



European Securities and  
Markets Authority

# Response Form to the Consultation Paper

**Guidelines on Article 25 of Directive 2011/61/EU**





## Responding to this paper

ESMA invites comments on all matters in this consultation paper and in particular on the specific questions summarised in Annex I. Comments are most helpful if they:

- respond to the question stated;
- indicate the specific question to which the comment relates;
- contain a clear rationale; and
- describe any alternatives ESMA should consider.

ESMA will consider all comments received by **01/09/2020**.

All contributions should be submitted online at [www.esma.europa.eu](http://www.esma.europa.eu) under the heading 'Your input - Consultations'.

### Instructions

In order to facilitate analysis of responses to the Consultation Paper, respondents are requested to follow the below steps when preparing and submitting their response:

1. Insert your responses to the questions in the Consultation Paper in the present response form.
2. Please do not remove tags of the type <ESMA\_QUESTION\_PFG\_1>. Your response to each question has to be framed by the two tags corresponding to the question.
3. If you do not wish to respond to a given question, please do not delete it but simply leave the text "TYPE YOUR TEXT HERE" between the tags.
4. When you have drafted your response, name your response form according to the following convention: ESMA\_PFG\_nameofrespondent\_RESPONSEFORM. For example, for a respondent named ABCD, the response form would be entitled ESMA\_PFG\_ABCD\_RESPONSEFORM.
5. Upload the form containing your responses, in Word format, to ESMA's website ([www.esma.europa.eu](http://www.esma.europa.eu) under the heading "Your input – Open consultations" → "Consultation on Position limits and position management in commodities derivatives").



## **Publication of responses**

All contributions received will be published following the close of the consultation, unless you request otherwise. Please clearly and prominently indicate in your submission any part you do not wish to be publically disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure. A confidential response may be requested from us in accordance with ESMA's rules on access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by ESMA's Board of Appeal and the European Ombudsman.

## **Data protection**

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## **Who should read this paper**

This document will be of interest to asset managers managing alternative investment funds and their trade associations.



## General information about respondent

Name of the company / organisation	CFA Institute
Activity	Other Financial service providers
Are you representing an association?	<input checked="" type="checkbox"/>
Country/Region	Europe

## Introduction

*Please make your introductory comments below, if any*

<ESMA\_COMMENT\_PFG\_1>

CFA Institute appreciates the opportunity to provide its view on the ESMA proposed guidelines on Article 25 of the AIFMD.

CFA Institute is the global association of investment professionals that sets the standards for professional excellence. We are a champion for ethical behaviour in investment markets and a respected source of knowledge in the global financial community. Our mission is to lead the investment profession globally by promoting the highest standards of ethics, education, and professional excellence for the ultimate benefit of society. There are more than 178,000 CFA charterholders worldwide in 162 markets. CFA Institute has nine offices worldwide and there are 159 local member societies.

The work performed by ESRB and ESMA in the EU along with long-standing workgroups set up by IOSCO and FSB on Non-Bank SIFIs and shadow banking are an important part of regulators' responsibility to ensure that an increasing globalization of exchanges and financial services is not unduly affecting the stability of local economies. The 20 years following the dotcom crisis of early 2000s have sowed doubts that authorities and governments were losing control over the risks posed by an internationalizing and expanding financialization of the economy.

CFA Institute has a history of working on systemic risk in financial services in general and asset management in particular. Please see the link below for our various positions on the topic:

<https://www.cfainstitute.org/en/advocacy/issues/systemic-risk>



CFA Institute also sponsors the CFA Institute Systemic Risk Council, a private sector, non-partisan body of former government officials and financial and legal experts committed to addressing regulatory and structural issues relating to global systemic risk.

<https://www.systemicriskcouncil.org/>

A balance needs to be found between the industry and regulators. Risk mitigating cannot be pursued as an absolute objective as it would stifle innovation, entrepreneurship and sound risk taking by private actors. Conversely, it is no longer acceptable for financial services to engage in risky activities in an asymmetric fashion hoping that authorities and the tax payers will ultimately be responsible for the stabilization of the system. Somehow a re-balancing needs to take place and it is probably fair to assume regulators have a role to play in this regard through the data they now have access to and the appropriate means to be put in place to analyse this data in order to make an informed judgment on the level of risk in the system.

CFA Institute remains of the view that the agency nature of the asset management industry does not pose the same level of potential systemic risk as the banking world, which represents principal risk.

Nevertheless, we recognize that leverage (financial and synthetic) is the one important channel where risk can migrate from fund shareholders to the wider economy, through other counterparties, banks and CCPs. It is therefore important to monitor the build-up of risk in the system through leverage and appropriately control the firms who wield this leverage through the funds they manage.

Of particular importance is also the inherently global and international nature of the alternative investments industry. In this regard, international regulatory cooperation continues to play an important role in data sharing. We can mention in particular the difficulties in comparing and merging data from AIFMD with that coming from the US SEC's Form PF. Yet, it is vital for regulators to obtain a complete picture of the situation for appropriate policies and decisions to be taken. In the same vein, we should mention that most funds which employ leverage are domiciled in off-shore locations, which should prompt as well some form of regulatory rapprochement to ensure proper oversight of the manager and the vehicle.

We support the two-step approach proposed by ESMA and also detailed by IOSCO in a similar manner with its December 2019 Framework for Assessing Leverage in Investment Funds. Such an approach would lend itself more precisely to the identification of the correct sources of risk which could then lead to targeted regulatory intervention. The first step correctly identifies gross leverage (GNE) as the primary distinguishing factor which should separate a vast majority of funds from a very small minority of highly leveraged vehicles employing specific instruments such as interest rate and FX derivatives. This targeted approach appears to us the right intellectual way of thinking about risk in asset management.

We would caution though against a blanket approach to leverage restriction and would recommend targeted actions depending on the market situation and also depending on a thorough assessment of any given firm's risk management systems and processes. This means the need to combine quantitative and qualitative approaches as part of the analysis.

<ESMA\_COMMENT\_PFG\_1>





## Questions

**Q1** : What are your views on the frequency at which the risk assessments should be performed by NCAs?

<ESMA\_QUESTION\_PFG\_1>

The issue with analyzing risk in the highly skewed sector of alternative funds relates to how the sector is in and of itself clustered into different buckets of risk.

For the vast majority of AIF vehicles, yes, quarterly, semi-annual or annual reporting is appropriate. A large majority of vehicles do not exhibit leverage in any meaningful manner which should prompt quicker reaction from authorities. So the current rules are appropriate. CFA Institute continues to be of the view that leverage is the principal mechanism through which financial risk transmits and propagates across the system. Without significant leverage, existing shareholders assume the risk of their fund's position through their equity which closely matches the liabilities of a fund.

The problem materializes for a small sub-set of highly leveraged hedge fund vehicles involved in the sphere of global macro and interest rate arbitrage. These vehicles employ substantive amounts of synthetic leverage through the use of interest rate and foreign exchange derivatives (swaps and forwards).

Please refer to the successive publications from the Financial Conduct Authority (UK) or from IOSCO on hedge fund risk from the annual hedge fund survey and data aggregation using AIFMD and other international sources. An important conclusion from these studies is the highly concentrated nature of risk in the hands of a handful of highly geared vehicles. This concentration is exacerbated when considering synthetic leverage and gross notional exposure (GNE) as the measure of market footprint.

For these highly leveraged vehicles, it could make sense to create an additional cluster of reporting at a higher frequency. For example, a bar could be set at 50 times GNE over NAV. Funds meeting this threshold should immediately report this fact to authorities, triggering a specific risk monitoring programme in order to reduce the gap between the observation of potential risk and the materialization of risk propagation given default or fear of default.

Such an approach would facilitate the concentration of supervisory attention where it matters most.

<ESMA\_QUESTION\_PFG\_1>

**Q2** : What are your views on the sample of funds to be included under Step 1? Do you agree in including in the risk assessment not only substantially leveraged funds but also funds not employing leverage on a substantial basis which may pose financial stability risks?

<ESMA\_QUESTION\_PFG\_2>

CFA Institute agrees with a two-step approach to systemic risk identification and management, also explained and detailed by IOSCO in its recent work on leverage.

A fine balance needs to be found between two competing tendencies. One, a desire to curtail risk in the system to such an extent that it stifles natural innovation and entrepreneurship. Two, the opposite idea of letting markets run free from any form of oversight and risk management at a macro level. Recent crises and the compounding effect of globalization have shown that society cannot really count on a purist approach to self-regulation as the balancing mechanism of choice. A number of reasons explain why self-regulation does not really work, from professional ethics issues, to over-confidence and of course ever increasing levels of intervention by authorities in the form of expansionary monetary policies which tend to magnify market reactions.

Ideally, the level of risk in the system and related control mechanisms should be such that the system at large would be resilient and strong enough to tolerate the failure of specific parts in an orderly manner, without undue spill-over effect.

In principle, CFA Institute continues to support the idea that, without leverage, an investment vehicle's equity should be a sufficient buffer to counter the effects of default in parts or in all of the portfolio's assets. Shareholders by definition assume the risk, which should not propagate beyond the immediate fund shareholders.

It is also possible that specific new sources of risk emerge and generate potential systemic risk even without the use of leverage. One such potential source could be the rise of CLOs, bank loan funds and leveraged finance in general. This sector has been thriving on the back of lowering interest rates and global asset returns. Should such non-bank lending continue to rise in proportion of companies' financing needs and if specific sector risk could cause widespread defaults in the field (dry powder driving lower returns and lower quality in a feedback loop manner), it is possible that the economy could suddenly suffer from a lack of financing which would need to be addressed by authorities and central banks in another form of interventionism.

Yet, including non-leveraged fund in the analysis should be done with a clear process or underlying reasoning, such as that described above, otherwise all funds may be included which will continue to result in indiscriminate and inefficient risk monitoring programmes.

CFA Institute would argue a specific focus needs to be set on those funds which employ leverage (financial or synthetic) in a significant manner. Such funds should be under targeted risk supervision programmes and report more frequently on their positions and also on their internal risk management processes.

<ESMA\_QUESTION\_PFG\_2>

**Q3** : Do you agree with the proposed threshold identified under Step 1? Would you set the same threshold for all AIFs, or would you be in favour of setting different thresholds based for different types of AIFs (e.g.: real estate, hedge funds, private equity etc) or sub-types of AIFs (please specify) based on a statistical analysis (e.g. percentile)? Should you prefer the latter option, please provide proposals and detailed arguments and justification supporting them.

<ESMA\_QUESTION\_PFG\_3>

Yes, the proposed threshold are fine and use readily available data from existing sources of reporting.



In terms of setting different thresholds, we think it depends on the objective. If the objective is to focus regulatory supervision on the most stringent sources of potential systemic risk, then leverage is the key step 1 measure that should determine where step 2 measures should pay attention. From this perspective, the same threshold should be applied all across since it is very likely only specific types of hedge funds will be captured, that which employ interest rate and FX derivatives in large scale.

If we collectively would also like to consider non-leveraged sources of risk, then it would make sense to use different thresholds depending on the sector. For example, CLOs, leveraged finance funds or direct lending funds employ specific financial leverage techniques through debt but will almost always represent lower levels of overall leverage than highly geared global macro hedge funds. So we could apply a specific threshold for this sector and focus on the large representatives. Similarly, for real estate funds, we have seen over the years how this sector is prone to liquidity mismatch risk and how it affects the wider real estate industry by ricochet. It could make sense to set a particular focus on the largest funds in this sector even if they employ low levels of leverage at fund level; the leverage is rather found at property level.

Further analysis should be considered if regulators consider applying different thresholds for low leveraged fund types.

<ESMA\_QUESTION\_PFG\_3>

**Q4** : Would you identify other relevant transmission channels?

<ESMA\_QUESTION\_PFG\_4>

We agree with the list of transmission channels as presented.

<ESMA\_QUESTION\_PFG\_4>

**Q5** : What are your views on using not only leverage indicators, but also other types of indicator such as those indicated under Table 2 of the draft Guidelines? Do you agree with the list of indicators provided?

<ESMA\_QUESTION\_PFG\_5>

The list of indicators is good as attempting to use already available regulatory data.

Regulators should stay mindful of the fact the vehicles most likely to generate systemic risk will often be based in multiple locations, therefore with scattered data about their activity. Regulatory cooperation in these instances will be important to ensure regulators work on a complete set of data. Institutions like IOSCO and FSB play an important role in this regard.

We would like to point to the historical work performed by IOSCO Committee 5 and FSB work on shadow banking on potential additional indicators, for example:

- Collateral over Equity (the higher the ratio, the riskier the fund)

- Proportion of OTC derivatives trading over all trading activity
- Derivatives trading proportion that is centrally cleared (the higher the more complex)
- A measure of rehypothecation
- Unencumbered cash over GNE (the lower the riskier the situation)

<ESMA\_QUESTION\_PFG\_5>

**Q6** : What are your views on using not only AIFMD data but also other external data sources to perform the assessment? Which types of external data sources would you consider more useful for the purpose of performing the assessment under Step 2, other than those already identified in Annex of to the draft Guidelines?

<ESMA\_QUESTION\_PFG\_6>

Ideally, AIFMD reporting should provide all data necessary, over time, perhaps through regulatory developments.

In the meantime, yes, regulators should have access to compensating sources of information, to the extent that they provide comparable measures.

Again, it is important to engage in international regulatory cooperation to ensure the completeness of the data set. In a context of Brexit, it will be important for EU ESAs to continue to have access to hedge funds managed out of the UK, for example, even if the vehicles are domiciled off-shore. Also important is to maintain an operational relationship with the SEC and CFTC on Form PF data for US-managed funds. Comparability between the two frameworks is not perfect, hence why the intermediation provided by IOSCO and FSB on data comparability continues to be crucial.

ESAs could also consider private sources and initiatives like Open Protocol Enabling Risk Aggregation.

<ESMA\_QUESTION\_PFG\_6>

**Q7** : Which other restrictions would you consider as appropriate?

<ESMA\_QUESTION\_PFG\_7>

We think the framework for leverage limitation is carefully laid out and reasonable.

We would like to add that leverage limits are inherently dependent upon the very situation markets are in, the investment style of funds concerned and of course the risk management seriousness and sophistication of the investment firm.

Regulators should avoid reactions intending to blanket markets or parts of the market with leverage restrictions, which is precisely why a two-step approach is right as it allows to focus on the vehicles most likely to generate risk and spill-over effect.

Once a fund or specific manager has been identified as a potential source of trouble given market condition, this manager should be first put under direct risk monitoring and supervision before concluding leverage restrictions are in order. An assessment of risk management processes should be engaged to determine if restrictions will actually be necessary. For example, whether we trust the manager goes beyond VaR to measure its risks and potential for default.

<ESMA\_QUESTION\_PFG\_7>

**Q8** : What are your views on the application of the leverage limits? Should those be applied only on the single fund or, where appropriate, limits should also be applied on group of funds? In this case, how would you identify the group of funds?

<ESMA\_QUESTION\_PFG\_8>

CFA Institute is against blanketing the market with leverage restrictions as this approach could have secondary consequences akin to a depressurising airplane.

Surgical strikes and targeted action using quality data to determine risk of spillover is what is required.

This ultimately also means that regulators should also start using judgment rather a simplistic application of rules when it comes to determining if risk has acceded acceptable thresholds. The works of Andy Haldane on this question (Ref. The Dog and the Frisbee; 2012) is particularly relevant.

By definition, risk is an event that has not yet occurred. So one way to think about this is regulators getting equipped with data and judgment to alleviate the formation of uncontrolled risk before it morphs into a crisis. This change in conundrum is not to be underestimated.

<ESMA\_QUESTION\_PFG\_8>

**Q9** : How would you assess the efficiency of leverage limits in mitigating excessive leverage?

<ESMA\_QUESTION\_PFG\_9>

It will always be difficult to measure after the fact whether a crisis has been averted, like in any risk mitigation activity.

Robustness of the system should be measures through time and through consulting with industry on the effectiveness of the mechanism.

ESMA is correct in identifying service provision quality as a metric of success. Regulation and supervision should not stifle innovation and entrepreneurship. Rather, the system should encourage risk taking with a clear message that this will not be permitted to an extent that endangers the system at large.



Essentially, the spirit should move from one where the tax payer and authorities are expected to step in (asymmetric risk) to one where risk taking needs to be accompanied by responsible risk management.

We would stress that it remains very important for NCAs to engage in robust assessment of risk management systems and processes when potentially systemic funds have been identified. The first line of defence will always be the investment firm. Leverage limitation should be a last resort in case regulators are judging that the level of risk in the system is too high and certain funds could default while causing ripple effects.

<ESMA\_QUESTION\_PFG\_9>