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May 2025 update:
This letter is historical. See our supervisory correspondence page for more information and current views.

20 January 2020

Dear Chief Executive

Our Alternatives Supervision Strategy

This letter outlines our view of the key risks of harm that alternative investment firms[1] pose to their customers or the markets in which they operate. You should consider whether your firm presents these risks and your strategies for mitigating them.

Our view of the key causes of harm

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. The sector is growing and changing in significant ways, but its purpose remains unchanged: to protect and grow the capital of its customers and to oversee their investments effectively over the long term. To deliver this, you must act in the best interests of your customers.

We believe that progress is needed for the sector to deliver this purpose effectively. Overall standards of governance, particularly at the level of the regulated entity, generally fall below our expectations. Far too often, the appropriateness of investment products for investors is not adequately considered. In particular, this presents a significant risk of harm where high risk alternative investments are made available to less-sophisticated investors. CASS oversight and controls are not always robust, creating a risk of loss to client money and custody assets. Weak systems and controls can lead to the risks of market abuse, other types of financial crime and harm or disruption to market integrity not being effectively mitigated.

Our supervision strategy addresses these key issues, which inform our priorities set out below. Your firm may be asked to take part in one or more pieces of work related to these priorities. We expect you to consider them priorities and take appropriate action.

[1] Our alternatives portfolio is comprised of FCA authorised firms that predominately manage alternative investment vehicles (for example, hedge funds or private equity funds) or alternatives assets directly, or advise on these types of investments or investment vehicles. Our asset management portfolio is comprised of FCA authorised firms that predominantly directly manage mainstream investment vehicles, or advise on mainstream investments, excluding wealth managers and financial advisers. We recognise that many of the issues within the sector will be common to both types of firms and that business models will often overlap.

Supervisory priorities

Investor exposure to inappropriate products or levels of investment risk

By their nature, alternative investments can carry significant levels of investment risk. It is important that, where relevant, firms offering products and managing investments with exposure to alternative assets and strategies consider the appropriateness or suitability of those investments for their target investors. This should reduce the risk of consumers having inappropriate exposure to certain investments or levels of risk. Such considerations will include:

- identifying the client type and investment need, when manufacturing or distributing products, recognising that alternative products may only be appropriate for a niche market;
- complying with relevant restrictions on marketing to retail investors when communicating or approving financial promotions for alternative products; and
- adequately assessing the appropriateness or suitability of alternative investments for retail investors. Appropriateness would apply to non-advised access while suitability would apply to advised or discretionary services.

Where firms allow investors to 'opt up' to elective professional status, we expect them to robustly assess a client's knowledge and experience of the relevant market, alongside meeting the relevant quantitative tests, and refrain from re-categorising a retail client if they do not meet the threshold.

We will review retail investor exposure to alternative investment products offered by alternatives firms. This will cover a broad spectrum of alternative investment products and strategies. In particular, we 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. We want to know if they have taken reasonable steps to ensure that investors adequately understand the risks they are exposed to through their investments and are not inappropriately exposed to products that carry risk beyond their risk profiles.

Client money and custody asset controls

You must follow rules set out in the Client Assets Sourcebook (CASS) whenever you hold or control client money or safeguard custody assets. This is crucial in helping to ensure that client money and custody assets remain safe and can be returned to customers if firms fail and exit the market.

As part of our review of retail investor exposure to alternative investment products, we will also test whether firms that have permission to hold client money and safeguard custody assets are exercising those permissions under robust control frameworks to:

- support the oversight of CASS operations;
- maintain adequate books and records; and

- operate in a CASS-compliant manner.

Market abuse

Market abuse damages market integrity and undermines confidence in financial markets. Robust systems and controls are critical to mitigating the risk of market abuse. Alternatives firms are key buy side participants in financial markets. We expect firms in the sector to ensure their market abuse controls enable them to discharge obligations under the Market Abuse Regulation (MAR). Firms must also make sure they are sufficiently comprehensive and tailored to their individual business models to effectively mitigate the risks of facilitating market abuse or it occurring within their firm. We generally observe that market abuse controls across the sector have significant scope for improvement.

We recently assessed the adequacy of market abuse controls in the sector. We visited a number of firms and provided individual feedback. We also sent a questionnaire to a large sample of firms across the buy side. We may conduct similar exercises in the future and may include your firm.

While we expect firms to strive for best practice, we require firms to fully comply with their obligations under MAR. Where firms do not comply with MAR we will consider the need for enforcement action.

Market integrity and disruption

Alternatives firms often have scope to take significant investment risk in managing their products. This can include market risk, credit risk and liquidity risk, as well as more idiosyncratic risks in certain strategies, such as legal risk. Use of leverage and illiquid investments presents risk to their 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.

Where firms adopt very high-risk investment strategies, particularly where significant leverage is employed, we expect commensurately high quality risk management controls. We may choose to undertake in-depth assessments of firms' controls and may involve your firm.

Anti-money laundering and anti-bribery and corruption

As part of our responsibility to ensure the integrity of the UK financial markets we require all authorised firms to have systems and controls in place to mitigate the risk they might be used to commit financial crime. Alternatives firms should be alert to the risk they could be used to facilitate financial crime and operate appropriate and proportionate systems and controls to mitigate this risk. Due diligence on third parties and Know Your Client (KYC) checks are particularly important. Like many firms in the financial services industry, alternatives firms should be aware of the risk they could be used to facilitate fraud, money laundering, terrorist financing, and bribery and corruption.

We intend to review firms' systems and controls to mitigate this risk. We will pay particular attention to the risks of money laundering and terrorist financing.

EU withdrawal

The UK government has committed to the UK leaving the EU with a Withdrawal Agreement on 31 January 2020. When that happens, the UK will enter an implementation period during which it will negotiate its future relationship with the EU. The implementation period is due to operate until 31 December 2020. During this time EU law would continue to apply in the UK and passporting would continue. We expect you 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. For information on Brexit, including what the implementation period will mean, visit our **website**. We will update our pages after exit.

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.

We recognise there may be occasions when your firm faces urgent issues of strategic importance. In such circumstances, please contact the Head of the Asset Management Department, Nick Miller, on 0207 066 0602 or at nick.miller@fca.org.uk. If Nick is not available please contact Paul Faircliff on 0207 066 5096 or at paul.faircliff@fca.org.uk.

Yours faithfully

Marc Teasdale
Director of Wholesale Supervision
Supervision - Investment, Wholesale & Specialists Division