Introduction
Aberdeen Asset Management is a global asset manager and a FTSE 100 company. We are based in 25 countries with 33 offices, over 700 investment professionals and around 2,500 staff overall. Our assets under management were £324.4 billion as at 30 September 2014.

As a pure asset manager, we are able to concentrate all our resources on our core business. We believe this is key to our performance. Assets only managed for third parties, not our own balance sheet, helps reduce conflicts of interest.

Our business is predominately the active management of financial assets. Our investment expertise is delivered through both segregated and pooled products – allowing us to serve a range of clients from institutions to private investors.

Areas of specific interest
We have responded in detail to the specific questions of interest to Aberdeen Asset Management (Aberdeen) via the Investment Association (IA). There are three themes of particular interest to us which run through the review:

1 Regulatory developments and implications for liquidity;
2 New issue allocation; &
3 Global complexity.

Aberdeen is supportive of the IA draft submission in general and particularly where the IA raises concerns in respect of liquidity. We also wish to take this opportunity to respond directly to express our views on the three areas listed here.

<u>1 Regulatory developments and implications for liquidity</u>

Bank regulatory developments since the onset of the financial crisis have significantly altered the amount of balance sheet allocated by market makers to their secondary market trading book. These developments include:

- The Basel III capital framework – through the materially higher risk weights applied to trading books;
- Higher leverage ratio minima; &
- The Volcker rule.

These developments have materially changed the economics of secondary trading, not only directly through higher capital requirements (and lower returns) but also indirectly through the impact on the repo market (and the ability to finance positions) or the ability to hedge positions.

Secondary market liquidity is ultimately the ability to trade a financial instrument at a given price and in reasonable size at any point in time. Measures of liquidity include:

- Overall market maker inventory;
- Bid ask spread;
- Trading volumes: &
- Average ticket sizes.

Market data as well as Aberdeen Asset Management's dealing desk experience suggests that we have indeed experienced a material reduction in secondary market liquidity over the past two to three years.

Regulators globally need to understand this risk of reduced market liquidity, which has arisen from actions taken to reduce bank systemic risk.

The over-the-counter (OTC) nature of the credit market and the lack of standardisation of corporate bonds - be it around issuer, tenor, structure, issue and free-float size or covenants, means that secondary market liquidity is difficult to achieve in practice.

The reduction by market makers of capital allocated the secondary market trading, by definition, will see a significant increase in market volatility versus the historical average as the credit market increasingly moves to an agency trading model.

Ultimately, investors will need to adjust the way to manage credit assets – increasingly moving to buy and hold strategy and maintaining a higher exposure to cash and other highly liquid instruments, and be paid appropriately for taking liquidity risk.

Unless liquidity increases, regulators will need to accept that credit market volatility will materially increase from here – particularly for higher risk asset classes e.g. high yield, which could in itself increase systemic financial risk.

2 New issue allocation

Bonds issued in the primary market play a crucial role in the investment process of asset managers and are vital to investment performance. However**, there are multiple aspects of the primary market that make it less than fair in our view.**

In the book building process, books are frequently left open for hours or days. At the same time, information on the order book is disseminated (although not necessarily homogenously) by the lead managers, allowing participants to gauge the likely performance of a new issue and jump on the band wagon at a late stage.

This frequently disadvantages long-term investors who have done the fundamental credit analysis that made a bond deal possible in the first place, by reducing the allocations available to them. **In our view, the communication on the state of the order book should be restricted significantly more than the IA is suggesting.**

As new deals are frequently oversubscribed (as described above), the available amount of bonds needs to be allocated across participants. Such allocation of new bond issues is implemented by lead managers in a very opaque way. **While there is no evidence of market manipulation, the fairness and efficiency of the process has to be questioned.**

Large asset managers who provide early interest (considered "lead orders" and prove the viability of an order book to the market) as well as clients who are seen by lead managers as particularly profitable business partners are believed to be given favourable allocations. We believe this to be unfair.

Aberdeen agrees with the IA in that the range of allocations should be made public in order to be able to judge whether such prioritisation is actually occurring. However, we believe it to be unworkable to tackle the practice of order inflation by investors, as appropriate order size is subject to a portfolio manager's judgement and so is subjective. If the state of the order book was not disclosed during book building then participants would be unable to gauge the likely size of their allocation. A participant submitting an inflated order would therefore run the risk of receiving a full allocation. Limiting disclosures during the book building process should ensure a fairer outcome.

We do not agree with the argument that a more objective way of allocating is impossible on the basis that they have to be balanced against the interest of the issuing company. When an issuer is using a public market, the interest of the end investor must be paramount.

Aberdeen favours the introduction of primary auctions for corporate bonds in order to eliminate such issues of fairness. An auction process would favour investment managers that feel able and confident to assess the value of an asset, as opposed to those who wish merely to benefit from technical information on the demand for such asset. We believe this to foster efficient pricing.

We would also favour measures that would make it more difficult for agents from benefiting from the fundamental analytical work of long term investors by jumping on apparently well-performing primary deals.

Concerns about the interests of the issuer or the increased risk of a failed auction are not sufficient to rule out the introduction of an auction process for issuance in public bond markets. However, we acknowledge that in certain circumstances, auctions might not be the best option and some flexibility may therefore be needed to allow for such circumstances.

It is worth noting that equity IPOs are conducted on a similar basis and participants in this market express similar concerns. These challenges may be intrinsic to this type of offering mechanism and regulatory solutions should be considered carefully.

3 Global complexity

Improvements in transparency and consistency in the regulation of markets naturally will increase liquidity as capital flows move with greater ease between markets thus reducing technical arbitrage opportunities. Consistency of regulation across global markets should improve liquidity as only small changes in value will be required for liquidity to flow to markets as required. Market participants would be able to benefit from lower spreads and liquidity is improved. During periods of stress, this will prove particularly important as liquidity will flow more easily to where it is needed and not stay where it is trapped.

Aberdeen believes electronic trading to be beneficial and we would welcome its introduction, including use for larger size tickets. The EU is falling behind the US on swap central clearing as the implementation of the EMIR regulations is protracted and EU regulators are being indecisive.

This is resulting in a two-tier market between central clearing in the US, under Dodd-Frank, and in the EU, under EMIR, which investment banks may exploit. Operational risks in particular are easily reduced through electronic trading.

Swaps in the US are traded electronically up to a certain size above which trading reverts to communicating by phone to offer counterparties more discretion in the market. **Electronic trading in general is beneficial and its use should be expanded in EU markets.** EU regulators appear less in favour of electronic trading than their US counterparts.

An example of the impact of regulatory impact on these markets is the introduction of regulated central clearing for derivatives, in EMIR, which has led to a concentration of risk in the four major clearing houses. The clearing houses may be becoming too big themselves. In the event of a dysfunction within one of these clearing entities, the stress on the financial system would be severe and the consequences very significant.

Mifid is going to implement pre-trade and post-trade rules for transparency. While Aberdeen applauds these changes in the absence of a suitable time delay before disclosure, market practitioners may opt for alternative trading venues such as dark pools. We are also concerned that these pre-trade transparency measures may discourage our counterparties from quoting prices, which could damage trading liquidity even further. **Mifid pre-trade transparency initiatives need to be calibrated very carefully to protect liquidity.**