



The City of London Law Society

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Asset Management Unit
HM Treasury
1 Horse Guards Road
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Email: AIFMR@hmtreasury.gov.uk

Dear Sir / Madam,

Financial Conduct Authority's Call for Input: Future regulation of alternative fund managers

The City of London Law Society ("**CLLS**") represents approximately 17,000 City lawyers through individual and corporate membership, including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi-jurisdictional legal issues. The CLLS responds to a variety of consultations on issues of importance to its members through its specialist committees.

This response to the Financial Conduct Authority's ("**FCA**") "Call for Input: Future Regulation of Alternative Fund Managers" (the "**CFI**") has been prepared by the CLLS Regulatory Law Committee (the "**Committee**" or "**we**"), a list of whose members can be found on the [CLLS website](http://www.clls.org). The Committee not only responds to consultations but also proactively raises concerns where it becomes aware of issues which it considers to be of importance in a regulatory context.

Introductory Remarks

The CLLS supports the FCA's review of the rules currently in place for alternative investment fund managers and relevant sections of the FCA's Handbook. In preparing responses to the CFI, the CLLS has identified what it considers are key issues that would benefit from reform and sets out its view on the CFI in the annex to this paper (the "**Annex**").

The CLLS agrees with many of the adjustments proposed by the CFI. However, the CLLS is of the view that the FCA's key reform - the proposed thresholds for AIFMs - requires further analysis. As explained in our responses in the Annex, the CLLS considers that the proposed threshold for small firms, set at £100m NAV, is too low and will result in firms which qualify as "small AIFMs" under the current rules and are only required to comply with limited requirements, being faced with a more burdensome set of prescriptive and expectation-based rules. The CLLS considers this application disproportionate to the risk posed by such firms and inconsistent with the FCA's stated aim in amending the rules which apply to AIFMs. We therefore suggest raising the lower threshold and limiting the use of expectation-based rules.

We hope the above feedback (and that in the Annex) will be useful to you. If you would like to discuss any of these comments then we would be happy to do so. Please contact Hannah Meakin by telephone on +44 (0)20 7444 2102 or by email at hannah.meakin@nortonrosefulbright.com in the first instance.

Yours faithfully

A handwritten signature in dark ink, appearing to read 'H Meakin'.

Hannah Meakin

Chair, CLLS Regulatory Law Committee

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ANNEX 1

Please find the CLLS' consideration of the key issues identified across the CFI.

Responses to the FCA's CFI

Structuring the presentation of our rules thematically based on the product cycle and business activities

The CLLS agrees that the proposed new structuring better aligns with the way in which firms organise themselves and the life cycles of the AIFs they offer.

In carrying out such work, the FCA should bear in mind that its rules for AIFMs may overlap with both wider rules that all firms must implement, for example in the Principles for Business and Senior Management Arrangements, Systems and Controls chapters of its Handbook as well as parallel rules for firms with permissions to carry out MIFID and other business.

Any revised rules should make these interactions clear. We encourage the FCA to consider how the revised regime interacts with these other requirements.

Do you agree with the principle of creating three levels of firms based on their size to achieve proportionality. If not, what alternative approach would you suggest?

The CLLS supports the concept of the FCA determining thresholds which will apply to AIFMs that require authorisation. However, we consider that there are two issues with the proposals, which we set out below:

1. At present, "small AIFMs" under the Alternative Investment Fund Managers Regulation (the "**AIFM Regulations**"), are those AIFMs (i) with AIFs whose assets under management ("**AUM**") are below €500m, (ii) which do not use financial or synthetic leverage, and (iii) which do not allow redemptions within the first five years of investment, are subject to only very limited aspects of the FCA's rules.
2. The FCA is proposing to set the following thresholds:
 - a. **Large firms**, with NAV \geq £5bn – will be subject to the majority of the rules that currently apply to full scope UK AIFMs i.e. the FCA's equivalent of the AIFMD's rules within the FCA Handbook (the "**Level 1 Requirements**") and the UK's implementation of the prescriptive requirements in the Commission Delegated Regulation (EU) No 231/2013 (the "**Level 2 Regulation**"), with some removal of detail where the FCA considers it proportionate;
 - b. **Mid-sized firms**, with NAV $>$ £100m – will be subject to the Level 1 Requirements but without the prescriptive requirements within the Level 2 Regulation, except where the FCA considers it necessary. The FCA will provide more expectation-based rules;
 - c. **Small firms**, with NAV of \leq £100m – will be subject to unspecified baseline requirements.

A small AIFM with AUM below €500m but above £100m under the current regime would be subject to the Level 1 requirements, those prescriptive aspects of the Level 2 regulation which have been retained and expectation-based rules, resulting in a material regulatory burden. This would represent an increased burden on such firms, i.e. would be inconsistent with the FCA's stated aim of "marketing it earlier for firms to grow, compete, innovate and enter the market".

If the FCA proceed with the creation of thresholds, we would suggest that the lowest threshold (for small firms) be increased. The current €500m AUM threshold for small AIFMs

was set in 2013 and has not been adjusted for inflation. We therefore suggest that the threshold for application of the Level 1 Requirements (i.e. for the proposed mid-sized firm requirements) be adjusted upwards from the proposed £100m to £750m. AIFMs with total NAV lower than this threshold could be allowed to opt-in to the additional rules applicable to mid-sized AIFMs if they determine that it is appropriate to do so.

We also consider that, in the interests of the smooth operations of the revised regulation practice. There should also be appropriate transitional provisions for firms crossing the relevant thresholds, to avoid any sudden cliff-edge effects of transitioning between categories.

3. The FCA has proposed the use of "expectation-based" rules based on the prescriptive requirements of the Level 2 Regulation for mid-sized firms. The CLLS welcomes the intention to move away from inflexible rules where these are not appropriate, but would reiterate the FCA that an alternative approach needs to be designed carefully if it is to avoid unfortunate unintended consequences: Unclear expectation-based rules can create uncertainty and there is the risk that firms, in seeking to appease investors or avoid the risk of non-compliance, will apply the Level 2 Regulation in its entirety, regardless of their size. Given the increase in cost and complexity, the CLLS consider it likely (particularly if the proposed £100m threshold for small firms is retained) that affected firms will be pushed towards the expense of using a host AIFM or using consultants before they otherwise would need to. As such, the CLLS would recommend that the use of expectation and expectation-based rules is carefully constructed and concise and that the drafting such rules the FCA tests what unintended consequences might flow from them if they are interpreted in particular ways.

Remuneration

The CLLS welcomes the FCA's proposal to reconsider the current approach to AIFM remuneration, particularly in light of the FCA and Prudential Regulatory Authority's joint consultation CP16/24 Remuneration reform, and the intended alignment of solo regulated firms' remuneration requirements with banks and dual regulated firms.

While the AIFM Remuneration Code (SYSC 19B) is not as restrictive as the current MiFID remuneration code (SYSC 19G), the CLLS considers that would benefit from reform. The current provisions within the AIFM Remuneration Code allow flexibility to set aside the pay-out process rules based on proportionality. This indicates a recognition by regulators that these rules are not a proportionate means of regulating AIFM behaviour. Given that AIFM compensation is, as an industry standard, linked to fund performance, there is already a natural alignment between the interests of its staff and the fund.

Further, the investor base for funds offered by AIFMs primarily consists of professional, rather than retail, investors, mitigating the level of moral hazard present in bank remuneration structures involving retail clients and shareholders.

Prudential standards

Thought will also need to be given to the prudential standards which apply to firms as they move between thresholds. For example, if the AIFM business restrictions in Article 6 AIFMD are removed and harmonised with other regimes such as MIFID (which we would support), it should be remembered that the IPRU-INV 11 prudential framework that currently applies to AIFMs does not require prudential consolidation, which is consistent with the FCA's stated aim of fostering growth, innovation, competition and new entries to the market. Adding new MIFID permissions could bring more AIFMs (beyond current CPMI firms) in scope of IFPR with the attendant ICARA and other requirements. Any such additional requirements should in our view be limited as far as possible, given the significant additional burdens they would impose on firms.

Definition of AIF Custodial Assets

The FCA should also clarify the definition of AIF custodial assets in its Glossary – "assets which can be held in custody and be more explicit as to what is and is not a custody asset. The definition currently comes from the EU AIFMD level 2 regulation and does not fit well with UK law, since almost any instruments can be registered in a depositary's books. Market practice has been to interpret the term as "assets which can be held through a control securities depositary or similar systems" and we would propose that the Glossary be amended to reflect this.

Regulatory reporting

As the FCA notes, the reporting regime has not been reviewed since it was introduced. Under the current rules, UK AIFMs are still required to submit overly burdensome Annex IV and AIF002 reporting which are not tailored to the types of activities they engage in.

In addition to reviewing the regime from an efficiency perspective, including the manual nature of the AIF002 submission and lack of roll-forward functionality for standing qualitative items, we welcome the FCA's commitment to considering a more effective reporting regime that is proportionate and tailored in its demands of firms.