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

> THE GENERAL DATA PROTECTION REGULATION

The General Data Protection Regulation (GDPR), which will apply from **25 May 2018,** promises wide ranging and substantial change to the way firms handle customer data. The Regulation aims to remove the current divergence of rules, requirements, and practices from across the EU, while also strengthening individuals' fundamental Data Protection rights.

Scope
In brief the GDPR impacts the processing of **personal data** (see below) by:

i. EU firms - even if they have delegated that processing outside of the EU; and

ii. Non-EU firms if they offer services into the EU or receive client data from an EU entity.

The GDPR centres around 'data controllers' and 'data processors'.

What is personal data?
Personal data is defined in GDPR as "any information relating to an identified or identifiable natural person." The more obvious example would be client (and staff) files of an investment firm, completed application forms, share registers, etc. However, the definition is wide enough to capture less obvious examples such as identification/file numbers and electronic key fobs – there is no prescriptive list of what is, or what is not, 'personal data'.

What is a 'data controller'?
This is the entity, or natural person, that determines the purposes and means of data processing, so in the example above the investment firm would be the controller of client personal data.

What is a 'data processor'?
This is the entity, or natural person, that handles ('processes') the personal data under the instructions of the data controller. If for any reason the data processor did 'determine the purposes and means of data processing' then they would be regarded as the 'data controller' under the GDPR. Typically, our example investment firm ('data controller') would

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"Regardless of Brexit, firms must take action to ensure that they're ready to comply with GDPR on 25 May 2018."

appoint a third-party administrator to undertake back-office functions such as, say, the handling of client applications or maintenance of the register, etc. In such circumstances the administrator would be the 'data processor'.

Key GDPR Requirements
GDPR is wide-ranging and imposes a high bar for compliance. Below are some of the key requirements:

1. Privacy by Design - Data protection must be considered when designing systems, and not as an add on. Firms should only hold and process the data necessary for the completion of its duties, and access to that data should be limited to those needing to carry out the processing.

2. Accountability and Governance - You must both do the right thing and be able to prove that you have done the right thing. At a minimum, firms should ensure that suitable policies and procedures are in place, and that they are supported by staff training and regular monitoring/internal reporting of data processing activities. Consideration should be given to the appointment of a Data Protection Officer.

3. Transfer of Data - Restrictions are imposed on the transfer of personal data outside the EU, and these restrictions may only be imposed when certain conditions are met. You should be cautious and conduct a detailed review of your arrangements if you plan to do this.

4. Individuals' Rights - enhanced rights for individuals is a key feature of the GDPR and includes:

• 'right to be informed' of how and why an individual's personal data is being used;

• 'right of access' under which a firm must provide the individual with a free copy of their personal data within one month;

• 'right of rectification' in that any incorrect information must be corrected without delay upon notice;

• 'right to be forgotten' requires the deletion of all personal data where e.g. the individual has withdrawn their consent for the use of their data (note that this right only arises in a limited set of circumstances);

• 'right to restrict' the processing of personal data in defined circumstances;

• 'right to data portability' gives the individual the right to receive their personal data and to transmit it to another data controller;

• 'right to object' permits the individual to object to the processing of their personal data.

5. Consent - Individuals must give unambiguous consent for their personal data to be processed - implied consent is no longer acceptable. Consent must be as easy to withdraw as it is to give and must also be recorded and able to be demonstrated if requested.

6. Data Breach Notification - Data breaches must be notified to supervisory authorities "without undue delay, and where feasible, not later than 72 hours after becoming aware of it" unless the breach "is unlikely to result in a risk to the rights and freedoms of natural persons." Where the data breach is likely to result in a high risk to rights and freedoms of individuals, then the individual(s) concerned must also be notified "without undue delay".

7. Impact Assessment - This must be conducted where the processing of data could result in a high risk to individuals (e.g. when using automated processing to evaluate individuals and make decisions).

So, what does this mean for my firm?
Regardless of Brexit, firms must take action to ensure that they're ready to comply with GDPR on 25 May 2018. Failure to be compliant with the Regulation could result in a fine of up to 4% of annual global turnover, or €20m, whichever is greater.

OPTIMA PARTNERS RECOMMENDS THAT:

GOVERNANCE

Including:
• Senior Management and firm-wide awareness;
• Clear allocation of responsibilities (and appointing a Data Protection Officer if appropriate); and
• Understanding any extraterritorial scope.

PAST DATA REVIEW

Including:
• Conducting a data audit across the firm, including:
a) The data gathered;
b) The rationale for gathering it;
c) The data's use;
d) Who the data is shared with;
e) The security of the data (including when stored at third parties); and
f) The data's retention requirements.

FUTURE DATA STRATEGY

Including:
• Conducting a Data Necessity Test and Data Protection Impact Assessment where appropriate;
• Designing "privacy" into products and services;
• Fulfilling customer facing responsibilities;
• Maintaining appropriate records;
• Implementing a data response plan; and
• Protecting the firm against any data breaches.

EUROPEAN COMMISSION PROPOSAL ON THE PRUDENTIAL REQUIREMENTS FOR INVESTMENT FIRMS

On 20 December 2017 the European Commission submitted proposals for a Directive and a Regulation to amend the current prudential requirements for EU investment firms subject to the CRD IV prudential framework (Capital Requirements Directive "CRD") and the Capital Requirements Regulation "CRR".

"The draft Directive and Regulation are Level 1 drafts and are still in their consultation phases."

The aim of the proposed Directive and Regulation is to introduce prudential requirements which are more tailored to the risk profiles and business models of investment firms, as CRD IV was drafted predominantly with banks in mind.

The draft Directive and Regulation are Level 1 drafts and are still in their consultation phases. As such, no proposed implementation dates have yet been determined by the European Commission. In light of Brexit and typical EU timelines for consultation, drafting, and adoption of Level 2 technical standards, it remains to be seen whether these new rules will take effect ahead of the Brexit date and whether the Financial Conduct Authority will draft and implement corresponding Level 3 rules.

Classes of Investment Firms

Under the new proposed rules, investment firms will be categorised into the following classes:

CLASS	DEFINITION AND SCOPE
Systemic investment firms (Class 1)	Firms which: • Have permission of dealing on own account, or underwriting or placing financial instruments on a firm commitment basis. • Have total value assets exceed EUR 30 billion.
Other firms (Class 2)	Firms which: • Are not Class 1 firms, and • Are not Class 3 firms
Small and non-interconnected firms (Class 3)	Firms which meet all the following conditions*: • AUM is less than €1.2bn • Total annual gross revenue is less than €30m • Balance sheet is less than €100m • Client Orders Handled (COH) is less than €100m per day for cash trades or €1bn for derivatives • Zero client money / client assets (ASA) • Zero daily trading flow (DTF) • Zero net position risk (NPR) or clearing member guarantee (CMG) • Zero trading counterparty default (TCD)

*Calculation methodologies for each of these threshold conditions factors (COH, ASA, DTF, NPR, CMG, TCD) are set-out within the draft Regulation COM(2017) 790 final

Revised Initial Capital Requirements (IC)

Depending on the regulatory MiFID II permissions of the investment firm, the Initial Capital Requirement will be as follows:

CLASS	DEFINITION AND SCOPE
€750k	• Dealing on own account • Underwriting of financial instruments and/or placing financial instruments on a firm commitment basis • Operation of an MTF • Operation of an OTF
€150k	• Investment firms, other than those falling into the category of €750k or €75k Initial Capital requirement
€75k	• Reception and transmission of orders in relation to one or more financial instruments • Execution of orders on behalf of clients • Portfolio management • Investment advice • Placing of financial instruments without firm commitment basis

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Minimum Capital Requirements (MC)
Depending on the class of investment firm, Minimum Capital Requirements (MC) for an investment firm will be determined based on the higher of the following types of capital requirements:

- Permanent Minimum Capital Requirement (PMC)
- Fixed Overhead Requirement (FOR)
- K-factor based capital requirement

CLASS	PERMANENT MINIMUM CAPITAL (PMC)	MINIMUM CAPITAL REQUIREMENTS (MC)
Systemic investment firms (Class 1)	€5m	Calculated as per current CRD IV requirementsfor credit institutions (CRR Article 12)*
Other firms (Class 2)	Initial Capital Requirement (IC) of €750, €150 or €75k	Higher of: • PMC • FOR • K-factor based capital requirement
Small and non-interconnected firms (Class 3)	Initial Capital Requirement (IC) of €750, €150 or €75k	Higher of: • PMC • FOR

*The CRR definition of a 'credit institution' will be amended under the proposed Regulation (see Article 60)

K-factor Based Capital Requirements – Class 2 Firms Only
The proposed Regulation introduces a new concept of K-factors to calculate capital requirements for Class 2 firms, where the capital requirement equals the sum of:

Risk-to-Customer (RtC) + Risk-to-Market (RtM) + Risk-to-Firm (RtF)

Risk-to-Customer (RtC) = K-AUM + K-CHM + K-ASA + K-COH

Risk-to-Market (RtM) = Higher of K-NPR and K-CMG

Risk-to-Firm (RtF) = K-TCD + K-DTF + K-CON

Some of the K-factors have an assigned coefficient which determines the amount of capital to be held for those K-factors, based on the following formula:

K-factor capital requirement = Element * Coefficient for the K-factor

The coefficients for the individual K-factors are as follows:

K-FACTOR	ELEMENT	COEFFICIENT
K-AUM	Assets under management, both discretionary and non-discretionary	0.02%
K-CMH	Client money held	0.45%
K-ASA	Assets under safekeeping and administration	0.04%
K-COH cash	Client orders handled – cash orders	0.1%
K-COH derivatives	Client orders handled – derivatives orders	0.01%
K-DTF cash	Daily trade flows in cash	0.1%
K-DTF derivatives	Daily trade flows in derivatives	0.01%

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For the other K-factors which are not based on a coefficient calculation methodology, the regulation specifies detailed requirements around how to determine the capital requirements for each of those:

K-FACTOR	CAPITAL REQUIREMENT FOR:
K-NPR	Trading book positions
K-CMG	Positions that are centrally cleared
K-TCD	Trading counterparty default
K-CON	Concentration risk

Changes to Tier 1 capital ratios
The Regulation also proposes changes to the current ratios for the type of capital firms are required to hold as capital. Specifically, the investment firm's total capital resources may consist of at least:
- 56% Common Equity Tier 1 capital
- 44% additional Tier 1 capital
- 25% Tier 2 capital

Next steps
The proposals will be put forward for adoption by the European Parliament and the European Council. There is also a brief feedback period (closing 8 March 2018) allowing persons to respond to the proposal – a summary of responses received will be presented to the Parliament and Council to consider as part of the legislative debate.

Useful Links
The draft Regulation (COM(2017) 790) can be found ***here.***
The draft Directive (COM(2017) 791) can be found ***here.***

> FCA WATCH

Senior Managers & Certification Regime:
The FCA published three Consultation Papers on the extension of the Senior Managers and Certification Regime on 13/12/2017.

The papers set out:

• How the FCA proposes to move firms and its senior staff members over to the new regime; and

• A proposal to extend the 'Duty of Responsibility'.

The Senior Managers & Certification Regime aims to make individuals more accountable for their conduct and competence. The new regime replaces the Approved Persons Regime, and changes how individuals working in financial services are regulated. The aim is to reduce harm to consumers and investors and strengthen market integrity by holding individuals more accountable. Two key parts of the regime are to encourage a culture of staff at all levels to take personal responsibility for their actions, and to ensure firms and staff clearly understand and can demonstrate where responsibility lies.

For most firms, the FCA is planning to automatically convert Approved Persons Functions to Senior Management Functions. This means that the vast majority of firms will not need to submit anything to the FCA in order to make this process happen.

Under the 'Duty of Responsibility', Senior Managers of banks are held responsible and accountable for the business areas that they lead. It is proposed to extend this responsibility to capture Senior Managers of insurers and FCA solo-regulated firms.

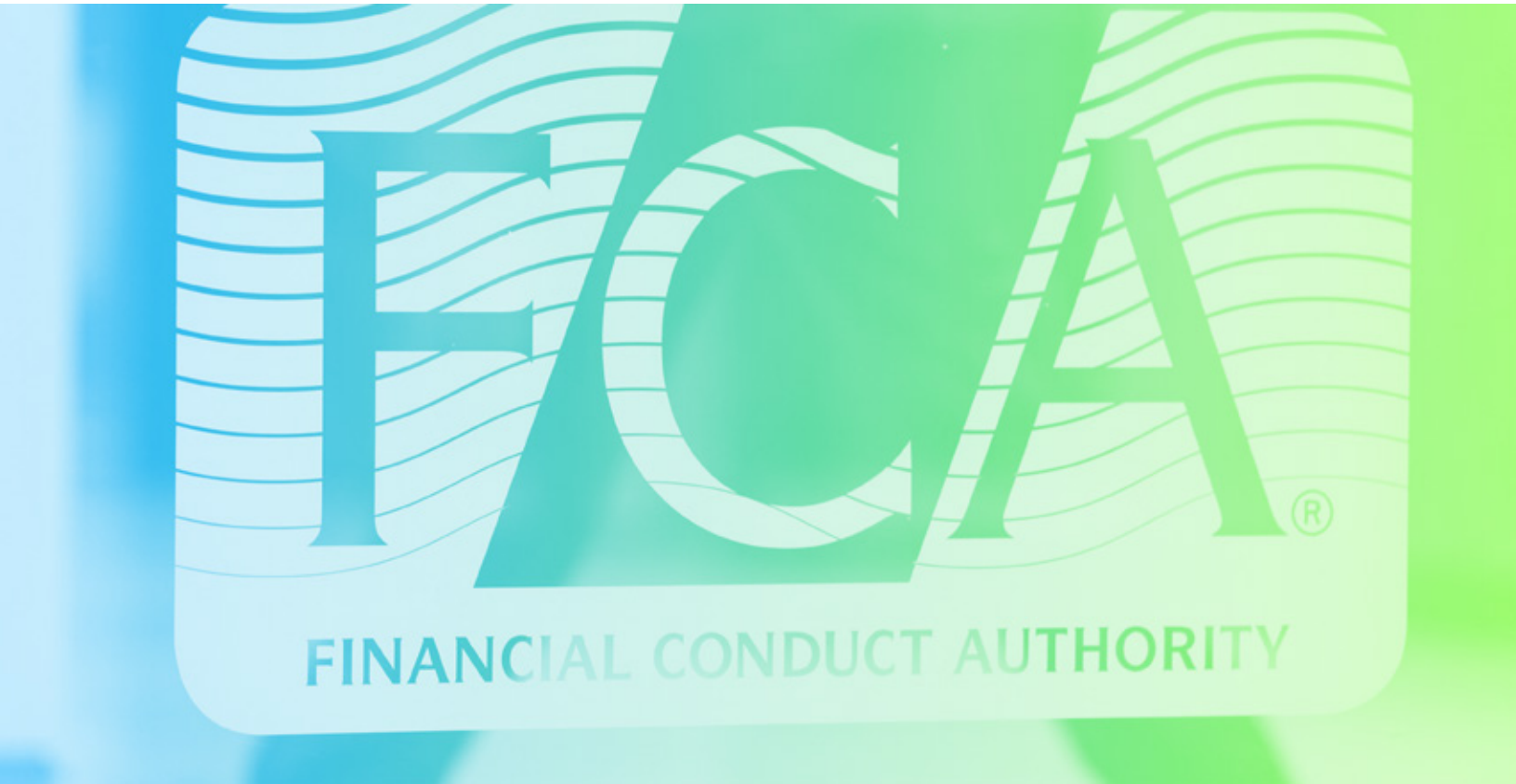
The Senior Managers & Certification Regime will be extended to insurers "in late 2018". This will be followed by commencement of the regime for FCA solo-regulated firms in "mid to late 2019". It is anticipated that the extension of the 'Duty of Responsibility' will align with these start dates, although the actual commencement date will be announced and set by the Treasury in due course. The Consultation Papers can be found ***here,*** ***here*** & ***here.***

Handbook Rule Changes for Wealth Managers, Investment Managers, Brokers & Private Banks:
The FCA has published the following instruments as having undergone rule changes:

• **Financial Services Compensation Scheme (FSCS) (Extension of Scope to Recognised Investment Exchanges) Instrument 2017** to bring the activity of a recognised investment exchange (RIE) operating a multilateral trading facility (MTF) or organised trading facility (OTF) into the scope of the FSCS with a base cost contribution of £1,000 per year per recognised investment exchanges (RIE).

• **MiFID II (Deferred Matters) Instrument 2017** to address the consequential changes arising out of the implementation of MiFID II to the Prospectus Rules and Handbook Glossary and to implement the remaining proposed changes to DEPP and EG.

FCA fines bond trader £60,000 for Market Abuse:
The FCA has imposed a financial penalty of £60,090 upon Paul Walter, a former Bank of America Merrill Lynch International Limited bond trader. Following an investigation, the FCA found that Mr. Walter engaged



in market abuse by creating a false and misleading impression as to supply and demand in the market for Dutch State Loans (DSL) on 12 occasions in July and August 2014.

On 11 occasions, Mr. Walter entered a series of quotes that became the best bids, giving the impression that he was a buyer in a DSL. Other market participants who were tracking his quotes with algorithms followed him in response and raised their bids. Mr. Walter then sold to those other participants and cancelled his own quote. Despite placing quotes that suggested he wanted to buy, he actually sold the DSL.

It is interesting to note that:

• The FCA accepted that Mr. Walter probably made no personal gain from the market abuse; and

• It was likely that Mr. Walter did not appreciate that his actions constituted market abuse.

Despite this, Mr. Walter's behaviour constituted market abuse within the meaning of section 118(5) of the Act in that it gave a false and misleading impression as to the price and supply or demand of the DSLs, and it also secured the price at an artificial level. The FCA therefore imposed a £60,090 financial penalty on Mr. Walters.

The FCA's Final Notice can be found ***here.***

AIM Investment Company fined for failing to disclose Inside Information As Soon As Possible:
The FCA fined Tejoori Limited £70,000 for failing to inform the market of inside information as required by Article 17(1) of the Market Abuse Regulation (MAR). This is the first fine the FCA has imposed on an AIM company for late disclosure following the introduction of MAR on 3 July 2016.

In early 2016, Tejoori had two material investments, one of which was a shareholding in BEKON Holding AG (BEKON) which Tejoori valued in its financial statements at USD 3.35 million. On 12 July 2016, Tejoori was notified by BEKON about a compulsory acquisition of its shares by Eggersmann Gruppe GmbH & Co. KG (Eggersmann). The acquisition required Tejoori to sign a share purchase agreement (SPA) and to sell its BEKON shares to Eggersmann for no initial consideration and with only a possibility of receiving deferred consideration that was materially lower than the value of Tejoori's investment in BEKON.

The information about the sale to Eggersmann was inside information and, under MAR, Tejoori was required to disclose the information as soon as possible. This did not happen.

The FCA's Final Notice can be found ***here.***

> SEC WATCH

The SEC has indicated that If a cryptocurrency has features other than being a medium of exchange or store of value it could be a security under certain circumstances; for example, an initial coin offering (ICO) of tokens. We believe that the SEC's position on cryptocurrencies means that investment advisers should consider the consequences of (i) trading in cryptocurrencies on behalf of clients and (ii) employee personal trading of cryptocurrencies.

Anti-fraud Provisions
If an investment adviser provides advice concerning investing in cryptocurrencies, such advice is subject to the anti-fraud provisions of the Investment Advisers Act of 1940 ("Advisers Act")..

Code of Ethics Rule
Under the Advisers Act's Code of Ethics Rule, "access persons" of investment advisers are required to report their personal securities holdings and personal securities transactions and, if the cryptocurrency offering is a "limited offering" or an initial public offering (IPO), to preclear such transaction with the Chief Compliance Officer.

Custody Rule
If the cryptocurrency is deemed to be a security, under the Advisers Act's Custody Rule, such assets must be maintained with a "Qualified Custodian" absent the availability of an exemption. It currently may be difficult to find a Qualified Custodian willing to hold cryptocurrencies.

Optima Partners is currently providing advice to its clients regarding updating their compliance policies and procedures as appropriate regarding the trading of cryptocurrencies.

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OCIE RELEASES 2018 EXAMINATION PRIORITIES

Last year, the annual examination priorities of the SEC's Office of Compliance Inspections and Examinations ("OCIE") were released on January 12. This year, the OCIE examination priorities were released on February 7. As a result, we wondered if the delay meant that there would be significant changes in the OCIE's priorities or approach. Upon reviewing the OCIE's 2018 National Exam Program National Examination Priorities ("2018 OCIE Priorities") we do not believe that the new priorities have changed significantly from last year (with the exception of cryptocurrencies that we discuss separately in this edition).

PRIORITIES BY REGULATED ENTITY
The following are summaries of the top 2018 OCIE Priorities for each type of SEC registrant.

Investment Advisers
• *Wrap Fee Programs.*

• *Never-Before-Examined Investment Advisers.* This includes both newly-registered advisers and advisers that have not been examined in "some time."

• *Cybersecurity.* Focusing on governance and risk assessment, access rights and controls, data loss prevention, vendor management, training and incident response.

Mutual Funds / ETFs
• *Risky Performers.* Focusing on: mutual funds who (a) have experienced poor performance or liquidity, (b) are managed by advisers with little experience, or (c) hold securities which are potentially difficult to value during times of market stress (e.g., collateralized mortgage-backed securities); and (ii) mutual funds and ETFs at risk of having to liquidate assets.

Broker-Dealers
• *Fixed Income Order Execution.* Assessing whether broker-dealers have implemented best execution policies and procedures, consistent with regulatory requirements, for both municipal bond and corporate bond transactions.

Multiple Registrants
• *Senior Investors and Retirement Accounts and Products.* Investment advisers and broker-dealers that offer services and products to investors with retirement accounts will be targeted.

• *AML Program.* Reviews of broker-dealers and mutual funds will cover, e.g., whether these entities are filing timely, complete, and accurate Suspicious Activity Reports (SARs).

• *Disclosure of the Costs of Investing.* Evaluating whether fees and expenses are calculated and charged in accordance with the disclosures provided to investors and focusing on firms with practices that may create increased risks that investors will pay inadequately disclosed fees, expenses, or other charges.

• *Electronic Investment Advice.* Focusing on "robo-advisers."

• *Cryptocurrency, Initial Coin Offerings (ICOs), Secondary Market Trading, and Blockchains.* Ensuring that financial professionals maintain adequate controls and safeguards to protect these virtual assets from theft or misappropriation, and evaluating whether financial professionals are providing investors with adequate disclosure of the risks associated with these assets. The SEC has also indicated that certain cryptocurrencies may be "reportable securities" under the Code of Ethics Rule of the Investment Advisers Act of 1940 (see our "SEC Watch" in this edition).

"Except for cryptocurrencies, there were no significant changes to the OCIE's priorities from last year."

How Optima Partners Can Help
Optima Partners provides compliance advisory support regarding the appropriate policies, procedures, and controls based on the risk profile of the client.

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