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Secretariat of the Financial Stability Board,
c/o Bank for International Settlements,
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Submitted via email to FSB Secretariat *fsb@fsb.org*

21st September 2016

Dear Sir/Madam,

Re. Financial Stability Board Consultative Document (dated 22nd June 2016)

HSBC Global Asset Management ("HSBC") appreciates the opportunity to comment on the FSB's Consultative Document and the proposed policy recommendations which aim to address "*Structural Vulnerabilities from Asset Management Activities*".

In **PART A** we make some observations on the policy recommendations and respond to the specific questions raised in the Consultative Document.

We have also included separately a **PART B**, which provides an overview of the approach to liquidity risk management that HSBC has developed based on its experience managing over $429[1] billion for funds and institutional clients around the globe. We believe our position, as outlined in **PART B,** is pertinent to our response as it relates to the subject of "*Liquidity mismatch between fund investment assets and redemption terms and conditions for fund units*" which we believe is important and have commented on recently in response to the SEC proposals on *Open-End fund Liquidity Risk Management Programs, swing pricing and Re-Opening of Comment Period for Investment Company Reporting Modernization Release* (September 2015) and the AMIC/EFAMA report on *Managing fund liquidity risk in Europe* (April 2016).

We would like to make the following point on the four structural vulnerabilities identified by the FSB.

Structural vulnerability (i) ***liquidity mismatch between fund investments and redemption terms and conditions for open-ended fund units***
The issue of liquidity mismatch is not a new phenomenon, though it has become perhaps more noticeable in the context of current market conditions; as the FSB notes the "*impact of extraordinary monetary policy operations*" has led investors to search for "*higher yielding, less actively-traded asset classes*" in a period of "*exceptionally low interest rates*". It is difficult to assess central banks' extraordinary monetary policy operations and understand how their future evolution might impact on financial markets and the extent to which this will contribute to the build-up of systemic risks.

With this in mind, we fully support any efforts by regulators to update existing regulatory frameworks to enable funds to better manage liquidity risk. Of the FSB's policy recommendations, we believe **enhancing investors' understanding of liquidity risk** through clear and transparent disclosures**, permitting the full range of available liquidity management tools** and providing **more guidance** and **common best practices on the use and application of these tools** would contribute positively to the management of liquidity risk and in turn help manage concerns around potential systemic market liquidity events.

1. Assets under management from March 2016

Due to the availability of safeguards, however, we disagree with the assertion that the "*potential mismatch in open-ended funds between liquidity of fund investments and daily redemption of fund units*" represents a key structural vulnerability and a potential systemic risk to the wider financial industry.

We have some concerns and suggestions which we address further in **PART B**. **In particular, we believe market liquidity and investor behaviour are multidimensional and difficult to quantitatively measure, thereby making it impossible to predict all the potential causes of liquidity crises. We agree that funds act in an agency capacity, but would be concerned by policy prescriptions that depart from this idea and instead treat funds as if they were liquidity transformation vehicles, which they do not set out to be.**

Just as asset managers cannot fully immunise investors from all other risk factors (market risk, credit risk, regulatory risk etc.), it would be inappropriate to create an expectation that they can deliver a different outcome with liquidity risk without inappropriately transforming the risk or inadvertently creating other adverse consequences (e.g. leverage, inappropriate risk transfer, etc.). HSBC does not believe liquidity risk is or should be treated differently from other risks.

Further, the use of certain pre-emptive liquidity management tools (e.g. forcing asset managers to hold more liquidity in their funds) may detrimentally impact those investors who understand and seek the risk premium illiquidity brings from investing in relatively less liquid assets (e.g. bank loans, private equity, real estate etc.). Forcing funds to hold more liquidity restricts the investor's ability to choose what risks they wish to be exposed to which in turn limits their desired returns.

Structural vulnerability (ii) – *leverage within investment funds*
We support authorities' efforts to assess the robustness of existing control frameworks relating to funds that employ material leverage to enhance investor returns; of specific interest might be the evolving range of some "absolute return" funds or guaranteed funds, where specific stresses could mean that such funds could default on their derivative obligations. We would also welcome any efforts to agree on a definition of economic leverage and enhance the current measures of leverage; for example, to distinguish between the uses of leverage, to generate more consistent cross-jurisdictional measures and to increase investors' awareness of individual fund's potential (rather than current) leverage , in the form of a more simplified leverage percentage. We disagree, however, with the assertion that "*leverage within investment funds*" represents a ***material*** risk to the broader financial system as we believe this risk is generally well controlled as part of existing regulatory frameworks (e.g. UCITS, AIFMD, etc.); with the possible exception of highly leveraged hedge funds which are not captured by regulatory control frameworks.

Structural vulnerability (iii) *operational risk and challenges in transferring investment mandates in stressed conditions*
Whilst we do not believe "*operational risk and challenges in transferring investment mandates in stressed conditions*" represents a material risk to investors or to the broader financial system we have suggested recommendations and areas which may benefit from policy focus. For example, we believe further supervision of third party service providers and large complex asset managers that undertake non-core critical services would help ensure that any difficulties encountered by these entities have been appropriately risk managed and contained.

Structural vulnerability (iv) *securities lending activities of asset managers and funds*
It is difficult to assess whether "*Securities lending activities of asset managers and funds*" represents a material risk to the broader financial system, but **we support the FSB's recommendations to ensure that both the credit worthiness of the borrower and the strength of the indemnification (and the entity(ies) underwriting the indemnification) are sufficiently robust**. We also provide our views on additional

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potential structural vulnerabilities associated with or linked to asset management activities that the FSB might wish to address together with some recommendations.

Several of the FSB's policy recommendations call for greater information flow to regulators. Although we support the policy process and authorities' efforts to identify and help reduce systemic market risks, existing regulatory reform has already imposed substantial reporting obligations on financial markets participants' including asset managers (e.g. AIFMD reporting) and further requirements are pending implementation (e.g. transparency requirements under MiFID II, enhanced Key Investor Disclosures for PRIIPs).

As such, we request that more work is undertaken to determine what types of new data, if any, might enable sufficient insight into systemic risks from which meaningful policy decisions could be drawn; we believe authorities would be significantly challenged to identify how much liquidity and leverage is deemed to be appropriate for different scenarios in different market conditions. We agree, however, with the FSB in that the provision of new reporting information should "leverage existing national and international initiatives" rather than create new, complex and costly reporting requirements.

To reduce the burden on asset managers of having to maintain multiple reporting requirements and to enable regulators to cross-compare data across jurisdictions we request that efforts go into establishing a single set of globally harmonised reporting requirements/templates. Clearly the efficacy of the initiatives to source and use more data will depend on regulators' capacity to sufficiently handle the data.

As a matter of importance we would also request that regulators' explain further how any collected data will be used, what triggers might be employed as part of regulatory intervention and under what authority.

Yours faithfully

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Should the FSB have any questions regarding these comments, or if we can provide further information, please do not hesitate to contact:

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PART A
HSBC RESPONSE TO FSB QUESTIONS

Question 1: Does this consultative document adequately identify the structural vulnerabilities associated with asset management activities that may pose risks to financial stability?

(i) liquidity mismatch between fund investments and redemption terms and conditions for open-ended fund units;

The purpose of funds is to enable investors to invest in the underlying assets. The benefits of funds include diversification and pooling (e.g. diversification, lower costs, access to investment opportunities/returns, etc.) that may otherwise not be available or easily available to individual investors.

Whilst we support many of the FSB's recommendations in relation to liquidity mismatch (e.g. enhancing disclosures, extending the use of liquidity management tools, etc.), we disagree with the assertion that the "potential mismatch in open-ended funds between liquidity of fund investments and daily redemption of fund units" represents a key structural vulnerability and a potential systemic risk to the wider financial sector.

Studies[2] using empirical fixed income data (even in the high-yield market, where trading is deemed less liquid) also contradict the hypothesis that forced selling at distressed prices which leads to lower prices automatically causes greater redemptions, creating a negative "feedback loop" that can destabilise markets during a period of market stress.

Any proposed mitigants must therefore be relevant and commensurate to the risks posed by individual fund structures and asset management activities.

We believe the liquidity mismatch concerns cited by the FSB the do not appear to fully take into account what open-ended funds offer investors and what they can practically achieve. Expectations that open-ended funds can and will always offer daily pricing and investment "redeemability" are profoundly unrealistic. Whilst open-ended funds should be able to convert some portion of their holdings into cash on a frequent basis because they issue redeemable securities, open-ended funds do not provide liquidity transformation. This extreme hypothetical scenario draws synergies between the dynamics of open-ended funds and their underlying investments and expectations of what can be achieved in different market conditions. The FSB's statement "*…some investors do overestimate the liquidity of the assets held by the funds in which they invest, and may not expect the high cost or difficulty associated with funds exiting their positions or rebalancing their portfolios in a stressed environment*" acknowledges and supports the argument that more needs to done to better inform investors.

Funds' ability to raise liquidity depends on their capacity to divest the underlying investments within a given timeframe and with acceptable market impact. The changing and often binary nature of market liquidity complicates this process. Investors' perception that funds can deliver the benefits of excess returns while also providing the same or similar liquidity of a call deposit is profoundly misaligned to the risks associated with investing; something which current regulations may exacerbate. Again, notwithstanding expectations from investors for certain types of funds to offer daily liquidity, open-ended funds are not banks nor can they promise to deliver maturity/liquidity transformation.

2. Matching Models to Reality: In a Falling Market, the Real "Movers" May Be...the Buyers by Brian Reid (July 15th 2016); Retrieved from: https://www.ici.org/viewpoints/view_16_bond_fund_series_03

Investors wishing to sell their investment in stressed conditions will do so regardless of whether they have invested in an open-ended fund structure or whether they have invested directly in the underlying securities. The fact that investors have chosen to invest through a fund structure rather than in underlying securities does not create more (or less) liquidity in the system, nor does it magnify the market impact of material selling. Conversely, it could be argued that significant selling via a fund structure (as opposed to sales in the underlying securities) during a period of market stress, could dampen the overall effect of selling as asset managers typically aggregate and execute orders in tranches to deliver the best results as well as the professional evaluation by asset managers of fair value and their potential reluctance to sell at fire sale prices.

The contingent stabilisation measures used in times of market stress by asset managers to temporarily suspend trading in open-ended funds and stock exchanges' use of circuit-breakers are not wholly dissimilar[3] in that both are employed to protect the integrity of the financial markets and the interests of investors. While the suspension of one or more funds might be a function of volatile market conditions and/or excessive redemption requests, it is not necessarily indicative of a structural vulnerability with respect to funds' liquidity mismatch.

Investors must recognise that investing in securities through a fund does not remove the risk that would normally come from directly holding those securities (e.g. investment, credit or liquidity risks). Also, rather than holding the underlying securities, funds can potentially introduce other types of risks depending on the type and complexity of trading strategies employed, the nature of underlying investments, use of leverage, etc.

(ii) leverage within investment funds;

With respect to vulnerability 2 (leverage within funds), we agree that some work can be done to enhance the current measures of leverage (e.g. to distinguish between the uses of leverage, to generate more consistent cross-jurisdictional measures and to increase investors' awareness of individual fund's potential leverage, rather than current leverage, in the form of a more simplified leverage percentage). The use of synthetic leverage through financial derivatives instruments can take place for a variety of reasons including, as the FSB notes "for hedging purposes", "cost-effective investment reasons" or to "leverage specific exposures within a fund". Further, as the FSB notes the "*majority of investment funds are subject to regulatory limitations on traditional balance sheet leverage*". Rather than relying on supervisory intervention, we believe authorities should focus their efforts on implementing an appropriate regulatory control framework to manage the risks associated with the use of "material" leverage used to enhance returns which could lead to a fund being unable to meet its commitments (e.g. margin calls, option pay-outs etc.) under derivative contracts in stressed conditions, especially as these commitments do not benefit from the liquidity management tools available to manage investor subscriptions and redemptions; such a fund would consequently be considered to be in default if it failed to make a payment under a derivative contract. Of specific interest might be the evolving range of some "absolute return" funds or guaranteed funds, where specific stresses could mean that the fund could default on its derivative obligations.

(iii) operational risk and challenges in transferring investment mandates in stressed conditions; and

Whilst we do not believe vulnerability 3 ("*operational risk and challenges in transferring investment mandates in stressed conditions*") represents a material risk to investors or to the broader

3. Examples: (1) Germany's decision on 19/05/10 to ban naked short-selling of CDS on euro government bonds issued by the country's 10 most important financial institutions to protect against speculation; (2) circuit breakers suspending trading in shares in BT Group, Hays, Next, Northumbrian Water and United Utilities after each stock moved more than 5pc from their opening price on 25/08/10; (3) Barclays and RBS shares suspended from trading after falling more than 8% following Brexit on 27/06/16.

financial system, in our response to question 15 we put forward some recommendations and areas of focus such as further supervision of third party service providers and large complex asset managers that undertake non-core critical services to ensure that any difficulties encountered by these entities have been appropriately risk managed and contained.

(iv) securities lending activities of asset managers and funds.

It is difficult to assess whether vulnerability 4 (Securities lending activities of asset managers and funds) represents a material risk to the broader financial system, but we support the FSB's recommendations to ensure that both the credit worthiness of the borrower and the strength of the indemnification (and the entity(ies) underwriting the indemnification) are sufficiently robust.

Are there additional structural vulnerabilities associated with asset management activities that the FSB should address? If there are any, please identify them, as well as any potential recommendations for the FSB's consideration.

The FSB should consider the possible systemic risks associated with moving bilateral counterparty risk away from market makers to clearing houses; a move which we believe transforms but does not eradicate default risk.

In a scenario where markets become stressed, large price moves will require clearing members holding unprofitable positions to meet significant collateral calls (variation margin) in a very short time frame to cover their obligations. These calls need to be funded at a time when all markets are stressed. It is logical to infer clearing house calls for collateral are a demand factor for liquidity. If the clearing house doesn't receive collateral, its operating procedures will lead it to liquidate the collateral held against negative positions. If this happened in a systemically stressed, less liquid market, we have the components necessary for a negative feedback loop where stress causes collateral calls, which delay or fail due to funding stress, causing clearing houses to liquidate collateral into stressed, less-liquid markets, exacerbating the systemic stress.

Such a scenario would not be unlike 2008, the difference being a significant amount of counterparty credit risk has been transformed into liquidity risk. Basel III contains provisions attempting to reduce banks' reliance on short-term funding, but it is still a significant component of many banking entities' liabilities. Stress in funding markets consumes greater volumes of collateral because greater haircuts mean borrowers need more collateral to fund themselves. Additionally, clearing places significant demand on high grade assets specified as eligible collateral which banks would normally borrow against in financing markets to fund their collateral calls. In a stressed scenario, this collateral becomes more accessible only if a clearing member defaults and a clearing house liquidates collateral held against the defaulting member's positions. This could in turn have a knock-on impact for UK asset managers who run box positions for their collective investment schemes; in a rapidly falling market, some investors may decide not to commit to subscriptions they agreed to the previous day thus leaving the asset manager with a shortfall.

It seems prudent for policy makers and regulators to investigate the concentration of these risks as well as the robustness of existing frameworks governing central clearing models.

In addition, we would recommend that the FSB examine the impact of the following risks:

- Service Providers: some regulators have already started examining the risk posed by the failure of key service providers. Apart from clearing houses which were specifically discussed, funds have reliance on custodians, fund administrators, exchanges, market data vendors etc., and the failure of significant service providers could have a significant impact on the asset management industry.

- Collateralisation requirements: the risk that funds do not own eligible collateral required as margin for centrally cleared or other contracts that require collateral. With the focus on moving more actively to central clearing, an unintended consequence may be that even simple hedging contracts could create stress on funds.

- Cyber risk: along with the rest of the financial services industry, the extensive use of technology in asset management opens firms up to the risk that malicious infiltration into an asset managers systems could result in information security breaches or spurious orders being generated and client holdings being compromised which could lead to wider market disruption.

Question 2: Do the proposed policy recommendations in the document adequately address the structural vulnerabilities identified?

> ***Recommendation 1: Authorities should collect information on the liquidity profile of open-ended funds in their jurisdiction proportionate to the risks they may pose from a financial stability perspective. They should review existing reporting requirements and enhance them as appropriate to ensure that they are adequate, and that required reporting is sufficiently granular and frequent.***

As per our previous comments, subject to there being adequate investor awareness and tools to manage redemptions in periods of illiquidity, we disagree with the idea that the "*potential mismatch in open-ended funds between liquidity of fund investments and daily redemption of fund units*" represents a key structural vulnerability.

The Consultative Document fails to describe what type of "information" authorities should collect and explain how this information might be used.

It is difficult to see how basic information (e.g. a breakdown of holdings by asset type by fund weighting) could be used by authorities to infer the extent to which individual funds (and by inference) all funds across the entire industry contribute to systemic risks. Further, requests for additional information from authorities should be consistent across all jurisdictions and reconciled to existing reporting requirements (e.g. the AIFMD reporting schema).

It is difficult to see how the collection of more complex model-based liquidity risk metrics would be used by the FSB given the challenges in measuring liquidity and investor behaviour as per our comments in section 1 and 2 of PART B of this document. On the basis that there is no common industry approach to measuring market liquidity, the inability to predict liquidity crises or investor behaviour, by definition the use of different modelling standards by asset managers will generate inconsistent metrics across the industry making it difficult for authorities to infer the true meaning of this information and preventing authorities from making useful comparisons across fund ranges.

It is also difficult to understand what action authorities might mandate given the fiduciary obligations of asset managers and their duty to invest according to the agreed constraints and investment objective. The manager of an emerging markets debt fund forced to sell positions to address authorities' concerns in respect of wider systemic market risk, would struggle to invest in accordance with the investment objective and reconcile how holding "excess" liquidity is in the best interests of those longer term investors who do not wish to redeem. Authorities would also be significantly challenged to identify how much liquidity is enough for different scenarios in different market conditions.

We would support a drive from IOSCO to align existing reporting requirements across jurisdictions to

enhance consistency and to reduce the burden of reporting on asset managers. Overall, we believe the focus should be on supplying investors (not authorities) with better "information" through enhanced risk disclosures to enable them to better determine whether the product is aligned to their risk appetite as this will help reduce funds' potential impact on financial instability.

Recommendation 2: Authorities should review existing investor disclosure requirements and determine the degree to which additional disclosures should be provided by open-ended funds to investors regarding fund liquidity profiles, proportionate to the liquidity risks funds may pose from a financial stability perspective.

As per section 7 of PART B, we are supportive of the FSB's policy recommendation to review and enhance existing disclosure requirements to ensure investors clearly understand the risks they are taking in pursuit of investment returns and they are able to make an informed decision as to whether these risks and the features of each investment product are aligned to their individual risk appetite.

We believe that risk disclosures and the intermediary sales process should be extended to emphasise to investors that funds may not provide daily liquidity if market conditions do not permit. The use of available management tools is made more difficult by regulators' insistence in some jurisdictions that retail funds should provide daily liquidity leading to investors inferring that they can benefit from liquidity at all times (and with minimal market impact). This structural weakness exacerbates the risk of investor shock when these tools are deployed resulting in some investors wanting to dispose their holdings during periods of extreme market stress, further exacerbating the impact of herd mentality. The flawed notion that a direct property fund, for example, whose underlying investments are inherently illiquid, can always deliver liquidity to investors, at speed and with minimal market impact, should be dispelled and the reality disclosed to investors accordingly.

We strongly disagree with the statement "*proportionate to the liquidity risks funds may pose from a financial stability perspective*". The proportionality of a disclosure should be on the basis of the risks facing the target investor rather than the actual/perceived risks of a given product to the stability of the wider financial market. We request further guidance on what basis this could be determined.

Authorities should enhance existing investor disclosure requirements as appropriate to ensure that the required disclosures are of sufficient quality and frequency. In this regard, IOSCO should review its existing guidance and, as appropriate, enhance it.

As per our comments above we would like to stress the importance of clear and concise disclosures. However, we would like to understand the extent to which any required changes to fund disclosures might (a) be aligned to existing (and new) disclosure requirements such as those being implemented as part of the European PRIIPs regulations and (b) the extent to which IOSCO would be able help deliver consistency relating to cross-border disclosure requirements.

Our strong view is that an optimal disclosure would adequately explain the extent to which liquidity risk exists, examples of how and when it might occur together with the impact, but most importantly of all, ensure that investors understand they bear the risk and at no point can a fiduciary fully eliminate liquidity risk using pre-emptive tools.

Recommendation 3: In order to reduce the likelihood of material liquidity mismatches arising from an open-ended fund's structure, authorities should have requirements or guidance stating that funds' assets and investment strategies should be consistent with the terms and conditions governing fund unit redemptions both at fund inception and on an ongoing basis (for new and existing funds), taking into account the expected liquidity of the assets and investor behaviour

during normal and stressed market conditions. In this regard, IOSCO should review its existing guidance and, as appropriate, enhance it.

We do not agree with the recommendation that funds offering daily liquidity "*should invest mainly in liquid assets and have strict limits on their investment in illiquid assets (based on clear guidelines regarding the characteristics of such assets)*"; we do not believe regulators need to implement additional restrictions over and above existing fund-specific regulations (e.g. UCITS, AIFMD, US 1940 Act Funds) or those that are already formally set out in the fund documentation by the fund governing body.

Whilst we do not think it is necessary to match the pricing and dealing frequency of a fund to the investment strategy and objective of a fund, we can see the arguments for changing the frequency of those funds which are at the extreme end of the illiquidity spectrum (i.e., those with inherently illiquid assets such as direct real estate) as doing so would prevent these funds from giving the illusion that they can provide daily liquidity in all conditions. We request that more work is undertaken to provide guidance on how to align funds' dealing frequencies to different types of funds before national authorities implement this requirement, including a thorough assessment of the potential consequences. Failure to implement these rules in the same way by all national authorities will lead to asset managers applying different standards which will inevitably distort the asset management industry and create unintended consequences. Regardless of a fund's pricing and dealing frequency, investors must understand that funds cannot provide liquidity transformation.

We have serious concerns with the FSB's recommendation to explore the imposition of "*liquidity buffers and targets, asset tiering, and limits on illiquid assets*" for the reasons we have outlined in sections 1-4 of PART B, particularly if the FSB's expectations are that funds should hold sufficient liquidity to meet stressed market conditions. Given the challenges associated with measuring liquidity, predicting investor behaviour and liquidity crises, we fail to see how asset managers can reasonably be expected to understand how much liquidity would be sufficient to cover the liquidity demands in all conditions. Instead, we believe authorities should place significant emphasis on the use and application of practical mechanisms to manage systemic market liquidity events which can neither be predicted nor influenced by individual market participants.

However we largely agree with the notion that at the time of design of a fund, the "*redemption features should be designed and calibrated to be consistent with the fund's intended investment strategy and scope of investable assets*" – the design phase must ensure that sufficient liquidity management tools (e.g. semi-swing pricing) are available, where permitted by authorities', to manage liquidity demands during both normal and stressed market conditions in a way which treats investors fairly. Provided that the recommendations in respect of investor communication and liquidity management tools are satisfactorily addressed, we do not agree that funds should be restricted in their investment in any specific assets as it should be left to investors to determine in what they wish to invest. It is also worth noting the obvious challenges associated with requiring asset managers to design their funds to meet stressed conditions.

Recommendation 4: Where appropriate, authorities should widen the availability of liquidity risk management tools to open-ended funds, and reduce barriers to the use of those tools to increase the likelihood that redemptions are met even under stressed market conditions. In this regard, IOSCO should review its existing guidance and, as appropriate, enhance it.

We support the FSB's recommendation to widen the range of available liquidity risk management tools to open-ended funds to help ensure that redemption requests are handled in the best interests of investors during both normal and stressed market periods. We also agree further consideration should be given to how to better inform investors of the legal notice periods and the right of funds to invoke them.

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HSBC places significant emphasis on the use and application of practical ex-post mechanisms (e.g. swing pricing) for the benefit of investors which we believe contributes to the management of systemic market liquidity events.

Given the challenges associated with measuring liquidity, predicting investor behaviour and liquidity crises, investors' differing preferences for liquidity and the fact that funds do not provide liquidity transformation, for reasons outlined in sections 1-5 of PART B, HSBC is not supportive of all of the pre-emptive measures (e.g. liquidity constraints/buffers, and appropriate portfolio composition and diversification) described in recommendation 3 and 4.

HSBC firmly supports the use of liquidity fund monitoring as a mechanism for providing an indicative view of a fund's potential liquidity requirements, a way of monitoring a fund's appetite to liquidity risk, and to provide a trigger for Risk, or another control function, to discuss potential concerns with the Fund/Portfolio Manager and to consider appropriate follow up actions. However, on the basis that liquidity metrics do not provide sufficient explanatory power, HSBC believes that it is imprudent to use them for purposes of fund construction; we believe doing so would not be in the best interests of investors and as we have argued above, prevents asset managers from fulfilling their fiduciary obligations.

Recommendation 5: Authorities should make liquidity risk management tools available to open-ended funds to reduce first-mover advantage, where it may exist. Such tools may include swing pricing, redemption fees and other anti-dilution methods. In this regard, IOSCO should review its existing guidance and, as appropriate, enhance it.

HSBC strongly supports the proposal for asset managers to use all available liquidity risk management tools (e.g. swing pricing), where deemed appropriate, to allow the cost of material investor purchase or redemption activity to be passed on to those groups of investors and protect the interest of the remaining investors within the fund.

HSBC has experience of implementing and managing a range of liquidity management tools including semi swing pricing (the benefits of which have been reported by Association of the Luxembourg Fund Industry[4] and [5]) in a number of jurisdictions (Luxembourg, UK and Ireland) and efforts are underway to implement a semi swing approach within France following a recent change in regulation.

HSBC believes that both full and semi swing pricing mechanisms provide a useful compromise between the need to protect the interests of a fund's long term investors and the desire of many investors to deal in single priced funds without incurring a separate transaction charge such as an anti-dilution levy.

As per section 9 of PART B, HSBC believes asset managers should not meet redemptions through borrowing facilities for the funds other than to meet short term settlement mismatches. Such actions are inappropriate as they gear the funds to the potential disadvantage of those investors who are not redeeming (i.e., allocates additional risk and costs to remaining investors) and misleads investors into thinking that liquidity ought to always be available to them.

Recommendation 6: Authorities should require and/or provide guidance on stress testing at the level of individual open-ended funds to support liquidity risk management to mitigate financial stability risk. The requirements and/or guidance should address the need for stress testing and how it could be done. In this regard, IOSCO should review its existing guidance and, as appropriate, enhance it.

4. The Association of the Luxembourg Fund Industry (ALFI) (February 2011). Swing pricing, survey, reports & guidelines. Retrieved from http://www.alfi.lu/sites/alfi.lu/files/ALFI_Swing_Pricing.pdf.
5. The Association of the Luxembourg Fund Industry (ALFI) (December 2015). Swing Pricing Guidelines. Retrieved from http://www.alfi.lu/node/3104.

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Whilst HSBC undertakes stress testing (on both the assets and the liabilities of a fund) as a useful way of highlighting potential problems, identifying opportunities for risk reduction, and assisting in the creation of contingency plans, we strongly believe stress tests cannot be relied upon as way of predicting future liquidity crises so we disagree with the FSB's proposal that stress test results should be used to "*…tailor the fund's asset composition*". Using stress tests to tailor the fund's asset composition is imprudent, is misaligned to the interests of all investors, and prevents asset managers from fulfilling their fiduciary obligations.

Whilst HSBC would welcome further guidance from IOSCO on stress testing, the binary nature of liquidity means that in extreme market events liquidity shocks usually occur quickly and cannot easily be predicted by any model.

> ***Recommendation 7: Authorities should promote (through regulatory requirements or guidance) clear decision-making processes for open-ended funds' use of extraordinary liquidity risk management tools, and the processes should be made transparent to investors and the relevant authorities. In this regard, IOSCO should review its existing guidance and, as appropriate, enhance it.***
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> ***Recommendation 8: Authorities should provide guidance and, where appropriate and necessary, provide direction regarding open-ended funds' use of extraordinary liquidity risk management tools. In this regard, IOSCO should review its existing guidance and, as appropriate, enhance it.***

HSBC fully supports recommendations 7 and 8 and believes further clarity from IOSCO on the decision-making process for open-ended funds' use of extraordinary liquidity risk tools, including the circumstances under which funds may use such (e.g. suspensions of redemptions, gates, in-kind redemptions etc.) would help investors understand how and when such tools might be used. HSBC agrees that improving investor awareness of when and why such extraordinary measures might be used may help reduce the contagion effects to other funds.

HSBC agrees with the FSB that any regulatory requirements or guidance should acknowledge that the decision to use such tools should generally remain with the fund's governing body who is best placed to evaluate what is appropriate for a particular fund, in light of its investment strategies, the liquidity of its portfolio, investor base, current market conditions, and other relevant circumstances.

Regarding the comment "*…the relevant authorities could be granted the right to direct the application of such tools in exceptional cases where the manager is not best placed to make this evaluation*", HSBC cannot envisage a scenario in which the fund governing body (or asset manager with input from the relevant control functions and the Management Company) is not best placed to make the evaluation. As the FSB notes, the "*…decision to use such tools should generally remain with the asset manager because the manager is best placed to evaluate what is appropriate for a particular fund, in light of its investment strategies, liquidity of its portfolio, current market conditions, and other relevant circumstances.*"

> ***Recommendation 9: Where relevant, authorities should give consideration to system-wide stress testing that could potentially capture effects of collective selling by funds and other institutional investors on the resilience of financial markets and the financial system more generally.***

Re. recommendation 9, based on the challenges highlighted in section 1-2 of PART B, HSBC would question the level of insight authorities would be able to draw from performing system-wide stress testing exercises as well as any action authorities might wish to take given the structure of funds and the fiduciary obligations of asset managers to investors.

Further, stress testing on this scale naturally involves collating a material amount of data on individual funds (securities holdings and investor profiling). Such an initiative will place a significant reporting burden on asset managers and we believe would likely provide little insight. Instead we believe authorities should allocate resources in enhancing other aspects of the liquidity framework.

Recommendation 10: IOSCO should develop simple and consistent measure(s) of leverage in funds with due consideration of appropriate netting and hedging assumptions. This would enhance authorities' understanding of risks that leverage in funds may create, facilitate more meaningful monitoring of leverage, and help enable direct comparisons across funds and at a global level. IOSCO should also consider developing more risk-based measure(s) to complement the initial measure(s) and enhance the monitoring of leverage across funds at a global level.

Recommendation 11: Authorities should collect data on leverage in funds, monitor the use of leverage by funds not subject to leverage limits or which pose significant leverage-related risks to the financial system, and take action when appropriate.

Recommendation 12: IOSCO should collect national/regional aggregated data on leverage across its member jurisdictions based on the simple and consistent measures(s) it develops.

With regards to recommendations 10-12, HSBC would welcome further guidance from IOSCO on the measure(s) of leverage with due consideration of appropriate netting and hedging assumptions as long as these measures are universally adopted across different regulatory regimes e.g. AIFMD, UCITS etc.

With the possible exception of highly leveraged "absolute return" funds of a material size, HSBC is less supportive of authorities' plans to use these metrics to enable direct comparisons across funds and at a global level. With regards to the former, using a simplified single risk measure as a basis on which to compare funds will likely lead to incorrect conclusions. With regards to the latter, using these metrics to enable comparisons at a global level will not provide the necessary context within which to assess whether the levels of leverage might pose a systemic risk to the financial industry.

The FSB has not provided enough information on what types of additional "risk-based measure(s)" it is asking IOSCO to consider to complement the initial measure(s), however, as with the assessment of liquidity, the determination of whether excess leverage might prove problematic can only be made at an individual fund level. HSBC would question what action, if any, regulatory authorities might be able to take were they to determine that global leverage is deemed "excessive" and on what basis this would be defined globally.

HSBC also believes that the monitoring and imposition of leverage limits to those funds which are currently "*not subject to leverage limits*" should be carried out by the managers of the funds or management companies rather than authorities. As with existing rules relating to UCITS or AIFs, this assessment is carried out by the Permanent Risk Management function and reported to the relevant fund governing body. We also request further guidance on which funds are believed to "*pose significant leverage-related risks to the financial system*" together with supportive empirical evidence.

We request that further work is undertaken regarding enhanced liquidity and leverage reporting in order to assess whether the perceived benefits outweigh the administrative cost and burden.

Recommendation 13: Authorities should have requirements or guidance for asset managers that are large, complex, and/or provide critical services to have comprehensive and robust risk management frameworks and practices, especially with regards to business continuity plans and

transition plans, to enable orderly transfer of their clients' accounts and investment mandates in stressed conditions.

HSBC is supportive of recommendation 13 which proposes authorities should develop requirements or guidance for asset managers, however we feel that such requirements (e.g. those relating to BCP) should be assigned to all asset managers rather than to those that are specifically defined as large, complex, and/or provide critical services. It is important, however, to be clear that unless there are principal risks that the asset manager has assumed (in respect of which there should be clear restrictions), the key focus should be large and complex funds rather than the appointed asset manager.

Recommendation 14: Authorities should monitor indemnifications provided by agent lenders/asset managers to clients in relation to their securities lending activities. Where these monitoring efforts detect the development of material risks or regulatory arbitrage that may adversely affect financial stability, authorities should verify and confirm asset managers adequately cover potential credit losses from the indemnification provided to their clients.

HSBC is supportive of recommendation 14 and believes that indemnifications provided by agent lenders/asset managers in relation to securities lending activities should be backed by an appropriate level of unencumbered capital to ensure that the party providing the indemnification (and the associated insurance undertaking) is adequately able to cover potential credit losses. We will be supportive of a similar approach for any other type of principal market risk being undertaken by the asset manager (e.g. guarantees).

Question 3: In your view, are there any practical difficulties or unintended consequences that may be associated with implementing the proposed policy recommendations, either within a jurisdiction or across jurisdictions? If there are any, please identify the recommendation(s) and explain the challenges as well as potential ways to address the challenges and promote implementation within a jurisdiction or across jurisdictions.

Yes. In relation to recommendation 3, the use of pre-emptive liquidity management tools (such as forcing asset managers to hold more liquidity in their funds) may detrimentally impact those investors who understand and seek the risk premium illiquidity brings from investing in relatively less liquid assets (e.g. bank loans, private equity, real estate etc.). Forcing funds to hold more liquidity restricts the investor's ability to choose what risks they wish to be exposed to which in turn limits their desired returns.

HSBC believes the imposition of hard liquidity limits gives investors the illusion that they will always have "liquidity at will" especially in asset classes where they should not have that expectation. The FSB's recommendations therefore would deliver the wrong outcome.

HSBC would like to reiterate that investors must understand that investing in the financial markets involves risk and the liquidity associated with investing in a fund is a function of the underlying liquidity of the investments in a given fund.

Question 4: In your view, is the scope of the proposed recommendations on open-ended fund liquidity mismatch appropriate? Should any additional types of funds be covered? Should the proposed recommendations be tailored in any way for ETFs?

HSBC does not believe the scope of these recommendation should be extended.

Question 5: What liquidity risk management tools should be made available to funds? What tools most effectively promote consistency between investors' redemption behaviours and the liquidity profiles of

funds? For example, could redemption fees be used for this purpose separate and apart from any impact they may have on first-mover advantage?

Please refer to our response to recommendation 5.

Question 6: What characteristics or metrics are most appropriate to determine if an asset is illiquid and should be subject to guidance related to open-ended funds' investment in illiquid assets? Please also explain the rationales.

Liquidity risk is difficult to measure, partly because the liquidity observed in an unstressed market cannot always be relied upon to accurately estimate risk during periods of market stress. The changing and often binary nature of market liquidity also presents challenges when determining what asset might qualify as illiquid. History has shown that market liquidity can change rapidly. In the context of employing simple measures (such as the SEC's proposed three-day-liquid-assets calculation), assets which today are perceived to be liquid in three days may not necessarily be easy to liquidate in three days tomorrow, or even this afternoon. By way of example, term securitisation was one of the most "liquid" markets, as defined by relatively tight bid/offer spreads, pre-2008 crisis but liquidity evaporated rapidly during the crisis quickly making it one of the most illiquid markets.

Industry practitioners recommend considering a number of factors when assessing the potential liabilities of a fund including, but not limited to, the number of investors, the size/concentration of their holdings, their type (e.g. long term investor), investor behaviour and historical redemptions. However, this analysis is often limited due to challenges with data availability (e.g. commingled under nominee structures) or data limitations (e.g. over-reliance on historical redemptions as a way of predicting future redemption activity). The lack of efficient data management technologies also hinders firms from accurately projecting investors' inflows and outflows.

HSBC has experience in trying to measure market liquidity as well as projecting the liquidity demands of investors. On the basis that both are impossible to do with a high degree of accuracy, HSBC believes this is not a basis for which to demand asset managers to allocate more of funds' net assets into relatively more liquid holdings. In doing so, investor outcomes are likely to be adversely impacted by holding proportionately more liquid assets and funds that are managed relative to a benchmark are likely to experience a higher tracking error and it does not necessarily resolve the liquidity question given its unpredictability.

There are considerable challenges with information gaps, the general unpredictability of markets, and investor behaviour. Furthermore, the process for measuring liquidity is highly subjective and requires judgments as to the practical ability of a fund to sell a security, assumptions and/or the use of proxies where data availability is limited or thought to be unreliable.

For fixed income securities, the commonly adopted measure of liquidity (the bid-ask spread) can be flawed in two respects. Firstly, the spread is not always available (or is stale), and secondly, the spread does not take into account the volume/scale of a Fund Manager's intended buy and sell transactions. This challenge often exists for illiquid securities, where the analysis of liquidity matters the most.

HSBC recognises stress testing as a useful way for internal risk management teams to highlight potential problems, identifying opportunities for risk reduction, and assisting in the creation of contingency plans, but the binary nature of liquidity means that in extreme market events, liquidity shocks usually occur quickly and cannot easily be predicted by any model. This subject does not lend itself to a "one-size-fits-all" regulatory prescription.

Question 7: Should all open-ended funds be expected to adhere to the recommendations and employ the same liquidity risk management tools, or should funds be allowed some discretion as to which ones they use? Please specify which measures and tools should be mandatory and which should be discretionary. Please explain the rationales.

As per our comments on recommendation 3, there are practical difficulties and unintended consequences that will arise if all open ended funds are forced by regulation to adopt prescribed responses. It should indeed be more appropriate to leave the choice of tools to the fund's governing body. Also, as described under our response to Question 6, subject to adequate controls around leverage and use of derivatives, we do not support pre-emptive prescriptions in respect of the assets that a fund can hold. We recommend that further work is undertaken to develop thinking around the use and application of some pre-emptive measures (e.g. "*liquidity constraints and monitoring fund liquidity*", "*stress testing, and portfolio composition and diversification rules*") especially in relation to their impact (intended or otherwise) on the industry and on individual fund investors. HSBC does not support the use of these tools to inform how much liquidity individual funds should hold.

HSBC supports allowing asset managers to apply as many post-event measures as possible. Such tools are used by asset managers to manage the impact of liquidity risk once market disruptions or other events result in significant outflows or the prospect thereof. HSBC supports the availability of as many of these tools as possible, regardless of fund structure, but we strongly believe the decision to activate one or more of these tools should remain at the discretion of the asset manager (providing this responsibility has been delegated) or the fund governing body (not the authorities), who are best placed to evaluate the appropriateness of these decisions.

As per our response to recommendations 2 and 7, we strongly support the proposed initiatives to increase investor awareness of liquidity risk through enhanced disclosure requirements (albeit, investors must be made to understand that funds do not provide liquidity transformation) and increased transparency for investors on the circumstances under which they may use extraordinary liquidity risk management tools. HSBC believes these initiatives should be extended to all funds, regardless of fund type, jurisdiction, investment strategy etc.

Question 8: Should authorities be able to direct the use of exceptional liquidity risk management tools in some circumstances? If so, please describe the types of circumstances when this would be appropriate and for which tools.

We are uncomfortable with the idea that authorities should be empowered to request asset managers to use exceptional liquidity risk management tools. A fund's governing body has the fiduciary responsibility to safeguard the interests of fund investors in the way that it sees fit. Authorities are unlikely to possess sufficient information on "liquidity risks" within individual funds, any actions taken by an authority would likely be on the basis of incomplete information and result in unintended consequences.

We are supportive of further guidance on how the proposed recommendations, once finalised, might be employed by asset managers. As the FSB notes as part of recommendation 8, "*…the decision to use such tools should generally remain with the asset manager because the manager is best placed to evaluate what is appropriate for a particular fund, in light of its investment strategies, liquidity of its portfolio, current market conditions, and other relevant circumstances*."

Question 9: In developing leverage measures (Recommendation 10), are the principles listed above for IOSCO's reference appropriate? Are there additional principles that should be considered?

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HSBC agrees with principles (i) to (iv) however, as noted as part of our response to recommendation 10, HSBC does not support authorities' plans to use these metrics to enable direct comparisons across funds and at a global level. With regards to the former, using a simplified single risk measure as a basis on which to compare funds will likely lead to authorities' drawing incorrect conclusions. With regards to the latter, using these metrics to enable comparisons at a global level will not provide the necessary context within which to assess whether the levels of leverage might pose a systemic risk to the financial industry.

Were IOSCO able to develop further guidance on the calculation of different leverage measures, we request that these measures are aligned to the existing regulatory frameworks to prevent the implementation of different standards of calculation and reporting e.g. the UCITS definition of leverage which should be calculated as "…the sum of the notionals of the derivatives used"[6].

Question 10: Should simple and consistent measure(s) of leverage in funds be developed before consideration of more risk-based measures, or would it be more appropriate to proceed in a different manner, e.g. should both types of measure be developed simultaneously?

IOSCO should provide guidance to authorities on how to determine which funds present the greatest potential risk to the stability of the financial sector and assess whether existing regulatory frameworks sufficiently address these risks.

HSBC does not believe that additional complex risk-based measures should be developed and applied to all fund structures and strategies. For example, UCITS structures are already subject to a variety of risk based measures, many of which are disclosed to regulators and investors. It is difficult to understand what value can be drawn from calculating and reporting additional risk-based measures for these funds, particularly those UCITS which do not employ financial derivatives instruments.

We request that more work is undertaken to determine what measures (simplified or otherwise) might be required for different fund structures and investment strategies. Once finalised authorities should not implement new measures on a phased basis as this might confuse investors and necessitate multiple changes to systems and fund documentation.

Question 11: Are there any particular simple and consistent measures of leverage or risk-based measures that IOSCO should consider?

Question 12: What are the benefits and challenges associated with methodologies for measuring leverage that are currently in place in one or more jurisdictions?

In response to questions 11 and 12

The calculation of gross leverage (which includes both the short and long positions in securities), divided by a fund net asset value is less informative. This conservative measure considers long and short positions as mutually independent sources of risk, while in many cases they might be part of a single transaction (i.e. used for hedging purposes) or if not, it is assumed that these positions are non-correlated.

For example, a hedge share class of a UCITS sub-fund which holds long only securities together with a single forward foreign exchange contract used as a total portfolio hedge is considered, under UCITS rules, to be leveraged 100% of the fund's net assets. This method disregards the fact that the financial derivatives instrument is being utilised as a hedge and would make no distinction between this fund and a similar fund which holds the forward foreign exchange contract as part of a currency investment strategy (rather than a hedge). However, there will be circumstances in the future where the forward foreign exchange contract

6. Refer to Box 24 of CESR's Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS (CESR/10-788) dated 28 July 2010.

(and indeed other derivative contracts) will need to be collateralised and the impact of this will be worth studying in further detail.

Net leverage, which calculates the difference between both long and short positions, does not account for the risk created by long or short positions that are effectively independent bets (which could, in addition, be subject to stress from collateralisation). Thus this measure could, in certain circumstances understate risk.

HSBC recommends that further work is undertaken in order to identify more relevant approaches to calculating instrument leverage. These measures should also take into account principles (i) to (iv) identified by the FSB (as part of recommendation 10) as well as any exposures generated through funding leverage. We believe the outcome of this work will help arrive at a better considered position on what types of leverage to permit and to what extent.

Question 13: Do you have any views on how IOSCO's collection of national/regional aggregated data on leverage across its member jurisdictions should be structured (e.g. scope, frequency)?

As per our response to recommendations 10-12 above, HSBC would welcome further guidance from IOSCO on the creation of more meaningful measure(s) of leverage (refer to our response to questions 10-12 above) so investors are better able to understand the risks associated with individual funds. Ideally these measures would be accepted universally by national authorities and replace existing and proposed measures for all funds. Where relevant, we support additional prescriptions on limiting specific types of leverage that might lead to funds being unable to meet their obligation under derivative contracts in stressed conditions.

However, HSBC does not support authorities' collection of additional aggregated data on leverage. Collecting leverage-related metrics with a view to providing global or regional comparisons across funds and asset managers is unlikely to provide authorities with the necessary context with which to draw valuable conclusions, particularly if these metrics, once agreed, are imperfect or they are assessed in isolation without considering other relevant information.

Instead the focus should be on identifying enhanced leverage related metrics which investors and market counterparties might find useful in order that they can make an informed decision as to whether the risks associated with individual fund investments are aligned to their risk appetite. This information should be disclosed in a clear and concise manner to investors in all relevant fund documentation both prior to investing and on an ongoing basis. On the assumption that funds which are required to compute the enhanced leverage metrics do so, these would be made available to national authorities and IOSCO via their disclosure in the necessary documentation but HSBC would be less supportive of having to complete new reporting requirements.

Nonetheless, we believe the calculation and monitoring of leverage should take place by the managers responsible for the funds rather than a supra-national body.

Question 14: Do the proposed policy recommendations on liquidity and leverage adequately address any interactions between leverage and liquidity risk?

We accept that, generally, leverage does increase sensitivities to changes in asset prices and this can, in stressed conditions, exacerbate liquidity mismatches for funds, especially those funds which have a combination of material leverage and a liquidity mismatch between assets and liabilities. While it is too simplistic to infer that a leveraged fund will always experience a liquidity problem, it is worth looking specifically at the manner in which leverage is achieved. A fixed term borrowing could present different risks from a margined asset-based financing or derivative contract.

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Clearly there will be cases where funds that have to sell assets in order to obtain liquidity and deleverage, may impact other market participants through declining asset prices and increased margin calls. As the FSB acknowledges it is possible that the planned measures (in relation to central clearing and margin requirements for non-centrally cleared derivatives) will help limit the build-up of risks relating to leverage within funds and reduce the systemic risk within the financial sector, although conversely, as we have noted above, this move may also create unintended consequences.

Because liquidity risk is often a second-order risk resulting from the realisation of one or more other risks, assessing leverage and liquidity in and of itself is too simplistic an approach. Even a highly leveraged fund holding less liquid securities is prone to a market liquidity shock, but if investor liquidity demands are more stable, even during periods of market stress, liquidity risk poses less of a problem to that fund.

Should the policy recommendations be modified in any way to address these interactions? If so, in what ways should they be modified and why?

We believe the best way to manage liquidity risk is to (a) educate investors about the true nature of open-ended vehicles and the importance of tools like gating and swing pricing in protecting their own interests, (b) to ensure fund documentation and sales materials clearly disclose the liquidity of the underlying investments and the fact that this will determine the ultimate liquidity of the fund, (c) ensure fund documentation allows the use of a range of tools (suspensions, swing pricing etc.) and (d) develop efficient processes to rapidly and transparently deploy these tools when market conditions require it. We believe this approach this will help reduce the perception that leverage and liquidity mismatch create systemic risk in the financial sector.

Question 15: The proposed recommendation to address the residual risks associated with operational risk and challenges in transferring investment mandates or client accounts would apply to asset managers that are large, complex, and/or provide critical services. Should the proposed recommendation apply more broadly (e.g. proportionally to all asset managers), or more narrowly as defined in Recommendation 13? If so, please explain the potential scope of application that you believe is appropriate and its rationales.

We do not agree that "Operational risk in transferring investment mandates or client accounts" represents a "potential structural vulnerability" to the financial industry. As the FSB notes historically, "…there have not been serious operational incidents during stressed conditions" so it is "difficult to assess the potential materiality of such operational difficulties" and therefore the existence of this proposed vulnerability.

Nonetheless, we agree it would be sensible for authorities to assess the robustness of existing supervision frameworks relating to (a) third party service providers (e.g. those entities providing solutions such as fund accounting, transfer agency, etc.) together with the potential impact on asset managers were they to encounter difficulties, and (b) the strength of controls within complex asset managers that offer a range of non-core services (e.g. pricing models, information technology platforms, etc.) to other financial institutions. We also support the view that all asset managers, regardless of their size and complexity, should have in place sufficiently robust Business Continuity Plans. However, generally speaking the focus of supervision should be on individual investment mandates/funds rather than their managers and more narrowly, on those which are deemed to be large and complex (e.g. those which require extensive and material use of bilaterally traded OTC derivatives contracts and/or those which utilise material leverage).

We agree there might be some value in authorities' accessing "aggregated data/information on the OTC derivatives positions of funds" (e.g. notional amount outstanding, gross mark-to-market) but in reality such information would only serve to inform authorities on derivatives exposures rather than to provide

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extensive insight from which meaningful policy decisions could be drawn. We agree with the FSB in that the sourcing of such information should "leverage existing national and international initiatives" rather than create additional and complex reporting requirements.

However, we believe the potential operational risk and challenges in transferring investment mandates described by the FSB is overstated. While individual investment mandates transfer less frequently, transitions of this nature take place on a frequent basis within the industry during the course of normal business; in both normal and stressed market conditions. Such transfers, which take place for a variety of reasons (e.g. failure to meet the investment objective, poor performance, change in macro asset allocation, etc.) are often carried out using the services of a client-nominated transition manager. We agree with the FSB's statement that transition managers need to "ensure appropriate controls and oversight" given the importance of the services they provide and we would support authorities' plans to enhance existing frameworks if the FSB or IOSCO felt that these changes were justified.

Of the three difficulties cited by the FSB (1. termination of derivative contracts, 2. operational challenges in replacing ancillary services and 3. legal and regulatory difficulties associated with transferring client accounts) we believe only the first has the potential to present challenges during periods of extreme market stress; for example, in the unlikely event of one or more counterparties to bilaterally negotiated OTC derivative contracts entering default. In a non-default scenario, any open (non-centrally cleared) OTC contracts are likely to either be novated to a new counterparty or closed-out with minimal impact. It is unlikely that an investment mandate with an unsecured credit exposure to a counterparty that has entered administration would prevent the mandate from transitioning to a new asset manager. The lead administrator responsible for the defaulted entity's resolution would likely attempt to novate the contracts to a new counterparty, or the newly appointed asset manager would agree to step-in and face the administrators. We believe it would be sensible for the FSB to re-examine its view on this residual risk once key initiatives such as central clearing and the collateralisation of non-centrally cleared OTC derivatives have been implemented in full. We believe difficulties 2 and 3 exist in both stressed and normal market conditions and so do not present asset managers with any additional challenges.

Regarding the transfer of one or more funds from one fund sponsor/manufacturer to another (e.g. resulting from a sponsor encountering financial difficulties), the most likely scenario is that the funds themselves will be acquired by and transitioned to another asset manager. Even in this extreme/unlikely scenario, (a) the transition would take place in a way which does not compromise the interests of investors and (b) investors would likely still be free to redeem their investments during the relatively lengthy transition process.

Question 16: In your view, what are the relevant information/data items authorities should monitor for financial stability purposes in relation to indemnifications provided by agent lenders/asset managers to clients in relation to their securities lending activities?

In our view any principal guarantee provided by an asset manager should require capital in the same manner as a bank would need to hold for a similar transaction. Failure to do so would create the risk of regulatory arbitrage.

Question 17: Should the proposed recommendation be modified in any way to address residual risks related to indemnifications? For example, should it be more specific with respect to actions to be taken by authorities (e.g. identifying specific means for covering potential credit losses) or more general (e.g. leaving to authorities to determine the nature of appropriate action rather than specifying coverage of potential credit losses)?

Indemnities and similar types of activities should be considered as if the asset manager were conducting

non-fund management activities and should attract regulatory requirements on the asset manager that as similar to those applied to other organisations (e.g. banks) that undertake this activity as part of their business.

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PART B
HSBC's APPROACH TO LIQUIDITY RISK MANAGEMENT

HSBC's approach to the management of liquidity risk is founded on two important principles. Firstly, the need to meet fiduciary obligations by focusing on what has been agreed in investment management agreements, prospectuses and in all relevant documentation; and secondly, to ensure decisions and actions are fair to all investors. In the case of open-end funds this means ensuring that the interests of those investors seeking to redeem do not negatively impact those investors who remain invested.

The following forms the basis of HSBC's approach to achieving these objectives:

- Clear and transparent fund literature;
- The thoughtful management of capacity at both the strategy and fund level so funds are "soft closed" proactively;
- Where regulations permit, the use of swing pricing or similar anti-dilution mechanisms to help ensure the remaining investors do not subsidise investors redeeming from or investing in funds (e.g. HSBC's fund range domiciled in Luxembourg, HSBC Global Investment funds, employs semi swing pricing methodologies);
- The ability to, where possible, defer redemptions on any one day if a judgment is made that there is insufficient liquidity in the underlying investment market. While this process is not always popular, HSBC recognises that doing so is in the general best interests of remaining investors; and
- In exceptional cases, where permitted HSBC may choose to suspend subscriptions and redemptions from funds.

When using swing pricing, deferring redemptions and, on rare occasions, deciding to suspend funds, HSBC is acutely aware of the potential impact on the shape, characteristics and liquidity of the remaining portfolio once the most liquid assets have been sold to meet redemptions.

It is however true that not all dilution mechanisms are currently permissible in all jurisdictions in which HSBC operates and we would welcome changes to address this.

Given the challenges associated with measuring liquidity, predicting investor behaviour and liquidity crises, HSBC places significant emphasis on the use and application of practical mechanisms to manage systemic market liquidity events which can neither be predicted nor influenced by individual market participants. Provided that these mechanisms are permitted by the laws applicable to the fund, do not compromise the fair treatment of all investors, and funds are not managed in such a way that the investment strategy places heavy reliance on the availability of these measures, HSBC believes such mechanisms help to provide a strong practical foundation for robust liquidity management.

To the extent that these mechanisms are compatible with meeting all local regulatory and legal requirements, the key foundations that underlie HSBC's approach are as follows:

- Funds enable investors to receive, net of costs, the returns from the funds' underlying investments.
- Funds do not act as transformations vehicles but simply pass-through the risks and rewards of the underlying investments.
- The liquidity of a fund is a function solely of the market liquidity of the fund's underlying assets.
- Investors should be made aware of and accept all risks associated with investing, including liquidity risk.
- While HSBC has established and implemented a liquidity monitoring framework, we recognise that it is not possible to be completely certain of either market liquidity or investor behaviour.

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- Remaining investors in a fund must not be adversely impacted by investors who choose to redeem holdings.
- Funds and their Supervisory Bodies (e.g. Fund Boards) should be permitted to use as many tools as necessary to help ensure fairness to all investors (e.g. semi-swinging prices, deferred redemptions and in extreme situations, suspension of subscription and redemptions, etc.).

Known challenges and recommendations

1. Challenges associated with predicting investor behaviour

Attempting to predict the behaviour of the investors in a fund is at least as difficult, if not more difficult, than trying to measure and predict market liquidity, as:

- The asset manager does not have perfect 'look through' into the end clients' circumstances nor can it be expected to do so given the use of nominee structures and platforms that aggregate holdings;
- Even where investors are on the register directly, the asset manager does not always have a direct relationship with investors as the fund may be sold through distributors, hence the asset manager will lack the requisite knowledge of their habits and behaviours;
- Any attempt to look at investor behaviour using historical inflows and outflows is complicated by the fact that the asset manager is only able to review them in aggregate and there are intrinsic limitations to any model which seeks to predict the behaviour of the current investors in the fund; and
- HSBC has seen that investor redemption behaviour changes dramatically as markets change so even if an asset manager has data on the historical behaviour of the investors in the fund, it would not necessarily help them to build a perfect picture of what might happen in stressed conditions.
- It should also be noted that products are held with 3 year, 5 year or longer time horizons and the majority of investors see their fund holdings as a buy and hold investments. Whilst we do see heightened redemptions during periods of market dislocation, concerns relating to material redemptions has not materialised across open-ended funds bar some exceptional cases relating to specific asset classes.

2. Challenges associated with measuring market liquidity

Model subjectivity: the process for measuring liquidity is highly subjective and requires judgments as to the practical ability of a fund to sell a security, assumptions and/or the use of proxies where data availability is limited or thought to be unreliable. Market liquidity can be difficult to measure, partly because the liquidity observed in an unstressed market cannot always be relied upon to accurately estimate risk during periods of market stress. There are considerable challenges with information gaps and the general unpredictability of markets. As an example, for fixed income securities, the commonly adopted measure of liquidity (the bid-ask spread) can be flawed[7] and assets that don't trade regularly aren't always illiquid[8].

Limitations of stress testing and the unpredictable nature of financial markets: HSBC recognises and employs stress testing as a useful way of highlighting potential problems, identifying opportunities for risk reduction, and assisting in the creation of contingency plans, but the binary nature of liquidity means that in extreme market events, liquidity shocks usually occur quickly and cannot easily be predicted by any model.

Notwithstanding the argument that the estimation of market liquidity and the classification of position

7. Firstly, the spread is not always available (or is stale), and secondly, the spread does not take into account the volume/scale of a Fund Manager's intended buy and sell transactions. This challenge often exists for illiquid securities, where the analysis of liquidity matters the most.
8. Trading volume and price are correlated but are not mutually exclusive factors. An asset that exhibits high trading volumes does not automatically enable the Portfolio Manager / Trader to convert its position to cash at a price that does not materially affect the value of that asset immediately prior to sale in stressed markets – the ability to do this depends on a number of factors such as investors' appetite for risk and the perceived "safety" of specific securities in "risk-off" flight-to-quality market conditions. Furthermore, high trading volumes might be associated with high selling pressure on the asset and trades at that time may have a material price impact.

holdings according to their relative "spectrum" of liquidity helps to paint a picture of market liquidity, HSBC does not believe it is possible to predict the occurrence of material systemic failures of liquidity. History has shown that market liquidity can change rapidly. By way of example, term securitization was one of the most "liquid" markets, as defined by *relatively tight* bid/offer spreads, pre-2008 crisis but liquidity evaporated rapidly during the crisis quickly making it one of the most illiquid markets.

HSBC acknowledges the limitations related to monitoring market liquidity as a way of attempting to predict rapid and material declines in liquidity. Last year's market volatility in the China equity and fixed income markets[9] supports the idea that liquidity cannot always be measured nor can illiquidity be predicted.

3. Conflicts with the fiduciary responsibilities of the asset manager

HSBC is supportive of measuring liquidity and calculating suitable liquidity metrics, however, HSBC believes using this information to infer a set of meaningful and accurate metrics which must be used for fund construction is imprudent. Given investor expectations that funds will invest in accordance with their investment objective, it is difficult to justify how substituting a portion of a fund's investments for cash is in the interests of investors (particularly those who do not have a preference for liquidity). The use of imperfect metrics to calculate additional liquidity buffers therefore prevents asset managers from fulfilling their fiduciary obligations and meeting the agreed investment objective. Further, requiring asset managers to hold additional liquidity to meet potential future redemptions might also encourage "first mover advantage", which is precisely what the FSB's recommendations set out to prevent.

4. Investor preference for liquidity is not always aligned

Even within the same fund, it is important to recognise that investor preference for liquidity ahead of other drivers such as return, capital preservation and other motivations is not homogeneous. Investors that wish to match longer term liabilities are likely to have more stable redemption/subscription behaviour and be less concerned about short term volatility and falls in asset prices.

Liquidity demands on a fund of relatively less liquid assets (e.g. bank loans, private equity or real estate) held by long-term investors who understand and seek the risk premium illiquidity brings could be lower versus another fund of assets deemed to have some level of liquidity by asset-analysis, but which is subject to significant levels of short-term investor trading.

5. Funds do not deliver maturity (liquidity) or credit transformation

Open-ended funds offer an attractive investment option for many different types of investors as they can deliver economies of scale, diversification, professional management and enable investors to experience returns from assets in which the fund is invested in line with the fund's investment objectives. Whilst we do not believe that pooling should generate cross subsidisation between different fund investors, the pooling of monies can provide retail investors with access to certain investment strategies (particularly fixed income or alternative asset classes) or markets that might otherwise be impossible or time consuming for investors to replicate themselves.

Although open-end funds should be able to convert some portion of their portfolio holdings into cash on a frequent basis because they issue redeemable units, HSBC believes expectations that funds will always offer daily pricing and investment "redeemability" are unrealistic. Funds' ability to raise liquidity depends on their capacity to divest the underlying investments within a given timeframe and with acceptable market impact. The changing and often binary nature of market liquidity complicates this process. Investors' perception that funds can deliver the benefits of excess returns while also providing the same or similar liquidity of a call deposit is profoundly misaligned to the risks associated with investing; regulators should be careful not to exacerbate investor misunderstanding or misperception. HSBC believes that some

9. On 11 August 2015 China devalued the Yuan by 2% against the US Dollar. Over the period June through September 2015 there was significant market volatility in the China equity and fixed income markets. The situation culminated when more than 50% of the stocks traded on China exchanges were suspended.

regulatory policies, for example, rules that require funds settle securities within specific timeframes (US and Irish funds require seven and ten days respectively), exacerbate investor misunderstanding of market liquidity as they give investors the false impression that liquidity is always available, in all market conditions. Such policies also shift the burden of daily liquidity management and liquidity risk away from the investor (with whom risk/reward decisions ultimately rest) to the asset manager / fund manufacturer. Notwithstanding expectations from investors for certain types of funds to offer daily liquidity (i.e., money market funds), open-ended funds are not banks, nor do they promise to deliver maturity (liquidity) or credit transformation. We believe that if funds were to promise maturity or credit transformation, they would create additional tail risks for example, liabilities which do not fit with the role of a fiduciary, and should be prevented from doing so.

6. ***Risks associated with individual securities are not transformed by wrapping those underlying securities up within a fund***

The risks derived from directly investing in securities or investing in funds which hold securities are similar. The principal benefits from investing in funds arise from pooling (e.g. diversification, lower costs, access to investment opportunities, etc.) that may otherwise not be available or easily available to individual investors. Investors must recognise that investing in securities through a fund does not remove the risk that would normally come from directly holding those securities (e.g. investment, credit or liquidity risks). Also, versus the underlying securities, funds can potentially introduce other types of risks depending on the type and complexity of trading strategies employed, the nature of underlying investments, use of leverage, etc.

Valuation and liquidity may not be well understood by investors. In a strict sense, given transaction costs etc., the net asset value that is quoted at which transactions take place does not represent the value that would be received if the entire fund were to be liquidated immediately. Nevertheless, the net asset value is a fair basis for marginal transactions rather than for wholesale or significant liquidation. Liquidity is similar in that while in normal circumstances it is reasonable for the investor to expect asset managers to manage the funds so that redemptions can be met, it is unreasonable for investors to expect that all investors can redeem at the same time in the same way.

7. ***The importance of disclosure and risk acceptance***

Asset managers are obliged (and required) to go to great lengths to ensure investors understand that investing in funds is not without risk and yet expectations of how asset managers must manage liquidity risk appear inconsistent with the pass-through nature of a fiduciary agency. Just as asset managers cannot fully immunise investors from all other risk factors (market risk, regulatory risk etc.), it would not be appropriate to create an expectation that they can deliver a different outcome with liquidity risk without inadvertently creating other adverse consequences (e.g. leverage, inappropriate risk transfer, etc.). HSBC does not believe liquidity risk is or should be treated differently from other risks.

Rather than attempt to control liquidity risk and in doing so, create potentially unintended risks not fully understood or managed, a more practical approach to managing liquidity risk would be to ensure that all risks, including liquidity risk, are adequately described within fund documentation so investors better understand the risks they are taking in pursuit of returns and they are able to make an informed decision, either directly or via an intermediary, as to whether these risks are aligned to their own risk appetite. Failure to achieve this through adequate disclosures or disguising inherent risks (such as liquidity risk) within funds can result in moral hazard.

8. ***Matching a fund's liquidity with that of its underlying investments***

Investor expectations that funds can and should always offer daily pricing and investment “redeemability” are unreasonable assumptions that can be misaligned to the true reality of market liquidity. In “normal” market conditions the pattern of subscriptions and redemptions and the ease of trading in the marketplace

means investors often receive an enhanced liquidity experience through the fund than if they were investing themselves directly in the underlying assets. However, in stressed market conditions, when net redemptions might increase at the same time as it becomes more costly or impossible to liquidate securities in the market, an investor's ability to redeem their investments may be negatively impacted by the prevailing market liquidity of the underlying assets. HSBC believes investors should understand that the liquidity of their investment in a fund ultimately depends on the liquidity of the underlying investments in that fund and that illiquidity increases in stressed markets.

HSBC acknowledges that investors benefit from daily liquidity. While we ensure that redemption policies and dealing frequencies are suitably aligned to the liquidity of the underlying assets in the funds, we feel that expectations of asset managers' abilities to deliver liquidity at all times and to all investors with minimal market impact, are unrealistic. To help to focus investor expectations on how quickly they can liquidate their investments, we recommend that regulators require asset managers to align redemption policies more closely to the liquidity of the underlying assets within each fund. We believe the industry would benefit from further guidance from regulators on what types of policies should be followed for certain fund strategies in order to determine the most suitable dealing frequency. Such enhancements might also help investors compare policies across funds/fund families.

9. ***Borrowing to meet redemptions***

HSBC firmly believes that asset managers should not meet redemptions through borrowing facilities for the funds unless it is to meet short term settlement mismatches. Such actions are inappropriate as they gear the funds to the potential disadvantage of those investors who are not redeeming and misleads investors into thinking that liquidity ought to always be available to them. HSBC would like to reiterate that investors must understand that investing in the financial markets involves risk and the market liquidity associated with investing in a fund is both practically and legally different to the liquidity obligations bestowed upon a bank depository.