MANAGED FUNDS ASSOCIATION
The Voice of the Global Alternative Investment Industry
WASHINGTON, DC | NEW YORK

September 1, 2020

Via Electronic Filing

European Securities and Markets Authority
201 - 203 Rue de Bercy
CS 80910
75589 Paris Cedex 12
France

Re: MFA Comments on Consultation Paper on Guidelines on Article 25 of Directive 2011/61/EU

Dear Chairman Maijoor:

Managed Funds Association ("MFA")[1] appreciates the opportunity to respond to the European Securities and Markets Authority's ("ESMA") consultation paper, Guidelines on Article 25 of Directive 2011/61/EU (the "Alternative Investment Fund Managers Directive" or "AIFMD"). MFA understands the goal of developing guidelines to operationalize Article 25 of the AIFMD. We appreciate that ESMA's Guidelines must conform with the parameters set out in Articles 24 and 25 of the AIFMD; however, it also is paramount that the Guidelines reflect the significant work done by the International Organization of Securities Commissions ("IOSCO") to assess leverage and identify any financial stability risks that may arise from the use of leverage. Key to the comprehensively negotiated IOSCO framework is that it calls for regulators to assess leverage by asset class and by long and short exposures. In that regard, we appreciate your recognition of the IOSCO framework in your August 18, 2020 letter to Executive Vice-President Dombrovskis on the upcoming review of the AIFMD and your statement in the letter that the AIFMD framework should be aligned with the IOSCO framework.[2] Consistent with the IOSCO recommendations and your letter to the Commission, we encourage ESMA to revise the proposed Guidelines to reflect the important refinements IOSCO made to its framework and to ensure that ESMA's recommendations are consistent with a regulatory approach that addresses markets and activities across all market participants to address systemic risk.

[1] The Managed Funds Association (MFA) represents the global alternative investment industry and its investors by advocating for sound industry practices and public policies that foster efficient, transparent, and fair capital markets. MFA, based in Washington, DC, is an advocacy, education, and communications organization established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry's contributions to the global economy. MFA members help pension plans, university endowments, charitable organizations, qualified individuals and other institutional investors to diversify their investments, manage risk, and generate attractive returns over time. MFA has cultivated a global membership and actively engages with regulators and policy makers in Asia, Europe, North and South America, and many other regions where MFA members are market participants.

[2] https://www.esma.europa.eu/sites/default/files/library/esma34-32-551_esma_letter_on_aifmd_review.pdf.

600 14th Street, NW, Suite 900 | Washington, DC 20005 | 202.730.2600 | Fax 202.730.2601 | www.managedfunds.org

As discussed in more detail in response to the questions set out in the Guidelines, we encourage ESMA to modify its Guidelines in several important ways. Specifically, the Guidelines should:

(1) incorporate the work done by the International Organization of Securities Commissions ("IOSCO") by discussing the importance of assessing leverage broken down by asset class and by long and short exposures and identifying the limitations on using gross notional metrics in assessing leverage;
(2) recommend that national competent authorities ("NCAs") assess systemic risk by analyzing investment fund use of leverage in the context of the broader markets in which funds operate, and not simply by comparing the characteristics of alternative investment funds to other similar funds;
(3) recommend that NCAs consider how regulations focused on markets and activities across all market participants would better address identified risks than imposing leverage limits under Article 25 of the AIFMD; and
(4) provide a framework for NCAs to identify whether the use of leverage creates risk, determine whether the particular use of leverage in a fund increases or decreases risk in a fund, whether that risk is systemic in nature or another type of risk.

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

No comments.

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?

No comments.

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.

We believe that the Step 1 thresholds should be designed to efficiently identify funds that warrant a further, risk-based assessment by NCAs. We believe that the first proposed threshold is likely to be overinclusive in this regard, as the threshold of "employing leverage on a substantial basis" in Article 24 of AIFMD was intended as a threshold for reporting purposes, not as a metric for subjecting funds to additional regulatory scrutiny or an indication of risk. Further, the proposed threshold does not distinguish leverage by asset class or by long and short exposures, which were critical parts of IOSCO's recommendations on how to assess potential financial stability risk arising from the use of leverage.

We also do not believe that the proposed method of calculating funds with "unusually high use of leverage" is well suited to efficiently identify funds for further review. In particular, comparing a fund's use of leverage only to other funds of the same type or comparing a fund's use of leverage to its historical average, particularly if that leverage comparison does not distinguish leverage by asset class and by long and short exposures, will not help identify whether a fund poses financial stability risk. By overstating potential risks associated with the use of leverage in lower risk assets (or leverage to reduce overall portfolio risk) and understating potential risks associated with the use of leverage in higher risk assets, we believe the proposed approach is likely to be both overinclusive and underinclusive in identifying potential risks associated with the use of leverage.

IOSCO worked closely with its member regulators and industry participants as it developed a meaningful approach to measure leverage and assess potential systemic risks arising from the use of leverage. Unless data are distinguished by asset class and by long and short exposures, NCAs are likely to make regulatory decisions based on misleading signals, which could lead to potentially imposing leverage limits that could increase risk to fund investors, without addressing any potential systemic risks. Accordingly, we encourage ESMA to reconsider the proposed Step 1 thresholds to better identify funds whose use of leverage warrants further assessment. Discussed below are key elements we encourage ESMA to include in recommending a framework for measuring and assessing leverage.

Measuring Leverage by Asset Class and by Long and Short Exposures

Consistent with IOSCO's framework for assessing leverage, we strongly encourage ESMA to recommend NCAs assess a fund's use of leverage by asset class and by long and short exposures, rather than as a single aggregate number.[3] While we recognize that data reported under the AIFMD may not allow for a full assessment on an asset class-by-asset class basis, we believe it is critical for ESMA's recommendations to recognize the importance of assessing leverage by asset class and by long and short exposures. As noted above, we appreciate that your August 18 letter to the European Commission supported aligning the AIFMD with the IOSCO framework.

Because asset classes each have distinct risk exposures,[4] leverage metrics based on a single aggregate number across asset classes do not provide a meaningful basis on which to make an assessment of the risks associated with an investment fund's use of leverage and are likely to mislead regulators. The significant differences in the relative riskiness of underlying asset types in derivatives contracts make a single aggregated leverage number meaningless, or worse, misleading; for example, a fund may have higher exposure to derivatives to gain exposure to low-risk assets, while a different fund may have more modest derivatives exposure, but to higher risk assets.

Avoiding the shortcomings of a single aggregated number by adopting an asset class-by-asset class model also gives regulators the ability to sum and compare similar exposures across relevant sets of leveraged funds allowing for a better assessment of the leverage-related risks posed by different funds across the financial system. IOSCO's report expressly acknowledges this, recommending that regulators assess leverage metrics by asset class and not as an aggregated single

[3] IOSCO Recommendations for a Framework Assessing Leverage in Investment Funds (December 2019), available at: https://www.iosco.org/library/pubdocs/pdf/IOSCOPD645.pdf.

[4] For example, the risk profile of a $10 million notional position in interest rate swaps is very different from the risk profile of an equivalently sized position in credit default swaps.

number. This approach supports the key policy objective to develop measures that allow for meaningful monitoring of leverage for financial stability purposes. We also note that the IOSCO report provides what MFA believes is a reasonable approach to determine the asset class breakdown.[5]

Gross Notional Exposure (GNE), Adjusted GNE, and Net Notional Exposure

In addition to measuring leverage by asset class and by long and short exposures, we encourage ESMA to consider the respective strengths and weaknesses of different metrics to measure and assess the use of leverage by investment funds. Notional measures of leverage, particularly unadjusted gross notional exposure ("GNE"), are misleading in that they do not represent the amount of leverage or risk of an investment fund's investment positions. To the extent that NCAs decide to use notional based metrics however, certain adjustments and netting should be used to make the metrics more risk sensitive, as outlined below.

Adjusted GNE metrics ("Adjusted GNE") can provide NCAs with a more meaningful measurement than unadjusted GNE, for example, by permitting adjustments to interest rate derivatives in terms of ten-year bond equivalents and permitting delta adjustments for options. We recommend that ESMA discourage the use of unadjusted GNE and instead clarify that it is mainly useful as a building block for calculating Adjusted GNE. We believe that including certain types of netting or hedging in calculating Adjusted GNE would provide a more refined metric for NCAs to consider in conducting assessments.

In addition, we believe that net notional exposure ("NNE") may be useful as an additional and complementary step to be considered alongside Adjusted GNE or as a standalone metric. Permitting the netting or hedging of eligible positions would add further refinement to the identification of risk, on an asset class basis.

Lastly, we encourage ESMA to state in final guidelines that a possible result of any NCA's assessment of leverage, in Step 1 or Step 2, is that no financial stability risk concerns exist and, accordingly, leverage limits do not need to be imposed. We believe that a multi-step approach is consistent with that principle as it contemplates that further consideration and regulatory work must be done *if* an NCA identifies a financial stability risk concern. For example, the Step 1 process might identify a fund or group of funds that have relatively higher amounts of leverage in a particular asset class, such that an NCA decides to conduct a further assessment of those funds.[6] As part of that Step 2 assessment, the NCA could determine that, after considering other relevant facts including counterparty exposures, the size of the market in which the fund trades, and the participation in that market by a number of other financial institutions that the fund(s) do not pose systemic risk.

We believe these proposed changes to the ESMA Guidelines would better align them with the IOSCO framework, consistent with the view expressed in your August 18 letter to the European Commission. As discussed in more detail below, we also encourage ESMA to recommend that NCAs consider how approaches that apply to market participants broadly, rather than imposing

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5 *See* table on page 10 of the IOSCO report.

6 We note that a result of the Step 1 process could be that an NCA determines no Step 2 assessment is required for any fund or group of funds.

leverage limits on individual investment funds, could be more effective to address identified systemic risks

Q4. Would you identify other relevant transmission channels?

No comments.

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?

MFA agrees that NCAs should consider supplementary data points in combination with leverage metrics to develop a more comprehensive assessment.[7] In addition to the suggested data points in the ESMA Guidelines, we believe that the IOSCO report contains a useful list of additional data points that would help NCAs assess what type(s) of leverage a fund is using, how the fund is using, measuring and managing its leverage, and how the use of leverage might impact the fund if it had to unwind. Because leverage can decrease risk, it is important for NCAs to develop an analytical approach that distinguishes between leverage that increases risk and leverage that decreases risk. Consistent with this, we encourage ESMA to modify its Guidelines to recommend NCAs consider what types of derivatives a fund is using and whether those derivatives are used primarily for hedging/risk management purposes or for other purposes. We believe this additional information and comprehensive approach would enable NCAs to better determine what risks, if any, are created by a fund's use of leverage and whether such risks would rise to the level of a threat to financial stability.

It is important for NCAs to look at the activities of investment funds in context with other types of financial institutions that provide similar services. To the extent that NCAs look at investment funds in isolation, it may create a misleading impression of the relative size or complexity of a fund. Similarly, NCAs should consider the relative size and importance of the market and industry in which a fund operates to determine whether any risks might be systemic in nature.

We are concerned that the ESMA Guidelines do not adopt this framework for assessing potential systemic risk. Instead, the ESMA Guidelines recommend NCAs assess funds "according to the absolute value of the indicators and the relative value, compared to funds of the same type and other alternative funds."[8] We fundamentally disagree that NCAs can conduct an assessment of sytemic risk by comparing funds only to other similar funds, rather than assessing funds in the context of the markets in which they operate. We also believe that comparing funds only to other similar funds too narrowly focuses only on one entity type within a much larger ecosystem, which is fundamentally inconsistent with a markets-based approach to assessing systemic risk. We strongly encourage ESMA to modify this approach and recommend NCAs assess funds in a broader context.

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

[7] We note that this is consistent with the recommended approach in the IOSCO report.

[8] Paragraph 1 in Annex II of the ESMA Guidelines.

useful for the purpose of performing the assessment under Step 2, other than those already identified in Annex of to the draft Guidelines?

We believe that NCAs should use relevant data to conduct their assessments. In considering whether additional data sources are needed, we encourage NCAs to identify data they already collect under the AIFMD as well as other regulations to minimize creating additional reporting costs on the industry if not necessary. We note in that regard, the March 31, 2020 position paper from the Alternative Investment Management Association discussing how regulators may consider revisions to reporting under AIFMD, which MFA provided input on and generally supports. We also encourage NCAs to appropriately tailor any additional data requests to information that is needed for their assessment and to ensure they have strong confidentiality and data protection measures in place before requesting such data.

Q7. Which other restrictions would you consider as appropriate?

We believe that any regulations intended to address identified financial stability risks should be applied to all market participants in a manner that is even-handed and limits opportunities for regulatory arbitrage. With a comprehensive focus on markets and investing activities, regulators can strengthen the system as a whole, rather than merely changing characteristics of certain isolated individual market participants or categories of market participants. While we recognize that Article 25 of the AIFMD contains regulatory authority to set limits on the use of leverage by alternative investment funds, we believe this approach fails to address the goals of overall systemic risk regulation by targeting the activities of only a small portion of the financial sector in ways that will be both ineffective and disproportionately harmful. We encourage ESMA to modify its Guidelines to acknowledge this important point and recommend that NCAs consider how a broader, markets-based approach to addressing identified systemic risks could be more effective than imposing leverage limits on individual funds.

We also note that the Guidelines recommend that NCAs consider restrictions on funds managed by non-EU fund managers ("AIFMs"), despite the fact that Article 25 of the AIFMD does not apply to non-EU AIFMs. We disagree with this recommendation as it is inconsistent with the scope of the AIFMD and is likely to create an unlevel playing field across different Member States. Because of the likelihood of such an outcome, we also believe the recommendation is inconsistent with the objectives of the Capital Markets Union. We encourage ESMA to delete this recommendation in its final guidelines.

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?

No comments.

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

We encourage ESMA to modify this question to better reflect the underlying policy objective of limiting financial stability risks, not simply limiting leverage. We believe that as drafted, the question mistakenly focuses on a different objective than the policy basis for imposing leverage limits under Article 25 of the AIFMD. We also believe that it presupposes that leverage increases risk in an investment fund.

As stated in ESMA's Guidelines, the relevant policy objective of Article 25(1) of the AIFMD is:

> 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".

Given this clear policy objective, we do not believe NCAs should assess the efficiency of limiting leverage (or excessive leverage), they should assess whether and how leverage limits would be efficient in mitigating identified systemic risks (as opposed to firm level risk). We believe it is important for leverage assessments to be conducted consistent with the following principles. First, it is important to acknowledge that leverage by itself does not equal risk. Second, because leverage can decrease risk, it is important for NCAs to develop an analytical approach that distinguishes between leverage that increases risk and leverage that decreases risk. Finally, it also is important for NCAs, as they assess leverage and risks arising from leverage, to distinguish "investment risk" or "counterparty risk" from risks that pose "risks to financial stability."

We also encourage ESMA to note that the policy objective of assessing leverage is not to prevent investment funds from taking risks. As capital markets participants, investment funds are required to take market risks in order to achieve investors' investment objectives (*e.g.,* investment risk). As such, we believe that a guiding principle for NCAs is to undertake further work to determine whether any risks identified in the proposed two-step assessment create policy concerns and, if so, whether regulatory action is needed to address those policy concerns. We also believe that NCAs should be careful to distinguish between risks that are relevant to investor protection from risks that are relevant to financial stability to better focus on the key policy objective of identifying and addressing systemic risks. We encourage ESMA to include language in the final guidelines to NCAs on how they can distinguish between such policy objectives.

MFA appreciates the opportunity to provide comments to ESMA in response to its draft guidelines to implement Article 25 of the AIFMD. If you have any questions regarding any of these comments, or if we can provide further information with respect to these or other issues, please do not hesitate to contact the undersigned at (202) 730-2600.

Respectfully submitted,

/s/ Michael Pedroni

Michael Pedroni
Executive Vice-President & Managing Director,
Head of International Affairs

/s/ Benjamin Allensworth

Benjamin Allensworth
Managing Director & Counsel,
Tax and Finance