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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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> SEC PROPOSES AMENDMENTS TO FORM ADV AND INVESTMENT ADVISERS ACT RULES

On May 20, 2015, the U.S. Securities and Exchange Commission ("SEC") issued a proposed rules release (Release No. AI-4091) describing proposed amendments to Form ADV Part 1A (available on the SEC's website but not required to be delivered to clients) and to certain provisions of the Investment Advisers Act of 1940 ("Advisers Act"). This article summarizes certain of the more significant changes that may impact registered investment advisers ("RIAs").

"To close the gap on information concerning a RIA's different advisory accounts, the proposed amendment requires a RIA to report information on its SMAs"

Separately managed account ("SMA") information. In 2012, Form ADV was amended to require RIAs to report detailed information about their private funds. To close the gap on information concerning a RIA's different advisory accounts, the proposed amendment requires a RIA to report information on its SMAs, i.e., any account other than a pooled investment vehicle. RIAs with at least $150 million in regulatory assets under management ("RAUM") attributable to SMAs would be required to report aggregate data annually on the types of assets held by, and the use of derivatives and borrowings in, such SMAs. RIAs with at least $10 billion of SMA RAUM must provide further detailed information about derivatives exposure and provide the information semi-annually and annually in the RIA's annual updating amendment.

"Umbrella Registration." Pursuant to the terms of a 2012 no-action letter, the SEC has permitted RIAs to file a single Form ADV that covers both the filing adviser and certain of its affiliated advisers ("relying advisers"). The SEC found that the guidance provided was applied inconsistently, so the amendments are designed to codify the concept of an Umbrella Registration as contained in the no-action letter and to simplify the registration process for relying advisers. In this regard, the SEC has proposed a new schedule to Form ADV Part 1A, "Schedule R," that would need to be filed for each relying adviser and would provide identifying and ownership information.

Clarifying and Other Amendments. The proposed amendments include revisions designed to clarify Form ADV and its instructions. Many of such revisions are derived from questions received by the SEC's staff. Other significant amendments include additional information about an RIA's use of social media and retention of an outsourced chief compliance officer.

Books and Records Rule. The SEC proposes to close a gap in record keeping by amending the Books and Records Rule to require that RIAs maintain supporting documentation for performance claims contained in a communication that is distributed to any person. Currently, RIAs are required to maintain such documentation only for communications distributed to 10 or more persons.

Comments on the proposed amendments are due by August 11, 2015. Optima Partners will provide an update following the anticipated adoption of the proposed amendments.

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> FCA WATCH

• One of the hot topics in the FCA's **June edition of Regulation round-up** is Principle 11 and how firms co-operate with the regulator. The FCA emphasized the importance of informing the regulator at the earliest opportunity if a firm identifies "any potential or actual misconduct, significant risks, or anything that might affect their ability to comply with our rules and regulations". The regulator also confirmed that it will take very seriously a failure to co-operate during any investigation.

• In June 2015, the FCA published **PS15/15: FCA regulated fees and levies 2015/2016**, which sets out the final rules on periodic regulatory fees and levies. It also includes the FCA's feedback on the responses received to the consultation on the draft fees and levies rules in CP15/14 FCA Regulated fees and levies: Rates proposals 2015/16, published 26 March 2014.

> SEC WATCH

• On June 29, the **SEC charged high-profile private equity firm** Kohlberg Kravis Roberts and Co. ("KKR") with misallocating more than $17 million of "broken deal" expenses in violation of the Advisers Act's anti-fraud provision and in breach of its fiduciary duty. It is the SEC's first case charging a private equity fund adviser with misallocating broken deal expenses. The SEC considered a broken deal expense to be more than just a "break-up fee" and included research costs, travel costs and professional fees, and expenses incurred to evaluate particular industries and regions for buyout opportunities. The SEC's press announcement indicated that "KKR's failure to adopt policies and procedures governing broken deal expense allocation contributed to its breach of fiduciary duty."

• In this issue of Optimize, we summarize the recent guidance issued by the OCIE regarding broker-dealers' compliance with anti-money laundering ("AML") regulatory requirements. Unlike broker-dealers, there currently are no specific AML regulatory requirements for investment advisers. Regardless, investment advisers with a compliance infrastructure have adopted certain policies and procedures around AML compliance as part of their fiduciary duty, typically delegating the day-to-day function to their fund administrator(s). The U.S. Treasury Department's Financial Crimes Enforcement Network ("FinCEN") proposed imposing AML requirements on investment advisers over a decade ago, but the proposal was never adopted. However, it was recently reported that FinCEN sent a new proposed rule regulating investment advisers' AML compliance to the White House Office of Management and Budget (OMB). Based on the content of FinCEN's original withdrawn rule proposal, it is likely that FinCEN would require investment advisers to implement a program with requirements very much like those applicable to broker-dealers. If such a rule were to be adopted, it is likely that OCIE examiners of investment advisers would adopt an approach similar to their broker-dealer counterparts.

> OCIE'S BROKER-DEALER EXAMINATION PROGRAM'S GUIDANCE ON AML COMPLIANCE

On June 18, 2015, Kevin W. Goodman, National Associate Director of the Broker-Dealer Examination Program of the Office of Compliance Inspections and Examinations ("OCIE"), made a "Speech" before the Securities Industry and Financial Markets Association entitled, "Anti-Money Laundering: An Often-Overlooked Cornerstone of Effective Compliance." This article summarizes the significant guidance contained in the Speech.

"A broker-dealer's role goes beyond just preventing traditional money-laundering that implicates drug cartels or terrorist operations"

Background
The Bank Secrecy Act ("BSA") establishes the basic framework for AML obligations imposed on financial institutions. The USA PATRIOT Act amended and strengthened the BSA and imposed a number of AML requirements on broker-dealers, including requirements for a written AML compliance program, customer identification program ("CIP") and suspicious activity monitoring and reporting (what Mr. Goodman referred to as the "three major AML requirements"). Broker-dealers can satisfy their obligation under the U.S. PATRIOT Act by implementing and maintaining an AML compliance program that complies with the requirements of a self-regulatory organization ("SRO"). The SEC has approved FINRA Rule 3310, the AML compliance rule of the Financial Industry Regulatory Authority ("FINRA"), the SEC's SRO.

Significance of Anti-Money Laundering ("AML")
Mr. Goodman addressed the importance of strong AML compliance. The OCIE will take exception to a firm that views AML compliance as a peripheral or unimportant component of its compliance

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infrastructure. The OCIE believes that broker-dealers play a vital front line role in identifying and addressing suspicious activities to prevent the U.S. financial system from being used for criminal activity. This role goes beyond just preventing traditional money-laundering that implicates drug cartels or terrorist operations; it also includes activity that may indicate fraud, insider trading or manipulative trading schemes. For example, federal authorities have used filed suspicious activity reports ("SARs") to identify fraud such as Ponzi schemes.

Discussion of AML Requirements
Mr. Goodman provided the following color on steps that OCIE examiners will take in their review.

AML Compliance Program. FINRA Rule 3310 requires FINRA members to establish a risk-based AML compliance program including "reasonably designed" policies and procedures, designation of an AML compliance officer, ongoing employee training and independent testing of the AML compliance program.

OCIE examiners will:
- Assess the background and experience of the designated compliance officer and whether the officer has the necessary resources to perform his or her duties.

- Consider whether training provided to employees is adequate.

- Confirm that the firm documents its independent testing.

CIP Program. Broker-dealers must implement a CIP to obtain the identifying information for each customer and have a method to verify that information.

OCIE examiners will:
- Review a firm's verification policies and procedures to ensure that they are reasonable given the firm's assessment of the risk factors associated with its customer base.

- Ensure that the firm understands who is a "customer" for purposes of triggering CIP requirements, including taking into account not just direct customers but other persons who may execute securities transactions through the broker-dealer.

Detecting and Reporting Suspicious Activity. Broker-dealers must report suspicious activity that involves or aggregates funds or other assets of at least $5,000 which the broker-dealer has reason to suspect, among other things, involves funds derived from illegal activity or is intended to disguise funds from illegal activity.

OCIE examiners will:
- Evaluate whether firms are using monitoring processes and tools commensurate with the volume and types of activities occurring in the firm's accounts.

AML Examination Initiatives – Areas of Focus
Mr. Goodman discussed where the OCIE examination program is directing its resources by highlighting business activities that the OCIE has identified as potential sources for AML concerns.

- *Thinly traded or low market value securities.* The OCIE has issued **a National Exam Program Risk Alert** that provides insight into issues and risks that broker-dealers might face if their customers actively trade low-priced securities.

- *Direct market access.* The SEC has adopted Securities Exchange Act of 1934 Rule 15c3-5 that requires broker-dealers who provide customers with direct market access to adopt a system of risk management controls including restricting access to persons and accounts pre-approved and authorized by the broker-dealer.

- *Master-/sub-account relationships.* In this relationship, sub-account holders are allowed to trade through a master brokerage account. Failure to adequately monitor trading activity by ignoring the patterns of sub-account holders may put firms at risk for AML deficiencies.

- *Bank-Oriented Products and Services.* Examiners will evaluate the use of brokerage accounts that offer "comprehensive asset management" or "cash management" features by assessing all transaction methods for movement of cash and securities.

> SUMMARY OF CONCLUSION

Mr. Goodman concluded his speech by emphasizing the importance of, among other things:

- Adequate staffing of the AML compliance program.

- Documentation of monitoring and testing that is performed.

- Inclusion of indirect customers for purposes of SAR reporting based on transactional activities that run through the broker-dealer.

- The need to file SARs, using the SEC's SAR alert message line (202-551-SARS) when a SAR may require immediate attention.

PRE AND POST TRADE MARKET ABUSE CONTROLS FOR FCA REGULATED FIRMS - WHAT'S THE RIGHT AMOUNT?

Pre and post trade controls have always been around and firms generally have varied approaches as to how they conduct pre and post trade controls. Generally pre trade controls have consisted of having a restricted list, ensuring employees were appropriately trained and, in a few cases, blocks on Order Management Systems. However, firms should focus more on post trade controls, checking trading patterns and looking for large market movements.

While market abuse has always been hot on the FCA's radar, only recently has the FCA really examined the controls the industry has in place to detect possible market abuse. This has become a hot topic for the FCA following the release of the "Asset management firms and the risk of market abuse thematic review", the "Financial Crime Guide Parts 1 and 2" and "Market Watch 48", which collectively set out the FCA's expectations in this area.

While there is an element of proportionately that can certainly be adopted, any firm that simply sits back idly instead of reviewing their internal procedures and reporting to senior management, may well find themselves being critised by the regulator and investors alike.

What steps should I take?
The first step is to assess the controls the firm has in place and the risk to the business. Consider the following:

- ***Does the firm come into contact with inside information?*** Consider how often insider information is received and the likely sources.

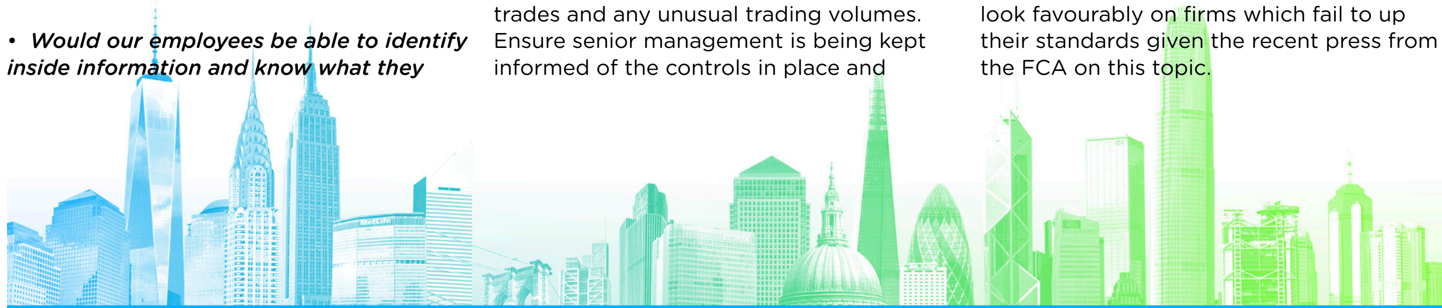
- ***Would our employees be able to identify inside information and know what they should do if they accidently come into contact with it?*** Consider who are the individuals that are most likely to come into contact with inside information. Ask them specifically about the firm's internal procedures. Could they identify it even when they are expecting to receive it (such as a pre-wall crossing call or a call with an expert network – including where they have requested not to receive such information).

- ***What pre-trade controls are in place?*** Large firms generally have teams dedicated to reviewing trades and have automated systems designed to detect possible market abuse. Small firms should consider separate reporting lines for the portfolio manager and the traders or an independent sign off on trades (this will act as a secondary control). Other controls include ensuring there is a restricted list in place and where possible automated stops or e-mails on the Order Management System.

- ***What post-trade controls are in place?*** Ensure trading activity is monitored against market announcements and market movements. Check employee trading for signs of style drift. Consider regular monitoring of the most and least successful trades and any unusual trading volumes. Ensure senior management is being kept informed of the controls in place and any exceptions. Larger firms may decide to model price movements outside a probability range and conduct automated media searches around the trade dates. Trade monitoring should be tailored to the types of instruments traded and the markets traded.

- ***What personal trading controls are in place?*** While most firms will adopt a pre-approval policy, many will not adequately follow up with breaches of the firm's policies, such that they regularly reoccur. Those which do not require pre-approval should have enhanced monitoring to ensure employees are not front running the fund or client positions. All personal account trading should be monitored against the restricted / insider lists maintained by the firms.

This is far from an exhaustive list of the types of controls firms should consider adopting. Ultimately firms will need to consider, given the size and nature of the firm, the risk of insider dealing or market abuse. In all cases we strongly recommend to our clients that pre and post trade controls are discussed and documented by the Governing Body. The FCA is unlikely to look favourably on firms which fail to up their standards given the recent press from the FCA on this topic.



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