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FINANCIAL SECTOR ASSESSMENT PROGRAM

June 2016

FUND MANAGEMENT AND EQUITY TRADING PLATFORMS: REGULATION, SUPERVISION, AND SYSTEMIC RISK MONITORING—TECHNICAL NOTE

This Technical Note on Fund Management and Equity Trading Platforms: Regulation, Supervision, and Systemic Risk Monitoring on the United Kingdom was prepared by a staff team of the International Monetary Fund. It is based on the information available at the time it was completed in March 2016.

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FUND MANAGEMENT AND EQUITY TRADING PLATFORMS:
REGULATION, SUPERVISION AND SYSTEMIC RISK
MONITORING

Prepared By
**Monetary and Capital Markets
Department**

This Technical Note was prepared in the context of an IMF Financial Sector Assessment Program (FSAP) in the United Kingdom in November 2015 and February 2016 led by Dimitri Demekas. It contains technical analysis and detailed information underpinning the FSAP findings and recommendations. Further information on the FSAP program can be found at <http://www.imf.org/external/np/fsap/fssa.aspx>

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Glossary

ACS	Authorized Contractual Scheme
AIF	Alternative Investment Fund
AIFM	Alternative Investment Fund Manager
AIFMD	Alternative Investment Fund Managers Directive
APA	Approved Publication Arrangement
AUM	Assets under Management
AUT	Authorized Unit Trust
BCN	Broker Crossing Network
BMSA	Business Model and Strategy Analysis
BoE	Bank of England
CIS	Collective Investment Scheme
CMA	Competition and Markets Authority
CRD	Capital Requirements Directive
CRM	Consolidated Risk Map
EEA	European Economic Area
ELTIF	European Long-Term Investment Fund
EMO	Enforcement and Market Oversight Division
ESMA	European Securities and Markets Authority
EU	European Union
EuSEF	European Social Entrepreneurship Fund
EuVECA	European Venture Capital Fund
FCA	Financial Conduct Authority
FPC	Financial Policy Committee
FSMA	Financial Services and Markets Act 2000
FSR	Financial Stability Report
FTE	Full Time Equivalent
HFT	High Frequency Trading
HMT	HM Treasury
ICAAP	Internal Capital Adequacy Assessment Process
ICVC	Investment Company with Variable Capital
IOSCO	International Organization of Securities Commissions
MiFID	Markets in Financial Instruments Directive
MiFIR	Markets in Financial Instruments Regulation
MMF	Money Market Fund
MTF	Multilateral Trading Facility
NAV	Net Asset Value
NPPR	National Private Placement Regime
NURS	Non-UCITS Retail Scheme
OEIC	Open-Ended Investment Company
OTC	Over-the-Counter

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PG-BMSA	Peer Group Business Model and Strategy Analysis
PRA	Prudential Regulation Authority
QIS	Qualified Investor Scheme
REIT	Real Estate Investment Trust
RIE	Recognized Investment Exchange
RM	Regulated Market
ROIE	Recognized Overseas Investment Exchange
RRR	Recognition Requirements for Recognized Investment Exchanges
SFT	Securities Financing Transaction
SI	Systematic Internalizer
SORP	Statement of Recommended Practice
SREP	Supervisory Review and Evaluation Process
TDM	Trade Data Monitor
UCIS	Unregulated Collective Investment Scheme
UCITS	Undertaking for Collective Investment in Transferable Securities
VaR	Value-at-Risk

EXECUTIVE SUMMARY

The size and interconnectedness of the U.K. investment management sector and equity markets pose a significant challenge to the U.K. authorities. More than half of the investment funds managed by U.K. fund managers are domiciled abroad. The proportion is even larger in the case of alternative investment funds (AIFs). U.K. equity trading platforms dominate European equity trading, covering almost half of the total value of on-platform trading. This interconnectedness creates a potential for inward and outward spillovers, and dealing with them requires effective domestic supervision and systemic risk monitoring, supported by international cooperation.

The Financial Conduct Authority (FCA) uses a sophisticated risk-based approach to dealing with its supervisory challenges arising from the large number of supervised entities. It has focused on developing its recently-launched new approach to supervision. In the investment management sector, robust sector analysis supports the prioritizations the FCA makes. Explicitly articulated risk appetites guide the day-to-day choices of staff supervising firms and funds. The FCA has developed various tools to assist it in identifying trends and outliers in the markets. With the current level of resources, the new approach appears to strike the right balance between firm-specific and market-based supervision. Potential risks lie in the extent this approach is used in authorizing new entrants and reacting to events in the large population of firms that are not subject to an ongoing cycle of proactive firm-specific supervision. To mitigate these risks, the FCA should ensure that its approach to authorizing fund managers and investment managers continues to take into account their specific risks, and that its centralized event supervision function is sufficiently staffed or supported by investment management experts.

The regulatory and supervisory approach for fund management is sound, but would benefit from some enhancements to prevent the build-up of risks. U.K. funds are subject to detailed valuation requirements, and depositaries are responsible for monitoring compliance and reporting pricing errors to the FCA. However, at the same time, the FCA needs to ensure that its own supervision of investment funds' compliance with valuation requirements is sufficient. The Financial Policy Committee (FPC) and the FCA are conducting timely work on liquidity risk management of corporate bond funds. The U.K. framework also provides the fund managers with the ability to use a suite of tools to manage the risk arising from large redemptions. These measures should be complemented with enhanced liquidity risk management requirements for managers of Undertaking for Collective Investment in Transferable Securities (UCITS) funds.

The availability of data on investment funds—in particular AIF—is a challenge. The authorities should extend, if legally possible, the scope of transparency reporting under the Alternative Investment Fund Managers Directive (AIFMD), and strive for enhanced international exchange of information to improve data availability. This is important to monitor the potential systemic risk of foreign-domiciled AIFs and their managers with significant investments managed in the United Kingdom or with exposures to U.K. counterparties. The authorities' ability to assess risks of AIFs and other investment funds would also be enhanced by adopting a globally harmonized calculation

method for fund leverage. The U.K. authorities should continue to actively contribute to international work in this area.

Changes to European Union (EU) legislation are expected to align the regulatory treatment of various trading platforms, which would be welcome. The current regulatory framework applicable to regulated markets (RMs) and multilateral trading facilities (MTFs) is comprehensive, and they are subject to robust supervision. However, broker crossing networks (BCNs) currently operating in the U.K. are not regulated and supervised in an equal manner, despite conducting similar business. The regulatory requirements for various trading platforms are due to be aligned through the revised Markets in Financial Instruments Directive (MiFID II), which is currently planned to enter into application one year later than originally planned. Pending the application of the new requirements, the FCA should ensure that BCNs' activities are sufficiently supervised and monitored, taking into account the nature of their business as trading system operators.

The U.K. authorities are engaged in important work on identifying and monitoring potential systemic risk in fund management and equity trading platforms. The December 2015 Financial Stability Report (FSR) presented the FPC's review of the potential risks to U.K. financial stability arising from the activities of investment funds. The FPC is also undertaking a detailed assessment of the investment activities of hedge funds. The FCA's contribution to this process includes input by its sector experts and supervisors, whose expertise ranks highly in international comparison. The FCAs' role in systemic risk monitoring is backed by one of its three operational objectives, according to which it is expected to protect and enhance the integrity of the U.K. financial system.

Table 1. United Kingdom: Main Recommendations on Regulation and Supervision of Fund Management and Equity Trading Platforms	
Recommendation	Priority
Fund management	
Ensure that the FCA's approach to authorizing fund managers and investment managers continues to take into account their specific risks	Medium
Ensure that the FCA's centralized event supervision function is sufficiently staffed or supported by investment management experts in order to be able to effectively deal with relevant Pillar 2 events	Medium
Ensure that the FCA's own supervision of investment funds' compliance with valuation requirements is sufficient	Medium
Enhance liquidity risk management requirements for UCITS fund managers	Low
Extend, if legally possible, the scope of the AIFMD transparency reporting to cover non-European Economic Area (EEA) managers and funds, where relevant for systemic risk monitoring, and strive for enhanced international exchange of information	High
Develop a practical approach to measuring investment fund leverage and continue to contribute to international work to harmonize the leverage calculation method	Medium
Equity trading platforms	
Ensure that BCNs' activities are sufficiently supervised and monitored	High

INTRODUCTION¹

1. **The United Kingdom (U.K.) has the largest fund management market in Europe and a key role as the host for some of the most important European equity trading platforms.**

The total authorized investment fund assets under management (AUM) by U.K. fund managers reached GBP 1,730 billion² at the end of 2014, representing 95 percent of the U.K. GDP. Fifty-two percent of these assets belonged to foreign domiciled funds, reflecting the U.K.'s nature as a fund management hub.³ In 2014, 11 U.K. based exchanges and MTFs held a 45 percent market share in all on-platform equity trading in Europe. At the same time, the eight U.K. based "dark" (non-pre-transparent) trading platforms dominated European dark trading with an 85 percent market share.⁴ In addition, many U.K. based brokers (banks and investment firms) operate their own electronic crossing networks whose trades are reported as over-the-counter (OTC).

2. **This note reviews the effectiveness of the regulation, supervision, and systemic risk monitoring of investment funds and their managers.**

A significant proportion of the regulatory framework in this area, in particular that related to conduct of business and disclosure requirements, has been harmonized at the European Union (EU) level and is largely in line with the relevant international standards.⁵ As a result, this note focuses on the areas where the EU requirements leave room for discretion by member states and where IOSCO has issued more detailed standards.⁶ Particular emphasis has been placed on requirements with most direct relevance for financial stability, namely valuation, segregation, and safekeeping of fund assets, and redemption of fund units. In addition, the mission reviewed how the FCA has in practice applied the EU and domestic regulatory framework in authorizing and supervising firms and funds, and how the authorities have analyzed the potential systemic risk arising from fund management.

3. **Similar analysis was conducted on the regulation, supervision, and systemic risk monitoring of equity trading platforms.** IOSCO's work in this area has focused on certain high level

¹ The main author of this note is Ms. Eija Holttinen, Senior Financial Sector Expert from the Monetary and Capital Markets Department of the IMF. The on-site work supporting the findings and conclusions was conducted during November 2015 and February 2016. The information in this note is current as of February 2016.

² This includes only UCITS funds and authorized AIFs. Data on unauthorized funds is not covered.

³ Source: Asset Management in the U.K. 2014–2015, The Investment Association Annual Survey.

⁴ Source: Fidessa Fragulator and IMF staff calculations. This does not include two MTFs that are not covered in the Fragulator data.

⁵ The EU regulatory framework has been assessed against Principles 24–28 of the International Organization of Securities Commissions (IOSCO) Objectives and Principles of Securities Regulation (IOSCO Principles).

⁶ Relevant IOSCO work includes Principles of Suspensions of Redemptions in Collective Investment Schemes (CIS), January 2012; Policy Recommendations for Money Market Funds (MMFs), October 2012; Principles of Liquidity Risk Management for CIS, March 2013; Principles for the Valuation of CIS Assets, May 2013; and Standards for the Custody of CIS Assets, November 2015.

principles that are expected to be applied appropriately in different market structures.⁷ Increased fragmentation of equity trading across multiple (partially dark) trading venues, challenges in access to real-time consolidated trade information and increased use of high-speed trading technology may pose challenges to market quality, fairness and transparency. As a result, this note focuses on reviewing the application of the current U.K. regulatory framework (largely based on EU legislation) as well as the authorities' approach to addressing the risks arising from market fragmentation and technological changes.

4. The FCA has the primary responsibility for the regulation and supervision of fund management and equity trading platforms, and is guided in this work by a single statutory objective and three operational objectives. Its statutory objective is to ensure that the relevant markets function well. Its operational objectives are to: secure an appropriate degree of protection for consumers; protect and enhance the integrity of the U.K. financial system; and promote effective competition in the interest of consumers.⁸ The second operational objective covers the financial system's soundness, stability and resilience, and the orderly operation of financial markets. Accordingly, the FCA is required to have regard to systemic issues which could have an adverse impact on the stability of the U.K. financial system.

FUND MANAGEMENT

A. Market Structure

5. Investment funds encompass a wide variety of different types of funds. In the EU, a regulatory distinction is made between funds regulated under the Directive on Undertakings for Collective Investment in Transferable Securities (UCITS) and non-UCITS funds, referred to as AIFs, whose managers are regulated under the AIFMD.⁹ The latter category covers a range of different funds, including hedge funds, private equity funds and real estate funds, but also retail funds that are very similar to UCITS funds but can only be marketed in the home member state of the fund.

6. While the U.K. fund managers manage a significant number of foreign domiciled UCITS funds, there is very limited cross-border management of U.K. funds by other EEA fund

⁷ Relevant IOSCO work includes Principles 33–35 of the IOSCO Principles and the following Standards: Principles for Dark Liquidity, May 2011; Regulatory Issues Raised by the Impact of Technological Changes on Market Integrity and Efficiency, October 2011; and Regulatory Issues Raised by Changes in Market Structure, December 2013.

⁸ From April 1, 2015, the FCA has concurrent competition powers with the Competition and Markets Authority (CMA). This means that it is able to investigate breaches of the Competition Act, conduct market studies under the Enterprise Act 2002, and make market investigation references to the CMA. Of direct relevance to the scope of this technical note is the market study on competition in asset management that the FCA is undertaking during the fiscal year 2015/16.

⁹ Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) and Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers (AIFMs) and related implementing measures.

managers. As of July 2015, out of 945 U.K. UCITS funds, only five were managed by non-U.K. managers. The rest were managed by the 115 U.K. UCITS fund management companies.¹⁰ The AUM of U.K. domiciled UCITS funds as at end-September 2015 reached GBP 759 billion, with the AUM of equity funds accounting for GBP 464 billion and that of fixed income funds GBP 130 billion. Money market funds (MMFs)' AUM were only GBP 6 billion.¹¹

7. With regards to alternative investment management, the available data suggest a picture of a very sizeable and global sector. There are more than 1,800 U.K. domiciled AIFs. Most of them are managed by U.K. AIFMs, whose total number exceeds 500. In addition to U.K. AIFs, the U.K. AIFMs manage more than 2,200 non-U.K. AIFs, more than 60 percent of which are non-EEA AIFs. According to Q2/2015 quarterly reporting, the total net asset value (NAV) of the assets managed by U.K. AIFMs was GBP 636 billion.¹² Among those, the NAV of hedge funds amounted to GBP 150 billion, while that of the funds of funds was GBP 122 billion, private equity funds GBP 14 billion and real estate funds GBP 53 billion. At the same time, 484 foreign AIFMs reported that they were marketing 611 AIFs with a total NAV of GBP 347 billion in the U.K.

8. AIFs are primarily intended for professional investors, and some AIFs are subject to financial promotion constraints in the United Kingdom. They prohibit the promotion of Qualified Investor Schemes (QIS) and unauthorized AIFs to ordinary retail investors in the U.K., but do not impose any restrictions on promotion to sophisticated investors and high net worth individuals.¹³

B. Regulation

9. The United Kingdom has a comprehensive legislative and regulatory framework for fund management largely based on the relevant EU framework. The Financial Services and Markets Act 2000 (FSMA), the Open-Ended Investment Company Regulations 2001 (OEIC Regulations), the Alternative Investment Fund Managers Regulations 2013 (AIFMD Regulations), and various FCA Handbook rules are the main legal instruments that transpose the relevant EU legislation and include additional U.K. specific requirements for fund managers and funds. The key EU Directives for fund management are the UCITS Directive and AIFMD. The latter had to be transposed into the member states' national law by July 22, 2013, while the transitional period for existing AIFMs to seek authorization or registration ended a year later. Member states had to transpose the recast version of the UCITS Directive (UCITS V Directive) by March 18, 2016; the previous version, referred to as the UCITS IV Directive, had been in place since 2011.

¹⁰ Source: FCA.

¹¹ Source: Investment Association. In addition, the AUM of mixed assets funds were GBP 66 billion, property funds GBP 3 billion, and other funds GBP 89 billion.

¹² The Q2/2015 reports covered a total of 2,431 funds, 1,207 of which were U.K. domiciled funds and 1,224 non-U.K. domiciled funds. Of the total number of funds, 527 were hedge funds, 606 funds of funds, 53 private equity funds, and 144 real estate funds.

¹³ Non-UCITS Retail Schemes (NURS) can however be promoted to ordinary retail investors, subject to specific FCA requirements. In addition, listed closed-ended funds (investment trusts) can be acquired by retail investors.

Box 1. Investment Fund Types

As an EU member state, the United Kingdom has to comply with the EU UCITS Directive and AIFMD.

This means that all U.K. investment funds fall into one of two categories: UCITS funds or AIFs. The UCITS Directive requires an UCITS fund to be authorized, whereas the AIFMD applies to the manager (rather than the fund). However, the U.K. regulatory framework requires some AIFs to be authorized. Authorized funds can take only one of three possible legal forms, whereas other funds are not subject to particular restrictions in that regard. Investment funds can be managed on a cross-border basis. The manager of a U.K. UCITS fund, NURS and QIS can be located in any state within the EEA, whereas unauthorized AIFs can be managed also from outside the EEA.

Type of fund		Legal form	Manager
Authorized fund			
UCITS fund		Open-Ended Investment Company (OEIC)/Investment Company with Variable Capital (ICVC)	U.K. or EEA UCITS management company ³
AIF	Non-UCITS Retail Scheme (NURS) ¹	Authorized Unit Trust (AUT)	A full-scope or small ⁴ authorized U.K. or EEA AIFM
	Qualified Investor Scheme (QIS)	Authorized Contractual Scheme (ACS) ²	
	European Long-Term Investment Fund (ELTIF)	No restrictions on the legal form, but must be closed-ended or semi-closed-ended	Authorized U.K. or EEA AIFM
Registered fund			
AIF	European Venture Capital Fund (EuVECA)	No restrictions on the legal form, can be open-ended or closed-ended, may or may not be listed	Small registered or authorized U.K. or EEA AIFM
	European Social Entrepreneurship Fund (EuSEF)		
Unauthorized fund			
AIF	Listed Investment Trust	Closed-ended corporate structure	A full-scope or small registered or authorized U.K. or EEA AIFM ³
	Listed Venture Capital Trust		
	Listed Real Estate Investment Trust		
	Other type of non-UCITS collective investment scheme (CIS)	No restrictions on the legal form, can be open-ended or closed-ended, may or may not be listed	A full-scope or small U.K., EEA or non-EEA AIFM

¹ A NURS is a CIS that does not comply with all the conditions to which a UCITS is subject, but that can be marketed to retail investors in the U.K. They are subject to similar conditions as UCITS funds, but can invest in a wider range of eligible investments (e.g., property) and have less restrictive borrowing rules.

² An ACS can be either an Authorized Co-ownership Scheme or an Authorized Limited Partnership.

³ Can also be a self-managed UCITS.

⁴ A small AIFM is an AIFM whose total AIF AUM does not exceed EUR 500 million in cases where the portfolios of AIFs consist of AIFs that are unleveraged and have no redemption rights exercisable during a period of 5 years following the date of initial investment in each AIF; or does not exceed EUR 100 million in other cases, including any assets acquired through the use of leverage. A full-scope AIFM is an AIFM whose total AUM exceeds these thresholds or that has opted in to the full scope of the AIFMD.

10. Both the UCITS Directive and AIFMD include a comprehensive set of regulatory requirements. The former covers both fund managers and funds, whereas the focus of the AIFMD is

on the managers (AIFMs). Another key distinction is that the AIFMD includes a detailed framework for non-EEA AIFMs and the management and marketing of non-EEA AIFs in the EEA. This framework is not yet fully applicable; instead, non-EEA AIFMs and AIFs are currently subject to National Private Placement Regimes (NPPRs) implemented by some member states, including the United Kingdom.

11. The discussion below focuses on the elements of the regulatory framework that are considered most relevant for financial stability. It describes the EU framework if the U.K. requirements are directly based on it. If the U.K. has additional requirements, those are highlighted separately. The discussion points out the areas where the regulatory framework is not compliant with the relevant IOSCO Principles or Standards, or where enhancements are otherwise recommended to be made. The manner in which the FCA addresses compliance with the regulatory framework when authorizing and supervising firms and funds and monitoring the sector risks is discussed in sections C and D.

Valuation of assets

UCITS funds and Non-UCITS Retail Schemes (NURS)

12. The UCITS Directive leaves the determination of valuation requirements for UCITS funds to the member state of the fund. It only requires that the rules for valuing the assets and calculating the price of UCITS units be laid down in the applicable national law, in the fund rules, or in the instruments of incorporation of the investment company.¹⁴ A management company managing a UCITS fund domiciled in another EEA state has to comply with that state's valuation, accounting and pricing rules. Fund managers are responsible for calculating the NAV of the fund and determining the related subscription and redemption prices. To this end, they must have procedures to ensure the proper and accurate valuation of the assets and liabilities of the fund in accordance with the fund rules and prospectus. Analogous requirements apply to the AIFMs of NURS under the FCA Handbook.

13. The required valuation frequency depends on the type, redemption frequency and volatility of a fund. The UCITS Directive specifies that a UCITS fund must have at least two valuation points in a month that are at least two weeks apart. In addition, FCA rules require that a UCITS fund is valued at least as frequently as subscriptions and redemptions can take place. The same requirements apply to NURS under the FCA Handbook; however, certain NURS with limited redemption arrangements can be valued only every six months. Higher volatility funds and QIS must generally be valued every business day.

14. The FCA Handbook provides additional guidance on valuation and pricing. Fair value pricing for a security is expected to be applied when no reliable price exists (e.g., because trading is suspended) or the most recent price available does not reflect the manager's best estimate of the value of the security. The fair value price must take into account the type of fund, the securities involved, the basis and reliability of the alternative price used, and the manager's policy on the valuation of the fund assets, as disclosed in the prospectus. The accounts of UCITS funds, NURS, and

¹⁴ Further references to fund rules in this note cover also the instruments of incorporation of an investment company.

QIS are also required to comply with the Statement of Recommended Practice (SORP) issued by the Investment Association. The SORP is approved by the Accounting Standards Board and complies with the U.K. Financial Reporting Standard 102 which is based on the International Accounting Standards Board's International Financial Reporting Standards for SMEs. As a result, the U.K. requirements appear to comply with Principles 26 and 27 of the IOSCO Principles that require that the CIS accounts are prepared and their NAV is calculated in accordance with high quality, internationally acceptable accounting standards.¹⁵

15. The FCA Handbook includes specific requirements for the valuation of MMFs. Qualifying MMFs¹⁶ must be valued every business day at amortized cost basis, while short term MMFs¹⁷ must generally be valued every business day either at amortized cost or mark to market basis. Regular money market funds must be valued on mark to market basis. Additional requirements apply to MMFs that are valued on an amortized cost basis.¹⁸ There is currently only one U.K. MMF (with AUM of GBP 2.2 billion) that aims at maintaining a constant NAV. The current lack of constant NAV MMFs would provide an opportune moment for the FCA to consider removing the ability to establish new constant NAV MMFs from its Handbook along the lines of Recommendation 10 of IOSCO Policy Recommendations for MMFs.¹⁹ However, the U.K. authorities have indicated that they prefer to wait for the outcome of the negotiations on the planned EU Money Market Funds Regulation (that may permit constant NAV MMFs subject to certain safeguards) before making any domestic policy amendments.²⁰ Pending the EU level negotiations, the FCA should however aim at ensuring that any new constant NAV MMFs comply with the safeguards of the IOSCO Policy Recommendations. In

¹⁵ In the context of this mission it has not been possible to conduct a detailed comparison of the accounting requirements.

¹⁶ A qualifying MMF is defined in Article 18 of the MiFID Implementing Directive. Its primary investment objective must be to maintain the net asset value of the undertaking either constant at par (net of earnings), or at the value of the investors' initial capital plus earnings. It is subject to restrictions in terms of the maturity of its individual investments and the weighted average maturity of fund property that are the same as for short-term MMFs.

¹⁷ A short-term MMF is subject to a 397 day residual maturity limit for investment in securities and a 60-day weighted average maturity and 120 day weighted average life requirement for the fund property.

¹⁸ The fund assets must be valued on a mark to market basis at least once every week and the fund manager must ensure that the mark to market value does not differ by more than 0.5 percent from the value determined on an amortized cost basis. The fund manager should advise the depositary when the mark to market value differs from its amortized cost value by 0.1, 0.2 and 0.3 percent and agree with the depositary on procedures to stabilize the fund's value.

¹⁹ Recommendation 10: "MMFs that offer a stable NAV should be subject to measures designed to reduce the specific risks associated with their stable NAV feature and to internalize the costs arising from these risks. Regulators should require, where workable, a conversion to floating/variable NAV. Alternatively, safeguards should be introduced to reinforce stable NAV MMFs' resilience and ability to face significant redemptions."

²⁰ The European Commission published a proposal on the regulation of MMFs on September 4, 2013. The European Parliament's position on the proposal was reached on April 29, 2015, but the negotiations in the Council of the European Union have not made significant progress. Therefore, it is currently unclear whether and when the Regulation may be adopted.

addition, the FCA may wish to pay attention to the extent to which valuation at amortized cost basis is used by short-term MMFs.

16. At the time of the FSAP, the FCA Handbook still enabled using both forward and historic NAV for determining the subscription and redemption prices of fund units, but the FCA's intention is to remove the possibility to use historic NAV. Even under the existing rules, using forward pricing has been compulsory in certain cases, including for a higher volatility fund, where the regular valuation points are more than one business day apart, at the request of the subscriber/redeemer, and where the fund manager has reason to believe that the price that would reflect the current value of the fund property would vary by more than two percent from the last calculated price. The FCA's consultation where it proposed deleting the possibility to use historic NAVs from its Handbook closed on December 7, 2015.²¹ In its consultation paper, the FCA noted that it does not believe that any fund managers are still using historic pricing. IOSCO Principles for the Valuation of Collective Investment Schemes (Principle 9) provide that the purchase and redemption of CIS interests should not be made at historic NAV. Permitted exemptions are very limited. It is therefore important that the FCA proceeds with its plan to remove the possibility to use historic pricing from its rules.

Other AIFs

17. The valuation requirements for other AIFs are based on the AIFMD. AIF assets must be valued and the NAV per unit calculated at least once a year. For open-ended AIFs, the frequency has to be appropriate to the assets held by the AIF and its issuance and redemption frequency. The valuation of financial instruments must take place every time the NAV per unit is calculated, and other assets must be valued at least once a year and every time there is evidence that the last determined value is no longer fair or proper. For closed-ended AIFs, such valuations and calculations must be carried out in case of an increase or decrease of the AIF's capital. AIFMD implementing measures include detailed requirements on the content, consistency of application and periodic review of the valuation policies and procedures, use of models to value assets, and review of individual asset values.

18. AIFMD also includes requirements as to who can conduct the valuation. If the AIFM performs the valuation, those responsible for valuation must be functionally independent from the portfolio management function and the remuneration policy and other measures must ensure conflicts of interest are mitigated. Any external valuer must be independent from the AIF, the AIFM, and any other person with close links to the AIF or AIFM. The AIF's depositary cannot be appointed as an external valuer of the AIF, unless it has functionally and hierarchically separated the performance of its depositary functions from its external valuer tasks; and potential conflicts of interest are properly identified, managed, monitored and disclosed to the investors. The external valuer is prohibited from delegating the valuation function. The AIFM must notify the competent authority of the appointment of the external valuer. If the valuation function is not performed by an independent

²¹ FCA Consultation Paper CP15/27, UCITS V Implementation and Other Changes to the Handbook Affecting Investment Funds.

external valuer, the AIFM's competent authority may require the AIFM to have its valuation procedures and/or valuations verified by an external valuer or auditor. The competent authority can require an external valuer to verify the independence of internal valuation.

Role of depositaries and auditors

19. Both UCITS and AIF depositaries have important obligations with regard to the valuation of fund units. Under the UCITS Directive and AIFMD, the depositary is required to ensure that the value of the fund units is calculated in accordance with the applicable national law and the fund rules. AIFMD further requires the depositary to ensure that the valuations are made in accordance with the AIFM's valuation procedures. The FCA Handbook expands on these requirements by obliging a UCITS and a NURS depositary to ensure, among other tasks, that the fund manager has adopted appropriate procedures to ensure correct calculation of the unit price and maintained sufficient records. The depositary must confirm that the systems in place are satisfactory and, from time to time, review other aspects of the valuation of each fund for which it is responsible.

20. Fund auditors review the valuation of the fund assets as part of their review of the fund's annual accounts. A UCITS fund must appoint an independent auditor who is authorized by its EEA home state to audit its annual accounts. In the U.K., the auditor's opinion has to confirm that the annual accounts have been properly prepared in accordance with the SORP, the FCA Handbook and the fund rules.

Treatment of pricing errors

21. The UCITS Directive and AIFMD include only general references to the treatment of pricing errors. The UCITS Directive only notes that the UCITS home state rules apply to the errors in the NAV calculation and related investor compensation. AIFMD implementing measures require an AIFM to ensure that remedial procedures are in place in the event of an incorrect calculation of the NAV.

22. The FCA Handbook provides guidance on the recording and reporting of instances of incorrect pricing of UCITS funds and NURS. The fund manager should record each instance of incorrect pricing and report it to the depositary together with details of the action taken to avoid repetition. The depositary should report any material breaches immediately to the FCA as well as make a monthly return summarizing the number of instances of incorrect pricing.²² The fund manager must reimburse affected unitholders and the fund itself for instances of incorrect pricing, except if it appears to the depositary that the breach is of minimal significance. The depositary should satisfy itself that any such payments are accurately and promptly calculated and paid.

²² The FCA Handbook currently requires quarterly reporting, but in practice reporting takes place monthly based on a voluntary arrangement. The FCA has consulted on changes to its Handbook that would formalize the monthly reporting arrangement.

Managing the redemption risk

Risk and liquidity management

23. UCITS funds are subject to investment limits and the fund manager is required to manage and measure the funds' risk on a continuous basis. The detailed investment limits are set out in the UCITS Directive, which also requires the manager to employ a risk management process which enables it to monitor and measure at any time the risk of the positions and their contribution to the overall risk profile of the portfolio. The UCITS Implementing Directive includes additional requirements on due diligence in the selection of investments and on risk management and measurement. The risk management policy must comprise procedures to enable the manager to assess the exposure of each UCITS to, among others, liquidity risk. The competent authority must review the risk management policy when authorizing the manager and on an ongoing basis. Any material changes to the policy must be notified to the competent authority. A UCITS fund manager must adopt effective arrangements, processes and techniques to establish, implement, and maintain a documented system of internal risk limits, including for liquidity risk, where relevant. The manager must employ an appropriate liquidity risk management process to ensure that each UCITS complies with its redemption obligations and, where appropriate, conduct stress tests which enable assessment of the UCITS liquidity risk under exceptional circumstances. The liquidity profile of the UCITS must be appropriate to the disclosed redemption policy.

24. The above regulatory requirements on liquidity risk management are comprehensive, but some additional requirements would further enhance the robustness of the framework. UCITS fund managers are required to conduct liquidity stress tests to assess liquidity risk only in exceptional circumstances. Principle 14 of the IOSCO Principles for Liquidity Risk Management for CIS requires that appropriate liquidity risk assessments should be carried out also for normal scenarios. The robustness of the regulatory framework would be enhanced by requiring UCITS fund managers to conduct liquidity stress tests also under normal liquidity conditions, which would also align the requirement with that in the AIFMD (see below). The FCA is encouraged to seek enhancements to the liquidity risk management requirements for UCITS fund managers, either through changes to the UCITS Directive or through its own measures.

25. The FCA Handbook also includes a requirement for prudent spread of a UCITS fund's risk. Investing in illiquid instruments is not prohibited, but the fund manager must ensure that there is a prudent spread of risk, including liquidity risk. In practice this means that firms cannot simply sell the most liquid assets to meet redemptions leaving remaining investors with sub-optimal exposure. If it is not possible to provide a prudent spread of risk after meeting redemptions, the fund manager would be required to suspend or defer redemptions (see below).

26. In addition to comprehensive risk management requirements, AIFMD includes detailed obligations on the AIFM's liquidity management system and procedures. An AIFM must ensure that the investment strategy, liquidity profile and redemption policy of each AIF it manages are consistent. It is required to employ an appropriate liquidity management system and adopt procedures which enable it to monitor the AIF's liquidity risk and to ensure that the liquidity profile of

the AIF's investments complies with its underlying obligations. It must also regularly conduct stress tests under normal and exceptional liquidity conditions, which enable it to assess and monitor the liquidity risk of the AIF. Further, the AIFMD requires the AIFM to disclose to investors a description of the AIF's liquidity risk management, including the redemption rights both in normal and in exceptional circumstances, and the existing redemption arrangements with investors. AIFMs must also identify, manage and monitor conflicts of interest between redeeming and remaining investors and between the AIFM's incentive to invest in illiquid assets and its redemption policy.

Pricing tools

27. Subject to the fund rules and prospectus, the FCA rules enable the use of pricing tools to address first mover advantage in single priced funds.²³ The use of such tools would pass costs onto the investors exiting the fund rather than the remaining investors. Such pricing tools include:²⁴

- Swing pricing, where the unit price is determined by calculating the NAV for the fund before subscriptions and redemptions and then adjusting it by a pre-determined amount (the swing).
- Dilution levies, where a separate charge is made to investors buying or selling fund units and paid into the fund to mitigate the effects of dilution on remaining unitholders.
- Dilution adjustments, where the unit price is adjusted to reduce dilution in the scheme.

28. Redemption in kind may also be used. In practice it is used only for large (primarily institutional) redemptions.

Suspension and deferral of redemptions

29. There are no specific requirements on the suspension of redemptions in the UCITS Directive or AIFMD. The UCITS Directive only provides that a UCITS fund may, in accordance with the applicable national law and the fund rules, temporarily suspend the redemption of its units. This is possible only in exceptional cases, where suspension is in the interest of unit holders. Under the U.K. rules (that also apply to NURS), the action also requires the agreement of the depositary or may be required by the depositary. The FCA Handbook further specifies that difficulties in realizing fund assets or temporary shortfalls in liquidity may not, in isolation, be sufficient justification for suspension. The competent authority and investors must be informed about any suspension, as required in the UCITS Directive. The suspension is only allowed to continue for as long as is justified in the interest of the unit holders, with a formal review of the suspension to be held at least every 28 days. FCA requirements for QIS are similar.

30. U.K. rules permit deferral of redemptions under certain circumstances. A UCITS or NURS that has at least one valuation point on each business day may permit deferral of redemptions at a

²³ Using dual prices is also possible.

²⁴ In practice swing pricing or dilution levies would be applied in the event of very high redemptions in a period of market stress or high transaction costs.

valuation point to the next valuation point where the requested redemption exceeds 10 percent, or some other reasonable proportion disclosed in the prospectus, of the fund's value. No prior FCA approval is required and no maximum time period is set out. For QIS and unauthorized AIFs, the AIFM can defer redemptions so long as it is provided for in the fund rules.

31. The FSMA provides the FCA with the power to require the suspension of redemptions.

This is based on the FCA's general own initiative powers, the existence of which is not required under the UCITS Directive or AIFMD. However, in practice the FCA expects to be able to agree with the fund manager on the course of action, and has done so.

Limited redemptions

32. The AIFMD permits the use of limited redemption arrangements, which is an important tool to manage AIFs' liquidity risk due to the often illiquid nature of their investments.

Under the FCA Handbook, a NURS that operates as a Fund of AIFs that invests substantially in immovables or whose investment objective is to provide a specified level of return may provide for limited redemption arrangements appropriate to its aims and objectives. In this case, the NURS must provide for sales and redemptions at least once in every six months (instead of the normal twice monthly requirement for NURS). For QIS, the FCA Handbook guidance suggests that the maximum period between dealing days will depend on the reasonable expectations of the target investor group and the investment objectives and policy of the fund. For other AIFs, it is sufficient to provide information in the fund rules on any restrictions on the right to redeem units.

Use of leverage

33. The EU regulatory requirements on the use of leverage in UCITS funds and AIFs are very different.

A UCITS fund's global exposure has to be calculated using either the commitment approach or the Value-at-Risk (VaR) method. Borrowing is not taken into account when determining the leverage of a UCITS fund, but UCITS funds are permitted to borrow only up to 10 percent of their NAV. The UCITS Directive limits a UCITS fund's global exposure from derivative instruments to 100 percent of the total net value of the UCITS portfolio. The AIFMD defines leverage as any method by which the AIFM increases the exposure of an AIF, whether through borrowing of cash or securities, leverage embedded in derivative positions or by any other means. The Directive requires AIFMs to set leverage limits in respect of each AIF they manage, but does not set maximum limits on leverage. Leverage must be calculated using two methods: the gross method and the commitment method. The overall leverage of an AIF is expressed as a ratio of the AIF exposure to its NAV. The four leverage calculation methods are described in more detail in Box 2.

Box 2. Leverage Calculation Methods

UCITS Directive

The standard methodology for the calculation of a UCITS fund's exposure is the **commitment approach**. The global exposure under the UCITS Directive only takes into account financial derivatives and securities financing transactions (SFTs) that generate leverage. UCITS funds can apply netting and hedging arrangements to reduce their global exposure.

The calculation of leverage under the commitment approach can be summarized as follows:

Derivatives: sum of the equivalent positions in the underlying assets after netting and hedging arrangements
 +
 SFT: market value of the collateral received (including cash) when reinvested

UCITS funds should use a **VaR** method (relative VaR or absolute VaR approach depending on the investment strategy of the fund) when i) they engage in complex investment strategies which represent more than a negligible part of the fund's investment policy; ii) they have more than a negligible exposure to exotic derivatives; or iii) the commitment approach does not adequately capture the market risk of the portfolio.

VaR is to be calculated as follows:

Relative VaR

- VaR of the UCITS fund's current portfolio (which includes derivatives) compared to the VaR of an unleveraged reference portfolio. The portfolio VaR limit is twice the VaR of the unleveraged reference portfolio.

Absolute VaR

- Risk limited to maximum of 20 percent of NAV
- Specific requirements on confidence interval, holding period and effective observation period of risk factors

AIFMD

AIFMs have to calculate their exposures using two different methods.

The **commitment method** is similar to the commitment approach for UCITS, but with the important difference that AIFMs have to include all positions (not only derivative positions).

The **gross method** requires all the absolute values of the assets of the AIF to be summed without applying netting and hedging arrangements. Cash and cash equivalents are excluded for the purpose of the calculation.

- The leverage under the AIFMD commitment method is calculated in the following manner:

Direct positions: accounting value
 +
 Derivatives: sum of the market value of the equivalent position in the underlying asset (after netting and hedging)
 +
 SFT: market value of the collateral received (including cash) when reinvested
 +
 Reuse of cash borrowing: the higher of the market value of the investment realized or the total amount of the cash borrowed

- The leverage under the AIFMD gross method is calculated as follows:

Direct positions: absolute value
 -
 Cash equivalents

34. While the AIFMD requires AIFs' leverage to be reported to the competent authorities on a regular basis, the reporting requirements on UCITS funds' leverage are much more limited.

UCITS fund managers must only report annually on the types of derivative instruments used for each managed UCITS, the underlying risks, the quantitative limits and the methods which are chosen to estimate the risks associated with the derivative transactions. UCITS fund managers are currently required to notify the details of their derivative risk management process to the FCA at least annually. The FCA is now planning to improve the reporting by introducing a reporting template to be used to inform the FCA on, among others, a UCITS fund's gross long and short derivative positions and details of the risk measures used (commitment approach or relative or absolute VaR). The FCA intends to use the reporting to help focus its supervisory work on the most relevant funds and monitor potential risks building in the sector.

35. The absence of an internationally agreed standard for determining an investment fund's leverage is a major regulatory gap.

Market participants, in particular some hedge fund managers, are concerned about the potentially misleading leverage information that the current calculation methods may produce. Also, in order to allow authorities to have a clearer overview of the use of leverage by investment funds, a common method for the calculation of investment fund leverage would be useful.²⁵ The FCA and other U.K. authorities should develop a practical approach to measuring investment fund leverage, as well as continue to contribute to international work to harmonize the leverage calculation method.

Depositories²⁶

36. The UCITS Directive and AIFMD require the appointment of a depository for each UCITS fund and AIF.²⁷

As a general rule, a depository must have its registered office or a branch in the same country where the fund is domiciled. However, a non-EEA AIF's depository may be established in the AIFM home state. The competent authority of the UCITS home state must approve the depository to act as a depository for a fund domiciled in that EEA state. While there is no such requirement in the AIFMD, the FCA Handbook requires the FCA to approve the depository of a U.K.-domiciled AIF. Under the current UCITS IV Directive, when the UCITS fund and its manager are located in different EEA states, they must enter into a detailed written agreement that regulates the flow of information necessary for them to perform their roles. AIFMD and UCITS V Directive require such a written contract independent of the locations of the manager and depository.

Prudential requirements

37. The U.K. prudential requirements for UCITS depositories are more stringent than those of the UCITS IV Directive.

The UCITS IV Directive only requires a depository to be an institution

²⁵ This was also recommended in the IMF October 2015 Global Financial Stability Report (Chapter 1, p. 37).

²⁶ Reference to a depository in this section also covers a trustee of an AUT.

²⁷ The UCITS V Directive specifically requires a single depository for UCITS funds, which is currently not required under the UCITS IV Directive.

subject to prudential regulation and ongoing supervision, but leaves the determination of further eligibility criteria to member states. A U.K. bank subject to a EUR 5 million capital requirement or an investment firm²⁸ subject to a GBP 4 million capital requirement (i.e., higher than the regular MiFID EUR 730,000 requirement) can be authorized to act as a depositary of a UCITS fund. UCITS V Directive depositary eligibility requirements are more detailed, and provide the member states discretion to specify them further. The FCA plans to continue to apply stricter capital requirements than those applied under the UCITS V Directive.²⁹

38. The U.K. requirements for NURS and QIS depositaries also exceed the AIFMD requirements. An investment firm that is a NURS or QIS depositary has to comply with the same GBP 4 million capital requirement as a UCITS depositary instead of the standard EUR 730,000 capital requirement, which in the U.K. applies to depositaries of unauthorized AIFs. A depositary of a private equity AIF and a non-EEA AIF (under the AIFMD Article 36 'depositary light' regime) is subject to a minimum capital requirement of EUR 125,000 under the U.K. rules.

Depositary independence

39. AIFMD and UCITS V Directive include depositary independence requirements that go beyond the UCITS IV Directive prohibition for the management company to act as the depositary. They prohibit a depositary from carrying out activities with regard to a fund or its manager, unless the depositary has functionally and hierarchically separated the performance of its depositary tasks from its other potentially conflicting tasks, and the potential conflicts of interest are properly identified, managed, monitored and disclosed. AIFMD also specifically prohibits an AIF's prime broker from acting as the AIF's depositary, unless the prime brokerage and depositary functions are separated and conflicts of interest are properly identified, managed, monitored and disclosed.

40. The U.K. framework has additional requirements on depositary independence that are not based on EU legislation. They apply to UCITS funds and authorized AIFs (QIS and NURS), but not to unauthorized AIFs. In the former case, directors in common, cross-shareholdings³⁰ or contractual commitments between the fund manager and depositary are generally not permitted, although the FCA would be able to grant exemptions from the criteria in the Handbook. In practice, this has not been done. In the case of unauthorized AIFs, the AIFM and the depositary can be part of the same corporate group or otherwise connected, provided the general AIFMD requirements described above are complied with.

²⁸ In addition to investment firms, some other firms can act as depositaries, but they are subject to the same capital requirements as investment firms.

²⁹ See FCA Consultation Paper 15/27 "UCITS V Implementation and Other Changes to the Handbook Affecting Investment Funds."

³⁰ The limit for permitted cross-ownership is 15 percent.

Safekeeping and segregation of fund assets

41. The FCA Handbook's client asset rules include certain safekeeping and segregation requirements applicable to UCITS and NURS depositaries.³¹ A depositary is generally restricted from registering its own assets in the name of the client or any nominee in whose name a client's safe custody asset is also registered. Legal title to a safe custody asset can be registered in the name of another party or the depositary if that is the only option, the assets are subject to the law or market practice of a foreign jurisdiction and the depositary has notified the client in writing. A depositary's records and accounts must enable it to distinguish each client's safe custody assets from its own assets and those of other clients. The accuracy of records has to be checked through reconciliations. The auditor has to review the reconciliation method and confirm in its annual client assets report to the FCA that the depositary has maintained adequate systems to enable it to comply with the custody rules. There are also detailed rules on the treatment of shortfalls arising from record discrepancies. The use of client assets in securities financing transactions or otherwise for the account of the depositary or the account of another client requires the client's express prior consent.

42. The AIFMD includes segregation and safekeeping/record keeping requirements applicable to all AIF assets. Financial instruments that can be held in custody but that cannot be physically delivered to the depositary must be registered in a segregated financial instruments account opened in the name of the AIF or the AIFM acting on behalf of the AIF. Up-to-date records have to be kept of other assets.³²

43. The FCA Handbook also includes specific requirements on delegation of custody by a UCITS or NURS depositary. The subcustodian³³ must be subject to regulation and supervision in a country that specifically regulates and supervises the safekeeping of safe custody assets. If that is not the case and the country is a non-EEA country, the custody can be delegated only if the nature of the safe custody assets or of the investment services connected with those assets requires them to be deposited with a third party in that non-EEA country. Any safe custody assets deposited with a subcustodian must be separately identifiable from the assets belonging to the depositary and from the assets belonging to the subcustodian by means of differently titled accounts on the books of the subcustodian or other equivalent measures that achieve the same level of protection.³⁴

44. Delegation by the AIF depositary is subject to detailed AIFMD requirements, which permit delegating only safekeeping tasks. In order to provide subcustody for financial instruments, the delegate must be subject to effective prudential regulation and an external periodic audit of

³¹ No EU level requirements currently apply to UCITS depositaries.

³² The same requirements are due to be made compulsory for UCITS depositaries under the UCITS V Directive.

³³ The fund manager cannot act as a subcustodian.

³⁴ The UCITS V Directive significantly enhances the requirements on delegation by the depositary. Only safekeeping functions are permitted to be delegated, subject to specific conditions. Reuse of client assets for the account of the depositary or the account of another client is prohibited.

financial instruments in custody. Subject to informing the investors and specific instructions from the AIF or AIFM, this principle can be deviated from in the case of non-EEA countries, if the local law requires custody tasks to be provided by a local entity and none satisfies the above conditions. A delegate must segregate the assets of the depositary's clients from its own assets and those of the depositary in such a way that they can, at any time, be clearly identified as belonging to clients of a particular depositary. The delegate has to keep such records and accounts as are necessary to enable it at any time and without delay to distinguish assets of the depositary's AIF clients from its own assets, assets of its other clients, assets held by the depositary for its own account, and assets held for clients of the depositary which are not AIFs.³⁵ It cannot make use of the assets unless it has received prior consent from the AIF or the AIFM and notified the depositary.

45. The above U.K. requirements comply with the segregation and safekeeping requirements in IOSCO Principles and Standards.³⁶ However, given the lack of clarity on the interpretation of the segregation requirements under the AIFMD and the cross-border nature of the investment fund industry, it is important that the U.K. authorities continue to contribute to the EU level discussions on the development of a common approach. Differing interpretations would lead to operational challenges in custody arrangements and facilitate regulatory arbitrage.

Depositary liability

46. The U.K. requirements on depositary liability are more detailed than the UCITS IV Directive requirements. According to the UCITS IV Directive, a depositary is liable to the management company and the unit-holders for any loss suffered by them as a result of its unjustifiable failure to perform its obligations or its improper performance of them. The U.K. rules further specify that if a depositary retains the services of its own associate, the fund manager or that manager's associate, the depositary's liability remains unaffected. In any other case, it will not be held responsible for any act or omission of the delegate if it can show that it was reasonable for it to obtain assistance to perform the function; the person retained was and remained competent to provide assistance in the performance of the function; and it had taken reasonable care to ensure that the assistance was provided in a competent manner.

47. The AIFMD depositary liability requirements are more explicit than those of the UCITS IV Directive, but enable contractual discharge of liability in case of delegation. Notwithstanding delegation, the depositary remains liable for any loss of financial instruments held in custody. If a loss happens, the depositary will have to return to the AIF or AIFM a financial instrument identical to the type lost or the corresponding amount. The depositary will however not be liable if it can prove that the loss has arisen as a result of an external event beyond its reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary. Subject to the AIF's agreement, the depositary can also discharge itself of liability if it can prove that a written contract

³⁵ ESMA published a consultation paper on December 1, 2014, on guidelines on asset segregation under the AIFMD that covers the interpretation of these requirements. The final guidelines have not yet been published.

³⁶ Key Question 7 of Principle 25 of the IOSCO Principles and Standards for the Custody of CIS Assets.

between the depositary and the delegate expressly transfers the liability to the delegate and makes it possible to make a claim against the delegate.

48. The UCITS V Directive largely aligns the depositary liability requirements with those of the AIFMD. However, it does not allow any discharge of liability (including for loss of assets) when safekeeping duties have been delegated to a third party. The UCITS V Directive also requires member states to ensure that, in the event of insolvency of the depositary or its delegate, the assets of the UCITS held in custody are unavailable for distribution among the creditors of the depositary or of the third party delegate. In its open consultation published on October 23, 2015, HMT expressed the view that existing U.K. legislation, FCA rules, and U.K. insolvency laws ensure that custody assets are protected from creditor distribution upon the insolvency of a U.K. depositary.

C. Authorization

49. The FCA applies its general authorization approach to fund management activities. The applicant must be ready, willing, and organized to comply with the FCA's requirements and capable of being effectively supervised by the FCA. More specifically, it must comply with the FCA's five threshold conditions: (i) offices located in the U.K.; (ii) capability of being effectively supervised by the FCA; (iii) sufficient resources; (iv) fitness and properness; and (v) a suitable business model. In its authorization process, the FCA also has to take into account its competition objective and ensure that no unjustified barriers to entry into, expansion within or exit from the industry are presented.

50. The FCA has a centralized authorization function. The overall headcount of the function (Permissions Department of the Supervision—Retail and Authorizations Division) has varied between 69.8 full-time employees (FTE) at the end of 2014 and 77.0 at the end of 2013. The end-June 2015 headcount was 73.3 FTE. In principle, staff within the department is specialized in particular types of applicants, but peaks in the number of applications—such as the AIFM applications—have required staff to deal with types of applications that they are not specialized in as well as the FCA having to use temporary staff. While market participants understood the challenges faced by the FCA, some noted that the case officer for their AIFM application could change multiple times during the process. There was also a perception that the staff dealing with the applications had to focus on elements that were not key requirements for AIFMs.

51. The FSMA and AIFMD Regulations set the deadlines for dealing with the applications for authorization. The FCA has to make a decision within three months from receiving a complete application for authorization as a full-scope or small registered AIFM and within six months from receiving an incomplete application for authorization as a small registered AIFM. In the case of investment managers, UCITS fund managers and small authorized AIFMs, the FCA is required to make a decision within six months from receiving a complete application and within 12 months from receiving an incomplete application.³⁷ The FCA publishes key performance indicators for its retail and wholesale authorizations that include statistics on the volume of applications and distribution of all

³⁷ While no statutory deadline applies to incomplete applications for authorization as a full-scope AIFM, in practice the FCA applies the FSMA 12 month deadline.

applications between those approved, withdrawn and refused. During the transitional period, more detailed statistics were published for AIFM authorizations and registrations.

52. The FCA processes each application according to its risk appetite. Low risk applications are subject to standard checks, whereas medium and high risk applications are subject to more enhanced controls. If the FCA is satisfied that the applicant satisfies and will continue to satisfy the threshold conditions the case officer or a secondary decision maker approves the application. If not, the Legal Team of the FCA's Enforcement and Market Oversight Division (EMO) will be engaged. Table 2 provides information on the number of fund management related applications received, authorizations given, and applications withdrawn or refused.³⁸ Applicants tend to withdraw their applications if authorization within the above deadlines seems unlikely, since refusals are made public. Any refusal decisions are taken by the Regulatory Decisions Committee.

53. The authorization process is largely based on reviewing documents. In certain technical questions the case officer may seek the comments of the relevant experts, but no cross-departmental teams are formed to deal with the applications (cf. the approach to MTF applications). Additional contacts with the applicant are initiated on a when needed basis. The sheer volume of applications and recent peaks in the volumes pose significant challenges on the FCA's authorization process. The challenges are likely to continue with the implementation of MiFID II.

Managers

54. UCITS fund managers must be authorized and AIFMs must be either authorized or registered. A firm that manages a UCITS fund must be authorized as a UCITS management company, and a firm that performs risk management or portfolio management for an AIF must be authorized or registered as an AIFM. AIFMD requires a full authorization only for the AIFMs managing AIFs above the AIFMD Article 3 AUM threshold, whereas the sub-threshold AIFMs are only required to be registered.³⁹ However, the U.K. requirements go beyond the AIFMD minima for some AIFMs. The AIFMs of NURS and QIS have to be authorized either as full-scope AIFMs (possibly through opt-in) or as small authorized AIFMs (see Box 1).

³⁸ In addition to these applications from new applicants, there were a total of 852 variation of permission applications submitted by full scope and small authorized and registered AIFMs in the fiscal years 2012/13–2014/15. During the same time period, 807 variation of permission authorizations were granted and 32 withdrawn or refused.

³⁹ AIFMs that need to be registered are only required to identify themselves and the AIFs they manage, provide information on the investment strategies of the AIFs they manage, and regularly provide information on the main trading instruments and principal exposures of the AIFs they manage.

Table 2. United Kingdom: Number of New Firm Applications and Authorizations

Fiscal year	Number of applications	Investment management firms ¹	Full scope AIFMs ²	Small authorized AIFMs ²	Small registered AIFMs and EuVECA ²	Depositaries ²	Total ^{1,2}
2012/13	Received	168	0	7	0	0	175
	Authorized	154	0	0	0	0	154
	Withdrawn/refused	21	0	0	0	0	21
2013/14	Received	68	56	48	56	9	238
	Authorized	88	6	15	14	1	124
	Withdrawn/refused	19	0	3	6	0	22
2014/15	Received	109	61	39	51	2	300
	Authorized	90	68	51	123	9	341
	Withdrawn/refused	13	6	6	2	0	27

Source: FCA.

¹ These figures include both UCITS management companies and investment firms authorized to provide portfolio management services under MiFID. There have been very few UCITS management company authorization applications over the past few years, and none have been refused or withdrawn.

² Includes both transitional and business-as-usual cases.

55. Both UCITS fund managers and AIFMs are subject to comprehensive regulatory requirements, with certain exemptions for the AIFMs of non-EEA AIFs. An AIFM of a non-EEA AIF that is not marketed in the EEA does not need to comply with the depositary and annual reporting requirements of Articles 21 and 22 of the AIFMD. If the AIF is marketed in the EEA, the annual reporting requirement applies, but the AIFM is subject to the ‘depositary light’ regime under Article 36 of the AIFMD, which only requires the AIFM to appoint a depositary to carry out cash flow monitoring, safekeeping and certain monitoring tasks. The U.K. also requires small authorized and registered AIFMs to comply with the safekeeping and segregation rules described above.

56. Despite the large volumes, the applications for AIFM authorizations were in the past reviewed in a more comprehensive manner than those for authorization as a UCITS management company.⁴⁰ The latter reviews focused largely on compliance with the generic threshold conditions, while the former—reflecting the more extensive legislative and regulatory requirements on AIFMs—require the case officer to pay closer attention to how the requirements on valuation, delegation, risk management, leverage and marketing are complied with. The approach to non-AIFM applications risked falling short of the stringent requirements that IOSCO Principles pose on assessing the applicants’ compliance with certain key requirements. For example, Principle 24 of the IOSCO Principles requires the risk management and internal controls of an applicant to be reviewed.

⁴⁰ The process for investment firms is the same as that for UCITS management companies.

57. During the FSAP, the FCA took measures to enhance the process applied to the authorization of UCITS fund managers. According to the information provided by the FCA, the revised process for reviewing UCITS fund managers' applications incorporates many of the same elements as that for AIFM applications. These include valuation, delegation, and risk management (including liquidity risk management). This is an important change, given the similarities in the risks posed by UCITS funds and AIFs. The process for reviewing investment manager applications continues to focus on compliance with the threshold conditions.

58. While the changes made to dealing with UCITS fund manager applications are a clear improvement, the use of a risk-based approach to authorizations poses particular challenges to ongoing supervision. If applicants that were categorized as low risk in the authorization stage subsequently fall under the flexible portfolio in supervision (see paragraph 79), there is an increasing risk that undetected risks may accumulate in this portfolio of firms.⁴¹ As a result, it is important that the approach taken to authorizations continues to take into account risks specific to each sector. Such risks tend to change over time, leading to the need to continue to adjust the authorization process accordingly.

Delegated management

59. Under the UCITS Directive, member states have the discretion to determine whether and subject to which conditions delegation of investment management is permitted. The Directive prevents delegating investment management to the depositary or to any other person with potential conflicts of interest and requires the delegate to be authorized for asset management, prudentially supervised and, in the case of a non-EEA person, subject to cooperation between the relevant authorities. Delegation must not prevent effective supervision or the fund manager from giving further instructions to the delegate or from withdrawing the mandate. The fund manager is prohibited from delegating its functions to the extent that it becomes a letter box entity. The FCA Handbook includes some additional requirements focusing on ensuring that the fund manager remains fully responsible for discharging its regulatory obligations despite any outsourcing. A fund manager is also obliged to inform the FCA of its intention to delegate any function.

60. AIFMD includes similar requirements, but there are some differences. In general, AIFMD includes significantly more detailed requirements than the UCITS Directive, and the FCA does not apply any additional requirements. An AIFM must provide a detailed description of its entire delegation structure to its competent authority. Subject to the approval of the competent authority of its home state, an AIFM can delegate portfolio management or risk management to a person that is not authorized for asset management or subject to supervision.⁴² Delegation to such persons is not permitted under the UCITS Directive. Subdelegation requires the consent of the fund manager and notification to the competent authority. AIFMD specifically prohibits delegation and subdelegation of

⁴¹ This risk is more limited for UCITS fund managers, since their applications for authorization are typically subject to enhanced controls, whilst AIFMs' applications are normally subject only to the standard checks due to their lower risk to the FCA's customer protection objective.

⁴² The FCA has not given any such permissions.

portfolio management or risk management to a delegate of the depositary. An AIFM's liability towards the AIF and its investors is not affected by delegation or sub-delegation. Finally, an AIFM must not delegate its functions to the extent that, in essence, it can no longer be considered to be the AIFM of the AIF and to the extent that it becomes a 'letter-box entity'.

61. AIFMD includes additional requirements on delegation to non-EEA persons. A written agreement must exist between the relevant competent authorities. The agreement has to cover access to information and documents, the ability to carry out on-site inspections, and enforcement cooperation.

62. Delegation arrangements are common in the investment management industry, and pose supervisory challenges in particular in the case of cross-border delegation. This is particularly relevant for the U.K. due to its nature as an investment management hub. Typical delegation arrangements are cases where a U.K.-based investment manager manages hedge fund or private equity assets under delegation from a non-EEA AIFM. Such an AIFM would typically be domiciled in the United States. Similar delegation arrangements are made between fund managers in Ireland or Luxembourg and investment managers in the United Kingdom.

Foreign fund managers

63. Foreign fund managers can manage U.K. domiciled funds under the UCITS Directive and AIFMD passporting regimes and under the NPPR. In the case of passporting, the fund managers are subject to minimum harmonized requirements arising from the EU Directives. Under the U.K. NPPR regime, the non-EEA AIFMs managing U.K. AIFs or marketing AIFs in the U.K. are subject to their domestic requirements with no additional requirements imposed on them, except for the requirement for the depositary of an authorized U.K. AIF to be based in the United Kingdom (however, see below the section on foreign funds for the required cooperation arrangements).

Funds

64. The FCA follows the same process for the authorization of UCITS funds, NURS and QIS. Case officers are responsible for performing a detailed review of the information and documentation provided. The purpose of the review is to verify compliance with the relevant regulatory requirements, but also to ensure that the FCA is satisfied that the proposed fund is appropriate for the intended target investors. While the FCA considers the investment objective and policy of the fund, it does not assess or endorse the likelihood of a fund achieving its aim. The test applied is whether the proposed drafting of the objective and policy is sufficiently representative of how the fund will be managed; what expectations are created for investors; and whether an investor has a clear understanding of how the fund will seek to deliver its stated aim.

65. The FCA's fund authorization operates under agreed service standards. The current one month authorization timeline for QIS and two month timeline for NURS are shorter than the statutory deadline of six months. UCITS fund authorization works within the two month statutory timeline.

Table 3 includes information on the number of new funds authorized and amendments to existing funds.

66. When the FCA is not satisfied with the information provided or the disclosures made in an application for fund authorization, it challenges the proposal or aspects of it. This has resulted in the applicant making amendments to the fund documentation, sometimes multiple times, or withdrawing the application. Using this approach of continuing iterative challenge the FCA aims at ensuring that approved applications meet the required standard. Changes to the way the fund operates or significant changes to the prospectus have to be approved by the FCA. Where the FCA deems that a notification does not contain either of them it does not need to approve the change.

Table 3. United Kingdom: Number of New Fund Applications and Authorizations and Amendments to Existing Funds

	Number of new fund applications	Number of new fund authorizations	Number of amendments notified	Number of amendments approved ¹
2013	53	54	1509	956
2014	65	61	1896	1219
Q1–Q2/2015	35	38	588	596

Source: FCA

¹ Not all notifications lead to the need to approve the change. All notifications however have to be risk assessed.

67. The introduction of ELTIFs in the second half of 2015 is expected to increase the number of applications. ELTIFs are an add-on to the AIFMD requiring each ELTIF to be authorized. ELTIFs will not be limited to the legal structures that have previously been subject to FCA authorization, and dealing with ELTIF applications may require the FCA to develop additional expertise in reviewing the new structures.

Foreign funds

68. Foreign UCITS funds and AIFs can be marketed to U.K. investors under certain conditions. Distinction is made between funds that can be marketed to retail investors and those that can be marketed to professional investors. The process for EEA and non-EEA AIFs and AIFs managed by EEA and non-EEA AIFMs is also different. The foreign funds that can be marketed to retail investors are EEA UCITS funds passported under the UCITS Directive and EEA or non-EEA AIFs individually recognized by the FCA as equivalent to NURS or QIS (Section 272 FSMA). Such funds can become 'recognized schemes' and are not subject to the restrictions on the promotion of unauthorized funds to retail investors. While passporting under the UCITS Directive is common, currently only 15 non-U.K. AIFs have been recognized for marketing to retail investors.

69. Other AIFs can be marketed on a cross-border basis to professional investors only under the following frameworks:

- AIFMD passporting regime: available to EEA AIFs managed by full scope EEA AIFMs.
- U.K. NPPR: available to AIFs managed by non-EEA AIFMs and to non-EEA AIFs (and EEA feeder AIFs where the master fund is managed by a non-EEA AIFM or the master fund is a non-EEA AIF).⁴³
- Reverse solicitation: available to non-EEA AIFMs marketing any AIFs at the initiative of the investor.

70. The use of the NPPR is subject to sufficient cooperation arrangements.⁴⁴ The AIFMD requires that cooperation arrangements are in place for the purpose of systemic risk oversight and in line with international standards in order to ensure an efficient exchange of information that enables the relevant EEA authority to carry out its duties in accordance with the directive in two cases. In the case of the FCA this means that cooperation arrangements should be in place:

- Between the FCA and the supervisory authority of a non-EEA AIF in case a U.K. AIFM is marketing the non-EEA AIF; and
- Between the FCA and the supervisory authority of a non-EEA AIFM and, where different, the supervisory authority of an AIF, in case the non-EEA AIFM is marketing an EEA or non-EEA AIF in the U.K.

71. The FCA has established the necessary cooperation arrangements. In practice there is variation in the effectiveness of the cooperation, with good cooperation with some jurisdictions. Cooperation is particularly important for the FCA in cases where the AIFM is located in a non-EEA country, but has delegated the investment management to a U.K. firm.

D. Supervision

Organization and resources

72. FCA's investment management supervisory function currently lies in the Investment Management Department within the Supervision—Investment, Wholesale and Specialists Division. The Department has been subject to a recent reorganization as a result of the FCA adopting its new supervisory approach (see below). The new organization differs from the old one in two main aspects:

⁴³ Eligible AIFMs will be able to continue to use the NPPR until three years after a marketing passport for non-EEA AIFMs and AIFs may have been introduced.

⁴⁴ Different requirements apply to sub-threshold non-EEA AIFMs.

- The old organization had been built around three functions: firm supervision,⁴⁵ fund supervision, and sector analysis. The new organization continues to have the functions for fund supervision and sector analysis, but firm supervision is organized on the basis of the new supervisory approach to three types of teams responsible for supervision of (i) fixed portfolio firms; (ii) Pillar 2 supervision; and (iii) multi-firm supervision.
- Responsibility for investment management sector firms that are part of larger banking or insurance groups lies in the Investment Management Department in the new organization. Previously they were supervised together with their parent bank or insurer in other FCA supervisory areas with the Investment Management Department having a support role.

73. The organizational change has led to some changes in the responsibilities and staffing of the Department. The resource allocation across the three functions during the fiscal years 2013/14–2015/16 is set out in Table 4.

Table 4. United Kingdom: FCA’s Supervisory Resource Allocation

	Sector supervision	Firm Supervision			Fund Authorization and Supervision	Total
2013/14	8	44			6	58
2014/15	8	41			10	59
2015/16 (previous model)	8	36			14	58
2015/16 (budget)	10	Fixed	Pillar 2	Multi-firm	14	74 ¹
		11	13	26		

Source: FCA.

¹ Thirteen positions are currently open.

FCA’s supervisory approach

74. In its supervisory activities, the FCA aims at making forward-looking judgments about firms’ business models, product strategy, and how they run their businesses.⁴⁶ The aim is to identify and address problems before they cause harm and to ensure consumers get a better deal and markets are fair and orderly. This approach has been applied in the supervision of fund management since 2012. Where the FCA has responsibilities for prudential supervision, its focus is on

⁴⁵ Firm supervision had four teams: custody bank, alternatives, asset management, and thematic teams.

⁴⁶ The FCA has summarized its supervisory approach in ten key principles. It aims at being: (i) forward looking and more interventionist; (ii) focused on judgment, not process; (iii) consumer-centric; (iv) focused on the big issues and causes of problems; (v) interfacing with executive management/Boards; (vi) robust when things go wrong; (vii) focused on business model and culture as well as product supervision; (viii) viewing poor behavior in all markets through the lens of the impact on consumers; (ix) orientated towards firms doing the right thing; and (x) externally focused, engaged and listening to all sources of information.

reducing the impact on customers and the integrity of the financial system of firms failing or being under financial strain. When consumer detriment does actually occur, the FCA aims at seeking redress for consumers in a robust manner.

75. The overarching objective of the FCA's firm supervision is to mitigate risks to the FCA's statutory and operational objectives and thereby help the FCA in meeting those objectives. The operational objective which has most directly driven the focus of the FCA's supervision work, and which has been widely communicated externally, is the consumer protection objective.

76. The FCA applies a risk based approach to supervision, which combines a bottom-up sector risk analysis with a senior management top-down view. Sector risk analysis is used to identify and analyze the main risks, set strategic aims, and allocate resources based on regulatory priorities. Key criteria for prioritization are not only the extent of detriment that an unmitigated risk would cause, but also whether the detriment would involve vulnerable consumers. The risk identification, evaluation and validation process uses various approaches at departmental level, as well as quarterly risk challenge sessions that engage other key internal stakeholders and the FCA's Risk Framework Team. Validated risks are recorded on the FCA's Consolidated Risk Map (CRM). The creation of a 'house view' for each sector is a new cross-organizational effort to streamline the key risks and cross-sector risks. The first investment management 'house view' is expected to be completed by March 2016. Key risks driving the FCA's strategic priorities are also identified at the executive and Board level in the form of the FCA's annual strategy and business plan. The Risk Framework Team verifies whether the bottom-up risk processes in the various sectors are consistent and meet the risk framework agreed for the FCA as a whole.

77. The CRM includes a record of asset management risks identified for mitigation since the FCA's inception in 2013. There are 14 individual conduct risks that have already been mitigated, or are currently being mitigated. Examples of current asset management risks include systemic and conduct risks relating to shadow banking, AIFMD compliance and data quality.

78. A specific risk analysis method is the Peer Group Business Model and Strategy Analysis (PG-BMSA). It is conducted to gain a sector view of the various business models, trends, strategies, outliers and themes. It is prepared to assist in risk identification and assessment of the supervisory framework. Two PG-BMSAs for asset management have been completed in 2013 and 2014 involving 21 firms. The FCA is currently in the process of completing its third PG-BMSA with 20 firms in scope.

Conduct classification and supervision

79. The FCA recently amended its approach to the conduct classification of firms. This replaced the previous system, where each firm fell into one of four conduct categories (C1–C4). Under the new model, all firms have been allocated to one of two categories:

- Fixed portfolio firms that are a small population of firms across both retail and wholesale markets that, based on factors such as size, market presence and customer footprint, require the highest

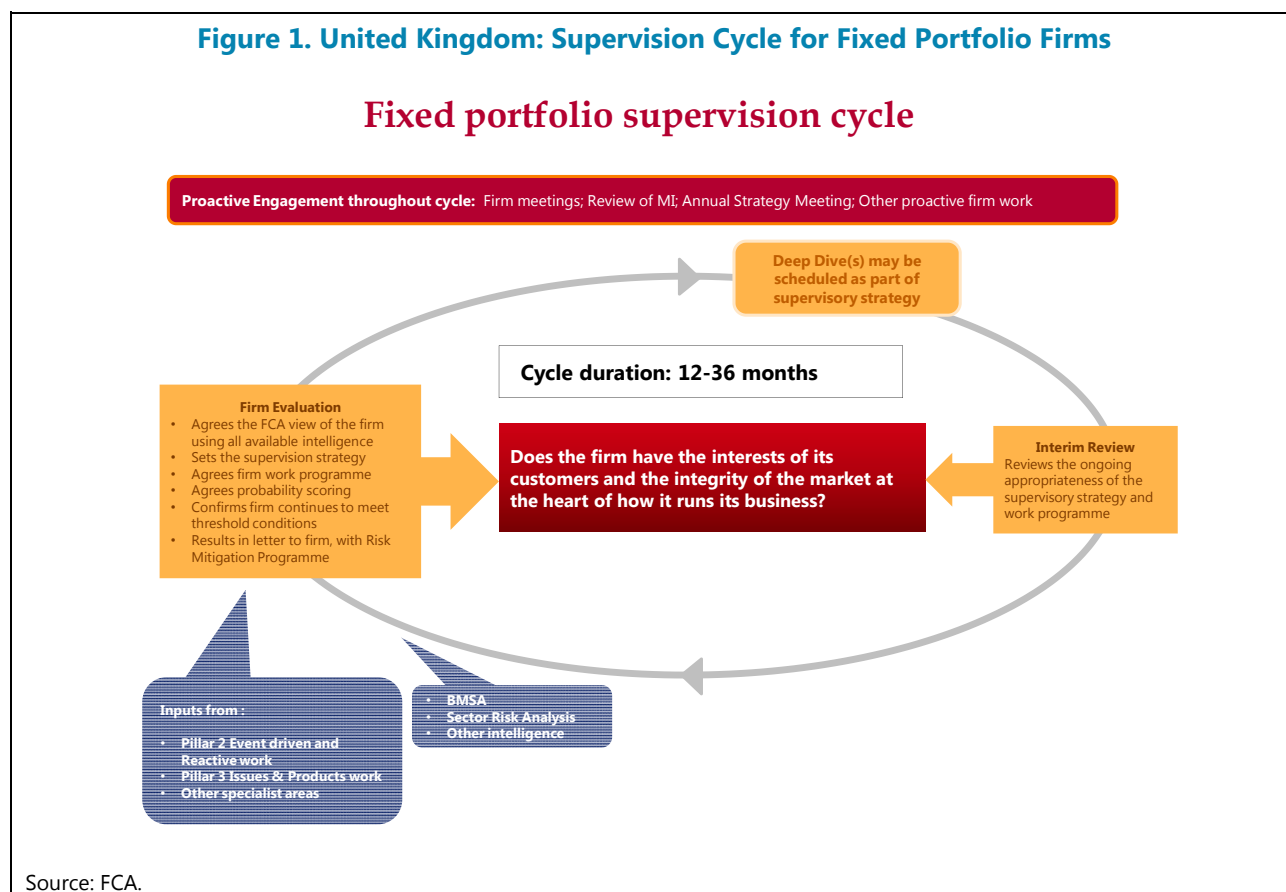
level of supervisory attention. These firms have a dedicated team of supervisors at the FCA and are subject to an ongoing cycle of proactive supervision.

- Flexible portfolio firms that are supervised through thematic and market-based work, and are subject to programs of communication, engagement and education aligned to the key risks identified in the relevant sector. The large majority of firms subject to the supervision of the Investment Management Department fall under this category.

80. The FCA’s conduct supervision model is built on three pillars of supervision activity.

Pillar 1 is a program of proactive, firm-specific supervision. Pillar 2 is event-driven, reactive supervision focused on dealing with crystallized or crystallizing risks in accordance with the FCA’s risk appetite. Finally, Pillar 3 is the FCA’s thematic approach, where it focuses on emerging risks, new products and other issues that are common to multiple firms.

81. The use of the three pillars in the supervision of fixed portfolio firms is summarized in the following figure:



Pillar 1

82. Under Pillar 1 the FCA engages with fixed portfolio firms to assess whether they have the interests of their customers and the integrity of the market at the heart of their business.

Pillar 1 supervision is used only for the fixed portfolio firms, each of which has a dedicated portfolio supervisor. Pillar 1 tools consist of:

- Proactive engagement;
- Regular meetings between FCA supervisors and the firm’s senior management and Board members;
- Regular reviews of management information (e.g., firm’s Board and Executive Committee packs);
- Annual strategy meetings between FCA senior management and firm executives;
- Deep dive assessments⁴⁷ as needed during each assessment cycle; and
- Periodic firm evaluations.⁴⁸

Pillar 2

83. Pillar 2 supervision includes two key elements: responding to events and baseline monitoring. The former is discretionary work based on intelligence or information received on a crystallized or crystallizing event. The latter involves reviewing the regulatory data submitted by firms and dealing with mandatory supervisory work, such as notifications by firms.

84. The FCA has a centralized function—the Event Supervision Department—that deals with events across most of the FCA’s supervisory areas. It has a case assessment team which assesses all new information and risk scores and prioritizes all new events. The action that can be taken includes closing the case with no action; risk based closing of the case; mitigating the risk; allocating the case to a supervision sector department to mitigate (generally when the matter requires particular expertise or intensive work with the firm); or referring the case straight to Enforcement.

85. To ensure a consistent approach to prioritization of events independent of where they are handled, the FCA has developed a decision tree approach. It provides clear decision points and factors to consider, making reference to the risk appetites developed for the relevant supervision function. Each supervision function has developed its own risk appetite with qualitative⁴⁹ and

⁴⁷ A deep dive is an in-depth assessment focusing on one of four risk groups: culture and governance; product design; sales and transaction processes; or post-sales/services and transaction handling.

⁴⁸ A firm evaluation is a summary of the FCA’s supervisory view of a firm and its risks. The results of a periodic firm evaluation, including the FCA’s strategy and work program for the next supervision cycle to address and mitigate the firm’s risks, are communicated through a letter to the firm and a presentation to the firm’s Board.

⁴⁹ Qualitative triggers refer to certain non-discretionary events that will always be dealt with by the relevant supervision sector department.

quantitative triggers to guide prioritization of Pillar 2 events. The quantitative triggers may differ between fixed and flexible portfolio firms and across sectors. The approach also takes into account the confidence that the FCA may have on the firm's senior management resolving the issue.

86. The final approach to dealing with investment management Pillar 2 events under the new supervisory model was in the process of being established during the FSAP. In the previous model, the relevant firm supervision team was responsible for responding to events in other than C4 firms in line with the overall supervision strategy for the firm. The Event Supervision Department handled all events for the C4 population. In the new supervisory model the Event Supervision Department will have the primary responsibility for all events relating to Investment Management Department's flexible portfolio firms. However, the Event Supervision Department is expected to transfer all complex events and those that exceed the sectoral risk appetite to the relevant Pillar 2 team in the Investment Management Department.

87. The FCA should closely monitor the impact of the new supervisory approach on the effectiveness of its Pillar 2 supervision. With an increasing number of firms becoming subject only to Pillar 2 supervision and possibly some Pillar 3 market-based reviews, the FCA has to continuously monitor that the Event Supervision Department is appropriately resourced to identify potentially complex events and risks. Such monitoring already takes place, including through compiling detailed statistics on the types and number of cases the Event Supervision Department has handled. In the future, appropriate resourcing may require that investment management expertise is available not only through consultation with the Investment Management Department but also within the Event Supervision Department.

Pillar 3

88. Pillar 3 supervision will primarily be used in the case of flexible portfolio firms, but may be applied to fixed portfolio firms where appropriate. It is driven by sector risk mapping, local risk prioritization decisions or directions issued by the FPC. Since 2012, the FCA has conducted the following thematic work in the areas covered in the section on Regulation (Table 5).

89. Assessing the impact of the new supervisory approach—in particular at a very early stage of its adoption—is challenging. In the context of this FSAP, it has been possible to review only the high level policy, the risk appetites for the relevant functions, and some examples of the application of the risk appetites. However, in light of the FCA's resources, the current risk-based approach seems to strike the right balance between firm-specific and market-based supervision.

Table 5. United Kingdom: Selected FCA Thematic and Market-Based Work

Theme	Topic	Timing	Communication of findings
Absolute Return Funds	Investment funds	Q1/2012	Published speech
Host Authorized Corporate Directors	Delegation	Q1/2012 and Q1/2014	Published speeches
Outsourcing	Delegation	Q1/2013	Thematic report
Vulnerabilities to reversal in interest rates	Risk management	Q2/2013	Report to the FPC
Custody bank ancillary services	Custody	Q3/2013	Published speech
Trustees and Depositories	Depository	Q4/2013	Bilateral feedback and industry association
Corporate bond fund liquidity management	Liquidity risk management	Q1/2014	Consumer factsheet
Liquidity management in normal and stressed scenarios by funds offering daily or near daily liquidity	Liquidity risk management	Q4/2015	Report to the FPC FCA good practice
Detailed assessment of hedge fund investment activities	Systemic risk	Ongoing	Report to the FPC

Source: FCA.

Product supervision

90. Since April 2014, the FCA has conducted supervisory work on authorized funds.

Particular focus has been on funds considered to present a risk to the FCA's consumer protection objective. The FCA's underlying assumption is that authorized funds are operated in compliance with their rules and maintain the appropriate liquidity and conduct standards until either the firm or a third party (e.g., a depository) alerts the FCA that there is an issue and/or the FCA identifies potential non-compliance or outlier behavior through its analytical or thematic work. The team prioritizes its work on the basis of a risk appetite based on the fund AUM, investor type, and potential or actual loss to consumers.

91. The work uses various analytical tools. A market data analysis tool conducts outlier analysis of approximately 3,000 authorized funds on a monthly basis, enabling the FCA to identify funds that exhibit different risk characteristics or trends from peers. Depositories have submitted certain data on authorized funds to the FCA since January 2015 (see section on reporting below), which the FCA uses to identify funds or firms with high or persistent levels of breaches, or firms with low or falling risk ratings from depositories. The FCA also aims at using AIFMD transparency information to identify AIFs (with retail investors) that have different characteristics from peers.

92. Since its establishment, the team has conducted four thematic reviews. A recently completed review focused on depository oversight of valuation and liquidity management of authorized funds conducting direct property investments. The team is currently undertaking a post-

authorization review of investment funds to assess whether the funds meet investor expectations. It has also worked on derivative reporting and disclosure and risk-targeted funds. The team is also responsible for reviewing various fund reports and notifications, the majority of which are addressed as part of Pillar 2 risk-based supervision.

Prudential classification and supervision

93. The FCA’s prudential supervision approach reflects the nature of the firms under its supervision. The FCA aims at minimizing harm to consumers, wholesale market participants and market stability when firms experience financial stress or fail in a disorderly manner. If firms are failing, the FCA considers that they should be allowed to do so in an orderly manner, regardless of their size. The FCA allocates firms under its sole supervision to one of the following prudential categories:

- P1 firms: their failure would cause lasting and widespread financial and reputational damage to the firm’s customers, client assets and the marketplace beyond. They are subject to periodic capital and, if applicable, liquidity assessment every 24 months.
- P2 firms: their disorderly failure would damage consumers and client assets but would be more easily dealt with than the failure of a P1 firm. They are subject to periodic capital and, if applicable, liquidity assessment, every 36 to 48 months.
- P3 firms: their failure is unlikely to cause any significant detriment to consumers or market integrity. Supervision of P3 firms is currently only reactive, with the exception of Capital Requirements Directive (CRD) IV firms in the P3 population.⁵⁰
- P4 firms: firms with special circumstances (such as administration) for which bespoke arrangements may be necessary.

94. In addition to periodic assessments, the FCA’s prudential supervision encompasses baseline monitoring of prudential returns. The FCA’s main regular prudential monitoring interaction with firms is when its prudential specialists perform a SREP of the firm’s Internal Capital Adequacy Assessment Process (ICAAP). Since the inception of the FCA its prudential specialists have carried out the following SREPs. Prudential returns are reviewed according to the established risk appetite.

⁵⁰ The European Banking Authority published Supervisory Review and Evaluation Process (SREP) guidelines in December 2014 with a view to driving convergence of approaches across the EU. The guidelines require reviews to be conducted on all firms within the scope of CRD IV with a minimum frequency of every three years starting from January 1, 2016. The number of P3 legal entities caught by CRD IV is approximately 700.

Table 6. United Kingdom: Capital and Liquidity Reviews of Fund Managers and Investment Managers

	Asset Managers ¹	Hedge Fund Managers	Total
2013	6	1	7
2014	9	2	14
2015	3	1	6
Total	18	4	27

Source: FCA.

¹ This includes investment firms authorized for investment management.

Reporting

95. The FCA receives a significant range of different types of reports relating to fund management, but relies on publicly available databases for information on UCITS funds' investments and risks. Fund managers are required to submit certain regular reports through the FCA's GABRIEL system, including periodic reports on financial resources. In addition to this core baseline reporting, risks and events are reported to the FCA on ad hoc basis and addressed under its Pillar 2 supervision. The FCA does not currently systematically collect and analyze regulatory data on the risk profiles of UCITS funds. Given the complexity and costs of regulatory data collection in a cross-border industry, relying on publicly available databases appears to be a sufficiently workable approach at the moment. However, it is important that the FCA ensures that the existing cooperation arrangements between the FCA and foreign authorities are used effectively to address issues related not only to customer protection and enforcement, but also to monitoring systemic risk arising from fund management activities.

96. Since January 2015, the FCA has received voluntary reporting from depositaries on relevant FCA Handbook breaches, including on material pricing errors. The reports are recorded, risk assessed and followed up on a case by case basis. In the period January 2015–May 2015 the FCA received notification of 3,163 breaches, including 864 pricing error breaches (of which 47 were material). The FCA reviewed the 47 material breaches and contacted the relevant firms about five pricing errors and required them to rectify the situation in two instances to date. No enforcement action has been taken.

97. A significant new reporting requirement applicable to AIFMs is the AIFMD transparency reporting. This reporting obligation has applied since end-September 2014 to the AIFMs (and AIFs) subject to the quarterly reporting obligation. The first annual reports⁵¹ were submitted for the end-

⁵¹ Small authorized and registered U.K. AIFMs and small non-EEA AIFMs marketing AIFs in the U.K. are subject only to the annual reporting obligation.

December 2014 reporting period; 1,203 AIFMs reported then on 4,966 funds. Appendix Table 1 provides a summary of the reporting obligations.

98. Information received during the first two reporting periods was not of sufficient quality to complete the planned risk analysis. The FCA had anticipated this given the significant complexity of the reporting requirements. The poor quality was primarily caused by undeveloped understanding and misinterpretation of the reporting requirements by firms and lack of experience with the new reporting regime. Recently the FCA has been able to continue to develop its analytical framework, although at the time of the missions the data was still not of sufficient comprehensiveness and quality. The FCA's primary focus has been in developing its capability to conduct cross-sector comparisons by each type of fund (hedge fund, private equity fund, real estate fund, fund of fund, other) on the funds' counterparty credit, investment, leverage, and liquidity characteristics.

99. The FCA has a number of initiatives to support improvements in the AIFMD transparency reporting's data quality and analysis. The former include developing systems to identify misreporting in a simple manner, educating firms through communications on common reporting errors, and providing proactive feedback to ESMA. Anecdotal evidence suggests that the FCA is more advanced in dealing with the AIFMD reporting challenges than many of its EEA peers. The data quality challenges are likely to diminish, once firms gain more experience in using the new reporting regime and the exchange of information between the EEA authorities becomes operational. With regard to analysis, the FCA intends to develop an automated charting and graphing functionality for each reporting period in a custom built data analysis tool, thereby enhancing its ability to conduct cross-period analysis on the outlined areas.

100. A larger challenge is posed by the fact that the FCA does not get any information on the non-EEA AIFMs managing AIFs that are not marketed in the United Kingdom. Only acquiring the information on the AIFs marketed—including feeder funds—is not necessarily sufficient for supervisory and systemic risk monitoring purposes. This is because the AIFs managed by non-EEA AIFMs are interconnected with the U.K. financial system even without direct marketing. For example, a non-EEA AIFM may have delegated portfolio management to an U.K. investment manager or may no longer be actively marketing the AIFs in the United Kingdom. The U.K. authorities should therefore extend, if legally possible, the scope of the AIFMD transparency reporting to cover also certain non-EEA AIFMs and seek to enhance data availability through international cooperation and exchange of information.

Use of supervisory and enforcement tools

101. A failure to comply with regulatory requirements is typically identified and considered by the relevant supervision division. Where supervisors consider that the use of formal powers might be appropriate or that enforcement expertise would assist in considering the issues, they discuss the case with EMO to agree an appropriate approach. Instead of, or in addition to launching an enforcement investigation, the FCA may consider whether to agree with the firm on the action required to be taken, appoint a skilled person to obtain an independent view of the firm's activities, prevent the firm from conducting particular activities, impose requirements on the firm on how to

conduct its activities, make the firm pay redress to customers and/or ban or restrict particular products or misleading financial promotions.

102. A decision on the appropriate tool to be used is made jointly by senior staff from EMO and the relevant supervision division, using specific enforcement referral criteria. The overarching question is whether an enforcement investigation would be likely to further the FCA's aims and statutory objectives. To answer this, the FCA considers specific enforcement referral criteria: the strength of the evidence and the proportionality and impact of opening an investigation, the purpose or goal to be served by any enforcement action (i.e., deterring wrongdoers, changing industry behavior, or protecting the industry by removing wrongdoers or imposing restrictions where appropriate), and any other factors relevant to assessing whether the purposes of enforcement action are likely to be met. If the appointment of enforcement investigators remains appropriate, a formal enforcement referral decision is taken by the relevant enforcement and supervision senior staff. Referral decisions are recorded in a formal referral document. A record of the reasons for the decision not to refer a significant case to enforcement is also maintained.

103. Investigation of suspected breaches generally takes into account the FCA's supervisory focus areas with the objective of delivering important messages in these areas. Key themes for investment funds have been: protecting client assets, providing clear and not misleading communications to customers, maintaining adequate and effective front office systems and controls, and identifying and managing conflicts of interest. In the last three years FCA regulatory investigations have also focused on the unlawful promotion and mis-selling of unauthorized AIFs (also referred to as Unregulated Collective Investment Schemes—UCIS).

104. The FCA has a wide range of enforcement measures at its disposal. It can, for example, impose a financial penalty, suspension, limitation, or public censure, issue a private warning, vary or cancel an authorized firm's permission or impose requirements on it, prohibit individuals or withdraw their approval, obtain injunctions, and obtain restitution and redress for customers. Settlement is possible at any stage of regulatory proceedings, subject to the FCA having a sufficient understanding of the nature and gravity of the issue to make a reasonable assessment of the appropriate outcome. In relation to funds, the FCA may take action to close the fund, cease unit dealing, or replace the fund manager or depositary.

105. The FCA has used its enforcement powers in the investment management sector in an effective manner. Between July 1, 2012 and June 30, 2015 the FCA publicly disciplined eight firms performing regulated activities related to investment funds which included imposing fines of up to GBP 126 million. During the same period, the FCA publicly disciplined firms and individuals in eleven UCIS related cases, which included imposing fines ranging from GBP 28,000 to GBP 350,000 as well as

prohibitions, withdrawals of approvals and restrictions/suspensions.⁵² It also issued one private warning in a UCIS related case.⁵³

E. Systemic Risk Monitoring

FCA

106. The FCA's integrity objective includes the financial system's soundness, stability and resilience, and the orderly operation of financial markets. Accordingly, the FCA is required to have regard to systemic issues which could have an adverse impact on the stability of the U.K. financial system. The AIFMD also places a requirement on the FCA to monitor the systemic risks of AIFs.

107. The FCA has a structured process to identifying risks, including systemic risk. As part of its Risk Framework, the FCA operates a Three Lines of Defense model in order to support its decision making and risk control, and to encourage effective risk governance.

- The first line undertakes the day-to-day operations of the organization and owns and manages risks to the FCA's objectives. Investment Management Department is one of these first lines.
- The second line (Risk & Compliance Oversight Division) provides organization-wide guidance on risk policies and procedures and oversees the first line's activities to provide assurance that risks are being appropriately managed.
- The third line (Internal Audit Division) provides independent assurance on the FCA's risk framework, risk management, internal controls, and the effectiveness of the interaction between the first and second lines of defense.

108. The FCA considers that few of its regulated firms are likely to be systemically important in isolation in most circumstances, and has focused its supervisory work more broadly on markets and sectors. As a result, the main responsibility for the FCA's work with regards to investment management activities lies in the department's sector team that has developed expertise in analyzing investment management risks through a structured process described in the section on supervision. The FCA has primarily focused on the risks presented by hedge funds, given the nature of their underlying investment strategies that have the potential to lead to high levels of leverage, large exposures, use of more complex and illiquid instruments, and asset concentrations. The FCA's hedge fund supervision work has focused on two main risks: potential systemic risk presented by the market, liquidity and counterparty risks of hedge funds and potential risk to market integrity (see above). The FCA has also undertaken market-based work on open-ended funds that offer daily, or near daily,

⁵² All fines and other sanctions have been set out in Final Notices published between July 1, 2012 and June 30, 2015.

⁵³ The information given in this paragraph is based on keyword searches conducted by the FCA across its case management systems and its 'Outcomes and Notices' webpage using the terms 'UCIS' and 'asset management.' Threshold conditions cases have not been included.

liquidity to investors (see above). Given the fact that the fund management risks do not typically lie in the managers, taking a sector based approach appears sensible.⁵⁴

FPC

109. The FPC is responsible for monitoring and managing systemic risk in the United Kingdom. Its primary objective is to identify, assess, monitor and take action to remove or reduce systemic risks with a view to protecting and enhancing the resilience of the U.K. financial system. Such systemic risks include those attributable to structural features of markets, risks relating to the distribution of risks within the financial sector and unsustainable levels of leverage, debt or credit growth. The FPC has a secondary objective to support the economic policy of the Government. It has eleven members, including the Chief Executive of the FCA, five members from the BoE, four independent external experts and a non-voting member from the HMT. The FCA's Financial Stability Team within the Strategy & Competition Division leads on the FCA's engagement with the FPC.

110. The FPC's risk assessments are published in the BoE FSR. Recent FSRs have discussed potential risks arising from asset management activities and investment funds. In the June 2013 FSR, the FCA, PRA and BoE were requested to provide an assessment to the FPC of the vulnerability of hedge funds to sharp upward movements in long-term interest rates and credit spreads in low interest rate environment. The June 2014 FSR identified the potential for increased liquidity risk in investment funds offering daily redemptions to investors while investing in longer-dated assets that are only liquid if secondary markets are functioning. More specifically, the report noted that increased investment in less liquid assets and a growth in funds where investors expect to be able to access their investments quickly are likely to have increased such liquidity risk, that liquidity risk could be exacerbated by the retrenchment in market-making by banks and broker-dealers, and that rapid asset sales to meet investor redemptions might lead to impaired market liquidity which may impact other participants in the financial system.

111. The June 2014 FSR also identified certain risks relating to hedge funds. More specifically, it noted that if market volatility leads to banks' exposures to hedge funds becoming inadequately collateralized, the failure of a large hedge fund could lead to significant losses for banks. Also, if a hedge fund becomes distressed, it could withdraw from markets or sell assets rapidly, resulting in a destabilizing impact on liquidity and pricing. The potential for forced liquidations and market distortions is amplified by the use of leverage by funds. Large hedge funds that account for significant positions in certain markets and/or represent large exposures to their counterparties, mainly banks, may be a particular cause for concern. The BoE and FCA staff are seeking to develop better risk measures, including of banks' stressed exposures to hedge funds and of the impact of hedge funds' activities in certain markets.

⁵⁴ This is also in line with the observations of the IMF April 2015 Global Financial Stability Report that noted that a product- or activity-based approach seems to be important, given that the fund management industry is diverse and that differences in investment focus seem to matter significantly for funds' contribution to systemic risk.

112. The July 2015 FSR reported on the FPC annual review of channels through which activities undertaken by the non-bank financial system could affect U.K. financial stability. This included a high-level review of thirty types of activity that are not part of the core banking system. The FPC did not recommend any changes to how these activities are regulated. However, the FSR stated that the FPC will undertake a detailed assessment of five activities over the coming year, including those of open-ended investment funds and hedge funds. On hedge funds' investment activities, the report noted that the BoE and FCA staffs continue to gather data on the sector. The work that is still underway has noted that hedge funds support secondary market liquidity and price discovery and are also interconnected with banks via repo transactions, margin loans and through derivative agreements.

113. As part of its assessment of financial stability risks and regulation of open-ended investment funds, the FPC tasked the BoE and FCA to undertake certain analytical work. The objective of this work was to understand whether investment funds may contribute to systemic risk, given the potential for liquidity mismatch between their offer of short-term redemptions and potential illiquidity of their assets. As part of this work, the BoE and FCA gathered information from U.K. asset managers about their strategies for managing the liquidity of their funds in normal and stressed scenarios. The information covered 17 large asset managers and 143 of their funds, focusing on those with large corporate bond holdings. A comprehensive data request was sent to firms to collect quantitative data, including an estimate of the amount of assets that could be liquidated under normal market conditions, and qualitative information on liquidity risk management processes and tools.⁵⁵

114. The December 2015 FSR presented the FPC's review of the potential risks to U.K. financial stability arising from investment fund activities, drawing on the information gathered by the BoE and FCA. The FPC supported the BoE's intention to incorporate the activity of investment funds into system-wide stress testing and, in the near term, to assess the resilience of markets to large-scale fund redemptions. It also supported further work by the FCA to assess investor awareness of the liquidity risks associated with investment funds, to communicate good liquidity management practices to the asset management industry, and to assess leverage in investment funds, including through international initiatives to address data gaps. The FPC also supported the recent Financial Stability Board statement that encouraged appropriate use of stress testing by funds to assess their ability individually and collectively to meet redemptions under difficult market liquidity conditions. The FPC will reassess its position in light of these international initiatives.

⁵⁵ This covered information on fund structures; investor redemption terms; liquidity risk management processes; how the sampled funds manage liquidity and redemptions, including the availability and historical use of different tools such as swing pricing, dilution levies, staggered/gated/deferred redemptions and payment in specie and suspension dealing.

EQUITY TRADING PLATFORMS

A. Market Structure

115. Equity trading in the U.K. takes place on several types of platforms and OTC. Systems based on multilateral, non-discretionary trading rules are either RMs or MTFs as regulated by MiFID.⁵⁶ RMs are operated in the U.K. by RIEs⁵⁷ that can also operate MTFs. There are also MiFID regulated systematic internalizers (SIs). OTC trading category under MiFID I incorporates a range of trading activities from traditional voice-based OTC trading to multilateral internal matching systems operated by banks or investment firms (commonly referred to as BCNs). RMs and MTFs are subject to specific trading system regulation under MiFID I, whereas SIs and BCNs are required to comply with standard investment firm requirements together with some additional pre-transparency obligations in the case of SIs (see below). The U.K. domiciled equity trading systems (RIEs, MTFs, SIs and some of the BCNs) are presented in Table 7.

116. BCNs where investment firms execute transactions on behalf of their clients in their capacity as brokers by crossing the clients' orders with those of other clients or by dealing on their own account against client orders are permitted in the United Kingdom. While BCNs are multilateral systems, their trading systems typically incorporate an element of discretion since orders are executed based on client instructions/permissions,⁵⁸ which carves them out from the MiFID I RM and MTF definitions. Complete information on BCNs' market share and trading functionalities is currently not available, although at European level their market share is estimated to be about 1.8 percent.⁵⁹

117. MiFID I does not appear to prohibit an RM or MTF operator from acting as a riskless counterparty or liquidity provider in its own trading system by executing client orders against its own capital. In practice, no U.K. RIE is currently acting as a riskless counterparty or liquidity provider. However, some MTF operators do. In addition, the affiliated entities and related parties of an RIE and MTF operator may trade in a principal capacity under the RM or MTF systems and rules.⁶⁰

⁵⁶ A multilateral system is defined in MiFID as a system that brings together or facilitates the bringing together of multiple third party buying and selling interests in financial instruments in the system and in accordance with its non-discretionary rules in a way that results in a contract.

⁵⁷ Recognized Overseas Investment Exchanges (ROIEs) are also subject to regulation in the U.K., but they are not discussed further in this note.

⁵⁸ Some BCN operators, for example, provide their clients the ability to choose the counterparty types against which the clients are willing to trade.

⁵⁹ Source: Rosenblatt Let There Be Light. This compares with the estimated market share of dark MTFs of approximately 4.3 percent.

⁶⁰ MiFID II (i) requires that investment firms operating an internal matching system which executes client orders on a multilateral basis must be authorized as an MTF; and (ii) prohibits RM and MTF operators from executing client orders against proprietary capital or engaging in matched principal trading.

Table 7. United Kingdom: Equity Trading Systems Domiciled in the U.K.

Type of operator	Operator	System (where applicable)
RIE	BATS Trading Limited	BATS Europe Regulated Markets (two)
		BATS MTF
	Euronext London Limited	Euronext London
		Smartpool (MTF)
	ICAP Securities & Derivatives Exchange Limited	ISDX Main Board (RM)
		ISDX Growth (MTF)
		ISDX Secondary Market MTF
London Stock Exchange plc.	LSE Regulated Market	
	LSE AIM (MTF)	
	LSE MTF	
MTF operator	Aquis Exchange Ltd	Aquis
	Cheuvreux Int Ltd	Blink
	Instinet Europe Ltd	Blockmatch
	Liquidnet Europe Ltd	Liquidnet
	Goldman Sachs Intl	Sigma X
	Turquoise Global Holdings Ltd	Turquoise
	UBS Ltd	UBS
SI	Citigroup Global Markets Limited	
	Citigroup Global Markets U.K. Equity Limited	
	Credit Suisse Securities Europe Ltd	
	Goldman Sachs International	
	Knight Capital Europe Limited	
	UBS Ltd	
	UBS AG (London Branch)	
BCNs ¹	Barclays	LX
	Citi	Citi Match
	Credit Suisse	Crossfinder
	Goldman Sachs	SIGMA BCN
	JP Morgan	JPMX
	Société General	Alpha Y
	UBS	Price Improvement Network

Sources: FCA, ESMA MiFID database, Rosenblatt, BCNs' websites.

¹ Since BCNs are not regulated as trading systems under MiFID, this list is not complete. It is based on partial information collected from Rosenblatt Securities Inc.'s Let There Be Light report and from the BCN operators' websites. It has not been possible to verify whether these platforms are operated by U.K. based legal entities.

118. An SI is an investment firm that on an organized, frequent, and systematic basis deals on own account by executing client orders outside an RM or MTF. This means that client orders are always executed against the proprietary capital of the investment firm. There are only 11 SIs in the EEA, seven of which are based in the United Kingdom.

B. Regulation

119. The U.K. legislative and regulatory framework for operators of equity trading platforms is largely based on the relevant EU framework. The FSMA and various FCA Handbook rules are the main legal instruments that transpose the MiFID and include additional U.K. specific requirements in particular for RIEs. A recast version of MiFID, referred to as MiFID II, is supposed to be transposed to member states' national legislation by July 3, 2016. During the FSAP, the European Commission proposed delaying the entry into application of MiFID II and the related Regulation, Markets in Financial Instruments Regulation (MiFIR), until January 3, 2018.

120. The discussion below focuses on the elements of the regulatory framework that are considered most relevant for financial stability. It describes the EU framework if the U.K. requirements are directly based on it. If the U.K. has additional requirements, those are highlighted separately. The discussion points out areas where the regulatory framework is not compliant with the relevant IOSCO Principles or Standards, or where enhancements are otherwise recommended to be made. The manner the FCA covers these elements when authorizing and supervising RIEs, MTF and BCN operators, and SIs is discussed in Sections C and D.

Financial resources

121. MiFID does not include specific financial resources requirements for RM operators and the U.K. framework provides discretion to the FCA in setting the requirements for each RIE. MiFID only requires an RM to have sufficient financial resources to facilitate its orderly functioning, having regard to the nature and extent of the transactions concluded on the market and the range and degree of the risks to which it is exposed. The U.K. rules require an RIE to have financial resources sufficient for the proper performance of its relevant functions. In determining the adequacy of those resources, the FCA must take all relevant circumstances into account including the exchange's connection with any person. In July 2012, the FCA revised its guidance on RIE financial resources to complement its "standard approach" with a risk based approach designed to ensure that an RIE is at all times capable of implementing an orderly wind-down of its regulated activities, after allowing for those financial losses that it might incur in stressed but plausible market conditions. This framework complies with the relevant requirements in Principle 33 of the IOSCO Principles.

Market monitoring and surveillance

122. MiFID requires RM and MTF operators to conduct market surveillance. As an RM operator, an RIE has to establish and maintain effective arrangements and procedures for the regular monitoring of the members' compliance with its rules. It must monitor members' transactions in order to identify rule breaches, disorderly trading conditions or conduct that may involve market abuse or financial crime. FCA has to be informed without delay on any such conduct or conditions. Similar requirements apply to MTF operators. Therefore, compliance with Principle 33 is ensured in case of the requirements for both RIEs and MTF operators.

Member access and supervision

123. Access to RMs and MTFs is subject to criteria derived from MiFID. RMs and MTFs must ensure that access to their facilities is subject to criteria designed to protect the orderly functioning of the market and the interests of investors. Members and participants must be fit and proper, have a sufficient level of trading ability and competence, have (where applicable) adequate organizational arrangements, and have sufficient resources for the role they are to perform. This framework is in line with the fair access requirement of Principle 33. Under the U.K. rules, RIEs also have to notify the FCA on proposals to accept member firms that may pose particular risks (such as unauthorized firms or firms from new jurisdictions).

124. Under the U.K. rules, RIEs and MTF operators have to conduct oversight and control of their members' access to the trading system. The FCA's August 2013 guidance sets out its expectations on the key elements of this obligation that require RIEs and MTFs operators to have effective risk assessment procedures at the time of approving and onboarding new members; ongoing arrangements to assess members' compliance with their rules; and monitoring and surveillance arrangements to assess potential breaches of their rules and market abuse. RIEs and MTF operators must be able to determine that their members' systems and controls can be reasonably expected to ensure compliance with their rules and trading procedures.

Dealing with disorderly trading conditions

125. MiFID requires RMs and MTFs to ensure fair and orderly trading and efficient execution of orders in line with the IOSCO requirements. To achieve this, they must have transparent and non-discriminatory rules and procedures and soundly managed technical systems, including effective contingency arrangements to cope with systems disruptions. They must comply immediately with any instruction from the competent authority to suspend or remove a financial instrument from trading and be able to do it themselves if a financial instrument no longer complies with their rules.

Pre- and post-trade transparency

126. MiFID pre- and post-trade transparency requirements apply to shares admitted to trading on an RM. Full pre-trade transparency obligations apply only to trading on RMs and MTFs, whereas SIs are subject to limited pre-trade transparency requirements.⁶¹ Investment firms that do not operate an MTF or meet the SI definition are not required to follow any pre-trade transparency requirements. Post-trade transparency obligations apply to all trades in shares admitted to trading on an RM independent of where the trades were made. For shares not admitted to trading on an RM

⁶¹ MiFID includes detailed pre-transparency requirements for various trading methods. RMs and MTFs must generally disclose the bid and offer prices and the depth of trading interest at those prices which are advertised through their systems. SI pre-trade transparency obligations apply only to trades up to the standard market size (as defined in Annex III, Table 3 of the MiFID Implementing Regulation) in liquid shares.

there are no minimum transparency requirements set at the EU level. However, the FCA expects that for shares traded on an MTF equivalent level of pre- and post-trade transparency is maintained.

127. MiFID provides the possibility for the competent authority to waive pre-trade transparency in certain circumstances, which the FCA has fully utilized. It has granted all four waiver types permitted under MiFID to various RMs and MTFs.⁶² For example, one of the largest U.K. RIEs is allowed to waive pre-trade transparency according to all other waiver types except the one for reference price systems, while another RIE benefits from all four waiver types. Most dark pool MTFs operate under the reference price waiver. Before granting a new waiver, an EEA competent authority is required to ask for ESMA's opinion on the waiver's compliance with the criteria in the MiFID Implementing Regulation. The FCA is currently conducting a thematic review on the operation of U.K. dark pools (MTFs and BCNs), under which it expects to gain a better understanding on the extent to which various waivers are in practice used.

128. MiFID post-trade transparency requirements apply in the United Kingdom and the FCA has approved delayed publication of certain trade information to the extent permitted by MiFID. Possibility for delayed publication applies to large risk trades (block trades) for all relevant U.K. trading that fulfills the requirements in Annex II, Table 4 of the MiFID Implementing Regulation. RIEs and MTF operators are required to notify the FCA that they plan to use the derogation, either during an application for recognition/authorization, or as part of ongoing supervision following a material change to their systems.

129. Publication of pre- and post-trade information in shares admitted to trading on an RM is subject to MiFID requirements. Publication arrangements must facilitate the consolidation of data and make the information available to the public on a non-discriminatory commercial basis at a reasonable cost. The FCA has imposed additional conditions on the publication arrangements. They must be accessible by automated electronic means in a machine-readable way, utilize technology that facilitates consolidation of the data and permits commercially viable usage, and be accompanied by instructions outlining how users can access the information. The FCA has also provided further guidance on arrangements fulfilling the machine readability criterion.

130. The FCA has issued guidelines for firms intending to use trade publication arrangements. A trade data monitor (TDM) is an arrangement confirmed by the FCA or an external auditor as enabling a firm to meet the FCA guidelines. FCA list of confirmed TDMs includes BOAT Services Limited, Deutsche Boerse AG, London Stock Exchange plc, ICAP Securities & Derivatives Exchange, and BATS Trading Limited. As the TDM scheme is voluntary, firms may publish their post-trade data through non-TDM arrangements, provided these comply with the MiFID requirements. In practice RIEs and MTF operators publish pre- and post-trade information both directly to customers and through data vendors or TDMs.

⁶² MiFID provides the following types of waivers: orders that are large in scale as determined in Annex II, Table 2 of the MiFID Implementing Regulation; systems that formalize negotiated transactions; reference price systems; and orders held in order management systems.

131. IOSCO Principles and Standards include only very generic requirements on the content and publication of pre- and post-trade transparency information. In general, the current U.K. framework therefore does not have any material gaps in terms of the content of the information. To improve consolidation of post-trade transparency information, the FCA has also promoted the use of TDMs for data publication. The changes planned to be made under MiFID II will bring a welcome enhancement to the content and timeliness of pre- and post-transparency information. MiFID II is also due to enhance the requirements on the consolidation of information to address the challenges arising from the current fragmented trading.

132. The FCA has started to consider how to implement the new MiFIR pre- and post-trade transparency requirements. The MiFIR requirements are more stringent than the current MiFID requirements both with regard to waivers from pre-trade transparency and delays from immediate post-trade transparency. The FCA published a consultation paper on the new rules in December 2015. So long as existing transparency waivers meet all the requirements under MiFID II, the FCA plans to grandfather them. In the case of the double volume cap mechanism,⁶³ under which the negotiated trade and reference price waivers may be suspended on a per share basis following a breach of one or both of the caps, the FCA will have to adopt new processes. MiFID II also introduces the concept of an Approved Publication Arrangement (APA), which is a firm authorized to provide the service of publishing post-trade transparency information on behalf of investment firms. TDMs will have to be authorized, if they wish to become APAs as there will be no grandfathering of existing approvals.

SIIs and BCNs

133. With the exception of post-trade transparency and tailored SI pre-trade transparency obligations the above obligations do not apply to SIIs or BCN operators that are subject only to MiFID investment firm requirements. These include the obligation to report to the FCA suspicious transactions and requirements aimed at ensuring compliance with certain fiduciary duties, including order handling rules, best execution requirements and other disclosure and due diligence obligations. In July 2014 the FCA published a report on best execution and payment for order flow, a section of which addresses the SIIs' best execution obligation. The report noted that executing a client order against a firm's proprietary position where the firm is making a decision on how the order is executed or executing the order by dealing as a riskless principal will always be cases where best execution applies. The application of the best execution requirement on SIIs and BCN operators is therefore one of the key distinctions between them and RIEs and MTF operators that are not subject to the best execution obligation.

C. Recognition and Authorization

134. The recognition/authorization stage is important in the FCA's approach to RIE and MTF supervision. The FCA uses this process to ensure it understands the nature of the risks posed by RIEs

⁶³ MiFIR limits the percentage of trading carried out on a trading venue under the reference price and negotiated transaction waivers to 4 percent of the total volume of trading in that share on all EEA trading venues over the previous 12 months, and overall EEA trading to 8 percent.

and MTFs to the FCA's objectives at the point of entry, and that operators have taken sufficient action prior to authorization to mitigate any risks.

RIEs

135. An RIE has to be recognized by the FCA. To be recognized, an applicant must comply with the recognition requirements laid down in the FSMA Recognition Requirements for Investment Exchanges and Clearing Houses Regulations 2001 (RRR). The RRR relate to financial resources; suitability; systems and controls; safeguards for investors; disclosure by issuers; promotion and maintenance of standards; rules and consultation; discipline; complaints; and default rules, and therefore comply with the requirements of IOSCO Principle 33. The FCA's multidisciplinary team reviews the application in a thorough manner and engages in meetings with the applicant before recognition is granted.

MTF and BCN operators and SIs

136. As investment firms, MTF and BCN operators and SIs are assessed for compliance with the FCA's threshold conditions. The FCA assesses, on a risk basis, the applicant's ability to monitor its system for market abuse and its business rules, governance, and risk management processes. In the past few years, there have not been any applications from investment firms that would have been planning to become an SI or operate a BCN, so the FCA does not have an established process for dealing with such applications. However, since a BCN is not a regulated trading system, the current operators may not necessarily have been subject to a particular analysis from the perspective of operating a trading system.

137. The fact that BCNs can be operated without being authorized as trading system operators is a deficiency in the current regulatory framework. However, this gap is due to be closed through the implementation of MiFID II. The FCA is aware of the risks that the gaps in the regulation of BCNs may cause, which is demonstrated by the ongoing dark pool thematic review (see below). Pending the application of the MiFID II requirements, the FCA should continue to ensure that BCNs' activities are sufficiently supervised and monitored, taking into account the nature of their business as trading system operators.

Specific requirements for MTF operators

138. Operating an MTF requires an investment firm to have the relevant permission under MiFID, which requires specific competence. In assessing the application, the FCA reviews the MTF's proposed business model and its operational, technological (including trading system) and surveillance arrangements to ensure that they are consistent with the fair and orderly trading requirements. Where appropriate, the applicant completes the Complex IT Controls Form, which includes information on its IT risk management procedures. The form and the operation of the proposed electronic trading platform are reviewed by the FCA's IT operational risk experts. The FCA also considers the appropriateness of the applicant's disaster recovery/business continuity plans. The

IT systems evaluation involves onsite visits to review the platform and the firm's market surveillance capabilities. In addition, the FCA reviews key documents such as the MTF's rulebook.

139. Dealing with an MTF operator's application is a long process involving several FCA Divisions. A typical application can take up to 12 months to process. While the assigned case officer makes the final recommendation on whether to authorize the firm to a Permissions Department manager (or above) as the ultimate decision maker, an MTF operator's application is subject to a collective review by the following teams:

- Wholesale Permissions Team, which reviews and assesses compliance with the threshold conditions.
- Financial Resources Team and Infrastructure & Trading Firms Team, which assess the firm's ICAAP and capital adequacy requirements.
- Infrastructure & Trading Firms Team, which assesses whether the applicant can comply with the relevant FCA rules and reviews the applicant's corporate governance arrangements with a focus on independent directors.
- Technology, Resilience and Outsourcing Team, which assesses the applicant's IT Systems & Controls Form to ensure the systems and controls meet the relevant threshold conditions in respect of technology risk.
- Market Surveillance Team, which reviews the firm's surveillance and monitoring capabilities.
- Trading and Post-Trade Policy Team, which liaises closely with the Infrastructure & Trading Firms Team to ensure the venue is compliant with EU and domestic legislation.

D. Supervision

Organization and resources

140. The FCA's supervisory arrangements for RIEs and MTFs on one hand and SIs and BCNs on the other hand are different. RIEs and MTFs are supervised by the FCA's Infrastructure & Trading Firms Department in the Supervision—Investment, Wholesale & Specialists Division. Supervision headcount for equity RIEs/ROIEs and MTFs is 13 FTEs. Since SIs and BCNs are operated by investment firms and banks as part of a suite of equity trading services, they are captured within the FCA's supervisory regime for investment banks in the Wholesale Banking Department. Both Departments report to the same Director.

FCA's supervisory approach

141. The FCA's supervisory approach to RIEs and MTFs seeks to ensure the achievement of comparable regulatory outcomes in line with the FCA's general supervisory approach (see above). This reflects the functional similarities between the RIEs' and MTFs' business, while

recognizing differences in the legal and regulatory framework. The same approach is not applied to BCNs and SIs, given the different regulatory requirements.

Conduct classification and supervision

142. RIEs and MTF operators are subject to the FCA’s general conduct classification system where each firm is supervised either as part of the fixed or flexible portfolio. The approach is described in more detail in the fund management section. Classifications take account of the complexity of the RIEs’ and MTF operators’ activities, market share, the presence of systemically important member firms, integration of trading and clearing activities, and role in the local primary market. The FCA assessments are guided by a risk map which has been developed by the relevant department as an overview of the key potential risks posed by operators of market infrastructure. Some MTF operators falling under the flexible portfolio are part of financial institutions which are classified as fixed portfolio firms. As a result, these operators may be captured by some of the firm supervision elements. The impact of the adoption of the new supervisory approach generally seems to be less significant for the supervision of RIEs and MTFs than for the supervision of firms conducting fund management activities.

143. The approach to Pillar 1 and Pillar 2 supervision for RIEs and MTF operators is the same as in the case of fund management, with the Pillar 2 event risk appetites tailored to the sector. However, RIEs’ and MTF operators’ Pillar 2 supervision is conducted in the Infrastructure & Trading Firms Department rather than in the Event Supervision Department. Pillar 2 events in the case of RIEs and MTFs can require, among others, review of order types, market structure, quality of market abuse and market manipulation referrals, and admission criteria, as well as dealing with suspected breaches of financial resources requirements.

Pillar 3

144. Under Pillar 3, the FCA has conducted some thematic reviews relating to RIEs and MTF operators. The FCA undertook a comprehensive thematic review of MTF rulebooks in 2013-2015, the end result of which was that the FCA sent a ‘Dear CEO letter’ to firms within the scope of the review and issued good practice guidance. The guidance emphasized, among other issues, that an MTF’s rulebook should be clearly labeled as such and be publicly available on the MTF operator’s website and that supporting documents such as participation agreements, terms of business, product lists, user guides, fee schedules, and technical specifications should also be publicly available and transparent. The FCA also published in a recent Market Watch article its findings from a thematic review of pre-trade controls, which were split in three major areas: pre-trade controls, control setting amendment procedures, and on-going monitoring and incident surveillance.

145. The FCA is currently conducting two thematic reviews in this area. The first one covers a selection of U.K. dark pools (BCNs and dark MTFs) and their operators. The review is seeking to assess whether the functionality of BCNs and dark MTFs is accurately represented to their users, for example in terms of client order routing/handling preferences, and how well operators identify and manage conflicts of interest that may arise through the operation of their pool. The intention is to publish the

findings in Q2/2016. The FCA also recently completed a comprehensive thematic review on the information and data sources used by high frequency and highly automated trading strategies and their connectivity options. The review's findings will be used to inform the FCA's supervisory work and future policy considerations. Since the review's objective was not to assess compliance with existing requirements, the FCA does not currently plan to publish the findings of this review.⁶⁴

Classification for market monitoring

146. The EMO Market Monitoring Department assists the Supervision Division in assessing RIEs' and MTF operators' arrangements and procedures to identify conduct that may involve market abuse. The department has not yet transitioned to the new supervisory approach. Therefore, firms that are assessed to fall within the two highest risk categories (in a scale of three) with respect to market abuse are subject to a periodic proactive review either every two or three years. The reviews include desk-based work, information gathering and an on-site visit including a demonstration of the surveillance system, a review of the surveillance staff's skills (through interviews and meetings), record keeping, policies and procedures and an assessment of the coverage and effectiveness of any surveillance in place. The overall review follows a similar format to that of the questions for new applicants, but takes into consideration the notifications received from the platform with regard to market misconduct, any issues raised, and information gathered since the previous visit. The lowest risk category firms are subject to an online questionnaire. If significant deficiencies and risks are identified, an on-site visit may be undertaken.

147. The FCA analyzes all market abuse notifications received from RIEs and MTF operators to understand trends and highlight any deficiencies. Such information feeds into a holistic analysis of the operator's market abuse detection capability. As part of this proactive review, the FCA also seeks to assess the quality of the operators' escalation and investigation process once a potential suspicion has been identified, including a review of their tools and data analysis methods. The FCA compares the notifications received from market operators with those received from market participants (suspicious transaction reports) and in-house surveillance in order to identify specific instances where the market operator may have missed potential market misconduct. In doing so, the FCA seeks to find specific deficiencies in the market operators' surveillance capability and provide education to the market of where market abuse systems and controls can be improved. The FCA also takes this approach for SIs, BCN operators and all other authorized firms arranging and executing transactions.

Prudential supervision

148. The FCA assesses the prudential health of U.K. RIEs to ensure they meet their financial resources requirements. The frequency of the RIE prudential reviews takes into account the FCA's risk appetite. All equity RIEs are subject to an annual prudential health review. They are asked to

⁶⁴ The review included proprietary trading firms, investment banks and hedge fund managers that employ systematic algorithmic strategies. As a result of the inclusion of hedge fund managers, the FCA's investment management experts also participated in the review.

provide a stress and scenario testing plan, taking into account the systems and controls to mitigate their risk.

149. All investment firms operating an MTF are subject to the general investment firm capital requirements and related reporting obligations. The required capital is EUR 730,000, and financial resources reports have to be submitted to the FCA on a regular basis. An automated report is created if the investment firm's financial resources fall below the required minimum.

Rule approval

150. The FCA reviews RIEs' and MTFs' rulebooks both as part of the recognition/ authorization process and, for RIEs and larger MTFs, on an ongoing basis. All RIEs and MTF operators have to notify the FCA of their rule changes. At application stage, comments are provided if the rules are unclear or not deemed sufficient. The FCA also requires assurances from the applicants that they have satisfied themselves that they have clear and transparent rules. RIEs must have procedures in place for consulting members and other users on proposed material changes (e.g., to order types) to their rulebooks. The responsible supervisors consider the consultation responses before forming an opinion on the proposal and provide no objection before changes take effect. Under Pillar 1 supervisory approach for RIEs, the FCA routinely discusses any proposed material changes to the RIEs' rules. The FCA applies similar principles in the supervision of larger MTFs. This approach complies with the requirements of Principle 34 of IOSCO Principles.

151. Listing is not the responsibility of RIEs in the U.K., but the FCA would normally review the RIEs' admission to trading rules, as well those of Primary Market MTFs. If an RIE operates a regulated but unlisted equity market, the FCA would review the proposed rules prior to launch. MTFs that admit to trading financial instruments not admitted to trading on an RM are referred to as Primary Market MTFs (e.g., the LSE AIM). The FCA reviews the rules of Primary Market MTFs operated by RIEs. Investment firms that operate Primary Market MTFs need a variation of permission to ensure that issuers admitted to trading on the MTF will be subject to sufficient disclosure requirements, in which context the FCA reviews their rules. The FCA's approach complies with the objective of the IOSCO Principle 33 requirement for the regulator to approve the admission to trading rules.

Reporting

152. In addition to standard periodic reporting requirements, RIEs and MTF operators are subject to ad hoc reporting obligations. RIEs must notify the FCA of certain events. Notifications are reviewed, logged and followed up where necessary. Follow-up actions may include ad hoc meetings or conference calls with the RIE or MTF operator.

153. RMs and MTFs must also supply without delay to the FCA information on significant breaches of their rules, disorderly trading conditions and conduct that may involve market abuse. The number of notifications submitted to the FCA over the last three years is presented in Table 8.

Table 8. United Kingdom: RIE and MTF Notifications to the FCA

	2012	2013	2014
RIEs	149	148	174
MTFs	24	39	63

Source: FCA.

Use of supervisory and enforcement tools

154. The standard approach to the use of supervisory and enforcement tools described in the fund management section applies to RIEs and MTF operators. This means that the FCA often resolves matters and obtains an appropriate result through supervisory discussion without the use of formal powers. No formal sanctions have been imposed on RIEs or MTF operators for regulatory breaches during the last three years. Given the limited number of equity RIEs and MTF operators and their close supervision, this does not raise any particular concerns about potential lack of effective enforcement.

E. Systemic Risk Monitoring

155. The FPC's work, described in more detail in the fund management section, has covered market-related topics. In recent months the FPC has been examining changes to both equity and non-equity market structure, with a focus on technological developments, such as the increase in algorithmic and high frequency trading. More specifically, the record from the FPC September 2015 meeting referred to the fact that a number of the recent episodes of high volatility, in particular in the markets of the United States, had shared common characteristics of originating in largely electronic markets that were often exchange-traded and experienced sudden reductions in market depth. It further noted that automated trading and the use of passive and other pro-cyclical trading strategies that in aggregate could amplify price moves might be growing in importance in these markets. It was emphasized that to date the episodes had been short-lived and without systemic consequences, but there was evidence that disorderly conditions in one market could spill over to others.

156. At the time of the FSAP, the BoE and FCA were undertaking additional analysis requested by the FPC. The FPC has asked the BoE and FCA to conduct further analysis of common causes of market volatility, and whether factors that had stabilized the markets in the past could be relied on. This recognizes the possibility that future heightened volatility and reductions in market depth could have more widespread and persistent effects, including on the provision of credit to the real economy. The FCA and FPC are encouraged to continue to monitor and analyze the potential risks arising from the structure and functioning of equity markets, taking into account the impact that their sound operation has on, among others, asset valuation.

- The reporting obligation below applies only to those AIFMs that are not small AIFMs (see Box 1).
- AIFMs whose AIFs' AUM exceed EUR 500 million but do not exceed EUR 1 billion, report on a half-yearly basis and AIFMs whose AIFs' AUM exceed EUR 1 billion report on a quarterly basis.
- An AIFM subject to the half-yearly reporting obligation still has to submit quarterly reports for each AIF whose AUM exceed EUR 500 million.
- An AIFM has to submit only annual reports for each unleveraged AIF that invests only in unlisted companies and issuers in order to acquire control.

Reporting obligations of authorized U.K. AIFMs and above threshold non-EEA AIFMs				
Type of AIFM	Content of the report for each AIF			
	AIFMD requirement			FCA additional requirement ¹
	Main instruments, markets, exposures and concentrations (AIFMD Article 24(1))	Instruments traded, turnover, illiquid assets, risk profile, risk management, asset categories and stress tests (Article 24(2))	Overall level of leverage, leverage breakdown (borrowing and embedded leverage), reuse of assets, five largest borrowing sources (Article 24(4)) ²	Geographical focus, hedging, VAR, and sensitivities (Article 24(5))
Full Scope U.K. AIFM managing a U.K. AIF or EEA AIF, whether or not that AIF is marketed in the U.K. or EEA	x	x	x	x
Full Scope U.K. AIFM managing a non-EEA AIF that is not marketed in the U.K. or EEA	x		x	x
Full Scope U.K. AIFM managing a non-EEA AIF that is marketed in the U.K. or EEA	x	x	x	x
Full Scope U.K. AIFM managing a non-EEA AIF that is not marketed in the U.K. or EEA that is the master AIF of a feeder AIF which the AIFM also manages and that feeder AIF is: (a) an EEA AIF; or (b) a non-EEA AIF that is marketed in the U.K. or EEA	x	x ¹	x	x
Above threshold non-EEA AIFM marketing in the U.K. (reporting only on the AIF being marketed)	x	x	x	x

Sources: AIFMD, FCA Handbook, FCA.

¹ These reporting requirements are additional FCA requirements based on ESMA's opinion on collection of information under the AIFMD.

² On each AIF that employs leverage on a substantial basis.