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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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> BREXIT
THE REGULATORY LANDSCAPE

For more than a decade, the European Securities and Markets Authority ("ESMA") has steadily worked towards implementing a consistent approach to regulation across all member states.

The Undertakings for Collective Investment in Transferable Securities Directive ("UCITS") was adopted in 1985, and saw open-ended funds investing in transferable securities subject to consistent regulation across member states. The UCITS laid the foundations for a consistent regulatory approach, with this furthered with subsequent iterations of the UCITS Regime and the introduction of the Markets in Financial Instruments Directive ("MiFID") which came into effect in 2007, increasing transparency across financial markets.

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"For the time being, it is business as usual for FCA regulated entities, with all existing and upcoming regulatory requirements (i.e. MiFID II and EU MAR) still in place or set to be implemented in line with ESMA's schedule."

This drive towards establishing a consistent regulatory approach was furthered with the implementation of the Alternative Investment Fund Managers Directive ("AIFMD") in 2013, which brought alternative investment funds into scope of EU financial regulation.

More recently, regulated firms have been preparing for the upcoming introduction of MiFID II set to occur in January 2018. MiFID II will see EU financial markets take a further step towards removing regulatory arbitrage across member states.

SO, WHERE DOES THIS LEAVE THE UK, GIVEN THE VOTE TO LEAVE THE EUROPEAN UNION?

For the time being, it is business as usual for FCA regulated entities, with all existing and upcoming regulatory requirements (i.e. MiFID II and EU MAR) still in place or set to be implemented in line with ESMA's schedule.

Given that the FCA has been at the forefront of regulatory developments introduced by ESMA, we are unlikely to see the FCA rolling back existing and upcoming regulatory requirements, instead we expect to see the FCA implement a system that mirrors current requirements.

The negotiation that occurs between the UK and EU, will determine the level of integration on an ongoing basis, however the worst-case scenario will see the UK treated in the same manner as non-EEA jurisdictions.

ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE ("AIFMD")

In the event of a hard BREXIT, alternative investment fund managers domiciled in the UK and managing EEA funds, would no longer be able to benefit from the marketing passport, and would instead be required to utilise national private placement regimes on a country by country basis. This is similar to current UK AIFMs managing non-EEA funds. At this point in time we believe it is unlikely that there will be a non-EEA passport under the AIFMD.

UNDERTAKINGS FOR THE COLLECTIVE INVESTMENT OF TRANSFERABLE SECURITIES ("UCITS")

BREXIT has the potential to have a material impact on UK-domiciled UCITS funds and management companies. A fundamental requirement of being a UCITS fund is to be domiciled within the EU, with a EU management company (or be self-managed). This means that there is a material risk that many of the benefits of the UCITS regime could be lost to UK funds post-BREXIT.

BREXIT may also impact a UK Investment Manager that has been delegated the investment management function by a EU ManCo. Typically, under this structure, the UK Investment manager operates under MiFID and has a MiFID Passport in place to provide services on a cross-border basis.

In a post-BREXIT model, this may well be lost, which would impact the marketing of the UCITS across Europe.

CLOSING THOUGHTS

We continue to see a similar number of new hedge fund launches, with BREXIT having no tangible impact on the number of firms requesting Part 4A permission (i.e. becoming authorised). Going forward, we fully expect that London will retain its crown as the lead jurisdiction within its time zone and the FCA continuing to cooperate closely with its European counterparts.

SEC'S GUIDANCE ON THE CUSTODY RULE

In February 2017, the Investment Adviser Association sought the SEC's clarification of whether acts by a "Qualified Custodian" (i.e., bank, broker-dealer, futures commission merchant, certain foreign custodians) of a registered investment adviser (an "Adviser"), pursuant to a standing letter of instruction established by the Adviser's client and the Qualified Custodian (an "SLOA"), result in the Adviser having "Custody" of the client's funds or securities ("assets") under the Investment Advisers Act's "Custody Rule."

An SLOA typically grants the Adviser limited power to disburse funds to one or more third parties as specifically designated by the client.

In response, the SEC issued the "IAA No-Action Letter" indicating that an Adviser with power to dispose of client assets for any purpose other than authorized trading has access to the client's assets and therefore has Custody of them. Once it is determined that an Adviser has Custody of the client's assets, the Adviser must maintain the client's assets in accordance with the Custody Rule which requires an Adviser to, among other things, undergo an "Annual Surprise Examination" by an independent public accountant of the funds or securities held in Custody.

However, the SEC indicated that, even if it was determined that the SLOA as structured resulted in the Adviser having Custody, the SEC would not recommend enforcement action against the Adviser if it did not obtain an Annual Surprise Examination, provided that the Adviser complied with seven (7) enumerated procedures, such as requiring the Qualified Custodian to perform appropriate verification of client's instructions, to employ a signature review to verify the client's authorization and to provide a transfer of funds notice to the client promptly following the transaction. Also note that the requirement to undergo an Annual Surprise Examination would not apply to an Adviser to pooled investment vehicles that delivers audited financial statements to its clients in accordance with the Custody Rule's "audit approach."

The SEC is permitting Advisers that wish to employ the enumerated procedures in the No-Action Letter a "reasonable period of time" to implement them, and indicated that an Adviser should include assets subject to an SLOA in Section 9 of Form ADV in its annual update after October 1, 2017.

Links to the IAA's request letter and the IAA No-Action Letter can be found at **here** and **here**, respectively.

"Inadvertent custody of a client's funds and securities under the Advisers Act's Custody Rule may result whenever an Adviser has power to dispose of client assets for any purpose other than authorized trading."

INVESTMENT MANAGEMENT DIVISION'S GUIDANCE

In February, contemporaneous with the IAA No-Action Letter, the SEC's Investment Management Division issued a related "Guidance Update." The Guidance Update stated that an Adviser would have inadvertent Custody if a custodial agreement between the Adviser's client and the Qualified Custodian authorizes the Adviser to withdraw client funds or securities, notwithstanding a provision in the advisory agreement between the Adviser and the client to the contrary.

According to the Guidance Update, an Adviser can avoid inadvertent Custody by drafting a document addressed to the relevant Qualified Custodian that limits the Adviser's authority to "delivery versus payment" (i.e., the transfer of funds or securities out of a client's account only upon a corresponding transfer of securities or funds into the account), notwithstanding the

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OPTIMA Supporting Success

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wording of the client's custodial agreement. The client and Qualified Custodian must provide written consent to the new arrangement. The Guidance Update can be found **here**.

CUSTODY FAQ QUESTION II.4

On the same day as the IAA No-Action Letter, the SEC revised its answer to Custody FAQ Question II.4. Question II.4 addressed when an Adviser is deemed to have Custody if it has the limited authority to transfer client assets between one or two of the client's accounts maintained with the same or a different Qualified Custodian. The original FAQ stated that an Adviser would not be considered to have Custody if the client authorized such a transfer in writing and provided a copy of the authorization to the Qualified Custodian, "specifying" the client accounts maintained with the Qualified Custodian. The revised FAQ clarifies that "specifying" means that the written authorization states with particularity the name and account numbers such that the sending Custodian has a record that the client has identified the accounts for which the transfer is being effected as belonging to the client. Such authorization does not need to be provided to the receiving Custodian.

In addition, an Adviser's authority to transfer client assets between the client's accounts at the same Qualified Custodian, or between affiliated Qualified Custodians that both have access to the account numbers and client account name, does not constitute Custody and does not require further specification of client accounts in the authorization. Therefore, the revision impacts wire transfers between client accounts at different, non-affiliated Qualified Custodians.

FAQ Question II.4 can be found **here.**

> FCA WATCH

- **Published: 07/04/2017 - FCA bans and fines two individuals for market abuse:** Firm Worldspreads Limited, which operated a spread betting business, collapsed in March 2012. The FCA has fined the firm's former Chief Financial Officer, Niall O'Kelly, £11,900 and former Financial Controller, Lukhvir Thind, £105,000, for engaging in market abuse and permanently banned them both from performing any function related to regulated activity.

- **Published: 30/03/2017 - FCA fines former investment banker for sharing confidential information over WhatsApp:** The FCA has fined Christopher Niehaus, a former investment banker, £37,198 for sharing client confidential information over WhatsApp. The FCA found that during his employment as managing director in the Investment Banking division at Jefferies International Limited, Mr. Niehaus failed to act with due skill, care and diligence. Mr. Niehaus received client confidential information during the course of his employment and, on a number of occasions between January and May 2016, shared that information with both a personal acquaintance and a friend, who was also a client of the firm.

- **Published: 31/01/2017 - FCA fines Deutsche Bank £163 million for serious anti-money laundering controls failings:** The FCA has fined Deutsche Bank AG £163,076,224 for failing to maintain an adequate anti-money laundering ("AML") control framework during the period between January 2012 and December 2015. This is the largest financial penalty for AML controls failings ever imposed by the FCA, or its predecessor the Financial Services Authority (FSA).

- **Published: 03/03/2017 - Investment managers still failing to ensure effective oversight of best execution:** The FCA outlined their findings from supervisory work looking at how investment managers deliver best execution for their clients. The FCA was concerned to find that most firms had failed to take on board the findings of their thematic review. The pace of change in improving client outcomes in best execution was slow, with few firms having a cohesive strategy for improving client outcomes. The FCA will be revisiting best execution in 2017 to see what steps investment management firms have taken to assess gaps in their approach to achieving best execution and how they can evidence that funds and client portfolios are not paying too much for execution. If the FCA finds that firms are still not fulfilling their best execution obligations, they will consider appropriate action, including more detailed investigations into specific firms, individuals or practices.

- **Published: 03/03/2017 - Firms continue to fail to meet our expectations on their use of dealing commission:** The FCA summarised their findings from a review that analysed dealing commission expenditure across 31 investment managers (covering asset managers, wealth managers and host-authorised corporate director providers) between 2012 and 2015. The FCA stated that more work needs to be done by investment management firms to ensure they spend their customers' money with as much care and attention as if it were their own. Despite some progress being made, much of the poor practice that the FCA highlighted previously is still commonplace, and this is an area of concern. Given these findings and the implementation of MiFID II, the FCA will continue to focus on the use of dealing commission.

> SEC WATCH

UNIBANCO UPDATE

It has been quite some time since the investment management industry has heard from the SEC regarding the "Unibanco No-action Letters," but in March 2017 the Investment Management Division ("IM") issued an "Information Update" for Advisers relying on the guidance contained in these letters. The Unibanco No-Action Letters refers to a series of no-action positions taken by the SEC in the 1990s regarding the application of Investment Advisers Act provisions to "participating affiliates." A "Participating Affiliate" is an SEC-registered Adviser's non-U.S. affiliate that shares personnel with the Adviser, and provides advice to U.S. clients through the Adviser, but does not register with the SEC itself.

The Unibanco No-Action Letters were preceded in 1981 by the "Richard Ellis No-Action Letter," which provided conditions for determining when a non-U.S. adviser may establish a separate, registered affiliate to conduct its advisory business in the U.S. and limit the application of the Advisers Act to the affiliate, thereby avoiding direct regulation of the non-U.S. adviser. The Richard Ellis No-Action Letter enumerated the conditions required for the affiliate to be regarded as having a "separate, independent existence and to be functioning independent" of the non-U.S. adviser. Certain of the Ellis conditions, particularly a requirement that the entities separate their investment advisory personnel, limited the utility of the Richard Ellis No-Action Letter.

In 1992, the SEC announced a "conduct and effects" test that would apply the Advisers Act to non-U.S. advisers only if their activities take place in the U.S. or have a substantial and foreseeable effect in the U.S. or on U.S. persons. This was followed by the first Unibanco No-Action Letter, where the SEC expressly permitted an Adviser subsidiary of a non-U.S. adviser to share advisory personnel with its unregistered non-U.S. parent, provided that they share personnel that are competent to advise clients appropriately and the Adviser was a separate legal entity. Subsequent Unibanco No-Action Letters provided assurances based on additional criteria, including: all personnel of the Participating Affiliate involved in the U.S. advisory business are deemed "associated persons" of the Adviser; and the SEC has adequate access to trading and other records of the Participating Affiliate and to its personnel to the extent necessary to enable it to identify conduct that may harm U.S. clients or markets. In addition, reliance on the Unibanco No-Action Letters is conditioned on Advisers committing to certain representations and undertakings.

In its Information Update, IM indicated that, over the years that Advisers have relied on the Unibanco No-Action Letters, Advisers have provided a wide variety of documents to support their representations and undertakings. The SEC indicated that the purpose of the Information Update was to update Advisers on the documentation that the SEC believes "most clearly" addresses the concerns raised in the Unibanco No-Action Letters regarding the staff's ability to monitor the conduct of Participating Affiliates. Such documentation includes: documentation of the appointment of an agent for service of process by the Participating Affiliate; a representation that the Participating Affiliate submits to the jurisdiction of U.S. courts for actions arising under the federal securities laws; and a representation that the Participating Affiliate will promptly provide the SEC any and all books and records required by the SEC's guidance and make available for testimony the Participating Affiliate's employees involved in investment advisory activities.

The full list of Information to be Submitted can be found in the Information Update available **here**.

JAY CLAYTON SWORN IN AS SEC CHAIRMAN

On May 4, 2017, Walter J. Clayton, known as Jay Clayton, was sworn into office as the 32nd Chairman of the U.S. Securities and Exchange Commission. Prior to joining the Commission, Mr. Clayton was a partner at Sullivan & Cromwell LLP, where for over 20 years he advised public and private companies on a wide range of matters, including securities offerings, mergers and acquisitions, corporate governance, and regulatory and enforcement proceedings. Mr. Clayton has indicated that, as opposed to his recent predecessors including a former prosecutor (Mary Jo White) and former senior regulator (Mary Shapiro) who focused on enforcement, he will focus more on capital formation and improving access to financial markets.

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