

# Heightened UK Financial Conduct Authority Focus on Alternative Managers — Implications for Firms and Steps to Take

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*January 27, 2020*

On 20 January 2020, the UK Financial Conduct Authority (FCA) published a “Dear CEO” letter from the FCA’s director of wholesale supervision, Marc Teasdale, to asset managers in the alternative investments sector (i.e., hedge funds, private equity funds and other non-UCITS funds) ([the Alternatives Letter](#)).

The Alternatives Letter sets out the FCA’s supervision strategy for such firms and outlines what the FCA sees as the key risks of harm that alternatives firms pose to their customers and the markets in which they operate. The letter identifies a number of areas where firms have work to do to meet the FCA’s expectations.

The tone and content of the Alternatives Letter suggest the FCA has cause for concern with firms across the sector. The FCA states that “progress is needed” and that “[o]verall standards of governance, particularly at the level of the regulated entity, generally fall below our expectations.” We summarise the FCA’s comments below and add our own observations.

On the same date, the FCA issued a separate “Dear CEO” letter to mainstream asset management firms ([the Asset Management Letter](#)). A number of the topics highlighted in the Asset Management Letter are of general application to all asset managers, so alternative investment firms should also consider the issues raised in that letter. Indeed, several hedge fund managers received the Asset Management Letter rather than the Alternatives Letter. We have detailed the most relevant points from the Asset Management Letter at the end of this paper.

## ***Sidley comment***

The Alternatives Letter represents the first time in recent memory that the FCA has directed concerns at the alternatives sector in such a direct fashion. The FCA (and its predecessor, the Financial Services Authority) used to conduct and publish a Hedge Fund Survey twice a year, but those surveys ceased in 2015. In 2016-17, the FCA carried out an Asset Management Market Study,<sup>1</sup> but that study did not include private equity funds or hedge funds directly.

The publications are a clear indication that the FCA will be engaging more closely with the asset management industry over the coming period.

## **Key Points from the Alternatives Letter**

The FCA highlights six supervisory priorities in the Alternatives Letter:

1. Investor exposure to inappropriate products or levels of investment risk
2. Client money and custody asset controls
3. Market abuse
4. Market integrity and disruption
5. Anti-money laundering and anti-bribery and corruption
6. EU withdrawal

We discuss and set out below our thoughts on each of the priorities.

### **1. Investor exposure to inappropriate products or levels of investment risk**

The FCA notes that alternative investments can carry significant levels of investment risk; firms must consider the appropriateness or suitability of those investments for their target investors. The FCA notes that it “will be testing that firms are aware of who their customers are and that they are placing a clear focus on acting in the best interests of their clients and funds.”

#### ***Sidley comment***

Firms should review their investor disclosures and the appropriateness and suitability of their products in light of their target investors.

The FCA also specifically refers in the Alternatives Letter to firms that “opt up” retail clients to professional client status. The opt-up procedure allows a firm to apply a lower level of client protection than would otherwise apply if the investor were to be treated as a retail client. It is also generally easier to market alternative funds to professional clients rather than retail clients. Finally, the opt-up process is useful for firms that wish to avoid having to comply with the Packaged Retail Investment and Insurance-based Products (PRIIPs) Regulation’s requirement to prepare a “Key Information Document” as that requirement applies only in relation to retail investors.

The FCA expects the opt-up process to be robust and makes clear that firms should be ready to justify their investor classification decisions.

### **2. Client money and custody asset controls**

The FCA notes that when firms hold or control client money, they must ensure that client money and custody assets remain safe and can be returned to customers if the firm were to fail. The FCA “will ...

test whether firms that have permission to hold client money and safeguard custody assets are exercising those permissions under robust control frameworks.”

***Sidley comment***

Most alternative investment firms will not have permission to *hold* client money or client assets; rather, firms will typically have permission to *control* client money. Firms should ensure that if they encounter client money or assets, they do so solely within the scope of their permissions.

### **3. Market abuse**

The FCA says in the letter that “[a]lternatives firms are key buy side participants in financial markets ... We generally observe that market abuse controls across the sector have significant scope for improvement.” The FCA notes that it has visited a number of firms and sent a market abuse questionnaire to buy side firms previously. The FCA “may conduct similar exercises in the future and may include your firm.” Ultimately, “[w]here firms do not comply with MAR we will consider the need for enforcement action.”

***Sidley comment***

Market abuse has been a key focus for the FCA since the introduction of the Market Abuse Regulation (MAR) in 2016, as is evident in the FCA’s business plan published each April. There have been a number of high-profile market abuse enforcement actions. The FCA makes clear that firms must have appropriate governance arrangements in place to oversee and combat the risk of market abuse.

Firms should ensure that their staff are properly trained on market abuse issues and that their market abuse policies and procedures are well understood by their staff. Policies and procedures should be tailored to the firm’s particular business and strategy, and firms should put in place appropriate monitoring and surveillance systems. Fixed income firms should bear in mind that the FCA has commented on the apparent market perception that “market abuse only happens in equities,” an assumption which “needs to be thoroughly broken.”<sup>2</sup>

### **4. Market integrity and disruption**

The FCA notes that “[u]se of leverage and illiquid investments presents risk to [firms’] own portfolios and can also create risk for other market participants and the wider markets. We expect firms to operate robust risk management controls to avoid excessive risk-taking and to ensure that the potential for harm or disruption to financial markets is appropriately mitigated.”

The FCA “may choose to undertake in-depth assessments of firms’ controls and may involve your firm.”

***Sidley comment***

Firms should consider their risk management systems and positions for potential impact on the broader market.

Firms which trade systematic/algorithmic strategies should also review their systems and controls, particularly when accessing venues directly or through direct electronic access. The FCA does not specifically refer to the provisions of MiFID II in this regard; however, firms should consider whether their systems and controls meet the detailed requirements set out therein.

## **5. Anti-money laundering and anti-bribery and corruption**

The FCA notes that “[a]lternatives firms should be alert to the risk they could be used to facilitate financial crime.” The FCA intends to review firms’ systems and controls and “will pay particular attention to the risks of money laundering and terrorist financing.”

### ***Sidley comment***

Firms should review their AML, anti-bribery and corruption policies, ensuring they are tailored to the firm’s particular business and, where relevant, capture amendments introduced by the EU Fifth Money Laundering Directive (MLD5). In 2019, the FCA visited a number of smaller firms (including asset managers) to scrutinise their financial crime/AML policies and procedures.

As well as client relationships, firms should consider whether any of their ongoing business relationships or counterparty relationships present a money laundering or terrorist financing risk. This is another area where firm governance is key. Appropriate oversight should be exercised by the firm’s senior management.

Under the new Senior Managers and Certification Regime (SMCR) that came into effect for asset managers from 9 December 2010, the senior manager performing the SMF17 function has responsibility for money laundering reporting. Such individuals may be required to respond to FCA queries and possible FCA visits and should ensure that they are sufficiently well equipped to deal with this.

## **6. EU withdrawal**

The FCA notes that the United Kingdom’s withdrawal from the EU on 31 January 2020 will be followed by an implementation period lasting until 31 December 2020, during which EU rules will continue to apply in the United Kingdom. The FCA expects firms to “consider how the end of the implementation period will affect you and your customers, and what action you may need to take to be ready for 1 January 2021.”

### ***Sidley comment***

If firms have not already put in place Brexit contingency plans, this will become more urgent in 2020. Any action will need to be ready to go live on 1 January 2021. The risk of a no-deal “hard Brexit”

remains at the end of the implementation period (31 December 2020) if the United Kingdom and the EU are not able to agree to the terms of a future relationship.

## **Asset Management Letter**

The FCA highlights seven supervisory priorities in the Asset Management Letter:

1. Liquidity management
2. Firms' governance
3. Asset Management Market Study (AMMS) remedies
4. Product governance
5. LIBOR transition
6. Operational resilience
7. EU withdrawal

Of these seven priorities, alternatives firms may wish to review in particular the topics of firms' governance and LIBOR transition; we deal with each topic below.

### ***Firms' governance***

As with the Alternatives Letter, the Asset Management Letter highlights that overall standards of governance fall below the FCA's expectations. The FCA emphasises the importance of the recently extended SMCR as being an opportunity for firms to deliver high standards of governance: "The SMCR should not be treated as a discrete compliance project."

### ***LIBOR transition***

Although there is still some uncertainty regarding the LIBOR transition, the FCA reminds firms that it has made clear (in a previous ["Dear CEO" letter](#)) that firms should plan on the basis that LIBOR will cease from the start of 2022. The FCA also expects firms to facilitate and contribute to an effective transition to new rates, such as SONIA.

## **Conclusion**

Given the FCA's outreach to alternatives managers in this direct fashion, it is fair to expect that the FCA will, in the coming period, be focussing more of its resources on the sector. Firms in the sector should be prepared for more direct contact with the FCA, whether in the form of thematic studies on the supervisory priorities, visits by the FCA to discuss some of those topics or enforcement action where firms fall short of the FCA's expectations.

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<sup>1</sup> The final report can be found [here](#).

<sup>2</sup> Speech delivered by Julia Hoggett, director of market oversight at the FCA, at the Association for Financial Markets in Europe Implementation of the Market Abuse Regulation in the UK event, London, which can be found [here](#).

## CONTACTS

If you have any questions regarding this Sidley Update, please contact the Sidley lawyer with whom you usually work, or

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