



Remarks at the Federal Reserve Bank of Atlanta 2015 Financial Markets Conference –
[Policy Session 2: Shadow Banks and Macroprudential Policy](#)

Regulation in Asset Management: Improving the Financial Ecosystem

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Importance of Education

Thank you for the opportunity to address risks in asset management. I would like to call your attention to the description of this session. One of the things you will find in your brochure is the statement that “...both the international Financial Stability Board (“FSB”) and the U.S. Financial Stability Oversight Council (“FSOC”) have sought to extend macroprudential regulation to shadow banks and some other large financial firms.”¹ And a second sentence: “Yet, whether and how these other market participants affect financial stability is often not well understood.”²

Today, I’d like to start with a discussion about what has occurred in the financial ecosystem since the Financial Crisis and then delve into what kind of risks exist and how those risks can be addressed. As policy makers have pivoted from banks to other financial institutions, there have been a lot of questions about, and a lot of engagement regarding, asset management. To put this in perspective, FSB and FSOC are just two of more than 20 official sector groups trying to identify systemic risk in asset management.³

Unfortunately, there is often an assumption that an asset manager is the same or very comparable to a bank. Let me point out a few fundamental differences between the business models of banks and asset managers, because that conflation is at the heart of a lot of the confusion. First, asset managers do not have access to the Federal Reserve discount window as banks do. Asset managers do not offer insured deposits, we do not guarantee any of our products, and taxpayer dollars are not at risk. And, there is no promise to return principal. When you think about things like capital buffers or liquidity buffers, you have to keep in mind that the investors are the ones at risk in these products. Unlike a bank, client assets are not held on the balance sheet of the asset manager – they are held at independent custodians, and the client assets are not intermingled with the assets of the asset manager. It is important to keep in mind how an asset manager makes money. There have been questions that suggest that asset managers make money in the same way that banks make money on the spread of client assets. In fact, the relationship of an asset manager to the investment vehicles it manages is analogous to the relationship any provider of services has with its customers. Asset managers provide services and receive fees for those services. The returns on the client portfolio, positive or negative, belong to the investors.

It is important to clearly define what kind of risks we are trying to address and support that identification of risks with data and facts. We must differentiate between market risk and systemic risk, and we must understand that the balance sheet risk at a bank does not exist at an asset manager. As a result, asset managers do not cease operations the way a bank can suddenly fail and asset managers do not create the systemic exposures that banks create.

Suggestions that asset management is “unregulated” unfairly discount the extensive regulation of both advisors and funds, including new rules implemented since the Financial Crisis.

Over the past few years, we have heard many different hypotheses about asset management. I will give you just a couple examples to emphasize how important it is that these hypotheses be tested, as several have proven to be far off the money upon deeper analysis.

It has been suggested that large asset managers utilize central decision-making, which concentrates investments and centralizes risk. In fact, the opposite is true. Although there are some exceptions, most large multi-product firms have multiple investment teams making independent decisions, whereas smaller firms may implement a “house view.” In general, the larger the asset manager, the more likely it is that they have a diversified platform.

A second area of concern has arisen about the impact of a reputational event. There is a theory that a reputational event at a large firm will lead to “platform contagion” where investors redeem from funds across the firm’s platform, in turn disrupting markets. The departure of Bill Gross from PIMCO provides a useful case study with regards to this hypothesis. When Gross abruptly left PIMCO, 70% of outflows were concentrated in products that were directly managed by Gross⁴ rather than across all funds, disproving the platform contagion premise. Funds flowed to multiple firms, highlighting the high degree of substitutability in the asset management industry. We also saw how each client has a different governance model – this could include the use of a committee, an outside consultant, or various other measures – and makes their own asset allocation decisions. The outflows did not all occur in one day, but rather they have been spread out over weeks and months.⁵ Today, we estimate there have been approximately \$200 billion in outflows from PIMCO,⁶ and yet the fixed income markets continued to function during a time period where everyone is talking about the challenges of reduced market liquidity. Clearly, we need to understand the dynamics of asset management better.

Regulation in Asset Management

In another part of the conference brochure, the question is posed: “For those that do pose a risk, can we adapt existing bank prudential regulation to meet the challenge or do we need a different paradigm?”⁷ As the first step in addressing this question, we must identify the problems that need to be solved. We must then consider the pros and cons of various potential policy measures. If we do things that result in eliminating mutual funds, do we have a better world? I would argue probably not. Focusing on the products and the activities, and focusing on them across the market ecosystem, is the key way to capture risk in asset management. A horizontal regulatory approach across products and practices is necessary to avoid creating regulatory gaps that will inevitably lead to regulatory arbitrage.

Let me give two examples of products and activities that have already been regulated across entities, illustrating just how important it is to regulate across the financial ecosystem.

Imagine what the over-the-counter (OTC) derivatives markets would look like today if the response of the regulators had been to only regulate the top two or three largest swap dealers. The business of those dealers would have simply moved to different market participants.

Likewise, if the securities regulators had chosen to apply reforms to money market funds (MMFs) to only a few of the largest MMFs, clients would move their assets to other non-affected MMFs.

In both scenarios, the money would have simply moved elsewhere. Rather than reducing risk, that type of entities-based approach would shift risk. If we want to have a reduction of risk, we need to think about products and activities system-wide.

The same approach needs to be used for other products and activities.

One area that has been getting a lot of focus lately is securities lending. I would like to explain why limiting or regulating one firm or even one group of firms will not reduce risk. Securities lending is done directly by asset owners, the investors. It is also done by securities lending agents, which include custodians, asset managers, and standalone businesses that specialize in securities lending.⁸ If there is a particular aspect of securities lending – be it haircuts, cash reinvestment pools, rehypothecation of collateral, or borrower default indemnification – the practice needs to be regulated, not the entity. If the activities are not addressed across all securities lending agents, clients will simply pick a different way of doing their securities lending. The practice itself is what needs to be regulated.⁹

The FSOC began by looking at individual firms in asset management but, in December 2014, FSOC issued a Request for Comment that focused primarily on “products and activities” in asset management.¹⁰ Unlike FSOC, we’ve seen the FSB jump ahead with a project to develop metrics for designating individual investment funds and asset managers, without identifying problems or policy measures that would address the problems.¹¹ I’d like to show you why this approach is somewhat problematic.

The current FSB proposal targets asset managers with over \$1 trillion in assets under management (AUM).¹² We believe that this method will identify “false positives” and “false negatives.”

For example, the International Monetary Fund (IMF) has suggested concerns that the largest asset managers may reallocate assets out of emerging markets, which may disrupt these markets.¹³ While we sympathize with concerns about emerging markets, a deeper analysis shows that the asset owners are the ones who control that strategic asset allocation decision. Asset managers are contractually obligated to manage client assets according to pre-specified guidelines defined in an investment management agreement. Importantly, the largest asset managers have very little overlap with the largest managers of emerging markets debt. Therefore, if the question is about emerging markets, it would be better addressed by analyzing firms with an emerging markets specialty and clients with significant allocations to this sector.

Likewise, the Office of Financial Research (OFR) has suggested concerns about “leveraged separate accounts.”¹⁴ Last April, SIFMA conducted a study of 9 firms with over \$4 trillion AUM in separate accounts.¹⁵ The study showed that 99% of separate accounts managed by the firms in the study were long-only and therefore clearly not-levered. While there may be some separate account portfolios that are levered, they are not with the largest funds and are more likely managed by alternatives specialists rather than by managers with over \$1 trillion in AUM.

These examples underscore the need to look in the right place rather than just screen entities by size since AUM is easy to measure.

Returning to the question of whether or not we can adapt existing bank prudential regulation to asset management, my answer is that we need a new paradigm. To create effective solutions, this paradigm must start by defining the issues and then crafting solutions.

2015 is not 2008

I'd like to look ahead and make a few suggestions for reducing risk. First, we need to acknowledge that 2015 is not 2008 and that the financial system has been fundamentally changed since the Financial Crisis. New regulations have strengthened the financial system, making it much safer and sounder, especially in the bank sector.

This session poses the question, "What are the unintended consequences of such regulation?"¹⁶ I'd like to instead consider the *intended* consequences of post-Crisis regulations. We saw reforms that enhanced bank capital, liquidity, and asset quality; addressed bank resolution; and reduced risks in the OTC derivatives markets through central clearing.

Looking forward, I would divide the next chapter of financial regulatory reform into three different areas.

First, we must consider unfinished business.

We've heard a number of people speak publicly about the need to make central clearing counterparties (CCPs) more resilient, including Federal Reserve Governor Powell,¹⁷ CFTC Chair Massad,¹⁸ and Bank of England Governor Carney.¹⁹ We need to address risks in CCPs system-wide. These risks affect everyone who deals with derivatives.

Another area to consider is the short-term investment funds (STIFs) of state-chartered banks, which are used for cash reinvestment. These cash reinvestment pools do not have the same rules as the STIFs of nationally-chartered banks. State banking authorities should consider how best to regulate these STIFs.

Second, we should consider tweaks or modifications to existing regulations based on what we have learned. It seems self-evident that with thousands of pages of legislation and regulation, every idea and every word cannot possibly be perfect. Dodd Frank is over 2,000 pages and the Volcker Rule alone is almost 900 pages. We should revisit existing rules and consider improvements – not to water down the regulations but rather – to make sure we're getting it right.

And, finally, we need to consider "plugging the gaps" to address any remaining issues. The elephant in the room, of course, is the "liquidity illusion": will a liquidity mismatch between the daily redemption of mutual funds and their underlying assets lead to systemic risk? It is important to keep in mind that \$1.00 net asset value (NAV) funds are fundamentally different from funds with a floating NAV, such as bond funds. "Daily liquidity" is not the same as "guaranteed price," although the two concepts are often conflated. Investors get liquidity in a floating NAV fund, but they get it at the market price – which is no different than owning the underlying securities and similarly not having a price guarantee.

Many of the proposed hypotheses about liquidity suggest that there could be massive withdrawals from funds across a firm's platform. This has never happened. I have received a number of questions inquiring how many times have we seen a massive withdrawal from funds, and my answer is that we have never seen that happen. Although such redemption scenarios have never happened and mutual funds have met their redemptions, even in major stress events, it is still worth exploring ways to make funds even more resilient. We urge policy makers to consider a three part solution.

We recommend improving the structural features of funds. Across the globe, there are a number of different fund features, including pricing mechanisms, redemption features, investor disclosure and more. Since no one has a crystal ball to predict the future and anticipate the next crisis, we recommend building a broad toolkit of measures available to fund managers, fund boards, and regulators to address any future, unforeseen risk. A broad toolkit would allow flexibility to address a variety of scenarios. Using existing features already available in different regulations, elements of the toolkit could include pricing mechanisms for subscriptions / redemptions, redemption provisions, borrowing for short-term purposes, limits on illiquid securities, and disclosures.

Let's go back to the importance of education for a moment. As I discussed earlier, we need to gain a better understanding of certain aspects of asset management, including the liquidity risk management practices currently being used by asset managers. We recommend raising the bar industry-wide and making sure everyone is incorporating the best practices. SEC Chair White has identified the need for measures to address liquidity risk management, including stress testing for mutual funds.²⁰ We are supportive of the SEC's efforts on this front, and we emphasize the need for stress tests that enable managers to tailor liquidity risk management for different types of funds, different environments, and different investors. We do not recommend prescriptive measures such as mandatory cash buffers but rather giving managers discretion on how to meet certain stress scenarios. You may notice that I did not include "capital" or "explicit cash buffers," as asset managers do not guarantee the NAV of bond or stock funds. If these capital buffers were imposed on a subset of funds, the result could be a drag on returns, which would shift capital around the system. This could drive money out of mutual funds and into separate accounts, simply shifting risk rather than reducing it.

And, finally, we should address market structure issues associated with the underlying investments. For bank loans, bank regulators can make bank loans more "security-like" by standardizing and reducing the settlement period, which would directly address the mismatch issue.²¹ For corporate bonds, regulators should encourage standardization of bond features as well as electronic trading.²² Regarding ETFs, we must recognize that these funds trade on an exchange, and the secondary market trading provided by the exchange enhances market liquidity. As we saw in October, ETFs played a role as a stabilizer in the bond market as funds flowed out of PIMCO, allowing investors to quickly stay invested in this asset class.²³

Market Risk vs. Systemic Risk

It is imperative to separate concerns about investment losses by asset owners from concerns that funds could create or transmit systemic risk. We have experienced a series of seismic market shocks over the past year that demonstrate this point. These include the flash crash (or some people call it a "flash rally") in U.S. Treasuries last October, the Bank of Japan and the Japan Government Pension Investment Fund making simultaneous announcements, the Swiss National Bank deciding to uncap the currency, and the European Central Bank expanding its QE program.

In each of these events, investors bore the brunt of the ensuing market volatility, while banks, which are at the core of our financial system, did not sustain any notable losses. We should be encouraged by this on multiple fronts. First, efforts to reduce risk-taking at banks are working. And second, in each of these market events, markets continued to function. We may not like the way that markets performed and we may not like the prices available, but the markets did perform and investors were able to withstand these market shocks.

Conclusion

At BlackRock, we support regulatory reform that improves the financial ecosystem for all market participants. As a large investor, we have the same goals as policy makers – think of it as living in a cleaner, safer neighborhood. We are supportive of the SEC’s approach of looking at the whole landscape to identify and address remaining concerns. SEC Chair White has laid out a series of reforms to activities in asset management, including: enhancing data reporting and disclosures; moving ahead with updated rules governing the use of derivatives in mutual funds and ETFs; and stress testing policies to ensure that the individual mutual funds have proper liquidity risk management measures in place.²⁴ Potential reforms in each of these areas could improve the financial ecosystem, and we look forward to active engagement on these topics as policy makers seek to find the balance between mitigating systemic risk and promoting growth.

As Governor Poloz of the Bank of Canada said, “A bright future is one where the financial system is safe and efficient—and innovative. Financial regulation needs to be designed to allow competitive forces to work, and allow innovation to happen.”²⁵ Effective solutions will require a clear understanding of complex issues and will require engagement between policy makers and market participants.

¹ Federal Reserve Bank of Atlanta, 20th Annual Financial Markets Conference: Central Banking in the Shadows: Monetary Policy and Financial Stability Postcrisis — March 30–April 1, 2015, available at <https://www.frbatlanta.org/news/conferences/2015/150330-fmc/papers-presentations-videos.aspx> (“Atlanta Fed Conference Program”).

² See Atlanta Fed Conference Program.

³ See FSB-IOSCO, Consultative Document (2nd), Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions: Proposed High-Level Framework and Specific Methodologies (Mar. 4, 2015), available at <http://www.financialstabilityboard.org/wp-content/uploads/2nd-Con-Doc-on-NBNI-G-SIFI-methodologies.pdf> (“FSB Second Consultation”); FSOC, Notice Seeking Comment on Asset Management Products and Activities (Dec. 18, 2014), available at <http://www.treasury.gov/initiatives/fsoc/rulemaking/Documents/Notice%20Seeking%20Comment%20on%20Asset%20Management%20Products%20and%20Activities.pdf> (note that FSOC is comprised of nine member agencies). See for additional examples, IMF, Global Financial Stability Report (Apr. 2015), available at www.imf.org/External/Pubs/FT/GFSR/2015/01/pdf/text.pdf; Hong Kong Securities and Futures Commission, Asset Management: Looking Forward (Jan. 21, 2015), available at [http://www.sfc.hk/web/EN/files/ER/PDF/2015%20RIM%20Report%20\(FINAL\)_ER.pdf](http://www.sfc.hk/web/EN/files/ER/PDF/2015%20RIM%20Report%20(FINAL)_ER.pdf); Banque de France, Financial Stability Review (Apr. 2015), available at https://www.banque-france.fr/fileadmin/user_upload/banque_de_france/publications/Revue_de_la_stabilite_financiere/2015/FSR19_global.pdf; Mary Jo White, Chairman, SEC, *Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry*, Speech at The New York Times DealBook Opportunities for Tomorrow Conference (Dec. 11, 2014), available at <http://www.sec.gov/News/Speech/Detail/Speech/1370543677722> (“SEC Chair White Speech”); Bank for International Settlements, 84th Annual Report (Jun. 29, 2014), available at <http://www.bis.org/publ/arpdf/ar2014e.pdf>; Canadian Securities Regulators, Capital Markets Stability Act – Draft for Consultation (Aug. 2014), available at <http://ccmr-ocrmc.ca/wp-content/uploads/CMSA-English-revised.pdf>; Daniel K. Tarullo, Governor, Federal Reserve System, *Advancing Macroprudential Policy Objectives*, Speech at the OFR and FSOC’s 4th Annual Conference on Evaluation Macroprudential Rules (Jan. 30, 2015), available at <http://www.federalreserve.gov/newsevents/speech/tarullo20150130a.htm>; Mark Carney, Governor, Bank of England, *The Future of Financial Reform*, Speech at the 2014 Monetary Authority of Singapore (Nov. 17, 2014), available at <http://www.bankofengland.co.uk/publications/Documents/speeches/2014/speech775.pdf>; Office of Financial Research, Asset Management and Financial Stability (Sep. 2013), available at http://financialresearch.gov/reports/files/ofr_asset_management_and_financial_stability.pdf (“OFR Asset Management and Financial Stability Report”); Stephen Poloz, Governor, Bank of Canada, *Speculating on the Future of Finance*, Speech at the Economic Club of New York (Dec. 11, 2014), available at <http://www.bankofcanada.ca/wp-content/uploads/2014/12/remarks-111214.pdf> (“Governor Poloz Speech”); OCC, Comptroller’s Handbook, Asset Management Operations and Controls (Jan. 2011), available at <http://www.occ.gov/publications/publications-by-type/comptrollers-handbook/am-operations-controls-rev8-18-11.pdf>; Steven Majoor, ESMA Chair, *Systemic risks and current policies in the EU fund industry – Can asset managers be too big to fail?*, Speech at the 25th Annual Conference on the Globalisation of Investment Funds (Jun. 10, 2014), available at http://www.esma.europa.eu/system/files/2014-619_systemic_risks_and_current_policies_in_the_eu_fund_industry_iba_conference_paris_-_steven_majoor.pdf; Mario Draghi, ECB Chair, Hearing before the Committee on Economic and Monetary Affairs of the European Parliament (Nov. 17, 2014), available at <https://www.esrb.europa.eu/news/pr/2014/html/is141117.en.html>.

⁴ See Kirsten Grind, *Pimco Sees \$48 Billion in Outflows After Gross Departure* (Nov. 5, 2014), The Wall Street Journal, available at <http://www.marketwatch.com/story/pimco-sees-48-billion-in-outflows-after-gross-departure-2014-11-05>. Oliver

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- ⁵ The PIMCO Total Return Fund saw overall outflows of \$68 billion from October 2014 through January 2015, with larger outflows in both January 2015 and December 2014 than in November 2014. See PIMCO Press Releases, available at <http://www.pimco.com/en/pressreleases/Pages/PressReleasesOverview.aspx>.
- ⁶ See Stephen Foley, *Pimco takes \$200bn hit in outflows* (Jan. 17, 2015), Financial Times, available at <http://www.ft.com/intl/cms/s/0/ee10715e-9de4-11e4-8ea3-00144feabdc0.html#axzz3Y3P9FQoF>.
- ⁷ See Atlanta Fed Conference Program.
- ⁸ Securities lending agents include BMO Global Asset Management, BNP Paribas, BNY Mellon, Brown Brothers Harriman, Citibank, Comerica Bank, Credit Suisse, Deutsche Bank, eSecLending, Frost Bank, Goldman Sachs Agency Lending, JP Morgan, Northern Trust, Schwab, Scotia Capital (USA) Inc., State Street Bank, Sumitomo Mitsui Trust Bank (USA) Ltd, US Bank, Vanguard Group, Wells Fargo.
- ⁹ For further detail on securities lending, see BlackRock, *ViewPoint, Securities Lending: The Facts* (May 13, 2015), available at <http://www.blackrock.com/corporate/en-us/literature/whitepaper/viewpoint-securities-lending-the-facts-may-2015.pdf>.
- ¹⁰ Financial Stability Oversight Council, Notice Seeking Comment on Asset Management Products and Activities, 79 Fed. Reg. 77489 (Dec. 18, 2014).
- ¹¹ FSB Second Consultation.
- ¹² FSB Second Consultation.
- ¹³ IMF, *Global Financial Stability Report, Risk Taking, Liquidity, and Shadow Banking: Curbing Excess While Promoting Growth* (Oct. 2014), available at <http://www.imf.org/external/pubs/ft/gfsr/2014/02/>.
- ¹⁴ OFR Asset Management and Financial Stability Report.
- ¹⁵ SIFMA, Comment Letter, Response to the FSB's Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions and the OFR's Asset Management and Financial Stability (Apr. 4, 2014), available at <http://www.sifma.org/issues/item.aspx?id=8589948419>. The report detailed the separate account data of 9 asset managers with aggregate assets under management ("AUM") of \$11.2 trillion, \$3.98 trillion of which was separate account AUM.
- ¹⁶ See Atlanta Fed Conference Program.
- ¹⁷ Jerome H. Powell, Governor, Federal Reserve System, *Financial Institutions, Financial Markets, and Financial Stability*, Speech delivered at the Stern School of Business, New York University (Feb. 18, 2015), available at <http://www.federalreserve.gov/newsevents/speech/powell20150218a.htm>;
- ¹⁸ Testimony of Chairman Timothy G. Massad before the U.S. House Committee on Agriculture 114th Cong., (2015) (statement of Timothy Massad, Commodities Futures Trading Commission, Chairman), available at <http://www.cftc.gov/PressRoom/SpeechesTestimony/opamassad-11>
- ¹⁹ Mark Carney, Bank of England, Governor, Letter to the G20 Finance Ministers and Central Bank Governors (Feb. 4, 2015), available at <http://www.financialstabilityboard.org/wp-content/uploads/FSB-Chair-letter-to-G20-February-2015.pdf>.
- ²⁰ SEC Chair White Speech.
- ²¹ BlackRock, *ViewPoint, Who Owns the Assets? A Closer Look at Bank Loans, High Yield Bonds and Emerging Markets Debt* (Sep. 2014), available at <http://www.blackrock.com/corporate/en-us/literature/whitepaper/viewpoint-closer-look-selected-asset-classes-sept2014.pdf>.
- ²² BlackRock, *ViewPoint, Corporate Bond Market Structure: The Time for Reform is Now* (Sep. 2014), available at <http://www.blackrock.com/corporate/en-us/literature/whitepaper/viewpoint-corporate-bond-market-structure-september-2014.pdf>.
- ²³ See BlackRock, *ViewPoint, ETFs Help Improve Market Stability: A Closer Look at Fixed Income ETF Behavior During Recent Bond Market Movement* (Oct. 2014), available at <https://www.blackrock.com/corporate/en-us/literature/whitepaper/etfs-help-improve-market-stability-october-2014.pdf>.
- ²⁴ SEC Chair White Speech.
- ²⁵ Governor Poloz Speech.

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