Consultation response: ESMA's draft technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive[1]

1. Introduction

The HFSB welcomes the opportunity to respond to the Consultation paper on ESMA's draft technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive.

The Hedge Fund Standards Board (HFSB) is the guardian of the Standards drawn up by international investors and hedge fund managers to create a framework of discipline for the hedge fund industry. The HFSB's mission is to promote the Standards through collaboration with managers, investors and the regulatory community

The Standards were drawn-up and published in 2008 in response to G8 policy leaders' concerns over financial stability. They serve the interests of all market participants and of the economy at large.

Many aspects of the standards are reflected in the AIFM-Directive, in particular in areas such as portfolio and liquidity risk management, disclosure, and valuation. However, it is important to highlight that the Hedge Fund Standards are based on a comply or explain mechanism, whereby managers provide an explanation to their investors in relation to those areas, where they chose a different approach. Overall, this framework acknowledges the responsibility of each investor to assess properly the relevant disclosures made by the managers before making an investment decision.

The HFSB is pleased to continue to inform the regulatory process about industry practices and how outcomes in the capital markets can be improved.

2. Overview: asset management regulation needs to be completely different from banking regulation

At a time when banking becomes more expensive as a source of finance for economic growth due to higher capital and liquidity requirements, capital markets and the investment sector will embrace a

[1] ESMA Consultation Paper: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:174:0001:0073:EN:PDF

significant expansion to fill the gap left by the banks. The AIFM-Directive focuses on this very important sector of financial services: investment specialists in such diverse fields as capital markets, real estate, and private equity.

Allowing this segment to flourish is vital for economic growth. Today, more than ever, Europe is in need of capital to fund productive investment for growth and prosperity. The asset management sector can afford risk taking without causing damaging externalities that arise in the banking sector.

Asset managers are in a better position to absorb potential losses than banks and underperforming managers can be easily closed down without systemic repercussions. A lot of the activities in the asset management sector have and meet “project type” characteristics, i.e. ability to stop or close them easily. This is very different from banks, where failure can cause significant damaging externalities.

This specific difference needs to be reflected in the regulatory approach. Banking regulation needs to be prudential, i.e. introduce a bias against risk taking given the damaging externalities that arise when banks fail and most importantly protect the financial system. The new regulations for the banking sector seek to reduce the type of excessive risk taking that had led to the recent financial crisis.

However, the purpose of the asset management sector is to provide risk profiles that meet the risk appetite of their investors. Therefore, regulation should not introduce a bias against risk taking there, as it is damaging: it will restrict providers of capital to structure the risk profile of their investments according to their needs, and consequently hamper economic activity, investment in innovation, job creation and economic growth. In addition, such a bias against risk taking might introduce pro-cyclical behaviour, putting further strain on the financial system at times of distress.

Therefore, it is critical to appreciate this important distinction between banking and asset management when assessing the AIFM-Directive, in particular in areas, such as risk management and leverage. The desirable outcome of regulation should not be to “regulate” risk taking and create a zero failure regime, but to ensure providers of capital can take risk in line with their (differing) propensity to absorb potential losses. The asset management sector is well positioned to take and manage risks on behalf of their clients, and therefore, it is important to ensure that the AIFM-Directive does not introduce a bias against risk taking in this area.

It should also be noted that the asset management sector itself is a valuable provider of highly qualified employment, and its diverse and in many parts entrepreneurial and small scale nature provides a breeding ground for financial innovation, where new strategies and approaches to manage risk can be tested and refined (without any damaging systemic implications), which might then find their way into mainstream asset management, banking and corporate risk management in the wider economy.

3. Consultation responses

The following sections provide responses to select questions raised in the ESMA Consultation Paper. Section numbers and page references refer to the ESMA Consultation document[2].

IV.I Possible Implementing measures on additional own funds and professional indemnity insurance

The HFSB agrees that professional liability risk should be covered by additional own funds or professional indemnity insurance.

Q10: Please note that the term "relevant income" used in Box 8 includes performance fees received. Do you consider this as feasible and practicable?

The HFSB agrees that liabilities can increase with rising AUM[3], however, the HFSB sees no evidence that income and performance fees are a good proxy for professional liability risk, as suggested by the consultation paper under option 2 (p. 36). In set ups with strong alignment of interest via performance fees, an underperforming manager would require lower levels of additional funds (because it is presumably less risky). Also, it is important to remember that levels of fees (the market price for the service to manage assets) are driven by supply and demand, and there is no evidence that a service which is in high demand (and therefore potentially pricier) is necessarily riskier.

Therefore, a concept based on relevant income, including performance fees appears to be unsuitable.

Q13: Do you see practical need to allow for the "Advanced Measurement Approach" outlined in Directive 2006/48/EC as an optional framework for the AIFM?

Box 7 suggests that AIFM should engage in data collection of operational failures and use such historical internal loss data within the risk management framework. While this approach might be suitable for very large organisations, such as banks, where indeed over time, time series and such data might provide meaningful insights in the operational risk characteristic of the firm, it is unlikely to provide any statistically useful insights in the context of AIFM. The approach stems from the banking world, where it applies to a much wider spectrum of "events" including fraud, employment practices, business disruption, vandalism, business failures which affect the balance sheet of the bank. There is a risk of "over-engineering", and over reliance on models, which might have limited power to explain professional liability risk.

Rather than focussing resources on "modelling" and measuring the risks, the HFSB believes that it is more important to focus on regular internal reporting of failures and operational risk and ultimately procedures to take corrective actions to rectify the shortcomings.

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[2] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:174:0001:0073:EN:PDF

[3] However, it might not increase linearly.

IV.II. Possible implementing measures on General Principles

General observations

Box 13 refers to "counterparties and prime brokers …which are subject to ongoing supervision by a public authority…". It is important to highlight that, for example, in commodity related strategies or in underdeveloped markets, counterparties might not necessarily be subject to ongoing supervision by a public authority. **Therefore, it is recommended that these restrictions should be relaxed.**

Box 29 refers among other things to "quantitative risk limits". The HFSB has been careful in not prescribing such risk limits in its standards, but usually refers to target ranges and averages, where appropriate. It is important to observe that many of the risk measures listed in box 29 will be ex post risk measures, which cannot necessarily be limited ex ante (e.g. market risk, i.e. volatility). Also, it is important to observe that encouraging the introduction of such "hard limits" could result in large scale amplifications of volatility in situations of market distress: when markets fall, those AIF with hard wired risk limits will likely be forced to sell their positions (again, irrespective of whether they actually have appetite for holding on to these positions), thereby giving rise to further market distress.

While a bias against risk taking is suitable for banks (in light of their systemic nature), the HFSB believes it is wrong to introduce such a bias in the asset management industry.

Q19: ESMA would like to know which types of AIFM will have most difficulty in demonstrating that they have an independent risk management function? Specifically, what additional proportionality criteria should be included when competent authorities are making their assessment of functional and hierarchical independence in accordance with the proposed advice and in consideration of the safeguards listed?

AIFM of smaller funds/start-up firms as well as computer driven investment strategies will find it difficult to demonstrate that they have an independent risk management function. It is important to remember the overall nature of the AIFM sector: a lot of small firms, applying innovative portfolio management techniques, often depending on the ability of a few talented individuals. In some respect, alternative investment management is like the "silicon valley" of finance and the regulatory regime should take account of this.

The Hedge Fund Standards propose separating the risk monitoring function from portfolio management, recognising that small managers and start-ups might consider it impractical to do so, and recommend disclosure by the relevant manager. This enables the investor to determine whether the risk management function is sufficiently robust in light of the nature and complexity of the firm and the AIF. Also, the HFSB acknowledges that portfolio managers provide input into the process. Finally, the Hedge Fund Standards are based on comply or explain, which leaves significant leeway for managers to pursue different approaches, as long as investors are informed about it. The key is here that investors are put in charge of assessing the suitability of the approach to risk management, as they are the best economic agents to carry out this assessment. This approach raises standards across the industry, but at the same time takes account of the diverse nature of alternative investments and allows firms constantly to innovate their approach to managing risk.

The HFSB recommends a more disclosure centric approach, allowing investors and competent authorities to assess the nature of the risk management approach in the individual context of the AIFM/AIF.

VI. Possible Implementing Measures on Methods for Calculating the Leverage of an AIF and the Methods for Calculating the Exposure of an AIF

Q55: ESMA has set out a list of methods by which an AIF may increase its exposure. Are there any additional methods which should be included?

In its Final Report published in January 2008, the HFSB has assessed the suitability of different types of leverage measures in the context of its Standards. One of the conclusions was that financial statement based ("e.g. gross") measures, which do not include hedges, may provide a misleading picture of "risk" and that generally risk based leverage measures (which relate a risk measure such as, e.g. VAR to the fund's ability to absorb losses) are more suitable, but require more assumptions and input parameters. However, in light of the wide spectrum of leverage definitions, the HFSB has not prescribed any specific method, but the Standards require disclosure of leverage by managers to investors, along with their definition of leverage.

In the context of the AIFM-Directive, leverage serves several purposes, including regulatory reporting (systemic risk monitoring), investor reporting, and setting maximum leverage (risk management).

ESMA is correct in stating that (in its classical sense) leverage is a magnifying factor that has the potential to increase the gains or losses of an AIF (p. 190). In light of this definition, it is questionable whether the proposed Gross Method in fact meets this assumption and can serve as a useful stand alone leverage measure.

The HFSB has in the past highlighted that fixed leverage limits are not a suitable instrument in managing risk of AIF. While such approaches have merit in the banking world, they are not suitable for asset management, and may induce pro-cyclical behaviour in the markets (i.e. certain leverage measures tend to increase when markets fall, potentially forcing investors to sell their positions when "leverage limits" are breached, irrespective of whether the investor actually has appetite to hold on to their positions), increasing overall market volatility and distress. It will be even more damaging if all AIFM employ similar methods for calculating leverage, irrespective of whether it provides a useful perspective on the magnifying factor of the positions in a portfolio, and will thereby restrict AIFM in calibrating the risk taking in their portfolios in line with their strategies and risk appetite.

In light of this assessment, the HFSB recommends that more flexibility should be introduced around the types of leverage measures AIFM can provide and employ, including risk based measures (for example under the Advanced Method). AIFM should disclose the definition of the method employed.

For regulatory reporting purposes (in the context of Article 24), the HFSB recommends that ESMA should review the report "Assessing possible sources of systemic risk from hedge funds"[4], which is based on the findings of the Hedge Fund Survey and Hedge Funds as a Counterparty Survey conducted by the UK FSA. In particular, the report uses a Gross Leverage method as a rough proxy for the scale of a fund's presence in the markets from a regulatory/systemic risk perspective. The UK-FSA has established the term **gross footprint** in this context.

ESMA may consider adopting this "gross footprint" terminology clarifying that this measure does not exhibit the characteristics of a useful leverage measure (i.e. magnifying factor), but may rather serve to inform systemic risk regulators.

VII. Possible Implementing Measures on Limits to Leverage or Other Restrictions on the Management of AIF

Q61: Do you agree with ESMA's advice on the circumstances and criteria to guide competent authorities in undertaking an assessment of the extent to which they should impose limits to the leverage that an AIFM may employ or other restrictions on the management of AIF to ensure the stability and integrity of the financial system? If not, what additional circumstances and criteria should be considered and what should be the timing of such measures? Please provide reasons for your view.

The HFSB would like to highlight that at present there is no evidence that alternative investment funds (AIF) are systemic by nature. In particular, they do not exhibit bank type characteristics, such as retail deposit taking, significant maturity transformation, and significant leverage (in terms of being a magnifying factor).

The framework to guide competent authorities in assessing the extent to which they should impose limits to the leverage an AIFM may employ, or other restrictions on the management of AIF to ensure the stability and integrity of the financial system, needs to be carefully drafted, since interventions by competent authorities with the risk appetite of investors and the price formation process in the market can have far reaching implications.

The overall approach to systemic risk proposed in the consultation paper for the alternative investment context is centred on two aspects:

i. The lessons learned from excessive leverage in the banking system in the run up to the financial crisis and the risk failing banks pose to overall financial stability: In this context, it is correct to clarify [see 4.(a), p. 211]that **financial institutions (i.e. banks) are a significant transmission mechanism for systemic risk**, and that excessive risk taking by such institutions can create damaging externalities (as seen in the recent financial crisis, where banks built up excessive risk in subprime mortgages).
ii. Concerns in relation to **"spirals in the prices of financial instruments"**, which "threaten the viability of such instruments or other assets".

[4] FSA: Assessing possible sources of systemic risk from hedge funds – A report on the findings of the hedge fund as counterparty survey and hedge fund survey (February 2009)

i. Risk to systemically relevant financial institutions

In general it is most appropriate to address risk taking by systemically relevant institutions (banks) in the regulations for such institutions. Besides, ESMA/the competent regulator might not be best positioned to assess fully risk-taking by such systemically relevant institutions (including potential hedges to mitigate these risks). It is the relevant banking regulators that should address such concerns. It is also questionable whether interventions with the risk taking of investors (i.e. AIF) are a suitable approach in this context.

However, if indeed competent authorities identify excessive risk taking by (systemically relevant) financial institutions, then such competent authorities should urge the relevant banking regulators that such risk taking by financial institutions be assessed in more detail and potential mitigating action be initiated. The HFSB believes that this approach is far more efficient than intervention with investors' desire and ability to take risks (e.g. AIF).

Therefore, it is recommended that the following should be added in Box 100:

> **6. Where a financial institution, and in particular, a systemically relevant institution (i.e. bank) is found to be engaging in excessive risk taking (i.e. market, liquidity, or counterparty risk) whether in the context of AIF or otherwise, the relevant banking supervisor should be notified.**

ii) "Downward spirals"

Guidance 4. (b) in box 100 refers to the use of leverage contributing to downward spirals in the prices of financial instruments, or other assets, in a manner which threatens the viability of such financial instruments or other assets.

First of all, a sound understanding of the nature and purpose of leverage in capital markets/the investment sector is a precondition before assessing intervening powers and potential regulatory measures.

i. In a classical sense, leverage is one of many tools allowing investors among other things to calibrate the risk/return profiles of their investments according to their specific risk appetite, and large investors, such as pension funds often achieve this by allocating a large variety of asset classes/investment strategies etc., combining risky investment strategies with absolute return and low risk/low return strategies, to deliver ultimately a diversified portfolio matching their overall risk appetite and return objectives.
ii. Leverage can also be a by-product of building sophisticated portfolios involving derivatives and other financial instruments to match exactly the desired investment strategy and market view, but without leverage being the type of magnifying factor, as described in section 6 (p.190) of the Consultation Paper. Indeed, situations might arise where a transaction intended to reduce the overall riskiness of a portfolio might result in an increase in certain leverage measures.

This illustrates that leverage (in its various forms) plays an important role allowing individuals, companies and institutions to optimise their investment/financing structures and risk profile.

Regulators should carefully consider all these aspects when assessing the role of leverage and potential measures to limit leverage or impose other restrictions on investors.

During the financial crisis, we saw significant drops in prices in many types of assets (e.g. asset backed securities, banking stocks, sovereign debt of certain issuers). In hindsight, many of the price corrections, that had occurred at the time and were popularly labelled as “fire price selling”, “downward spirals” or presumable “speculative attacks”, turned out to be justified corrections[5] reflecting the riskiness of underlying assets. It is certainty desirable if unproductive investments and bubbles are avoidable in the first place, but regulators are not in a position to assess and “second guess” the viability of investments and therefore, it is difficult to justify interference with investors’ desire and ability to take risk.

It is important to remember that market-based systems provide a framework for price discovery, balancing supply and demand and competition. At times, some investors may have appetite for more risk taking (which can include increasing leverage), which in turn enables allocation of risk capital to economic activity that might otherwise not happen. At other times investors might prefer to reduce risk (which can include reducing leverage, but, as illustrated above, can also result in increases in leverage, depending of the nature of approach/portfolio). Ultimately, overall investor risk appetite will always influence price formation in the market, and it should not come as a surprise that prices of risky assets fall when there is a rising risk aversion (and awareness). Prevention of justified price corrections in the market place can have many damaging consequences, including misallocation of resources, fuelling of potentially damaging bubbles, and preventing prices to find a level where investors are again prepared to buy/inject capital.

Therefore, when regulators exercise their powers, for example, to impose leverage limits on investors, it is important to mitigate any potential negative impact that regulatory intervention may have: the consultation paper rightly highlights any potential pro-cyclical effects which may result from imposing leverage limits.

The HFSB recommends that in addition to the pro-cyclical effects, regulators should assess any additional unintended consequences, such as distorting the price formation in certain markets or instruments, prevention of capital allocation (to potentially viable activities), whether their actions affect the functioning of certain important capital raising channels (i.e. for banks), and how investors might be impacted in their ability to manage risk and calibrate their investment portfolios according to their risk appetite.

The HFSB also recommends that ESMA should develop a staged engagement process to be applied by the competent authority with the AIFM, including notification, explanation by the AIFM of its approach to deal with excessive leverage, warning by the regulator etc.

[5] For example, see Bundesbank Monthly Report 12/2010, p. 50-56 on sovereign debt spreads

Q62: What additional factors should be taken into account in determining the timing of measures to limit leverage or other restrictions on the management of AIF before these are employed by competent authorities?

As per the assessment included in the answer to question 61, relevant authorities should keep in mind the overall impact on investor confidence, in particular, if intervention impacts price formation, causes unintended volatility or drives investors away when they are most needed. Intervention can also be (falsely?) understood by market participants to indicate that particular risks have build up in systemically relevant institutions (banks), which may impact such institutions' ability to raise capital.

Usually in times of crisis, investors with risk appetite are needed more than at any other time (as seen throughout the financial crisis), and it is potentially counterproductive to restrict risk-taking for those who are willing and can take and manage these risks.[6]

In summary, regulators should be particularly cautious with market intervention when such measures could potentially harm investor risk appetite, and seek to engage a staged approach as illustrated under question 61.

VIII. Transparency requirements

Q68: Do you think ESMA should be more specific on how the risk management system should be disclosed to investors? If yes, please provide suggestions.

The HFSB does not see a need for more specificity. However, it may help to clarify that the term system refers to a set of methods, procedures and routines, and not a narrower meaning, such as purely IT systems.

Q69: Do you agree with the proposed frequency of disclosure? If not, please provide alternative suggestions.

The HFSB agrees that better understanding of the activities in financial markets by regulators is important, and transparency is one building block in this. However, the HFSB recommends a risk based approach, focussing regulatory resources on those AIFM which are considered to be potentially more relevant from a systemic risk perspective in terms of scale and complexity, while applying a lower (e.g. annual) reporting frequencies for smaller AIFM.

[6] The short selling bans provide a useful illustration of how regulatory intervention can have far reaching implications, which might not be immediately obvious: short selling is an important technique used by investors to manage the risks arising in the context of convertible bond issuance. At a time when banks were in desperate need of funding, the short selling bans had ultimately restricted investors' ability to absorb the banks' convertible issuance.