Managed Funds Association
The Voice of the Global Alternative Investment Industry
Washington, D.C. | New York | Brussels | London

June 14, 2023

Ms. Sarah Pritchard
Executive Director of Markets
Financial Conduct Authority
12 Endeavour Square
London E20 1JN

Re: Reform of the UK Securitisation Regulatory Framework

Dear Sarah,

Managed Funds Association ("**MFA**")[1] would like to thank the Financial Conduct Authority (the "**FCA**") for inviting us to attend the FCA's Securitisation Roundtable (the "**Roundtable**") for investors on 8 March 2023. We view the FCA's industry engagement as a welcome step towards reforming the UK regulatory framework for securitisations.

We are writing to the FCA in anticipation of the repeal of the retained version of the UK Securitisation Regulation (EU) 2017/2402 ("**Sec Reg**") and the replacement and amendment of certain firm-facing requirements in the FCA's rulebook. We understand that the FCA's consultation on these rules can be expected in the third quarter of 2023.

MFA represents over 170 alternative asset managers—around half of whom have a presence in the UK—who collectively manage nearly £1.8 trillion of assets. Our membership includes hedge funds, credit, and crossover funds that invest across a diverse group of investment strategies. We have a vital interest in ensuring the UK remains a leading financial centre with a regulatory framework that promotes fair and efficient financial markets, and which delivers the best possible outcomes for consumers, investors, and other market participants.

MFA is supportive of moving firm-facing requirements into regulators' rulebooks to create a more agile regulatory framework in the UK. Accordingly, MFA encourages the FCA to set the scope of its upcoming consultation as widely as possible. It is our opinion that there are some fundamental issues with the Sec Reg that merit a comprehensive review. We believe that addressing these flaws will enable UK financial market participants to engage properly with international securitisation markets and will ultimately contribute towards the growth of the UK economy. Our proposed revisions would enhance compatibility with other jurisdictions' regulatory requirements, in addition to leveling the playing field for UK AIFMs to compete with other global investment firms in the global capital markets.

Given the existing requirements of Chapter 3.7 of the FCA Fund Sourcebook, the incentives upon and

[1] Managed Funds Association (MFA), based in Washington, DC, New York, Brussels, and London, represents the global alternative asset management industry. MFA's mission is to advance the ability of alternative asset managers to raise capital, invest, and generate returns for their beneficiaries. MFA advocates on behalf of its membership and convenes stakeholders to address global regulatory, operational, and business issues. MFA has more than 170 member firms, including traditional hedge funds, credit funds, and crossover funds, that collectively manage nearly $2.2 trillion across a diverse group of investment strategies. Member firms help pension plans, university endowments, charitable foundations, and other institutional investors to diversify their investments, manage risk, and generate attractive returns over time.

approach to risk of alternative investment fund managers ("**AIFMs**") and the sophisticated nature of alternative investment fund ("**AIF**") investors, there is a clear case for explicitly consulting on removing AIFMs from the due diligence parts of the Sec Reg and leaving the requirements with the originator/sponsor, as is the norm in other jurisdictions across the globe. That would significantly reduce the burden of complying with duplicative and overlapping regulation and give UK-based AIFMs significantly more scope to compete internationally and deliver the results their investors, such as pension funds, endowments and foundations, require.

This letter focusses on reform to the due diligence requirements in the Sec Reg for AIFMs investing in securitisations. It is our view that AIFMs should be removed from the scope of due diligence requirements in the revised rules. In this letter, references to "due diligence requirements" are to the investor due diligence requirements set out in Article 5 of the Sec Reg, as well as any future equivalent rules that are intended to replace Article 5 in the FCA's rulebook.

Context

In its December 2021 review of the Sec Reg, H.M. Treasury stated an interest in taking "certain non-UK AIFMs out of the scope of the due diligence requirements."[2] We agree that appropriate jurisdictional limits are warranted to prevent the inappropriate application of the due diligence requirements to non-UK AIFMs. Whilst HM Treasury acknowledges this proposed amendment in its latest Policy Note[3], we note that the amendment was not reflected in the definition of "institutional investor" in the accompanying illustrative draft statutory instrument. Our proposals below build on that recommended change and provide additional recommendations for expanding capital investment in the UK and investment returns for UK investors.

In speaking with our members globally, it is clear that the due diligence requirements under the Sec Reg indeed constitute a significant impediment to investment and therefore hamper the ability of AIFMs to exercise robust portfolio diversification and risk management on behalf of investors. In many cases, they find that they are unable to invest in securitisations that are not fully compliant with UK requirements. Whilst MFA understands the important role that regulation plays in market stability, it also recognises the value in proportionate rulemaking. As set out more fully below, the current scope of due diligence requirements is disproportionate to the risks associated with investments in securitisations.

The origin of due diligence requirements

It is important to recall the context behind due diligence requirements under the Sec Reg. As you are aware, investor due diligence requirements were introduced into the EU regulatory framework in response to the US subprime crisis in 2007-08, which was the primary catalyst for the Global Financial

[2] *Review of the Securitisation Regulation: Report and call for evidence response*, HM Treasury (December 2021), (at paragraph 9.11) available at: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1040038/Securitisation_Regulation_Review.pdf.

[3] *The Securitisation Regulation – Illustrative Statutory Instrument Policy Note*, HM Treasury (December 2022), available at: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1122997/Policy_Note_Securitisation_Regulation_Illustrative_Statutory_Instrument__1_.pdf.

Crisis ("**GFC**"). That crisis was compounded by the prevalence of the "originate to distribute" model, which was commonly used by banks to shift sub-investment grade loans off balance sheets and shed the associated credit risk by effectively transferring the risk of these loans to investors in securitised products. The effect of the crisis was felt globally and securitisations were identified as a chief cause, albeit not the sole cause. As the European Commission (the "**Commission**") observed at the time: "[T]he impact on EU banks was huge as they are exposed via securitisation to the risks that originate from the US."[4]

High profile collapses in the banking sector raised concerns about the conduct of originators and investors in the securitisation market. One of the first banks to collapse was the German bank IKB Deutsche Industriebank AG, whose downfall was publicly linked to its asset-backed commercial paper (ABCP) conduit which invested heavily in subprime collateralised debt obligations (CDOs). IKB's failure was considered to be emblematic of wide-spread over-reliance on ratings agencies and a lack of due diligence practices deployed by banks. The rating agencies received their own share of criticism for lacklustre methodologies and a failure to appropriately consider risks associated with securitisations. In the Commission's view, had IKB conducted adequate due diligence on the CDOs that its conduit was holding, it would have looked beyond the AAA ratings of the CDOs and conducted its own examination of the quality of the underlying assets (which were often subprime asset-backed securities). As a result of the inadequate efforts of the rating agencies and what in hindsight were judged to be limited due diligence practices deployed by banks, retail depositors and shareholders suffered large losses globally, leading to a widespread lack of confidence in the banking sector. Many banks were publicly bailed out by their respective home governments (and thus taxpayers) as a result.

It is critical to contrast the banks' public bailout with the experience of AIFMs investing in securitisations during the period leading up to and following the GFC. Any losses sustained by AIFs did not affect retail investors or the wider financial system, as the losses were contained to the fund and experienced by the institutions and sophisticated investors who were fully apprised of the risks of investing. There was no taxpayer bailout required to protect the larger financial ecosystem, nor was any such bailout provided (or indeed available).

To address the issues faced by credit institutions, the Commission proposed amendments to the EU Capital Requirements Directive ("**CRD II**"). In the Impact Assessment accompanying the Commission proposal for CRD II,[5] the Commission focussed on the losses of EU banks and poor internal risk management more generally.

The CRD II amendments, which were reflected in a new Article 122a of the CRD, mandated that no credit institution would be allowed to become "exposed" to a securitisation position unless the originator, sponsor or original lender retained, on an ongoing basis, a "material net economic interest" of at least 5 percent in the securitisation. Article 122a also contained disclosure requirements for sponsor and originator institutions towards investors and obligations for sponsors and originators to ensure the application of the same sound and well-defined criteria for credit-granting with respect to

[4] Accompanying document to the Proposal for a Directive of the European Parliament and of the Council amending Directives 2006/48/EC and 2006/49/EC as regards banks affiliated to central institutions, certain own funds items, large exposures, supervisory arrangements, and crisis management, Impact Assessment COM(2008) 602 final, p. 17. Available at: https://ec.europa.eu/smart-regulation/impact/ia_carried_out/docs/ia_2008/sec_2008_2532_en.pdf

[5] *Id.*

exposures to be securitised and exposures to be kept in the institution's books.

The CRD II amendments (and the accompanying restrictions on resecuritisations in the subsequent EU Capital Requirements Directive (known as CRD III)) were then consolidated in 2019 for other EU financial institutions, including investment firms, insurance and reinsurance undertakings, occupational pension schemes, AIFMs and UCITS management companies, in the EU Securitisation Regulation (EU) 2017/2402 ("**EU SR**").

The approach taken in the EU was different than that taken in the US under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd Frank**"). Like CRD II, Dodd-Frank included a 5 percent risk retention requirement and enhanced disclosure requirements; however, the requirement there was (and continues to be) for the originator/sponsor to retain the risk, rather than prohibiting the investor institution from investing unless the originator/sponsor retained the risk. We do not see the merit of penalising the investor for the failure of the sponsor/originator from complying with the risk retention requirement. The effect is that US institutional investors in securitisations face a more efficient risk management system than EU institutional investors in securitisations. It is thus no surprise that the US securitisation market has made a stronger, faster and broader recovery from the GFC than the European securitisation market. US companies, for a variety of factors, have had greater access to capital and financing than their UK peers. We support the healthy growth of the UK securitisation market and addressing what the Governor of the Bank of England (in a slightly distinct but comparable context) described as ".... The need to finance investment to support stronger potential growth, from its current weak level".[6] The Commission itself recently acknowledged that the US securitisation market grew "substantially" between 2015 and the end of 2021, whilst the EU market shrunk.[7] Disparate regulatory burdens are not likely the sole cause for this divergence, but they cannot be discounted as a material, contributing cause.

MFA recognises the policy behind these initial measures in CRD II. Strong regulatory efforts in this area have had positive impacts on risk management and transparency of information in the banking sector, and MFA members have embraced their role as risk managers and the importance of the buy-side in a robust, thriving securitisation market. Wider regulatory reforms have effectively muted a culture of excessive risk-taking in the financial services sector – both for banks and non-prudentially regulated firms. This effective regulatory infrastructure, borne by all market participants, would support an effort by the FCA to introduce greater proportionality into the regulatory framework by removing due diligence requirements under the Sec Reg for UK and non-EU AIFMs.

General due diligence requirements under the Sec Reg

AIFMs are sophisticated buy-side firms, who have a fiduciary duty to their investors and operate in a highly regulated environment. The relationship between an AIFM and its AIF's investors is subject to detailed disclosure and contractual requirements that underpin and govern the benefits and burdens imposed on each party. Under global regulatory frameworks, they are subject to high standards of

---

[6] Monetary and Financial Stability: lessons from recent times – speech by Andrew Bailey, Washington D.C., 12 April 2023. Available at https://www.bankofengland.co.uk/speech/2023/april/andrew-bailey-remarks-at-the-institute-of-international-finance

[7] Report from the Commission to the European Parliament and the Council on the functioning of the Securitisation Regulation COM(2022) 517 final, p. 5. Available at https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=COM:2022:517:FIN

governance, compliance and risk management.

In the EU and the UK, AIFMs are already subject to specific risk management requirements in respect of their AIFs under Article 15 of the Alternative Investment Fund Managers Directive ("**AIFMD**"), which was implemented in the UK under Chapter 3.7 of the FCA FUND Sourcebook.

In particular, FUND 3.7.5 R provides:

"1.

(a) An AIFM must implement ***adequate risk management systems*** to identify, measure, manage and monitor all risks relevant to each AIF investment strategy and to which each AIF is, or may be, exposed.

(b) In particular, an AIFM ***must not solely or mechanistically rely on credit ratings*** issued by credit rating agencies … for assessing the creditworthiness of the AIF's assets.

2. An AIFM must, at least:

(a) implement an appropriate, documented and regularly updated ***due diligence process*** when investing on behalf of the AIF, according to the investment strategy, objectives and risk profile of the AIF;

(b) ***ensure that the risks*** associated with each investment position of the AIF and their overall effect on the AIF's portfolio ***can be properly identified, measured, managed and monitored*** on an ongoing basis, including through the use of appropriate stress testing procedures; and

(c) ***ensure that the risk profile of the AIF corresponds to the size, portfolio structure and investment strategies and objectives of the AIF*** as set out in the instrument constituting the fund, prospectus and offering documents." (Emphasis added)

That is, UK authorised AIFMs are already subject to strict due diligence and ongoing monitoring requirements. In addition, the requirement not to "solely or mechanistically rely on credit ratings" addresses indirectly the poor practices of the rating agencies and more directly of IKB and other banks that invested in securitisations on the basis of credit ratings without proper diligence. There is no need in our view to replicate such requirements specifically for securitisations, when AIFMs are able to make risk-based decisions, without separately mandated due diligence requirements, to invest other assets that may have higher risk profiles, such as crypto-assets or complex derivatives.

Instead of improving risk management, the due diligence requirements under the Sec Reg have created an unnecessary barrier to investment, hindered global investment management strategies of many AIFMs and dampened the participation by AIFMs in the securitised markets generally. MFA of course recognises the importance of protecting investors, and AIFMs are well-equipped to understand the risks of their investment opportunities – robust risk management is core to AIFM business models generally – and investors demand no less through initial and ongoing due diligence of the AIFM. As noted above, AIFMs currently are required under the AIFMD/FUND 3.7 to have robust internal due diligence processes to help them make meticulous, well-informed investment decisions, regardless of the views of rating agencies, and regardless of their obligations under the Sec Reg. The due diligence

requirements under the Sec Reg also create unnecessary limitations on AIFMs who otherwise do not face mandated investment limitations (this stands in contrast to UCITS management companies, and UCITS shares are sold widely to retail investors). In addition, investors in AIFs are typically experienced, large institutional investors, who are provided with detailed pre-contractual disclosures under the AIFMD and carry out extensive diligence on AIFs and their AIFMs before investing.

It was noted by various participants during the Roundtable that due diligence requirements can be a substantial barrier to investment in securitisations (as also noted above). AIFMs subject to the Sec Reg are restricted to investing only in Sec Reg and EU SR-compliant securitisations, which eliminates access to large portions of the global securitisation market. This ultimately makes it more difficult for AIFMs to diversify their portfolios and execute on their investment strategy to generate risk-adjusted returns for their investors. The result is a shrinking of the investor pool in securitised investments generally, which could result in banks retaining additional credit risk if they are not able to use securitisations to transfer the risks completely off the banks' balance sheets and to the public markets, and concentrates the risks of the securitisation products sold to a smaller number of AIFs and other purchasers electing to meet the due diligence requirements of Sec Reg. This lack of diversification saddles the AIFs' underlying UK investors, such as pension funds, with additional risk that ultimately is passed along to the investors' UK beneficiaries.

In our view, removing due diligence requirements for AIFMs would unlock investment opportunities on a global basis for UK AIFMs and allow them to compete on a level playing field with other investment firms in the global capital markets. As the FCA is aware, the Financial Services and Markets Bill, which is currently moving through the UK Parliamentary process, will introduce a secondary objective for the FCA to facilitate the international competitiveness of the UK economy. Indeed, in its recent Business Plan for 2023/24 the FCA states, "we fully embrace this secondary objective as already significantly in line with our approach. We will further increase our focus on international competitiveness and growth in delivering our primary objectives, while ensuring that there is no compromise on consumer protection, market integrity or competition in the interests of consumers."[8] In view of the existing controls, maturity of the sector and negative impacts of the Sec Reg on our sector, taking a proportionate approach to the application of firm-facing requirements is one fundamental way in which the FCA can satisfy all its objectives.

Risk retention due diligence requirement

If the FCA does not consider it feasible to remove due diligence requirements for AIFMs altogether, MFA believes that the FCA should at least consider removing the specific requirement for AIFMs to conduct due diligence on risk retention. That is, removing the requirement that an AIFM may not cause its AIFs to hold securitisation positions unless the originator, sponsor or original lender retains on an ongoing basis 5 per cent of the securitisation.

The requirement to verify risk retention is a particularly difficult criteria for AIFMs to satisfy when investing in international markets. MFA members have found that, in their experience, US securitisations that are compliant with the specific risk retention requirements under the Sec Reg and EU SR are in the minority, in spite of the fact that US originators/sponsors are required to retain an interest in transactions, but they are able to do so through different prescribed modalities, which can

[8] https://www.fca.org.uk/publications/business-plans/2023-24

make it challenging for an AIFM to verify on a deal-by-deal basis.

If, notwithstanding the arguments presented above, the FCA elects not to remove the risk retention due diligence requirements for AIFMs, then MFA would propose that – at a minimum – the reformed UK securitisation framework should allow AIFMs to invest in securitisations in foreign jurisdictions that have similar rules relating to risk retention and deliver similar outcomes as regards investor protection.

Similarly, MFA submits that if local law does not require risk retention for certain types of securitisations, UK rules should recognise and give comity to the compliance with local, applicable non-UK rules. For example, in the US, sponsors of open-market CLOs are not required to retain an interest in the transaction. UK AIFMs should not be prevented from investing in such US open-market CLOs as a result. The regulatory focus should be on the nature of the securitisation and the laws which govern it, rather than the domicile of the fund which is investing. Such an approach would considerably enhance UK competitiveness, rather than applying additional and artificial barriers to the performance of UK AIFMs that will further hinder the long-awaited recovery of the UK securitisation market.

We also note that the Financial Services and Markets Bill will introduce an equivalence regime for STS securitisations. Accordingly, the new rules should aim to adopt a principles- and outcomes-based approach wherever possible in order to improve flexibility of the UK regime. Regarding risk retention, we believe that it would be appropriate to give due regard and consideration to other international frameworks – especially the US – which has the largest securitisation market in the world.

Definition of "institutional investor"

MFA believes that the most proportionate approach to reform of the Sec Reg would be to remove AIFMs from the scope of due diligence requirements altogether. A simple solution would be to remove AIFMs from definition of "institutional investors," which as discussed above would provide much needed refinement of the jurisdictional scope of Sec Reg to limit its extraterritorial application to non-UK firms.

* * * * *

We recognise that balancing the Sec Reg against the competing needs of issuers, investors and their managers, and the markets more generally, is challenging. We look forward to working with the FCA to fine-tune the balance to allow the UK securitisation market to realise the same recovery that the markets have experienced elsewhere. MFA also recognises that certain aspects of the UK securitisation framework are within the purview of HM Treasury rather than the FCA, and so will be sending a copy of this letter to HM Treasury for their information and consideration.

MFA would be more than happy to elaborate on the points contained in this letter, should the FCA wish to engage in further conversation. If you have any questions about this letter, or if we can provide further information, please do not hesitate to contact the undersigned at Andrew Malin, Manager, International Government Affairs or the undersigned at (202) 730-2600.

Respectfully submitted,

/s/ Jennifer W. Han

Jennifer W. Han
Executive Vice President and Chief Counsel
Global Regulatory Affairs
Managed Funds Association

cc: HM Treasury
1 Horse Guards Road
London
SW1A 2HQ