European Securities and Markets Authority

Response Form to the Consultation Paper

Guidelines on Article 25 of Directive 2011/61/EU

27 March 2020 ESMA34-32-535

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 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 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

Information on data protection can be found at www.esma.europa.eu under the heading [Legal Notice](http://www.esma.europa.eu).

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	FUNDROCK MANAGEMENT COMPANY
Activity	Investment Services
Are you representing an association?	☐
Country/Region	Luxembourg

Introduction

Please make your introductory comments below, if any

<ESMA_COMMENT_PFG_1>

Who are we?

FundRock Group is a leading independent UCITS Management Company and Alternative Investment Fund Manager (AIFM), offering solutions for Luxembourg, UK, Ireland and French based funds, with paid up capital in excess of the €10 million capital requirement ceiling. We have built a long track record by offering full substance and robust funds governance based on a strong foundation dating back 1935 (RBS Trustee & Depositary Services).

Our clients are established blue-chip companies and leaders in their domestic market. This is important to us as well as being increasingly important to asset managers and investors, as it means there is a low contagion risk to their brand and investments.

We have over 130 dedicated staff in 5 countries (Luxembourg, Ireland, United Kingdom, Singapore and France). We manage over 440 funds with assets under management of € 83 billion (as at February 2020). Our funds are distributed over 30 countries.

Preliminary comments:

FundRock appreciates the opportunity to comment on the ESMA guidelines on article 25 of AIFMD (2011/61/EU). We have a keen interest in a strong and resilient European financial system and we also fully support the objective of issuing guidelines to ensure harmonisation among NCAs practises. However, we express some concern regarding the approach taken as it is focused mainly on active managed funds using leverage while other unleveraged funds may present higher systemic risk.

Before responding to the consultation, we would like to emphasise the following points:

1) **The asset management sector is not the banking sector**

Asset management and investment funds are quite distinct from banks and not engaged in banking activity. Consequently, the solutions put in place in the banking sector are not appropriate to the asset management sector.

2) **Leverage is not always synonym of risk**

The use of leverage should not always be considered risky per se and at the origin of potential systemic consequences. It involves risk only if other considerations (such as liquidity, maturity, asset classes, and type of investor) are not appropriate to the strategy pursued. For instance, selling highly leveraged funds to retail investors offering regular redemption periods is riskier than selling the same funds only to pension funds with a 10-year lock-up period, due to the nature of the investors and the lock up. Consequently, leverage cannot be the only criteria; other factors have to be considered.

Another example of highly leverage strategy without risk is the arbitrage of a future contract including the cheapest to deliver assets in the contract specification. This strategy of being long on the future contract and short on the cheapest to deliver (or vice versa) enables the market making of two (2) similar instruments. Without leverage the market making will not be possible as the strategy won’t be profitable.

3) **Active investment funds are all different and play a crucial role in financial markets**

Active managed funds offer different types of strategies, ensuring the efficiency of the financial markets by providing liquidity and pricing to securities. The diversity of those strategies, including leveraged funds, are essential to the functioning of the markets. Prohibiting or limiting the use of leverage will impact their functioning. Therefore, price and liquidity would be influenced by fewer market participants. This would be detrimental to the financial markets.

4) **EU supervision matters**

Triggering a leverage limitation across the EU-27 will only lead to a relocation of leverage funds or management companies outside the EU into off-shore financial jurisdictions. As a result, the EU NCAs would lose their supervision without having solved any systemic issues. Before triggering this leverage limitation, the EU should ensure that such limitations are established within other financial settings and jurisdictions. If not, it will undermine and diminish all the great efforts made by the European institutions and ESMA to set up a strong and efficient EU capital market union.

<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 frequency should be aligned with the AIF liquidity.

<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>
Leverage does not trigger systemic impact per se. The systemic impact is created in particular by the risk of fire sale and not the leverage. A clear example is MMFs, which do not use leverage but are highly systemic. Another example is unleveraged ETF funds, like the Eurostoxx 50 ETF, that can have a significant impact on the market in case of large redemptions or market event(s). In addition, some unleveraged ETFs using a very large percentage of their assets for efficient portfolio management techniques (e.g lending or repo agreements, etc.) can also create a large financial stability risk including counterparty risk with the banking sector.

Unleveraged large funds can have a significant impact on the market, while Step 1 will not cover those funds. Consequently, all AIFs should be within the scope of Step 1. For that purpose, Step 1 should include other criteria and not focus only on leverage.

If ESMA considers limiting under Step 1 to leveraged funds, all such funds should be covered and not only the substantially leveraged ones. For instance, a leverage ETF is not generally substantially leveraged but can be highly systemic depending of their assets and the size of the funds. Thus, according to the ESRB focus on leverage funds, at least all leveraged funds should be within the scope of Step 1.

<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>
We express some concerns with this approach as other systemic funds that are not leveraged are not covered.

Despite our concerns, should the proposed Step 1 be retained, the threshold must at least not be identical for all AIFs. When managed actively, AIFs use diverse strategies and invest in very different assets classes (such as real estate, hedge funds, private equity). Imposing a threshold without considering the AIF type or their assets under management will act negatively on the functioning of certain AIFs, such as private equity, real estate or infrastructure funds. Those investment strategies might then disappear, which would impact the functioning of the EU financial markets.

In addition, the use of the median as the threshold has two main drawbacks:

- It creates a competitive disadvantage to certain AIFs that are not ‘highly leveraged’ but have substantial assets under management. The assessment should consider the assets under management and the asset types in order to determine whether the AIF is eligible for Step 2.

- It creates a premium for AIFs that are just below the median or those that are below the upper limit (e.g. <90th). These AIFs will not be eligible for Step 2 despite that they may present a significant systemic risk.

<ESMA_QUESTION_PFG_3>

Q4 : Would you identify other relevant transmission channels?

<ESMA_QUESTION_PFG_4>
No
<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>
Other indicators should be used to define whether a fund is systemic. However, such indicators should always be assessed in a relative manner. Table 2 sets out a list of indicators, such as 1) investor concentration and 2) share of less liquid assets. A narrow range of considered indicators may prove to mislead an assessment. To illustrate:

- Investor concentration

Based on the proposed guideline, a high concentration could be seen as synonymous with high risk. However, it is not as simple as that. A high concentration of investors in the case of dedicated funds is not a risk per se. The type and nature of the investors should be considered. If funds are dedicated to pension funds, the risk of fire sale is lesser than if the funds are dedicated to 20 retail investors that will potentially behave in the same manner at the same time.

- Share of less liquid assets

Illiquid assets are not a risk per se. There is the risk of market impact and of fire sales in the case of mismatched liquidity among the underlying assets and the AIF’s redemption policy. This should be assessed jointly alongside other indicators like the liquidity profile and investor type, in order to determine the potential systemic risk of the funds.

Consequently, before triggering a leverage limitation, all the specificities of an AIF should be taken into account. A one-size-fits-all solution is not the best option. The assessment should be performed AIF by AIF or sub-fund by sub-fund.

<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>
If NCAs are obliged to use external data to perform the assessment of the systemic risk of AIFs, it demonstrates that the AIFMD reporting is not fulfilling its objectives. It is important to emphasize that all stakeholders have spent significant resources in complying with the AIFMD reporting obligations.

<ESMA_QUESTION_PFG_6>

Q7 : Which other restrictions would you consider as appropriate?

<ESMA_QUESTION_PFG_7>
Other appropriate restrictions could be to consider the application of gates or liquidity fees to avoid fire sales or to limit the market impact, rather than limits on leverage.

<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>
The leverage limitation should be used as a last resort and only if it has been demonstrated that it is the most suitable solution to reduce the systemic risk of a fund (see Question 7).

When an NCA considers applying a leverage limit, the limitation should only apply to a single fund or sub-fund Each actively managed AIF is distinct, due to specifics like their liquidity, maturity, assets, and investors. Applying a leverage limit to a group of AIFs will undermine certain investment strategies (e.g. futures strategies, which are among the main sources of liquidity in the market) and will create several types of damage that could impact the financing of the EU economy.

For example, actively managed AIFs dedicated to few investors are generally fine-tuned and cannot be compared with other AIF groups, even if the investment strategy and leverage are the same. Other parameters like the maturity of the AIF, investor type, liquidity, and the assets under management, should be taken into account. A deeper assessment of these parameters should be performed in order to genuinely understand whether funds are systemic or not. It might be challenging as the assessment is necessarily performed case by case in imposing such a restriction on a group of AIFs.

<ESMA_QUESTION_PFG_8>

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

<ESMA_QUESTION_PFG_9>
Ironically, one way to assess the efficiency of leverage limits is to count the number of actively managed leveraged AIFs that have relocated to non-EU jurisdictions if the EU is the only jurisdiction to implement these IOSCO standards and methodology.

The objective should not be to mitigate excessive leverage, but rather to ensure that any associated systemic risk is limited. This can be achieved by using all the tools available and not only leverage limitation.

<ESMA_QUESTION_PFG_9>