



1 September 2020

*Submitted electronically*

European Securities and Markets Authority  
201 - 203 Rue de Bercy  
75091 Paris  
France

**Re: Response to consultation paper about guidelines on Article 25 of Directive 2011/61/EU**

Dear Sir or Madam,

AQR Capital Management, LLC and AQR Capital Management (Europe) LLP (collectively, “AQR”) welcome the opportunity to respond to the European Securities and Markets Authority’s (“ESMA”) consultation about guidelines on Article 25 of the Alternative Investment Fund Managers Directive (“AIFMD”) (the “Consultation”).

As a firm, we have in recent years been substantially involved with international regulators on the important topic of leverage in investment funds, including extensive engagement with IOSCO on that organization’s consultation report covering this topic. This engagement has afforded us an appreciation for the important challenges presented to both global and national regulatory bodies in the context of implementing regulatory policy on leverage, specifically in the asset management industry. Our primary concern in engaging on this topic is to ensure that global and national regulators implementing policies designed to address potential risks associated with the use of leverage by investment funds do so in a manner that reflects the actual risks of different types of funds and their uses of leverage.

## **1. Executive summary**

AQR is broadly supportive of the two-step process for assessing potential leverage-related systemic risk in alternative investment funds (“AIFs”) as set out in the Consultation. We note at the outset that ESMA’s proposal (and the underlying recommendations from the European Systemic Risk Board that underpin the Consultation) covers many of the same topics as IOSCO’s final report (published in December 2019)<sup>1</sup> setting out a framework for monitoring leverage in funds for financial stability purposes (“IOSCO Leverage Report”). We also recognize and appreciate the letter ESMA recently sent to the European Commission (“EC”) regarding its impending review of AIFMD, in which ESMA

---

<sup>1</sup> IOSCO Final Report, Recommendations for a Framework Assessing Leverage in Investment Funds (Dec. 2019), *available at* <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD645.pdf>.

expressed strong support for adopting changes to AIFMD that would align with the IOSCO Leverage Report.<sup>2</sup> These suggested changes are consistent with many of our observations on the Consultation, including the following:

- First, we note that the Consultation, while acknowledging the IOSCO Leverage Report, would adopt a framework for European alternative investment fund managers that is inconsistent with that report in certain key aspects, particularly through the use of gross exposure as a means of measuring leverage (under Step 1 of ESMA's proposed process). We firmly believe that simplifying leverage into a single number such as gross exposure conceals meaningful information on potential systemic risk in investment funds and runs the risk of misleading national regulators when assessing the need to set leverage limits in those AIFs under their supervision. We have set out further detail below in Section 3 as to why we have a high degree of conviction that using gross exposure as a proxy for risk leads to incorrect and unintended regulatory outcomes. Instead, we advocate that any leverage metrics should break down notionals by asset class and long/short exposures. This approach is consistent with the IOSCO Leverage Report and ESMA's recent letter to the EC.
- Second, the Consultation's Step 1 process for identifying potential leverage-related systemic risk through analysis of "unusually high use of leverage" would lump hedge funds into an all-encompassing single class for purposes of this assessment. We are concerned about the unintended consequences of using such a broadly termed category, particularly given the wide spectrum of hedge funds operating in the market, their varying uses of leverage, and significant differences in the sources of risks of the underlying investments of these funds. Further detail about this topic is provided in Section 4 below. We believe that, as presently worded, the guidelines would likely misdirect the focus of regulatory scrutiny of certain investment funds that do not pose any systemic risk, while potentially failing to identify other riskier funds.

## **2. Background to AQR**

Established in 1999, AQR is a global asset management firm based in Greenwich, Connecticut, United States<sup>3</sup> and as at 31 July 2020 has approximately \$143 billion in assets under management across both traditional long-only equity strategies and alternative investment strategies, of which the firm is one of the world's largest providers. We offer investors access to these investments through separate accounts, UCITS funds, Luxembourg SIFs, offshore and onshore pooled vehicles, and through sub-advised mutual funds and U.S. open-end mutual funds.

AQR has been a leader in offering alternative investment strategies as registered mutual and UCITS funds and emphasizes risk control and best practices in fund governance. We possess a substantial understanding of derivatives, securities finance, and alternative investment strategies, which we believe

---

<sup>2</sup> ESMA letter to Mr Valdis Dombrovskis of the EC dated 18 August 2020 (ESMA34-32-550), *available at* <https://www.esma.europa.eu/press-news/esma-news/esma-recommends-priority-topics-in-aifmd-review>.

<sup>3</sup> With additional offices in London, Sydney, Frankfurt and Hong Kong.

positions us well to comment knowledgeably on this Consultation and the fundamental principles underpinning it.

In relation to AQR's European business that is in scope of AIFMD, AQR manages two Luxembourg-incorporated AIFs through its UK authorised alternative investment fund manager ("AIFM") based in London. Both of AQR's AIFs run alternative investment strategies that employ leverage on a frequent and material basis and, as such, the Consultation is highly relevant to AQR's European business.

### **3. Using gross exposures for measuring risk in investment funds**

#### *Gross and commitment methods for calculating leverage*

Under AIFMD, AIFMs are required to calculate and report leverage figures in their AIFs using both the gross and commitment methods, as prescribed by Articles 7 and 8 of the Delegated Regulation.<sup>4</sup> As such, AIFMs are required to calculate exposures in their AIF "using the sum of all absolute positions" and the Consultation relies on these measurements in its assessment of potential leverage-related systemic risk.

While the calculation methodology used for reporting leverage is not directly in scope of the Consultation, it is fundamental to the proper assessment of potential leverage-related systemic risk that is the goal of the Consultation. To that end, we strongly encourage ESMA to reconsider the Consultation in light of necessary changes to the current leverage calculation methodology for AIFs. It is impossible for national regulators to carry out meaningful assessments of potential systemic risk in investment funds as contemplated in Article 25(1) AIFMD<sup>5</sup> without effective leverage measurements upon which to base their analysis. As described below, the current aggregate leverage calculations under the gross and commitment methods do not provide national regulators with the information necessary to understand and address potential leverage-related systemic risk in AIFs, and we do not believe that ESMA should proceed with guidelines for assessing the leverage of AIFs that are reliant on those calculations. However, we do believe that ESMA's goals can be achieved with a simple modification to those methods.

#### *Why using gross exposures does not work as a proxy for measuring risk*

As noted above, AIFs compute their aggregated notional exposures under the gross and commitment methods by summing all their absolute positions, which involves adding together the AIF's exposures in individual asset classes to develop a single number. It is our strongly held view that this final process of aggregation across all types of assets is the fatal step that destroys the value of any notional measure as

---

<sup>4</sup> Commission Delegated Regulation 231/2013.

<sup>5</sup> Article 25(1) of the AIFMD provides that Member States shall "ensure that the competent authorities of the home Member State of the AIFM use the information to be gathered under Article 24 for the purposes of identifying the extent to which the use of leverage contributes to the build-up of systemic risk in the financial system, risks of disorderly markets or risks to the long-term growth of the economy."



it adds up numbers that do not reflect even roughly comparable risks, allowing important risks to be disguised within broader benign risks. For this reason, aggregated gross notional is in our view a useless sum of useful parts.

There are vast differences in the relative riskiness of underlying asset types in derivatives contracts and securities which make a single aggregated leverage number meaningless in terms of assessing the riskiness or the speculative character of a fund. A single aggregated number mixes exposures to high risk asset classes with exposures to low risk asset classes and makes it more difficult to differentiate between hedged exposures and unhedged exposures, or between portfolios that use leverage to amplify risk and ones that use it to reduce risk. In order to address limitations associated with aggregated gross notional, we recommend analyzing leverage on an asset class by asset class basis rather than basing this analysis on a single aggregated number.

In addition, we believe that proper analysis of fund leverage should include a further distinction between long exposures and short exposures, broken down by asset class. Just as aggregating exposure across asset classes of very different risk levels provides an uninformative view of leverage, so to do measures that aggregate long and short positions. There are typically vastly different contributions to both portfolio and systemic risk from positions of the same aggregate notional where one is long-only and the other is long and short.

In short, we believe that leverage should be reported by asset type and separately for long and short positions, but not summed to a grand total. These calculations are already done by AIFMs as part of their routine regulatory reporting, so for little additional burden there could be a large oversight benefit.

This type of analysis would provide national regulators with a much better understanding of the distinction between high and low risk exposures than does analysis of aggregated gross notional, and would prevent a fund's exposures to high risk assets from being masked by the often-larger exposures to low risk assets.

#### Worked examples: suggested approach

The approach we suggest, though more complex than a single aggregated gross notional number, is relatively straightforward to apply and allows a much more differentiated understanding of a fund's use of leverage. We describe the approach in greater detail below.

First, we adopt the concept of “**GNE**” as being the sum of notional exposures to different assets, some quite risky others less so, some positions long and some short.

$$\begin{aligned} \text{GNE} = & \text{GNE}_{\text{EQ-long}} + \text{GNE}_{\text{FI-long}} + \text{GNE}_{\text{FX-long}} + \text{GNE}_{\text{COMM-long}} + \text{GNE}_{\text{CR-long}} \\ & + \text{GNE}_{\text{EQ-short}} + \text{GNE}_{\text{FI-short}} + \text{GNE}_{\text{FX-short}} + \text{GNE}_{\text{COMM-short}} + \text{GNE}_{\text{CR-short}} \end{aligned}$$

Where:



$GNE_{EQ-long}$  and  $GNE_{EQ-short}$  are the notional exposure of long and short positions in equity underliers, whether securities or derivatives;

$GNE_{FI-long}$  and  $GNE_{FI-short}$  are the notional exposure of long and short positions in fixed income underliers.

Similarly, FX would denote currency exposure, COMM denotes commodity exposure, and, if credit exposures are to be treated separately from fixed income, then CR for credit.

The method is simple; rather than utilizing total GNE for purposes of analysing potential systemic risk, regulators would instead look at the component parts. Looking at these pieces enables regulators to both sum and compare similar exposures across relevant sets of leveraged funds and better assess risks across the financial system. This type of analysis also permits regulators to see risk across sets of funds even where none of the funds measured alone by way of an aggregate gross measure would have been identified for further review.

One of the benefits of this approach is that it also allows regulators to calculate risk measures when analysing a group of different funds, regardless of their investment manager. To undertake this additional type of analysis, regulators could take the information provided and apply a haircutting methodology to calculate potential stress losses or even a risk model, whether at the individual fund level or across a set of funds with similar strategies, to estimate exposures to risk factors under examination.

**Example 1: Risk parity fund composed of stock, bond, and commodity futures, with some inflation-linked bonds**

Fund exposures are:

- Equity index futures 35%
- Government bond futures 120%
- Inflation-linked bonds 40%
- Commodities 20%

The portfolio is long-only and completely unhedged. Under our proposed approach, portfolio reporting would make the following calculations and report three non-zero data elements:

$GNE_{EQ-long} = 35\%$   
 $GNE_{FI-long} = 160\%$   
 $GNE_{COMM-long} = 20\%$   
 $GNE_{EQ-short} = 0\%$   
 $GNE_{FI-short} = 0\%$   
 $GNE_{COMM-short} = 0\%$



In this example portfolio, the total gross notional exposure is 215%. But is 215% a lot or a little? It would be a higher risk fund if all 215% of the exposure was to equities or commodities, but not if that exposure were entirely attributable to government bonds. This slightly more detailed accounting shows quickly that there is moderate exposure to high risk assets (stocks and commodities), but that most exposure is to lower risk bonds and bond futures. Further, it shows that all exposures are directional and that the leverage is not used to create hedges. Unlike with risk-based reporting measures, the accounting information is all available for aggregation across many portfolios (say, all risk parity portfolios, managed by all managers) while some estimation of the riskiness of the portfolio can be made by regulators who no longer have to rely completely on fully processed and less transparent data presented by the asset manager.

Note that we make no distinction between the forms of the underlying exposure, be it cash securities or derivatives. All exposures are reported.

We explore how this approach might work by way of a further example below:

**Example 2: Market-neutral equity portfolio that is “beta” neutral**

The volatility of a \$1 long by \$1 short equity portfolio is low; too low to be of much investment interest since it is not risky enough to generate the returns needed to be considered a productive use of capital for most investors. In contrast, a portfolio that is \$3 long by \$3 short on \$1 of NAV could generate enough portfolio risk and possibly provide enough uncorrelated return to be of interest to investors. How would we measure its leverage? Again, using the same definitions, we analyse both long and short positions:

$$\text{GNE}_{\text{EQ-long}} = 300\%$$

$$\text{GNE}_{\text{EQ-short}} = 300\%$$

$$\text{GNE}_{\text{FI-long}} = 0\%$$

$$\text{GNE}_{\text{FI-short}} = 0\% \text{ (same for other asset classes)}$$

Regulators and experienced investors would understand from this data that this is a portfolio with meaningful exposure to risky equity underliers but constructed with the intent to offset much of those risks long vs. short. It does not say those risks have been successfully offset; only that that may be the portfolio manager's intent, and it does allow the identification of the full value of those exposures. Everyone can now observe that total notional exposure to risky assets is fairly high, but that the portfolio risks are likely very different from a portfolio of similar notional exposure that is long-only equities (and likely a great many times as risky).

This example also shows that the relatively high exposure is neither an attempt to construct a highly risky portfolio nor is it a portfolio that employs leverage because the underlying assets are low risk (they are not – they are stocks). Right away, we can see the potential issue; the portfolio relies on reasonably effective risk offsets across risky assets and it is that presumed property that must be

carefully analysed by investors or regulators. This reporting method exposes the issue to those parties; a total gross notional report, does not.

### Impact on this Consultation

We realise that the framework depicted above relates to the calculation methodologies as stipulated in Articles 7 and 8 of the Delegated Regulation that are not the subject of the Consultation and would not be possible under the current AIFMD reporting regime for AIFMs. However, we strongly believe that these methodologies ought to be revisited in light of this Consultation, and that ESMA should not adopt guidelines for the assessment of potential leverage-related systemic risk in AIFs that rely on a single aggregated notional number.

Without changes to the current calculation methodologies, we are concerned that routine regulatory data submitted by AIFMs (including the data calculated using the gross and commitment methods) could prevent national regulators from effectively understanding the uses of leverage by AIFs and ultimately undermine the goals of the Consultation. We also do not believe that these suggested changes would result in a significant new data collection exercise for AIFMs. As noted above, AIFMs must gather their exposures in individual asset classes in order to sum them up into aggregated notional exposures under the gross and commitment methods. Thus, while providing regulators with much more useful information for the purposes of analysing potential leverage-related systemic risk may require different reporting, it will not require substantial new work.

The benefits of analysing potential leverage risks on an asset class by asset class basis and by long and short exposures were confirmed by IOSCO when it adopted this framework in the IOSCO Leverage Report after an intensive review of these issues. ESMA also supported this framework in its recent letter to the EC on the AIFMD review, which specifically recommended amendments to the gross method calculation (in Article 7 of the Delegated Regulation) to align with the IOSCO framework. We strongly support these changes and believe they are a fundamental component of an effective regulatory approach to potential systemic risk driven by leverage in investment funds.

Despite ESMA's recent support for the IOSCO Leverage Report, as of today the current Consultation remains at odds with IOSCO on the use of gross notional exposures as a proxy for measuring systemic risk in investment funds. In addition to concerns about the effectiveness of the Consultation's approach noted above, this situation creates regulatory uncertainty. Global asset managers (and particularly those employing leverage across a broad spectrum of investment strategies, over a suite of different funds located in various jurisdictions, including European AIFs) will naturally prefer that their regulators take a coordinated and aligned view on key supervisory matters, including in the area of setting leverage limits for investment funds.

## **4. Unusually high use of leverage under step 1 of the proposed framework**

We note that Step 1 of the risk assessment set forth in the Consultation asks national regulators to identify AIFs with "unusually high use of leverage" based on a comparison with AIFs of the "same type." The Consultation further categorizes types of AIFs as "hedge funds, private equity, real estate,



fund of funds and other AIFs.” This framework effectively groups all hedge funds into a single class for the purposes of determining whether certain funds present more leverage risk than others and should thus be singled out for additional regulatory scrutiny.

We have serious concerns about this framework because it fails to account for the different types of hedge fund investment strategies and the underlying risks of the products in which they invest. As a result, the Step 1 process may cause national regulators to identify both false positives and false negatives in ways that would be counterproductive to the Consultation’s goals.

Examples utilizing two basic hedge fund strategies may be instructive on this point:

- ***Fund 1: Market-Neutral Equity.*** For the first sample strategy we use the same market-neutral equity fund as seen in Example 2 above. This fund is exposed to the risky equity asset class and uses meaningful amounts of leverage on both the long and short side, but is constructed to offset much of the equity risk through the use of these long and short exposures.
- ***Fund 2: Long-Only Commodities.*** The second sample strategy is a long-only fund that has modest leverage on its investments in natural gas, an extremely volatile underlying asset.

It is clear that the basic strategies, underlying investments, and overall risk profiles of these two common types of hedge funds vary greatly. Given these differences, a high-level comparison of the leverage of a market-neutral equity fund and a long-only commodities fund – as proposed in the Consultation – is not instructive when analysing whether they exhibit an unusually high use of leverage and could thus pose potential systemic risk.

### **Example 3**

First, we consider how the proposed framework might apply to these two funds where (as noted above) the market-neutral equity fund utilizes meaningfully more leverage than the long-only commodities fund.

Under the Consultation’s framework the market-neutral equity fund may appear to be an unusually high user of leverage when compared against the long-only commodities fund, which could then subject that fund to additional regulatory review. However, the market-neutral equity fund with its offsetting long and short exposures clearly has a much lower risk profile than the long-only fund with leveraged exposure to the volatile natural gas market.

Thus, an evaluation of the relative use of leverage by these two funds would tell us little about their comparative potential to create systemic risks. The ultimate question of whether the market-neutral equity fund’s use of leverage is unusually high in comparison to other funds cannot be answered by evaluating it against unrelated funds/strategies, but rather is a question of whether the fund uses leverage to a greater extent than other similar types of strategies. Under this example the Consultation’s framework could result in a false positive identifying a relatively low risk fund for additional regulatory scrutiny solely because its underlying investment strategy relies on greater leverage than another (potentially riskier) strategy.



#### **Example 4**

As a further example, now assume the same two funds, but the long-only fund uses an equal amount of leverage as the market-neutral equity fund, concentrating that leverage in its natural gas exposure.

In this case evaluating the two funds against each other as proposed under Step 1 of the Consultation might suggest that neither is an unusually high user of leverage. However, the leverage-related risk of the long-only fund would greatly exceed that of the market-neutral equity fund given the long-only fund's use of leverage to take directional exposure to an extremely volatile asset class and the market-neutral equity fund's use of leverage in both the long and short directions to offset risk.

Under this example the Consultation's framework could result in a false negative whereby a relatively risky levered fund could escape identification under this prong of the Step 1 process due to a misleading comparison against a fund with a completely different strategy and use of leverage.

These examples could be replicated throughout the broad and diverse range of categories of investment strategies commonly utilised by hedge funds. We do not believe that the Consultation can effectively identify funds with "unusually high use of leverage" under the relevant prong of the Step 1 process without assessing funds against those with common strategies and accounting for the risk of a fund's underlying investments. As a result, we suggest either that data collection under AIFMD be amended to add reporting of AIF strategy for these purposes (along with the asset class and long/short reporting noted above), or ESMA remove the "unusually high use of leverage" prong from the Consultation's Step 1 framework.

## **5. Conclusion**

AQR recognises that leverage is merely one of many complex metrics that ESMA and other national regulators must assess when seeking to identify potential risks to financial stability posed by investment funds. However, the current Consultation surrounding how individual national regulators can prudently impose leverage limits highlights the way that certain metrics, if not properly defined and used, could ultimately exaggerate the risks in certain investment funds while masking the risks in others. These challenges underscore the need for exactly the type of rigorous analysis, well-defined procedures, and transparent engagement that are the goal of the Consultation, and we hope that our comments will assist ESMA in developing final standards that achieve this goal.

Yours faithfully,

Michael Mendelson  
Principal  
Portfolio Manager

Richard Grant  
Managing Director  
Global Head of Regulatory  
and Government Affairs

Adam Blair  
Vice President  
Legal and Compliance