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Financial Conduct Authority
12 Endeavour Square
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Submitted via email

23 February 2022

Dear Mr. Curtis-Valino and Mr. Ewing,

Significant SYSC firm definition

We are writing on behalf of a number of Alternative Investment Management Association Limited (AIMA)[1] members who have been affected by the recent change to the Financial Conduct Authority (FCA) rules that replaced the prior "significant IFPRU firm" concept with a new concept, "significant SYSC firm", as part of the package of changes that were introduced on 1 January 2022 when the Investment Firm Prudential Regime (the 'IFPR') came into force.

The "significant IFPRU firm" concept was introduced into the FCA rulebook in 2014 as a mechanism for giving effect in the UK to various articles within the European Capital Requirements Directive ('CRD')[2] and the European Capital Requirements Regulation ('CRR')[3] which allow the relevant competent authority to apply proportionality to their application "taking into account the nature, scale and complexity of the relevant investment firm's activities." As such, the FCA decided to include within its rulebook a series of quantitative tests for determining whether an investment firm should be classified a significant IFPRU firm, set out in IFPRU 1.2. Where an investment firm was below all five thresholds, then it would not be a significant IFPRU firm and would not be subject to certain of the organisational requirements that would otherwise apply under the CRD or CRR,

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1 AIMA, the Alternative Investment Management Association, is the global representative of the alternative investment industry, with more than 2,000 corporate members in over 60 countries. AIMA's fund manager members collectively manage more than $2 trillion in assets. AIMA draws upon the expertise and diversity of its membership to provide leadership in industry initiatives such as advocacy, policy and regulatory engagement, educational programmes and sound practice guides. AIMA works to raise media and public awareness of the value of the industry. AIMA is committed to developing skills and education standards and is a co-founder of the Chartered Alternative Investment Analyst designation (CAIA) – the first and only specialised educational standard for alternative investment specialists. AIMA is governed by its Council (Board of Directors). For further information, please visit AIMA's website, www.aima.org.

2 *See* https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32013L0036.

3 *See* https://eur-lex.europa.eu/legal-content/en/TXT/?uri=CELEX:32013R0575.

whereas, if it was above any one or more of the five thresholds, it would be a significant IFPRU firm and would be subject to those requirements.

In order to be a significant IFPRU firm, the investment firm in question had to be an IFPRU investment firm, which meant that it had to be:

- authorised to carry on the MiFID investment services of:
    - dealing on own account;
    - placing financial instruments;
    - underwriting financial instruments; and/or
    - operating an MTF or OTF;
- authorised to carry on the MiFID ancillary service of safekeeping and administration of financial instruments; and/or
- permitted to hold client money or client securities.

The effect of this was that the significant IFPRU firm concept was limited to the investment firms that carry on the riskiest activities from a systemic and client harm perspective.

Most AIMA members are alternative investment managers and/or alternative investment advisers. As such, they generally do not have permission to carry on any of the activities that would have made them IFPRU investment firms under the old regime and, therefore, were not within the scope of the "significant IFPRU firm" concept. Such AIMA members were instead subject to the capital requirements in Chapter 11 of IPRU(INV) that are derived from the European Alternative Investment Fund Managers Directive[4] and/or the capital requirements for BIPRU firms (which were based on CRD III[5] or the requirements for exempt CAD firms in Chapter 9 of IPRU(INV). In December 2019, when the Senior Managers and Certification Regime ('SMCR') was implemented, the FCA decided to introduce a rule that investment firms that fell within the "significant IFPRU firm" definition would automatically become enhanced firms for the purposes of the SMCR rules. The rationale for this was set out in CP17/25:[6]

> "8.1 The majority of FCA solo-regulated firms will be subject to the core regime. However, we believe that a small number of solo-regulated firms should be subject to extra requirements.
>
> 8.2 These firms will generally be larger in size or have more complex structures where weaknesses in accountability or governance could cause greater harm to consumers, or impact upon market integrity. We refer to these firms as 'enhanced firms' and the regime as the 'enhanced regime'.

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4 *See* https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32011L0061.

5 *See* https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=celex:32006L0049.

6 *See* https://www.fca.org.uk/publication/consultation/cp17-25.pdf.

> 8.4 We propose using six objective criteria to identify firms that the enhanced regime will apply to. We've proposed these criteria because we believe they are representative of the size and complexity of firms."

One of the six tests introduced was that a firm would be an enhanced firm if it was a significant IFPRU firm. As explained above, this was not a concept that applied to the vast majority of alternative asset managers as they were not IFPRU investment firms. For asset managers generally, the FCA based the relevant test for enhanced firm status on an asset under management (AUM) threshold which was £50 billion (based on a three year rolling average – see SYSC 23 Annex 1, paragraph 8.2[7]). Clearly, the £50 billion threshold was set at a sufficiently high level that the enhanced firm status was only intended to apply to the very largest and most significant UK asset managers. In CP17/25, the FCA estimated that setting the threshold at this level would capture approximately 110 firms.[8]

As part of the rules introduced under IFPR, the IFPRU Sourcebook was removed from the FCA Handbook and, with it, "IFPRU investment firm" status. This resulted in a question about the "significant IFPRU firm" concept which, as explained above, had been limited (in terms of its application) to IFPRU firms. In CP 21/26,[9] the FCA's third and final IFPR consultation paper, the FCA proposed replacing the significant IFPRU firm concept with a new concept, significant SYSC firm (defined in SYSC 1.5.2R[10]), that would apply to all firms (not just IFPRU investment firms) and that would retain the same five quantitative tests as originally applied to significant IFPRU firms.

The proposal appeared in Chapter 8 of CP21/26 entitled consequential amendments to the Handbook. In commenting on the proposed consequential amendments generally, the FCA said:

> "8.4 Our overall approach in this CP to other modules of our Handbook affected by the introduction of MIFIDPRU is to propose only the consequential amendments that are needed to:
>
> • delete provisions that are no longer required
>
> • ensure that the interactions between them and MIFIDPRU work in practice
>
> 8.5 For example, there will no longer be a need for provisions that refer to various categories of MiFID investment firm (e.g., 'BIPRU firm'), as the IFPR will apply to all MiFID investment firms prudentially regulated by us.
>
> 8.6 We have not generally proposed material changes in underlying policy to the contents of other modules. However, we have made small policy changes where necessary to reflect the overarching policy objectives of streamlining and simplifying the regulatory requirements that currently differentiate between the various existing prudential categories of FCA investment firm."

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7 *See* https://www.handbook.fca.org.uk/handbook/SYSC/23/Annex1.html.

8 *See* the table in section 8.6: https://www.fca.org.uk/publication/consultation/cp17-25.pdf.

9 *See* https://www.fca.org.uk/publication/consultation/cp21-26.pdf.

10 *See* https://www.handbook.fca.org.uk/handbook/SYSC/1/5.html?timeline=true.

In commenting specifically on the proposed replacement of "significant IFPRU firm" concept with the "significant SYSC firm" concept, the FCA said:

> "We are not proposing to make any substantive changes to the definition itself. This would go beyond what is necessary to ensure the operability of the new MIFIDPRU sourcebook. The same substantive definitions and thresholds will continue to be used.
>
> This means a firm that is currently a significant IFPRU firm would also be a significant SYSC firm."

The commentary made no reference to the fact that by applying the concept to all investment firms rather than only to IFPRU firms, the FCA would be materially expanding the potential scope and impact of the concept (for example, the concept would now potentially apply to all asset managers, notwithstanding the different risk profile that such investment firms have (in systemic and client harm terms) when compared with investment firms that were IFPRU firms under the old regime).

One of the quantitative tests in the definition of significant SYSC firm in SYSC 1.5.2R(3) states that a firm will be a significant SYSC firm if "the annual fees and commission income it receives in relation to the regulated activities carried on by the firm exceeds £160 million in the 12-month period immediately preceding the date the firm carries out the assessment under this rule". This particular quantitative test has potentially significant consequences for a number of AIMA members as it has the *de facto* impact of significantly reducing the AUM threshold that results in enhanced firm status under the SMCR.

To explain, alternative investment management firms typically[11] charge their clients an annual management fee which is usually a percentage of the value of their AUM. That percentage is often between 1% and 2% of their AUM (although it can be higher). Most alternative investment management firms also typically charge an annual performance fee which is a percentage of the profits that they make for their clients during the relevant year. That percentage is often between 10% and 20% of the profits made for the investors (although, again, it can be higher).

As mentioned above, the original threshold for asset managers to be classed as enhanced firms under the SMCR was set at the deliberately high level of £50 billion of AUM in order to capture only the largest and most significant firms. At a conservatively estimated 1.5% average annual management fee (with no performance fee at all, for example where the manager does not make a return or does not make a sufficient return to exceed the applicable high watermark or hurdle rate) that level of AUM would translate to annual fee income of £750,000,000. Assuming an average 15% performance fee and modest positive performance of 5%, performance fee revenue for a firm managing £50 billion of AUM would be £375,000,000. When combined with the average 1.5% management fee, that would take overall revenue to £1.125 billion.

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[11] Such fee arrangements, while typical, are not universal. Some alternative asset managers (often those that act as sub-investment managers to other group entities) have a different fee structure whereby instead of receiving a management and performance fee they receive a fee based on transfer pricing analysis which is usually the amount of their expenditure plus a profit element of between 5% and 15%. Additionally, some asset managers, instead of receiving a management fee, have an arrangement with their clients whereby all of their costs are reimbursed.

By applying the significant SYSC firm revenue threshold of £160million to asset managers generally, the FCA has (on the basis of a conservative estimate of resultant revenue, consisting of an average 1.5% management fee and no performance fee) effectively lowered the AUM threshold from £50 billion to around £10.667 billion, which is a very significant reduction (over 78%). If the estimate of revenue also includes a 15% average performance fee and modest 5% positive performance, the corresponding AUM figure is reduced further to around £7.111billion (an almost 86% reduction). Please see the Annex to this letter for the relevant calculations.

We suspect that the FCA, in making the recent change, may not necessarily have appreciated the impact described above (i.e., the *de facto* reduction in the AUM threshold for enhanced firms). It was not identified in the commentary in the consultation paper or the policy statement as an intended consequence of the rule change and the impact was not discussed in detail. The impression that the commentary gave is that the amendments were purely consequential in nature and not intended to result in a material change to the number of investment firms that are enhanced firms for the purposes of the SMCR. In part, as a result of that commentary, we understand that the change and its impact was not appreciated by a number of investment firms who have now realised that they are potentially affected by it. We have recently become aware that a number of AIMA members have become significant SYSC firms as a result of this change and will, therefore, become enhanced firms with effect from April 2023 (when the fifteen- month grace period set out in the first row of the table in paragraph 10.5 of SYSC 23 Annex 1[12] expires). Many of these firms are relatively small (the smallest identified by AIMA thus far has only 25 employees) and AUM significantly below the original £50 billion enhanced firm status threshold (the smallest identified by AIMA thus far has AUM of £2.2 billion[13]). They are not, in our view, the types of investment firms that the FCA had in mind when establishing the enhanced firm regime. As stated above, the enhanced firm regime is intended to apply only to the largest and most significant firms. The regime should only apply to investment firms where, as a result of becoming enhanced, the number of senior managers at the relevant investment firm would be proportionate to the size of the organisation's overall staff base and the size and nature of its business.[14] In the asset management industry, using a revenue based metric to make the enhanced firm versus core firm distinction risks producing arbitrary results (given that revenue can fluctuate significantly from year to year as a result of asset performance). To date, AIMA has identified at least 16 members that have become significant SYSC firms or who, depending on performance last year, are in danger of becoming significant SYSC firms as a result of the change introduced by the IFPR.

We are, therefore, writing to request that, well in advance of 31 March 2023, the FCA consults on amending the definition of significant SYSC firm to exclude from the scope of SYSC 1.5.2R(3) investment firms whose permitted activities do not include dealing on own account, placing financial instruments, underwriting financial instruments, operating an MTF or OTF, safekeeping and administration of financial instruments and/or the holding of client money or client assets. This amendment would ensure that the scope of SYSC 1.5.2R(3) reflects the scope of IFPRU

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12 *See* https://www.handbook.fca.org.uk/handbook/SYSC/23/Annex1.html?timeline=True.

13 The investment firm in question came very close to falling within the definition of Significant SYSC firm last year and considers it very likely that it will do so next year.

14 Another consequence of becoming enhanced firms with effect from the end of March 2023 is that the investment firms in question will become subject to the new operational resilience rules in SYSC 15A. While operational resilience is an important issue for all investment firms, many of the obligations imposed by the new rules do not appear to be suited to smaller investment firms.

1.2.3R(3)[15] and would reverse the *de facto* (as, we suspect, unintentional) significant reduction of the AUM threshold for enhanced firm status. If the remaining time between now and 31 March 2023 is likely to be insufficient, in light of the FCA's intended legislative agenda, to amend the rule before that date, we would suggest that the FCA allows firms affected by the rule to opt into a modification by consent which would disapply their enhanced firm status until the formal rule change has been made.

AIMA would welcome a dialogue with the FCA in relation to this issue. For further information please contact Adam Jacobs-Dean, Managing Director, Global Head of Markets, Governance and Innovation, at ajacobs-dean@aima.org.

Yours faithfully,

Adam Jacobs-Dean
Head of Markets, Governance and Innovation
AIMA

[15] *See* https://www.handbook.fca.org.uk/handbook/IFPRU/1/2.html.

Annex

Worked examples showing the interplay between AUM and revenue for asset managers

The following worked examples demonstrate that the £50 billion AUM threshold for enhanced scope firms has effectively been significantly reduced by the introduction of the significant SYSC firm definition on 1 January 2022

Case study 1 – management fee but no performance fee

Assumptions:

Each manager (A, B and C) earns an average management fee of 1.5%

Each manager's performance does not result in a performance fee this year

Each manager was not an IFPRU firm

The rolling three year average, and 2021 year end, AUM of each manager is:

Manager A: £50,000,000,000
Manager B: £49,000,000,000
Manager C: £10,675,000,000

Manager A's management fee would be:

£50,000,000,000 x 1.5% = £750,000,000

Manager A was already an enhanced firm by virtue of exceeding the £50,000,000,000 AUM threshold. Manager A was not a significant IFPRU firm but has become a significant SYSC firm with effect from 1 January 2022 as a result of its fee income. Conclusion: No change in Manager A's status under SMCR.

Manager B's management fee would be:

£49,000,000,000 x 1.5% = £735,000,000

Conclusion: Manager B was not previously an enhanced firm as its AUM is below the £50,000,000,000 AUM threshold. Manager B was not a significant IFPRU firm but has become a significant SYSC firm with effect from 1 January 2022 as a result of its fee income. Conclusion: Manager B's status would change from a core firm to an enhanced firm with effect from 1 April 2023.

Manager C's management fee would be:

£10,675,000,000 x 1.5% = £160,125,000

Conclusion: Manager C was not previously an enhanced firm as its AUM is below the £50,000,000,000 AUM threshold. Manager C was not a significant IFPRU firm but has become a significant SYSC firm with effect from 1 January 2022 as a result of its fee income. Conclusion: Manager C's status would change from a core firm to an enhanced firm with effect from 1 April 2023.

Case study 2 – management fee plus performance fee

Assumptions:

Each manager (A, B and C) earns an average management fee of 1.5%

Each manager's generated performance in 2021 that is equivalent to 5% of its 3 year rolling average AUM and is entitled to a 15% performance fee

Each manager was not an IFPRU firm

The rolling three year average, and 2021 year end, AUM of each manager is:

Manager A: £50,000,000,000
Manager B: £49,000,000,000
Manager C: £7,125,000,000

Manager A's management fee would be:

£50,000,000,000 x 1.5% = £750,000,000

Manager A's performance fee would be:

£50,000,000,000 x 5% x 15% = £2,500,000,000 x 15% = £375,000,000

Total fees earned by Manager A would be:

£750,000,000 + £375,000,000 = £1,125,000,000

Manager A was already an enhanced firm by virtue of exceeding the £50,000,000,000 AUM threshold. Manager A was not a significant IFPRU firm but has become a significant SYSC firm with effect from 1 January 2022 as a result of its fee income. Conclusion: No change in Manager A's status under SMCR.

Manager B's management fee would be:

£49,000,000,000 x 1.5% = £735,000,000

Manager B's performance fee would be:

£50,000,000,000 x 5% x 15% = £2,500,000,000 x 15% = £367,500,000

Total fees earned by Manager B would be:

£735,000,000 + £367,500,000 = £1,102,500,000

Manager B was not previously an enhanced firm as its AUM is below the £50,000,000,000 AUM threshold. Manager B was not a significant IFPRU firm but has become a significant SYSC firm with effect from 1 January 2022 as a result of its fee income. Conclusion: Manager B's status would change from a core firm to an enhanced firm with effect from 1 April 2023.

Manager C's management fee would be:

£7,125,000,000 x 1.5% = £106,875,000

Manager C's performance fee would be:

£7,125,000,000 x 5% x 15% = £356,250,000 x 15% = £53,437,500

Total fees earned by Manager C would be:

£106,875,000 + £53,437,500 = £160,312,500

Manager C was not previously an enhanced firm as its AUM is below the £50,000,000,000 AUM threshold. Manager C was not a significant IFPRU firm but has become a significant SYSC firm with effect from 1 January 2022 as a result of its fee income. Conclusion: Manager C's status would change from a core firm to an enhanced firm with effect from 1 April 2023.

The above worked examples demonstrate that managers with even relatively modest levels of AUM could easily become enhanced firms under the new rules.