

09 August 2022

Dear Chief Executive

### **Our Alternatives Supervisory Strategy**

The FCA takes a strategic view towards sectors or 'portfolios' of firms with similar business models and regulatory permissions. We review these strategies on a rolling basis and seek to be transparent with the industry about what we intend to focus on. We supervise your firm in the 'Alternatives' portfolio<sup>1</sup>, alongside firms that are predominantly active in the alternative investment sector. This letter outlines our updated supervisory strategy and priorities for portfolio firms as well as stating areas where we believe improvements can be made. In writing to a large and diverse group of firms we accept that not all issues raised will be relevant to your firm. You should therefore discuss the letter with your Board or Executive Committee and consider which areas the firm and its assurance functions should focus on.

The asset management sector plays a critical role in the UK economy and in overseeing the savings and investments of millions of individuals and institutions across the UK and beyond. Alternative asset managers are an important and vibrant subset within this. The sector is evolving as markets and investor needs change, but its purpose - to protect and grow the capital of its customers and to effectively oversee their investments over the long term - remains the same. To effectively deliver on this objective, firms must act in the best interests of their customers.

Reflecting the diversity of the sector, the Alternatives portfolio encompasses a broad range of business models, with global hedge funds and private equity firms alongside many smaller providers. As a rule, alternative firms mostly deal with professional investors and counterparties capable of managing their own interests and our supervisory approach is reflective of this. However, this description is not accurate across the whole portfolio, with many firms dealing with retail or elective professional investors. These firms have a very different risk profile from a regulatory perspective, including the risk that investors are misclassified and subsequently denied appropriate protections. Part of our supervisory focus is to check these firms' business models and their approach to consumer protection.

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<sup>1</sup> Our alternatives portfolio is comprised of FCA authorised firms that predominately manage alternative investment vehicles (i.e., hedge funds or private equity funds) or manage and advise alternatives assets directly. Our asset management portfolio is comprised of FCA authorised firms that predominantly manage mainstream investment vehicles, or advise on investments, excluding wealth managers and financial advisers. We recognise that many of the issues within the sector will be common to both types of firm and that business models will often overlap. If you believe your firm's business model doesn't match our description of the alternatives portfolio, please let us know.

Since we last wrote to you in January 2020<sup>2</sup> there have been several significant events that have impacted the asset management industry, with firms having to navigate the COVID pandemic, Brexit and cessation of LIBOR. In general, the industry has shown resilience in the face of these challenges and market integrity broadly maintained. However, these challenges have also affected the work we chose to do against priorities outlined in January 2020, with both our and industry resources redirected to an appropriate COVID response. Subsequently, several of the risks outlined in January 2020 continue to be relevant and firms will see some commonality in terms of the priorities described in this letter as compared to prior correspondence.

Below we outline our view of the main risks of harm that alternative investment firms, and the markets in which they operate, pose to their customers - which in turn shape our supervisory priorities.

Your firm's Board or Executive Committee should consider which of the risks are applicable to your business and whether you have the appropriate strategies in place to address them. We expect you to take the actions that are considered necessary to mitigate risks and ensure that your firm meets our requirements.

Our portfolio priorities are consistent with the FCA's 2022 business plan commitments, with integrity of the markets and market abuse, ESG (Environmental, Social and Governance), and consumer needs all priority areas. Where they apply, firms should ensure their actions and culture support and promote these initiatives.

Our business plan also focuses on promoting competition and positive change, with a priority to strengthen the UK's position in global wholesale markets and attract new capital. Alternative firms have a vital role to play in achieving this. For the UK's status to be retained its markets must remain clean, liquid, and orderly and there must also be a collective understanding that all participants act with integrity. Those who do not will be held to account.

## **Our supervisory priorities**

### FCA Commitment - Putting consumers' needs first

#### *Investment strategies that carry inappropriate levels of risk for their target client*

When we wrote to firms in January 2020, we stated our concern that investors could be exposed to inappropriate products or levels of investment risk. While our ban on the mass marketing of speculative investments to retail clients has led to a reduction in harm, inappropriate distribution and marketing practices by firms targeting mainstream investors remains a concern. We have seen examples of informal governance processes compounded by poor due diligence and inadequate investor categorisation leading to investors with a lower risk appetite accessing high risk products that may not match their objectives. Firms should consider the appropriateness or suitability of the investments they offer for their target customers, be they retail or elective professionals.

Firms can reduce the risk to consumers with limited investment knowledge or risk appetite being exposed to inappropriate investment strategies by conducting thorough investor assessments. In order to achieve this firms should:

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<sup>2</sup> <https://www.fca.org.uk/publication/correspondence/portfolio-letter-alternatives.pdf>

- ensure that alternative investments are only offered to appropriate investor types, and that the investments meet client needs. Firms should recognise that not all alternative products are suitable for all investors.
- consider the application of relevant marketing restrictions to retail investors when communicating or approving financial promotions for alternative products.
- recognise that an adequate assessment of the suitability of alternative investments for retail investors is an essential mitigant in the reduction of potential harm.
- make sure that target markets are clearly outlined for distribution channels to ensure a clear understanding of in scope investors is in place.

Following receipt of this letter, firms that onboard retail or elective professional customers should review their processes to ensure they are effective, including the procedures for checking that elective professional investors meet the quantitative and qualitative tests required under COBS 3.5. Where firms market non-mainstream pooled investments, procedures must comply with COBS 4.12.

Our PS22/10 policy statement strengthens the financial promotions rules for high-risk investments, improves marketing restrictions and places higher standards on firms involved. In preparation for the rules coming into force - we expect firms to familiarise themselves with the new rules and amend their business practices in line with these new obligations. The main risk warning rules come into force on 1st December 2022, with the remainder landing on 1st February 2023.

We will publish final rules for the promotion of crypto assets once the Treasury formalises legislation to bring these into our remit. We expect firms to monitor regulatory developments in this area and promptly review their business practices as new rules are introduced.

Firms should also consider their new obligations under the Consumer Duty<sup>3</sup> which sets high standards of consumer protection across financial services by requiring firms to put their customers' needs first. The rules and guidance being introduced for new and existing products or services open to sale or renewal come into force on 31 July 2023, and later on 31 July 2024 for closed products or services.

In the coming months, we will be issuing a questionnaire asking all portfolio firms for information about their business model, products, investor categorisations and associated control framework. We will follow up with those firms exhibiting characteristics that increase the potential of consumer harm. As part of this supervisory work, you will need to evidence the reasonable steps taken to ensure your firm's target market is both appropriately defined and not exposed to an unsuitable level of risk.

#### *Conflicts of interest*

Firms are required to manage conflicts of interest fairly – this requirement is a core principle set out in our handbook (Principle 8), as well as the rules in SYSC 10 and relevant on-shored regulations. Poor management of conflicted positions can encourage market manipulation or improper fund performance reporting, in turn producing poor consumer outcomes and loss of market integrity.

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<sup>3</sup> <https://www.fca.org.uk/publications/policy-statements/ps22-9-new-consumer-duty>

We have also seen situations where firms have bypassed their own processes to make sales or increase Assets under Management, these being examples of conflicts that lead to investor detriment. Furthermore, internal firm conflicts can cause indirect harm to investors. Situations where dominant shareholders make material decisions independent of the firms' governance structure can also lead to conflicts and increase the risk of poor outcomes for investors.

Conflicts of interests, and decisions affected by them, are not always transparent and we cannot rely on normal market forces to manage them. Where we identify harm to investors, we will assess to what extent inadequate management of conflicts played a role and will consider the need for Enforcement action as appropriate. We would draw firms' attention to recent fines levied because of inadequate management of conflicts<sup>4</sup>. Firm Boards should carefully review their procedures to ensure conflicts are avoided, managed, or disclosed in a way that minimises harm to investors and markets.

Firms should also consider the impact of their shareholder structure and the potential implications this has on the effective governance of their organisation.

## FCA Commitment - Strengthening the UK's position in global wholesale markets

### *Market integrity and disruption*

Part of an investment manager's role is to harness and manage risk with investor capital to generate returns. For some alternative funds, investment risks can be significant. Our rules (including SYSC 4.1.2 where applicable) set out that firms' arrangements must be proportionate to the nature, scale and complexity of the risks inherent in the business model. Where funds employ high leverage or expose investors to elevated levels of risk, we expect firms to ensure their risk management systems, controls and resources are fit for purpose. This can be particularly relevant for larger hedge funds.

Our analysis shows that firms with concentrated or leveraged investment strategies can negatively impact liquidity during adverse market conditions leading to wider market instability and contagion risks. We have seen firms overestimate liquidity in the context of stressed or fast-moving markets and have also witnessed situations where leveraged structures have come under strain. Robust risk and liquidity management is essential at any time, but especially so given increased market volatility and rising interest rates which is leading to several new coexistent risks for alternative asset managers. Firm Boards should therefore ensure that risk functions are appropriately resourced, contemporaneous, and commensurate with the levels of portfolio and business risk being taken.

During the last two years we have conducted assessments of alternatives firms' risk controls and will continue to do so where market footprints imply a higher inherent risk of contagion or harm.

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<sup>4</sup> <https://www.fca.org.uk/publication/decision-notice/bluecrest-capital-management-uk-llp.pdf>  
<https://www.fca.org.uk/news/press-releases/fca-fines-gam-international-management-former-investment-director-timothy-haywood>

## *Market abuse*

Market abuse undermines confidence in, and the integrity of financial markets. Established, robust systems and controls are crucial in mitigating this risk, with firms providing a vital first line of defence.

We have previously observed that market abuse controls across the sector need to be improved. We expect firms to have strong prevention cultures and effective systems and controls to enable them to discharge their obligations under the UK Market Abuse Regulation (UK MAR). Firms must ensure UK MAR controls are tailored to their individual business models. Where firms do not comply, we will consider the need for criminal, civil or supervisory sanctions to provide effective deterrents.

## *Culture*

We take the view that a firm's corporate culture has a direct influence on its business practices, with a healthy culture seen as critical for consumer protection and our ambition for well-functioning and world leading markets. Understanding the culture of the firms we regulate is therefore central to the FCA's supervisory approach.

A firm's approach to remunerating and incentivising staff contributes to organisational culture. Remuneration policies can help ensure appropriate outcomes for customers and markets and reduce the likelihood of harm. Where employees are inappropriately incentivised, this can increase conflicts of interest and the potential for harm. Firms that are subject to the MIFIDPRU Remuneration Code are required to apply the relevant rules from the performance period on or after 1 January 2022.

During the forthcoming supervisory cycle, we will look at how senior managers and firm policies influence an organisation's culture. Evidence of staff being unable to speak up is an area of particular concern. Furthermore, we are interested to understand how healthy cultures are embedded in firms where founders or other senior individuals occupy a dominant role.

A further aspect of a healthy culture is diversity and inclusion. Firms should consider the steps they can take to provide an environment where diverse talent can flourish, and diversity of thought is encouraged. In July 2021, we published Discussion Paper 21/2, which outlines the issues and the benefits that diversity and inclusion would bring to the sector alongside potential policy interventions. We plan to produce a Consultation Paper later this year and expect firms' boards to fully consider this aspect of their organisation.

## FCA Commitment – ESG, a strategy for positive change

Environmental, Social and Governance ("ESG") based investment has the potential to meaningfully contribute to addressing sustainable investment goals. There has been growth in Authorised Funds that have a stated intent of investing utilising these themes, as identified in the communication to Authorised Fund Managers in July 2021<sup>5</sup>.

We have also seen growth of ESG investments in the Alternatives sector, with increases in the number of AIF (Alternative Investment Fund) registrations that have a stated focus on these

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<sup>5</sup> <https://www.fca.org.uk/publication/correspondence/dear-chair-letter-authorised-esg-sustainable-investment-funds.pdf>

themes. We recognise the importance of this dynamic and note the rapid pace of change as well as the challenges this presents to both industry participants and investors.

It is important that investors have confidence in the products they are being offered, and this has specific relevance for products labelled as being ESG focussed and with investment strategies benchmarked against ESG themes. Firms should ensure that documentation of such products are clear, not misleading and that firms' actions match the stated claims.

The FCA continues to assess authorised fund applications with an ESG or sustainability focus and firms should note that ESG remains a priority area in the Asset Management department. Firms offering such products should expect to be subject to review to ensure marketing materials accurately describe their product, with funds offering clear and consistent disclosure.

In December 2021, we made rules requiring asset managers, including authorised alternative investment fund managers, to make disclosures in line with those recommended by the Taskforce on Climate-related Financial Disclosures (TCFD). This applies initially to the largest AIFMs (Alternative Investment Fund Managers) but will apply to AIFMs with assets under management of over £5bn from 2023. The disclosures include both qualitative and quantitative elements at both entity and product level. We expect in-scope firms to be considering what steps they will need to take to be able to make these disclosures from 2023 as required.

### **Next Steps**

If you have any queries about this letter, please contact our dedicated Supervision Hub on 0300 500 0597. This is the primary contact for your firm's day-to-day interactions with the FCA. Further details of how we can be reached are available on our website at <https://www.fca.org.uk/contact>.

We recognise there may be occasions when your firm faces urgent issues of strategic importance and in such circumstances, please contact Howard Cornwell, Alternatives portfolio lead, at [howard.cornwell@fca.org.uk](mailto:howard.cornwell@fca.org.uk), or the Head of the Asset Management Department, Nike Trost at [Nike.Trost@fca.org.uk](mailto:Nike.Trost@fca.org.uk).

Yours faithfully

### **Nike Trost**

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