Managed Funds Association
The Voice of the Global Alternative Investment Industry
Washington, D.C. | New York | Brussels | London

May 22, 2023

Asset Management and Funds Policy Team
Wholesale Buy-side Division
Financial Conduct Authority
12 Endeavour Square
London E20 1JN

Re: Updating and Improving the UK Regime for Asset Management: Discussion Paper

Dear Sir/Madam,

Managed Funds Association ("**MFA**")[1] appreciates the opportunity to represent the views of the global alternative investment industry in this written response to the Financial Conduct Authority's ("**FCA**") discussion paper on updating and improving the UK regime for asset management (the "**Discussion Paper**"). The Discussion Paper, in conjunction with the UK government's Edinburgh Reform packages, represents an important opportunity for MFA and its members to underscore the vital role that alternative asset managers play in bolstering the UK financial markets ecosystem and ensuring that the UK's regulatory regime continues to underpin fair and vibrant markets.

MFA represents over 170 alternative asset managers—around half of whom have a presence in the UK—who collectively manage nearly £1.8 trillion of assets. Our membership includes hedge funds, credit, and crossover funds that invest across a diverse group of investment strategies. We have a vital interest in ensuring the UK remains a leading financial centre with a regulatory framework that promotes fair and efficient financial markets, and which delivers the best possible outcomes for consumers, investors, and other market participants.

MFA is supportive of the FCA's intentions to improve asset management regulation with a more modern and tailored regime to meet the needs of UK financial market participants. Taking steps to refine the overarching asset management regulatory framework will not only make the rules easier for asset managers to follow, but will also improve investor protection by applying consistent standards across different types of asset managers.

As the UK moves toward implementing the Future Regulatory Framework ("FRF"), policymakers should consider the many ways in which the alternative asset management industry contributes to increased liquidity and robust capital markets in the UK. Considering pragmatic changes to the asset management regulatory framework will ensure that the UK remains a world-leading centre for asset managers, investors, and facilitates financial markets that are both fair and predictable.

[1] Managed Funds Association (MFA), based in Washington, DC, New York, Brussels, and London represents the global alternative asset management industry. MFA's mission is to advance the ability of alternative asset managers to raise capital, invest, and generate returns for their beneficiaries. MFA advocates on behalf of its membership and convenes stakeholders to address global regulatory, operational, and business issues. MFA has more than 170 member firms, including traditional hedge funds, credit funds, and crossover funds, that collectively manage nearly $2.2 trillion across a diverse group of investment strategies. Member firms help pension plans, university endowments, charitable foundations, and other institutional investors to diversify their investments, manage risk, and generate attractive returns over time.

MFA agrees with the intent of the Discussion Paper which aims to better meet the needs of domestic, international, retail, and professional investors. In addition, MFA members, many of whom operate across numerous global jurisdictions, applaud the FCA's recognition that regulatory changes should be consistent with international standards and take into account the rules in other jurisdictions when consulting with a broad range of stakeholders. With greater consistency, asset managers can help more effectively pursue the varying portfolio diversification, risk management, and financial returns desired by investors and beneficiaries.

We acknowledge that the primary focus of the Discussion Paper focusses on the retail funds sector, however the Discussion Paper does raise important issues for the institutional asset management sector. We have identified several questions in the Discussion Paper's Annex to which we have responded (outlined in greater detail starting on page 5) that can help deepen the FCA's understanding of how to strengthen the asset management regulatory framework. These include:

- *Professional investor definition;*
- *Potential costs incurred from implementing a common asset management regulatory framework;*
- *Harmonizing conflicts of interest differences;*
- *Revisiting requirements applicable to professional investors;*
- *Regulatory capital;* and
- *Simplifying the FCA Register to make more comprehensible for non-lawyers.*

In addition, while the Discussion Paper intends to evaluate the asset management landscape more broadly, there are several policy issues in which alternative asset managers are particularly interested that are not included. While the UK government has ongoing work streams through the FCA, HM Treasury, and in Parliament, we would like to highlight several key areas in which the FCA may further explore as it continues the FRF consultation process. These include:

- ***Short Selling*** – In February 2023, MFA submitted comments[2] to His Majesty's Treasury's Call for Evidence on the Short Selling Regulation review which highlight how short selling benefits markets and investors by improving efficiency of price formation; improving market liquidity and reducing volatility; allocating capital more efficiently and unlocking capital investment; detecting corporate fraud; promoting environmental, social, and governance goals; and reducing risk of market bubbles. In addition, the comments suggest moving away from individual firm public disclosure toward publicly disclosing the aggregate net short positions on an issuer-by-issuer basis.

- ***Securitisation*** – We believe that there are some fundamental issues with the current UK Securitisation Regulation (UK SR) that merit a comprehensive review and we look forward to offering our perspective on the regulation when the FCA publishes its UK Securitisation Consultation in Q3 2023. A comprehensive review of the UK SR will enable UK financial market participants to engage properly with international securitisation markets and will ultimately contribute towards better portfolio risk diversification for investors and growth of the UK economy.

[2] https://www.managedfunds.org/wp-content/uploads/2023/03/MFA-Response-to-HMT-Call-for-Evidence-on-the-Short-Selling-Regulation_Signed_FINAL.pdf.

- ***Sustainable Disclosure Requirements*** **(SDR)** – In January 2023, MFA submitted comments[3] to the FCA's Consultation on Sustainability Disclosure Requirements and investment labels which express support for the reduction of greenwashing; increasing provision of standardised sustainability information along the investment chain; allowing consumers to more effectively navigate the market and make informed decisions; striking a balance between ensuring the regime works both for consumers and for firms that need to apply the rules in practice; and ensuring international coherence with other regimes like those in the EU and in the U.S.

We encourage the FCA to consider these issues as it evaluates the UK's asset management regulatory framework.

Further, the UK should be sensitive towards the potential costs and disruptions that would result from a major overhaul of its asset management regulatory framework and ensure that industry voices are heard throughout the consultation process. To that end, a revised regulatory framework should be both effective and proportionate, simplifying and standardising requirements where possible.

Context

MFA represents the global alternative investment industry supporting a policy environment that provides greater transparency, consistency, and trust in the market for sustainable investment products. Many of MFA's members are headquartered in the U.S. and nearly 40 percent of MFA members have offices in the UK. Importantly, this spring, MFA established its first permanent office in London which will facilitate dialogue between member firms and policymakers in the UK. Accordingly, MFA and its members are interested in the Discussion Paper and believe that the resulting regulatory framework, in conjunction with the UK government's Edinburgh Reforms, will play a fundamental role in guiding future consultations and policy discussions, setting expectations of fund managers and investors, and promoting dynamic capital markets in the UK.

The UK's asset management regulatory regime is the product of decades of EU policy and legislation under the Alternative Investment Fund Managers Directive, the Undertakings for Collective Investment in Transferable Securities Directive, and the Markets in Financial Instruments Directive. A consolidated asset management regulatory framework would allow managers to establish businesses much more quickly and would enhance UK financial market competitiveness. However, it is essential to maintain distinct frameworks for institutional and retail investment and the combining of the two could create a hybrid regime that fails to benefit either parties.

We understand that the FCA is considering the potential costs disruptions that may stem from a substantial transformation of the requirements, as well as potential divergences from other international regulatory standards. However, MFA considers that there is a clear benefit in having a well-constructed consolidated regulatory framework that is more intuitive for asset managers and ensures greater consistency of standards across manager types.

[3] https://www.managedfunds.org/wp-content/uploads/2023/01/MFA-Comment-Letter-UK-FCA-Consultation-Paper-on-Sustainability-Disclosure-Requirements-FINAL.pdf.

We have set out our responses to the relevant questions in the Annex hereto.

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MFA appreciates the opportunity to provide these comments to the FCA in response to the Discussion Paper. If you have any questions about these comments, or if we can provide further information, please do not hesitate to contact the undersigned at (202) 730-2600.

Respectfully submitted,

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ANNEX

CHAPTER 3. THE STRUCTURE OF THE ASSET MANAGEMENT REGULATORY REGIME

Q1 **Do you think that we should aim to create a common framework of rules for asset managers? What benefits would you see from this? What costs might this create? If you do not think we should do this, are there any areas discussed above where we should consider taking action, even if we do not create a common framework of rules? What would we need to consider around the timing of implementing a change like this?**

MFA Response

Options in relation to current regulatory framework

MFA recognises that the current framework of regulatory requirements derives from retained EU law structures, i.e. the Undertakings for Collective Investment in Transferable Securities ("**UCITS**") Directive, Alternative Investment Fund Managers Directive ("**AIFMD**") and Markets in Financial Instruments Directive ("**MiFID**").

In our view, creating a common framework of rules for asset managers could involve two possible options: (i) removing the legal distinction between fund structures and requirements under the UCITS Directive, AIFMD and MiFID; and/or (ii) harmonising certain requirements across the three regimes.

Option (i) (removing the legal distinction between the UCITS Directive, AIFMD and MiFID) would substantially simplify the UK asset management regulatory framework, whilst at the same time setting an appropriately robust regulatory standard. This would be greatly beneficial for the market. At present, asset managers are forced to choose between being authorised as an alternative investment fund manager ("**AIFM**") or a MiFID firm, which presents an artificial dichotomy of investment management services.

MFA notes that the Edinburgh Reforms do not contemplate such an overhaul of the existing framework. MFA recognises that such a task would be extensive and could be seen as more appropriately the purview of HM Treasury, rather than the FCA. In addition, a complete redesign of the asset management regulatory framework may be a costly exercise for the asset management industry if carried out without careful consideration.

Nevertheless, MFA believes that if the exercise of conducting Option (i) is properly executed with appropriate consultation with the industry, such an overhaul could help create a best-in-class regime in the UK. Accordingly, it remains worthwhile for both the FCA and HM Treasury to take these considerations into account for their future plans and objectives.

In the alternative, MFA would strongly support introducing changes to address the issues set out above. Most pertinently, the FCA is encouraged to consider changes that would enable asset managers to apply for the full range of permissions that are relevant to their business models, regardless of their classification as an AIFM or a MiFID firm. In this regard, please refer to our response to Question 4 below regarding the proposed extension of MiFID top-up permissions (see "*AIFMs with MiFID top-up permissions (and vice versa)*".

Furthermore, option (ii) alone does not contemplate a complete overhaul of the existing framework, but rather seeks to introduce a more harmonised and efficient set of rules for UCITS management companies, alternative investment fund managers ("**AIFMs**") and MiFID managers under which such firms may carry on their business.

There are several areas of commonality across the three regulatory regimes in terms of measures that apply to asset managers, including prudential rules on regulatory capital and remuneration, best execution, conflicts of interest, costs and charges disclosures, to name a few areas. In MFA's view, there is a sufficient number of basic concepts that can be harmonised without incurring excessive implementation costs for the industry and which can properly be considered.

UK asset managers currently have to refer to rules that are contained in different sections of the FCA Handbook (such as FUND, COBS and COLL) as well as primary and level 2 regulations. This patchwork of regulatory sources has meant that firms face difficulties with understanding which particular provisions actually apply to them as well as keeping track of any relevant regulatory updates.

In this regard, MFA encourages the FCA to undertake a thorough examination of the current regulatory regimes with industry members with a view to consolidating or harmonising certain aspects of the applicable rules. However such consolidation and harmonisation should not make the UK market less welcoming for institutional investment managers like our members. Protections for retail investors are of paramount importance, but the UK's regulatory regime should not include those protections in its rules for managers working with large, sophisticated investors.

Benefit for asset managers

From the asset manager's perspective, such changes would have the benefit of simplifying the basic technical rules that would apply to the asset manager, and allow the asset manager to focus on areas of real importance, such as portfolio management, risk management, market abuse and AML/financial crime compliance.

For example, the current regulatory framework results in an artificial construct whereby an asset manager that wishes to manage alternative investment funds ("**AIFs**") as well as carry out MiFID activities must be regulated under the AIFM regime, while there is no way for a MiFID manager (authorised under the MiFID regime) to carry out the AIFM activity of managing AIFs.

In addition, when MiFID II was implemented in the UK, some MiFID II rules (e.g. on conflicts of interest) were applied to AIFMs as well, but not other rules. The result has been complexity in terms of which rules apply. Similarly, when the Investment Firm Prudential Regime ("**IFPR**") was implemented more recently, certain aspects of the IFPR applied to AIFMs as well – firms were asked to apply the higher standard, for example in relation to the MIFIDPRU remuneration rules.

At the same time, a more harmonised and less complex regulatory framework will also bring down the barriers to entry for new asset managers. The complexity of the regulatory framework means that it is increasingly expensive for an asset manager to be able to generate a profitable business.

Benefit for end investors/clients

From the end investor/client's perspective, a reduction in the barriers to entry also means a more competitive asset management landscape, with more products available at a more competitive price point.

In addition, a simpler framework would have the benefit of helping end investors/clients understand the framework under which their chosen asset managers operate. For example, the Financial Services Register (the "**FS Register**") is very difficult for non-lawyers to understand, in part because of the confusing and overlapping AIFM, MiFID and UCITS management possibilities.

By way of example, the FS Register features technical legal terms that are impenetrable to non-technical users. Examples include:

> "BIPRU firm MiFID activity restriction"
>
> "CPMI Requirement"
>
> "Exempt CAD-may recv &trans ordrs &/or give inv adv"

Given that one of the primary purposes of the FS Register is to help end investors/clients (whether professional or retail) understand the regulatory status of the firms they deal with or appoint, the complexity caused by the current regulatory framework is significant and unhelpful.

In light of the advantages set out above, we believe that simplifying the regulatory regime would likely benefit end investors/clients.

Suggested approach

In carrying out the creation of a common framework or seeking harmonisation across the various regimes, it will be extremely important for the FCA to consider each rule under each regime, and the policy purpose of each rule.

It would be counter-productive and indeed damaging to asset managers and investors/clients if the approach taken by the FCA is that of simply taking the highest standard in one regime (e.g. the UCITS regime) and harmonising the other two regimes (AIFM and MiFID) up to that standard. That approach would be disproportionate and severely undermine the FCA's forthcoming secondary objective of facilitating the international competitiveness of the UK economy, which the FCA already "fully embraces".[4]

The UCITS regime is intended to serve a very different purpose than AIFMD and MIFID, so any harmonisation should take these different objectives into account. Any increase in regulatory requirements needs to be fully justified with consideration of the investors that the requirement is intended to protect.

MFA notes that the exercise should also take into account the differences in the nature of the respective business lines that are regulated, as well as the relative size, nature and complexity of businesses falling under the various regulatory requirements. If the FCA seeks to default to the highest standard as a general approach, this will likely increase costs, resource planning and implementation timings for the sector, especially if substantial changes are needed as a result. In this regard MFA applauds the FCA's recognition in the Discussion Paper that professional investors and retail investors require different levels of disclosure and protection under the regulatory regime.

Cost

In terms of cost, MFA appreciates that any change to regulation or the regulatory framework generally results in an increased cost to the industry from an implementation perspective, as new policies and procedures need to be adopted by the industry. The introduction of the AIFMD and changes brought about by MiFID II and IFPR more recently are clear evidence of such costs being incurred.

Nevertheless, MFA believes that such costs will likely be outweighed – particularly over time – by the potential benefits it will bring to firms and their investors/clients as discussed above, and to "UK PLC" as a whole. Moreover, MFA considers that the harmonisation exercise would likely seek to achieve outcomes that are similar to the current rules. As such, the actual impact to firms and their processes may be limited.

Timing

[4] The FCA's Business Plan 2023/24.

In terms of timing, MFA would stress the need for the FCA to plan a timeframe after thorough industry consultation. Given that the exercise may lead to different changes across different business lines, it is important to ensure that all of such proposed changes can be understood and implemented by asset managers at all levels. In addition, this will ensure that the common framework is effective and operable across the sector. Accordingly, we support the FCA's suggestion of allowing a lengthy timetable for implementation.

Q4 **Are there aspects of the current AIFM regime that professional investors do not value? Would there be benefit in us removing any of these?**

MFA Response

MFA notes that the FCA has asked a range of questions on protections for retail investors in retail authorised funds. As a general remark, MFA wishes to reiterate that any remedies aimed to protect retail investors should not be applied to funds that are marketed only to professional investors.

In addition, MFA agrees with the FCA that its rule changes should take the UK's status as a premier global asset management hub into consideration. However, MFA wishes to emphasise that any changes should only affect rules for asset managers and funds that are incorporated in or have a registered office in the UK, rather than making rules for non-UK funds that are marketed in the UK. MFA considers that any rules that go beyond such scope would risk creating additional expense and uncertainty and potentially diminish the UK's status as a place for managers and their funds to do business.

More specifically, MFA would like to flag the following aspects of the current regime for the FCA's attention and consideration.

<u>Revisiting requirements applicable to professional investors</u>

MFA encourages the FCA to take a holistic look at reducing some of the regulatory requirements imposed on asset managers when dealing with professional investors.

MFA is encouraged by the steps already taken under the UK's MiFID II "Quick Fix"[5] as part of the UK government's initial steps towards post-Brexit regulatory reform. The changes made, including reduced client reporting requirements for portfolio management services, the deletion of the "Top 5" reports under the best execution rules, and the addition to the list of acceptable non-monetary benefits under the inducements rules, were welcomed by our industry.

The Quick Fix was a good example of how a review of the needs of different types of investors/clients led to sensible and proportionate adjustments to the rules.

[5] Pursuant to The Markets in Financial Instruments (Capital Markets) (Amendment) Regulations 2021 and, separately, the FCA Policy Statement PS21/20 "Changes to UK MIFID's conduct and organisational requirements".

In this regard, MFA encourages the FCA to look further and holistically across the asset management framework (for AIFMs, MiFID managers and UCITS management companies) and make further adjustments. Such an assessment should consider the proportionality of requirements against the professional investor context to ensure that the obligations are not unnecessarily overly burdensome for asset managers. Some of these adjustments could include:

- *Cost and charges disclosure requirements for professional investors.* The FCA should consider removing disclosure obligations towards professional investors and eligible counterparties in respect of *ex ante* costs and charges for services including investment advice and portfolio management. Such MiFID disclosure requirements are not appropriate for professional investors and their prescriptive requirements are not proportionate for an asset manager's relationship with its professional investors.

  In the MFA's view, *ex ante* costs and charges are frequently highlighted as being unsuited for sophisticated products that have performance-related fees and/or are marketed only to professional investors.

- *Due diligence.* Please also see our response to Q9 below, in which we refer to the due diligence requirements that apply to AIFMs under the UK's securitisation regulation framework, which, in our view, have limited use for professional investors and should be removed.

<u>Exclusions for intra-group services</u>

The FCA should consider whether certain rules could be disapplied in intra-group scenarios. For example, many MFA members are US hedge fund managers with UK subsidiaries as sub-managers (typically MiFID firms). The US manager is the UK sub-manager's sole client.

The US manager and its UK sub-manager effectively trade as one firm, but because of the inducements and investment research rules in COBS 2.3A, the UK sub-manager has to establish a completely different system for paying for investment research from its US parent firm. As a legal matter, the UK sub-manager cannot even accept investment research that its US parent has received from third party brokers, and must seek to show some payment for it. This introduces significant complexity and cost in a situation where the client that the rule seeks to protect is the MiFID firm's own parent, who runs a single trading strategy.

Another example relates to providing information to the MiFID firm's client, including reporting of portfolio positions. In intra-group scenarios, there is often a central system established by the parent entity, in which case there should not need to be any specific reports delivered by the UK sub-manager.

<u>AIFMs with MiFID top-up permissions (and *vice versa*)</u>

As noted above, AIFMs may carry on certain MiFID activities, while MiFID managers may not manage AIFMs. This paradox seems to us to simply be a function of the AIFMD and MiFID having been implemented in the UK at different times (MiFID (originally) in November 2007, and AIFMD in July 2013). The regulatory framework would be better served by permitting asset managers – whether AIFMs or MiFID firms – to apply for authorisation for the range of AIFMD and relevant MiFID permissions, regardless of whether the asset manager would today be an AIFM or a MiFID firm.

If the FCA is not inclined at this stage to consider the level of harmonisation suggested above, then MFA asks the FCA to consider amending FUND 1.4.3 (which implements Article 6(4) of the AIFMD) so that the MiFID top-up permissions are extended so as to include "execution of orders on behalf of clients".

MFA notes that, under the existing FUND 1.4.3 MiFID top-up permissions, a UK AIFM (with MiFID top-up permission) that is the sub-manager of, say, a US parent hedge fund manager, could not place orders for financial instruments with third party brokers, where the investment decision is made by the US fund manager and passed to the UK AIFM sub-manager for placing with third party brokers. That is because FUND 1.4.3 does not include the MiFID service of "execution of orders on behalf of clients".

Under the current rules, such a UK AIFM sub-manager can only place orders for financial instruments in a situation where it has itself made the portfolio management decision. This construct seems to unnecessarily constraining on the UK asset management framework.

As noted above, FUND 1.4.3 implements Article 6(4) of the AIFMD. It is possible that the MiFID service of "execution of orders on behalf of clients" was not included in Article 6(4) because the EU policymakers did not want AIFMs to carry on brokerage businesses. Nevertheless, there does not appear to be a good policy reason to prevent an AIFM sub-manager from placing an order with third party brokers, just because the primary fund manager made the portfolio management decision, instead of the UK AIFM sub-manager.

CHAPTER 4. IMPROVING THE WAY THE REGIME WORKS

Questions

Q9 Do you have any comments on us making our expectations on investment due diligence clearer for all asset managers?

MFA Response

The Discussion Paper raises a particular concern around due diligence in relation to credit assessment. MFA considers that this is an issue for retail funds, rather than for funds marketed only to professional investors.

As noted in our response to Q4, due diligence forms an integral part of the investment allocation process for professional investors. We therefore consider that the current requirements under AIFMD are proportionate to investor risk and do not need to be expanded.

However, MFA agrees that it would be beneficial to provide clearer expectations on investment due diligence as we recognise that there are different investment restrictions depending on the relevant regulatory regime that applies to the asset manager.

MFA believes that a review of due diligence and the risk management framework under AIFMD as a whole will suggest that certain due diligence frameworks could be more targeted than their current form.

In particular, we believe that the due diligence requirements that are imposed on AIFMs under the UK Securitisation Regulation ("**Sec Reg**") should be removed, particularly in relation to due diligence requirements on risk retention.

AIFMs are sophisticated buy-side parties, who have a fiduciary duty to their investors and operate in a highly regulated environment. Under global regulatory frameworks, they are subject to high standards of governance and risk management. In the EU and the UK, AIFMs are already subject to risk management requirements under the AIFMD (and as implemented in the UK). In the United States, US AIFMs are subject to similar requirements under the supervision of the Securities and Exchange Commission.

Whilst we recognise the importance of protecting investors, AIFMs are not at risk of misunderstanding investment opportunities and hazards. AIFMs have robust internal due diligence processes to help them make well-informed investment decisions, regardless of their obligations under the Sec Reg.

However, under the Sec Reg, the due diligence requirements can be a major barrier to investment in securitisations, rather than improving investment by adding transparency. AIFMs subject to the Sec Reg are restricted to investing only in Sec Reg-compliant securitisations, which eliminates large portions of the global securitisation market and makes it harder for AIFMs to diversify their portfolios and portfolio risk. In turn, this lack of diversification disadvantages their investors/end clients.

In this regard, we are in the process of preparing a letter to the FCA following the FCA's Securitisation Roundtable for investors that took place on March 8, 2023. We respectfully request the FCA to refer to our forthcoming letter and discuss its contents with HM Treasury, which in December 2021 also identified the Sec Reg as an area for reform.[6]

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[6] Review of the Securitisation Regulation: Report and call for evidence response, HM Treasury (December 2021).