollar Amount Outstanding	Total Bonds Outstanding	Common Equity Securities	Preferred Equity Securities
GE	44	31.2%	1,014	1	4
J.P. Morgan	32	34.1%	1,645	1	13
Goldman Sachs	25	38.4%	1,242	1	8
Citigroup	39	35.8%	1,965	1	12
Morgan Stanley	29	40.1%	1,316	1	12
Bank of America	30	28.2%	1,544	1	39
AT&T	29	62.6%	74	1	0
Wal-Mart	26	71.6%	50	1	0
Verizon	26	60.8%	71	1	0
Wells Fargo	15	26.2%	274	1	8

Exchange Traded Funds

As exchange traded funds (ETFs) and other exchange traded products (ETPs) have grown significantly over the past several years, more attention has been focused on these

[15] Data available at the Federal Reserve Bank of New York website (available at http://www.newyorkfed.org/markets/gsds/search.html).

products. As an ETF sponsor, BlackRock has been an active participant in discussions related to ETFs focusing on both explaining the intricacies of ETFs and recommending specific areas for regulatory reform.[16] Key benefits that distinguish well-structured ETFs from open-end funds (OEFs, or mutual funds) include enhanced liquidity, a high degree of transparency, lower vulnerability to market timing and the ability to trade in and out of positions intraday. The benefits of index-based ETFs include low administrative expenses, low trading overhead, cost-efficient and convenient access to a variety of markets (both liquid and less liquid markets) and the ability to replicate exposure to various broad market benchmarks via a single vehicle.

ETFs are still relatively small compared to mutual funds, which presents a potential opportunity to introduce reforms that both protect investors and introduce structural improvements to foster growth and innovation without significantly disrupting existing markets. The following are specific recommendations for regulatory reform in this area:

- Improve the liquidity of underlying markets (e.g. fixed income) by standardizing issues and encouraging exchange trading where feasible;
- Ensure ETP sponsors are judicious in their selection of reference indices and rigorous in performing due diligence around index providers' calculations and data quality;
- Mandate clear labeling of product structure and investment objectives;
- Rely on multiple firms that create and redeem ETF shares wherever possible to diversify risk and enhance liquidity;
- Promote transparency around the multi-dimensional value proposition of ETF ownership rather than focusing solely on total expense ratios; and
- Use synthetic products sparingly, primarily in cases where accessing the underlying securities is either expensive or prohibited by local law, and only when accompanied by a highly disciplined risk management process, collateralization, multiple counterparties and detailed disclosure to investors.

Since our publication in 2011 recommending reforms, we have seen some improvements in market practices; however, we welcome the opportunity for continued improvement as we believe ETFs will continue to grow. As with our recommendations on other investment products, we recommend that regulators consider global harmonization of rules for ETFs wherever prudent.

Central Clearing Counterparties (CCPs) and Systemic Risk

Central clearing counterparties (CCPs) were created to reduce systemic risk by requiring central clearing of swaps and mandating collateralized transactions while increasing transparency and investor protection. The idea, promoted by the G-20 beginning at their Pittsburgh Summit in September 2009,[17] is a good one, as it increases transparency for regulators and market participants, and eliminates many of the counterparty risks inherent in bilateral OTC transactions. However, in this process, risk has been concentrated in CCPs, and this risk needs to be addressed. As policy makers begin to focus on the concentration risk created by central clearing, a number of questions have been raised. Do CCPs present a new systemic risk? Are CCPs "too big to fail"? Or should a CCP be allowed to fail? What protections should be put in place to protect the system and investors from a potential failure? In the event a CCP experiences distress, what should the waterfall look like to resolve the situation?

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[16] "*ViewPoint* Exchange Traded Products: Overview, Benefits and Myths," BlackRock (June 2013) (available at <https://www.blackrock.com/corporate/en-us/literature/whitepaper/viewpoint-etps-overview-benefits-myths-062013.pdf>); "ETFs: A Call for Greater Transparency and Consistent Regulation," BlackRock iShares (Oct. 2011) (available at <http://www.blackrock.com/corporate/en-us/literature/whitepaper/transparency-and-consistent-regulation-oct-2011.pdf>).

[17] Statement from the Group of Twenty Finance Ministers and Central Bank Governors, Leader's Statement from the Pittsburgh Summit (Sep. 24, 2009).

Some market participants have argued for the “recovery” of a failing CCP; others are advocating for a clearer approach to “resolution”. BlackRock is supportive of central clearing and believes it is crucial to implement measures that mitigate the risk of a potential CCP failure. Financial stability is best served by a regime where any entity, including a CCP, has a recovery and resolution plan that will prevent its failure from impacting market stability. In order to protect against systemic risk, policy makers should address the need to strengthen the defenses of a CCP in the event of a default by one or more of their clearing members. This approach starts with requiring CCPs to maintain adequate capital and to employ a rigorous approach to risk management with each of its counterparties. In the event of a problem, the “default waterfall” which specifies the order of the resources available to a CCP would start with the failing counterparties, and then be supplemented by the capital of the CCP, before tapping the funds of any other non-defaulting clients.

All market participants, including CCPs, should be allowed to fail while ensuring protections are in place to avoid systemic risk and to protect end-investors. A resolution plan that focuses on a rapid and complete wind down of the failing CCP’s positions, along with a timely and orderly repayment of margin monies is preferable to a recovery plan that uses customer margin to extend the state of a failed or failing CCP. By definition, the failure of a CCP reflects a flawed risk management process which in turn will impact customer confidence in the abilities of the CCP on a forward-looking basis. As such, customers would prefer a rapid liquidation of positions to close-out the clearing business very quickly and to return margin provided by non-defaulting clearing members and non-defaulting clients with minimum market loss. A rapid liquidation and return of margin would minimize end-user losses and would allow clearing members and their clients the option to establish replacement positions in the most efficient manner. The resolution plan could be followed by a timely recapitalization of the CCP if authorities deem that necessary. In order to affect this result, we recommend that a product not be subject to mandatory clearing until at least two CCPs can offer clearing for that product.

Harmonization of Global Data Reporting

Several new regulations require managers to report data on products that they manage. For example, private fund reporting is found in AIFMD and in regulations resulting from the Dodd Frank Act. The data requested on Form PF and Form PQR as well as the data requested for AIFMD is often similar but is requested in a slightly different manner on each form. The result is large amounts of fragmented data. Standardization would enable regulators to aggregate data and analyze data sets, and would facilitate comparisons. Swaps data, threshold reporting and securities lending are other obvious areas where consistency of data reporting would benefit regulators by providing “information”, not just raw data.

V. Conclusion

It is important to develop an understanding of asset management in order to identify the best ways to address potential systemic issues. The FSOC asked the right questions in 2012: What threats exist to systemic stability and how can these potential threats be best addressed? Given the agency model of asset management, regulation of a small number of managers or a small number of funds will not change the threats that are under consideration by the FSOC or the FSB. In each case, a systemic approach to regulation is required, otherwise assets will simply move from one set of managers or one set of funds to another group.