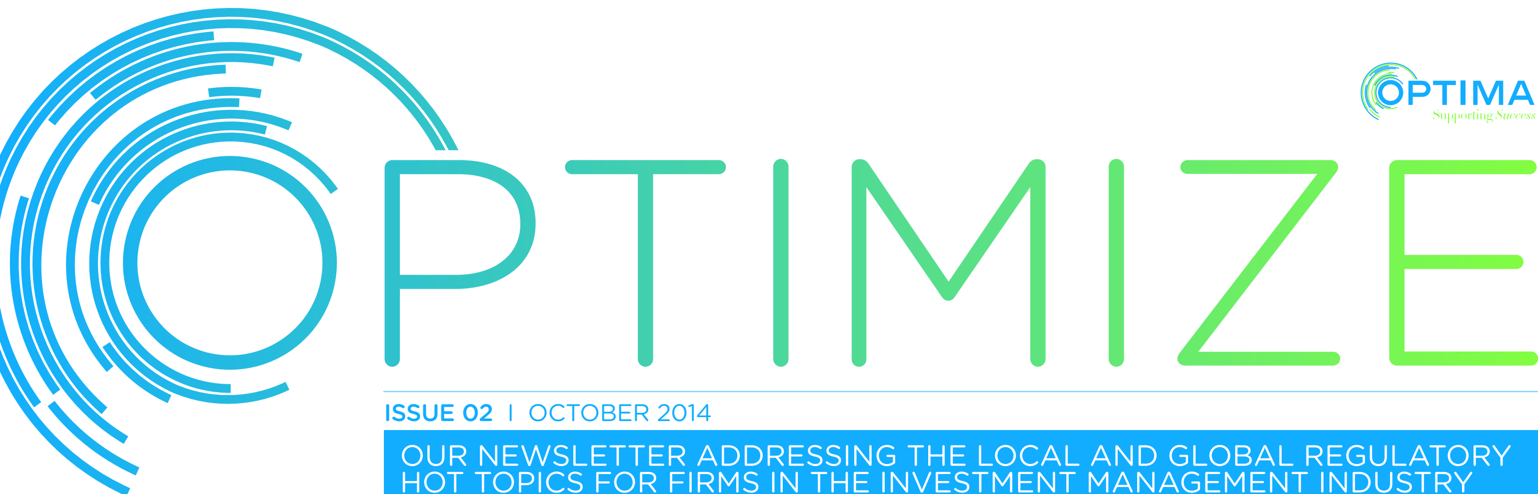

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OUR NEWSLETTER ADDRESSING THE LOCAL AND GLOBAL REGULATORY HOT TOPICS FOR FIRMS IN THE INVESTMENT MANAGEMENT INDUSTRY

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> NFA RIPPLE CAUSING TIDAL WAVES FOR CPOS

Since December 2012, when the transitional period for the repeal of Rule 4.13(a)(3) ended, investment managers trading any commodity interests had to register or file an exemption with the National Futures Association ("NFA").

"The knock on effect of this is that, unless the pools fit under the de minimus, they must be reported on quarterly, through NFA Form PQR and CPO Form PQR."

Those investment managers that could not rely on an exemption, had to register as a Commodity Pool Operator ("CPO") and subsequently report on the Commodity Pools it managed.

Optima represents a large number of CPOs and has been in discussions with the NFA over a recent change in their interpretation of the Commodity Pools under its supervision. We understand that following discussions between the NFA and the Commodity Futures Trading Commission ("CFTC"), it has been agreed that registered CPOs must list all the pools they manage (including those domiciled offshore) regardless of whether they have U.S. investors, are marketed in the U.S. or trade with U.S. counterparties. The NFA has already started picking up on this through their audits of CPOs.

The knock on effect of this is that, unless the pools fit under the de minimus, they must be reported on quarterly, through NFA Form PQR and CPO Form PQR. Foreign pools can file for the CFTC Advisory 18-96 exemption notice or for an exemption under Rule 4.7, which provides some relief from certain reporting and disclosure requirements, but the quarterly reporting remains.

For more information, please contact info@optima-partners.com

OPTIMA Supporting Success

> FCA WATCH

• In August 2014, the FCA launched a **guidance consultation** that is intended to clarify its approach to the supervision of financial promotions in social media. Ultimately, the FCA's financial promotion rules are media-neutral and in each case the overarching principle that the communication is fair, clear and not misleading applies. The consultation closes on November 6, 2014.

• On October 7, 2014, Patrick Spens, the Head of Market Monitoring at the FCA gave a **speech at the British Bankers' Association** on Market Abuse. Mr Spens highlighted the importance of submitting a Suspicious Transaction Report (STR) and that it was a mandatory requirement for the industry. STRs should be submitted to the FCA for any suspicious or potentially abusive behavior observed.

• **Barclays Bank Plc (Barclays) has been fined** £37,745,000 by the FCA for failing to properly protect clients' custody assets worth £16.5 billion. Barclays failed to properly apply the FCA rules when opening 95 custody accounts in 21 countries. This was compounded by flaws in account naming or incorrect data that suggested assets belonged to Barclays instead of its clients. The FCA's enforcement action reflects its objective to secure appropriate consumer protection and enhance the integrity of the UK financial system.

> SEC WATCH

• **The SEC anticipates** that at the end of October 2014, SEC staff will conclude a two-year initiative to conduct focused, risk-based exams of newly registered private fund advisers. These "presence" examinations have been shorter in duration and more streamlined than typical examinations, and have been designed both to engage with the new registrants to inform them of their obligations as registered entities and to permit the Commission to examine a higher percentage of new registrants. As of early September 2014, SEC staff had completed approximately 340 examinations of newly registered private fund advisers, and over 40 additional examinations are underway.

• On October 16, 2014, **the SEC announced** that in fiscal year 2014, new investigative approaches and the innovative use of data and analytical tools contributed to a very strong year for enforcement marked by cases that spanned the securities industry. In the SEC's fiscal year that ended in September 2014, the SEC filed a record 755 enforcement actions covering a wide range of misconduct, and obtained orders totaling $4.16 billion in disgorgement and penalties, according to preliminary figures. In fiscal year 2013, the Commission filed 686 enforcement actions and obtained orders totaling $3.4 billion in disgorgement and penalties. In fiscal year 2012, the Commission filed 734 enforcement actions and obtained orders totaling $3.1 billion in disgorgement and penalties. The agency's enfrcement actions also included a number of first-ever cases, including actions involving the market access rule, the "pay-to-play" rule for investment advisers, an emergency action to halt a municipal bond offering, and an action for whistleblower retaliation.

> SEC'S FOCUS ON ADVISERS' USE OF WRAP FEE PROGRAMS

The SEC's Office of Compliance and Examinations ("OCIE") has recently announced that it intends to focus on the fiduciary responsibilities of Registered Investment Advisers (RIAs) whose clients are participating in wrap fee programs.

Our recent experience with both Presence Exams and Never Before Examined SEC examinations has confirmed a heightened interest by SEC staff with respect to how Advisers handle fiduciary responsibilities to wrap fee program clients.

Wrap fee program sponsors charge clients a single flat fee that includes both advisory fees and brokerage transaction costs (e.g. flat 2% of AUM annually, with no separate charges for executing brokerage trades).

Many RIAs act as sub-advisers for wrap fee program sponsors and are paid a percentage of the fees paid by the client to the wrap fee program sponsor. There are several conflicts that arise in these arrangements, and the SEC seems keen to ensure that advisers are both aware of and managing these conflicts appropriately.

Suitability Risks.
Since these clients in many cases only sign an investment management agreement with the

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wrap fee program sponsor and not the sub-adviser directly, sub-advisers under these programs have little information with which to judge either the suitability of the client for the sub-adviser's investment strategy specifically, or the suitability for the client's involvement in the wrap fee program itself. Yet the SEC is taking the position that advisers cannot fulfill their fiduciary responsibility to the client without ensuring that these assessments are performed. The recommendation is that advisers in these situations must 1) obtain some sort of certification from the wrap fee program sponsor to the effect that the sponsor has performed the required suitability assessments, and 2) provide a disclosure in the adviser's Form ADV to the effect that the adviser relies on the wrap fee program sponsor for this assessment and that the adviser does not directly perform this assessment.

Trade Away Conflicts.
Because sub-advisers in these situations may not always execute trades using the wrap fee program sponsor's executing broker, conflicts arise when the sub-adviser executes client trades using other brokers and passes those trading costs along to the client. In these cases, the client is effectively paying twice for the trade: once through its payment of a fixed fee to the wrap fee program sponsor and second to the trade away broker. This conflict must be addressed very carefully by the adviser to ensure that the justification for the trade away exists and is in the best interest of the client. Documentation of the reasons for the trade away and empirical evidence that the trade away was done for the benefit of the client is required. For example, in cases where an adviser's recommended trade is large enough to move market pricing on a particular security, it may be that an adviser needs to execute a particular trade among multiple brokers in order to obtain the best overall combination of price/cost for the benefit of the client.

Disclosure Requirements.
Typically, sub-advisers whose clients are enrolled in a wrap fee program rely on the wrap fee program to provide the client with the required disclosures and deliver the sub-adviser's Form ADV Part 2. In our recent experience, the SEC seems to be unsatisfied with a representation that the wrap fee program sponsor is contractually bound to deliver these disclosures. The SEC is looking for both evidence that the wrap fee program sponsor actually delivered the required disclosures. In addition, the SEC is going to recommend that the adviser provide disclosure to potential wrap fee program clients in its Form ADV by highlighting the fact that the adviser relies upon the wrap fee program sponsor to carry out these important disclosure activities.

Documentation.
As with most compliance issues, documentation is the key to compliance in this area. Chief Compliance Officers are advised to:

1) get periodic certification from wrap fee program sponsors with respect to the conduct of suitability assessments and the delivery of required disclosures (e.g. adviser's Form ADV Part 2).

2) provide disclosure of wrap fee program risks to clients within the adviser's Form ADV Part 2, specifically with respect to the lack of direct suitability assessment on the part of the adviser and direct delivery of required disclosures to wrap fee program clients.

"There are several conflicts that arise in these arrangements, and the SEC seems keen to ensure that advisers are both aware of and managing these conflicts appropriately."

FCA FINDS FIRMS FAIL TO DELIVER BEST EXECUTION

On July 31, 2014, the FCA released a paper (the "Paper") presenting the findings of their thematic review (the "Review") of best execution practices and payment for order flow ("PFOF"). The Paper includes an analysis of how well firms act in their clients' interest and the integrity of the price formation process.

The Paper provides examples of good and poor practice which the FCA expects firms to assess their own best execution procedures against. The FCA looked at best execution capabilities of 36 firms, including investment banks, contract for difference providers, wealth managers, broker/interdealer brokers and retail banks. The guidance which the FCA has provided in the Paper will be of interest to all firms that execute, receive and transmit or place orders for execution, including investment managers. The Paper covers four main risks to the consistent delivery of best execution, namely:

Scope.
As per the FCA's best execution rules, firms must take a range of factors into account (such as price, speed and order size) to ensure they consistently deliver the best result. The FCA found that rules on best execution were often poorly understood or implemented. The FCA also found that 4 firms attempted to evade FCA rules by changing the description of services they offered to clients so that they could continue to receive payment for order flow, despite clear guidance on this in 2012. These firms have ceased this practice and the FCA will take action against any firm where it continues.

Monitoring.
The FCA found that most firms lacked the ability to monitor order execution or identify client outcomes. They found evidence of insufficient managerial oversight or engagement from front office staff for delivering best execution. Monitoring often did not cover all relevant asset classes, reflect all of the execution factors which firms are required to assess or include adequate samples of transactions.

Internalisation and connected parties.
Firms were also often unable to evidence how they managed conflicts of interest and delivered best execution when relying heavily on internalisation of order flow or on executing orders through connected parties.
Firms were also unable to show how they separated explicit external costs incurred on behalf of clients from internal costs or how their commission structures for internalisation avoided discriminating against other venues.

Accountability.
The FCA found that it was often unclear who had responsibility and ultimate accountability for ensuring execution agreements and policies met FCA requirements. Firms were conducting only cursory reviews of policy documents which did not address the full scope of their best execution obligations.

For further information on this topic, please contact info@optima-partners.com.

"The FCA looked at best execution capabilities of 36 firms, including investment banks, contract for difference providers, wealth managers, broker/interdealer brokers and retail banks."

> EXPERTS CORNER

"The FCA expects all firms to read the Paper and review their best execution arrangements in light of the Review findings. Firms should take immediate action to ensure that they comply with the FCA's best execution rules by maintaining a documentation-rich roadmap."

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