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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 CLARIFIES INADVERTENT CUSTODY GUIDANCE

In response to concerns from the Investment Adviser Association ("IAA") and other industry trade groups, the SEC's Division of Investment Management ("IM") recently provided clarification regarding its guidance on "Inadvertent Custody."

"Once it is determined that an Adviser has Custody, the adviser must maintain those assets in accordance with the Custody Rule"

In an "Information Update" released on June 5, 2018, IM updated its Staff Responses to Questions About the Custody Rule ("Custody Rule FAQs") to indicate that an adviser that does not have a copy of a client's custodial agreement, and does not know or have reason to know whether the agreement would give the adviser "Custody," need not comply with the Advisers Act's "Custody Rule" regarding that client's account.

Background

In February 2017, IM issued a "Guidance Update," Inadvertent Custody: Advisory Contract Versus Custodial Contract Authority that Optima described in our June 2017 edition of Optimize found ***here.***

As we indicated, the Guidance Update was issued contemporaneously with a no-action letter (the "IAA No-Action Letter") that indicated an Adviser with power to dispose of client assets for any purpose other than authorized trading has Custody of them. Once it is determined that an Adviser has Custody, the adviser must maintain those 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 client assets held in Custody. In addition, an adviser considered to have Inadvertent Custody of a client account must include those assets in Item 9 of Form ADV.

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“Separately managed account clients typically retain the services of the Qualified Custodian and the adviser often does not have access to the client’s custodial agreement.”

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The Guidance Update stated that an adviser would have Inadvertent Custody if a custodial agreement between the adviser’s client and a “Qualified Custodian” authorizes the adviser to withdraw client assets, notwithstanding a provision in the advisory agreement between the adviser and the client to the contrary. IM indicated that an Adviser could 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). The client and Qualified Custodian would need to provide written consent to the new arrangement.

Industry Feedback
Following release of the Guidance Update, the IAA and other industry trade groups indicated that IM’s guidance was causing confusion among advisers because:

- Separately managed account clients typically retain the services of the Qualified Custodian and the adviser often does not have access to the client’s custodial agreement. Even if the adviser has access to the custodial agreement, the Qualified Custodian is under no obligation to provide its consent to the Delivery Versus Payment limitation.

- Some adviser transactions would not meet the Delivery Versus Payment limitation including those involving bank loans, derivatives, and private placements.

New Inadvertent Custody Rule FAQs
In the Information Update, IM added two new Custody Rule FAQs, Questions II.11 and II.12. Question II.11 answered whether an adviser that does not know whether any of its clients’ custodial agreements would give rise to the Firm having Inadvertent Custody is required to comply with the Custody Rule. The FAQ states that IM will not recommend enforcement action for violation of the Custody Rule if an adviser does not have a copy of a client's custodial agreement, and does not know, or have reason to know, whether the agreement would give the adviser Inadvertent Custody regarding that client's account (assuming Inadvertent Custody would be the sole basis for Custody). The SEC notes, however, that this relief is not available where the adviser recommended, requested, or required the client to hire the Qualified Custodian.

Question II.12 addressed how an adviser should treat the following account scenarios:

- 60 accounts that provide the adviser with check-writing authority. The adviser has Custody of these accounts and must obtain an Annual Surprise Examination of the accounts and include them in Form ADV Item 9.

- 10 accounts that permit the adviser to deduct fees directly from the client’s account. The adviser has Custody of these accounts but does not need to conduct an Annual Surprise Examination of the account pursuant to the Custody Rule (part (b)(3)) and does not need to include these assets pursuant to the Form ADV Instructions to Item 9.A.

- 30 accounts for which the adviser has neither check-writing authority nor the ability to deduct fees directly from the client’s account. The guidance in Question II.11 applies to these accounts and there would be no Inadvertent Custody if the adviser does not have knowledge of the client’s custodial agreement.

Remaining Issue
The industry’s concerns regarding IM’s language in the Guidance Update that an adviser has Custody unless transactions are conducted on a Delivery Versus Payment basis was not resolved in the Information Update. Optima will keep readers posted on any additional guidance from the SEC on Inadvertent Custody.

INTRODUCING THE FCA DIRECTORY

The FCA has published its latest Consultation Paper "Introducing the Directory" (CP18/19).

Under the Senior Managers and Certification Regime **(SM&CR)** – which takes effect for dual-regulated insurers later this year and on 9 December 2019 for solo-regulated firms - only Senior Managers approved to perform designated senior management functions will appear on the FCA Register, but not those who may be subject to the Certification Regime e.g. portfolio managers.

To counter this the FCA proposes to introduce the **Directory** to cover a wider range of individuals (which will require additional information from firms about the individuals – see paragraph 4.7). For the information to remain relevant the FCA will need to be informed of any changes "without undue delay" – the Consultation Paper proposes, unless exceptional circumstances apply, no later than the end of the individual's first business day and, for 'leavers', no later than one business day after leaving the role (this will capture both leavers and those remaining in the firm in another role).

Whilst there is an example of a screen shot in Chapter 3 of CP18/19, below provides a summary of the proposed FCA Directory (see 'Useful Links').

The Directory will contain **'Directory Persons'** as in:

- an appointed representative Directory person
- a certification employee
- a non-SMF director Directory person
- a sole trader Directory person

Information on Directory Persons will appear in the Directory alongside information on the Senior Managers approved under the SM&CR - even those continuing to appear on the FCA Financial Services Register.

The Consultation Paper highlights the following Directory customer-focussed features:

- **Workplace location** – To help customers find someone to meet face to face it will be possible to find out which of those are based in the local area. This information will only be available for customer facing roles i.e. those subject to a qualification requirement or the client dealing function (i.e. CF30).

- **Business qualified to carry on** – Users will be able to search the Directory to find suitably qualified individuals. For example, a customer will be able to search for a certain type of qualified individual – say someone who is a pensions transfer specialist or can advise on investments.

- **Regulatory sanctions and prohibitions** – Where such action has been taken and published by the FCA and PRA, these will appear in search results to make clear which individuals are prohibited or have limitations on the activities they are permitted to undertake.

The proposed commencement date of the Directory for banking firms and insurers is **10 December 2018** but with a deadline of **10 December 2019** for upload to the Directory. The dates for other firms will be **9 December 2019** and **9 December 2020** respectively. Note that firms are not required to take action before the final rules are made ("summer 2019").

Draft Handbook text can be found in Appendix 1 of CP18/19. Note the introduction of additions to SUP 16: SUP 16.25 "Reporting of information about Directory persons" and SUP 16 Annex 44AR "Directory persons report" (with Guidance notes appearing in SUP 16 Annex 4BG).

The FCA invites comments on the proposals by 5 October 2018.

Useful Links

Directory Screen Shot

CP18/19

"For the information to remain relevant the FCA will need to be informed of any changes "without undue delay""

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THE VACATED DOL FIDUCIARY RULE AND THE SEC'S PROPOSED STANDARD OF CONDUCT

"If the IA Conduct Release is adopted, it will mostly confirm that the current Duties of Care and Loyalty that currently apply to advisers will continue with more clarity from the SEC."

DOL Fiduciary Rule Vacated: On March 15, 2018, a U.S. Fifth Circuit Court of Appeals ("Fifth Circuit") ruling vacated the Department of Labor's Definition of the Term 'Fiduciary'; Conflict of Interest Rule -- Retirement Investment Advice ("DOL Fiduciary Rule").

On June 21, 2018, the Fifth Circuit issued a mandate that put into effect its decision striking down the DOL Fiduciary Rule. However, on May 7, 2018, in anticipation of the originally scheduled date of the Fifth's Circuit's mandate, the Department of Labor issued a "Field Assistance Bulletin" (copy attached) that would maintain the temporary enforcement policy it put in place last year when the regulation went partially into effect pending additional guidance from the DOL available ***here.***

SEC's Proposed Standard of Conduct Release

Meanwhile, the SEC unveiled its take on a fiduciary rule on April 18, 2018 when the SEC released three rule proposals related to the fiduciary obligations of it registrants ("SEC Standard of Conduct Release"):

I. Interpretation Regarding Standard of Conduct of Investment Advisers ("IA Conduct Release") proposes an interpretation of certain aspects of an adviser's fiduciary duty under Advisers Act Section 206. The stated purpose for the SEC's proposed interpretation of an adviser's standard of conduct is to address in one release certain aspects of the fiduciary duty that an investment adviser owes to its clients (i.e., Duty of Care (including Best Execution), Duty of Loyalty). In addition, the IA Conduct Release requests comments on three potential enhancements to an investment adviser's legal obligations (areas where investors have protections in the broker-dealer area but not currently in the investment adviser area):

> 1) Federal Licensing and Continuing Education: Whether investment adviser representatives should be subject to federal continuing education and licensing requirements.
>
> 2) Provision of Account Statements: Whether the SEC should propose rules to require advisers to provide account statements, either directly or through the client's custodian, regardless of whether or not the investment adviser is deemed to have custody of the client assets.
>
> 3) Financial Responsibility: Whether advisers should be subject to financial responsibility requirements.

If the IA Conduct Release is adopted, it will mostly confirm that the current Duties of Care and Loyalty that currently apply to advisers will continue with more clarity from the SEC. If the three proposals for comment are adopted, it would result in additional burdens for investment advisers.

II. "Proposed Form CRS Release" proposes new and amended rules and forms under both the Advisers Act and the Securities Exchange Act of 1934 ("Exchange Act") to require registered investment advisers and registered broker-dealers to provide a brief relationship summary to retail investors (defined as a prospective or existing client or customer who is a natural person) at the beginning of the investor's relationship with the firm.

Since Form CRS would apply only to retail investors, the impact of this proposal would be minimal for most registered investment advisers to private funds.

III. Proposed "Regulation Best Interest" proposes a new rule under the Exchange Act that would require all broker-dealers and natural persons who are associated persons of a broker-dealer, when making a recommendation of any securities transaction or investment strategy involving securities to a "Retail Customer" (defined as a person,

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or the legal representative of such person, who: (1) receives a recommendation of any securities transaction or investment strategy involving securities from a broker, dealer or a natural person who is an associated person of a broker or dealer, and (2) uses the recommendation primarily for personal, family, or household purposes"), to act in the best interest of the Retail Customer at the time the recommendation is made without placing the financial or other interest of the broker-dealer or natural person who is an associated person making the recommendation ahead of the interest of the retail customer.

Regulation Best Interest is the proposal that would appear to "replace" the DOL Fiduciary Rule. Under Regulation Best Interest, broker-dealers would be required to disclose their financial conflicts of interest, at a minimum mitigate any conflicts of interest they may have, and "exercise reasonable diligence, care, skill and prudence" to ensure they are selling products and carrying out transactions that are in a client's best interest. Regulation Best Interest requires brokers to provide a written document to clients stating whether a broker is acting only as a salesperson or has a Duty of Loyalty to the client's interests. One significant difference between Regulation Best Interest and the DOL Fiduciary Rule is that the SEC rule would apply to both retirement and non-retirement accounts whereas the DOL Fiduciary Rule only applied to retirement accounts.

The comment period for all three parts of the SEC Standard of Conduct Release ends on August 7, 2018.

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CAYMAN ISLAND FUNDS

"An unregulated fund is one that falls within the exemption under MFL s4(4) e.g. having not more than fifteen investors, the majority of whom are capable of appointing or removing the operator of the fund (note that this particular exemption does not apply to master funds)."

The Cayman Islands (CI) has enhanced its anti-money laundering regime, the effect of which will mean:

- Unregulated funds have been subject to the CI anti-money laundering regulations with effect from 31 May 2018; and
- Both regulated and unregulated funds will need to appoint 'natural persons' to specific AML roles.

Regulated or Unregulated funds?
Under the CI Mutual Funds Law (MFL) regulated funds will:

- Hold a Mutual Fund Licence under MFL s4(1)(a) ("Licensed Mutual Fund"); or

- Will have a licensed mutual fund administrator providing its principal office in the CI under MFL s4(1)(b) ("Administered Mutual Fund"); or

- Be a fund meeting certain investment criteria e.g. minimum investment of CI$80,000 (US$100,000) under MFL s4(3) ("Registered Mutual Fund").

An unregulated fund is one that falls within the exemption under MFL s4(4) e.g. having not more than fifteen investors, the majority of whom are capable of appointing or removing the operator of the fund (note that this particular exemption does not apply to master funds).

Although regulated funds are subject to the Islands' AML provisions, until now unregulated funds have remained outside the CI's AML framework – although it may well be that these funds have nevertheless fallen within the AML regime because a regulated external administrator has been appointed.

AML functions
All funds that are subject to the CI AML Regulations – and so will apply to both regulated and unregulated funds – will be required to appoint natural persons at managerial level to the roles of:

- Money laundering reporting officer (MLRO);

- Deputy money laundering reporting officer (DMLRO); and

- AML Compliance officer (AMLCO).

The AML Regulations permit the delegation of AML functions, but before such delegation can take place it will be necessary to appoint natural persons for the above roles. It is recognised that it is possible that the fund in question may have no employees or senior members of staff based in the Cayman Islands. In such circumstances it is permissible to appoint external staff resources e.g. make recourse to firms providing administration services or, possibly, the fund's investment manager. However the overriding requirement is that the individuals so appointed have a full understanding of the requirements expected of them (see below).

A Notice issued by the Cayman Islands Monetary Authority (CIMA) advises that an AMLCO may also act as the MLRO (or vice versa) provided that the individual is competent and has sufficient time to perform both roles efficiently. However the MLRO and DMLRO must be separate persons.

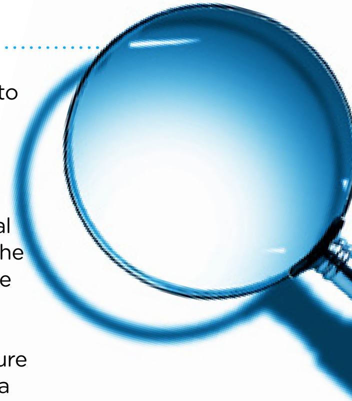
CIMA has published AML Guidance Notes for firms. Among the areas addressed are the requirements expected of the MLRO/DMLRO and the AMLCO - see pages 71 and 22 respectively.

The section on 'Other internal controls' (page 80) will be of assistance to those firms that wish to outsource these roles and should be read in conjunction with Part VI which provides specific guidance to mutual funds and their administrators. The appointment of natural persons to these roles for existing funds must be complied with by 30 September 2018. Compliance with the appointment of these functions will need to be evidenced for new funds registering as at 1 June 2018.

Note that regulated funds must inform CIMA of the designated MLRO, DMLRO and AMLCO by way of submission of the information via CIMA's 'REEFS' portal.

Useful Links
CIMA Notice re AML functions
CIMA Guidance Notes
CI AML Regulations
CI Proceeds of Crime Law
CI Mutual Funds Law

> SEC WATCH



U.S. Supreme Court Rules Hiring of SEC Administrative Law Judges is Unconstitutional
On June 21, 2018, in Lucia v. SEC, the U.S. Supreme Court issued a decision holding that the SEC's previous practice used in hiring its in-house Administrative Law Judges was unconstitutional. The Supreme Court concluded that Administrative Law Judges are "officers" who must be appointed pursuant to the U.S. Constitution's Appointments Clause. The SEC historically hired Administrative Law Judges as "employees." However, the Supreme Court noted that Administrative Law Judges hear testimony, conduct trials, rule on the admissibility of evidence and enforce compliance with discovery orders. The Supreme Court's decision did not, however, address whether the SEC's current Administrative Law Judges occupy those posts constitutionally, or whether litigants who did not challenge the constitutionality of their proceedings have any recourse. In addition, by the SEC's estimate, there are 106 cases for which an Administrative Law Judge had already issued an initial decision and it is unclear what will happen to those cases.

Broker-Dealer AML: Customer Due Diligence
Earlier this year, the Office of Compliance Inspections and Examinations ("OCIE") released their examination priorities (see our discussion in the [date] Optimize here [LINK]). One area the SEC indicated it would focus on was registered broker-dealers' anti-money laundering ("AML") programs.

The SEC and FINRA recently filed a joint proposal to change FINRA Rule 3310 (Anti-Money Laundering Compliance Program) effective May 11, 2018. The amended rule adopts the Financial Crimes Enforcement Network's ("FinCen") final rule on Customer Due Diligence Requirements for Financial Institutions ("CDD Rule"). The proposal enhances the CDD Rule's AML compliance program due diligence procedure requirements for member firms. With the new proposal, elements of the risk-based due diligence model include: (1) understanding the nature and purpose of customer relationships to develop a customer profile; and (2) conduct ongoing monitoring to identify and report suspicious transactions and on a risk basis, to maintain and update customer information. The purpose of the new rule is to aid and strengthen detection and reporting of suspicious transactions through adherence to existing AML program requirements of member firms. The SEC's official notice for the new rule can be found ***here.***

In a recent case, the SEC charged Chardan Capital Markets, LLC and its AML Officer, Jerard Basmagy, with penalties for failing to file Suspicious Activity Reports (SARs) for the suspicious sales of billions of penny stocks. In the final settlement, released on May 16, 2018, both Chardan and Basmagy were penalized $1 million and $15,000, respectively, along with cease and desist prohibitions from future violations. In addition, Basmagy was barred from industry and penny stocks for at least three years. The SEC's litigation release can be found ***here.***

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WHISTLEBLOWING

As widely reported in the media, Mr James Staley, CEO of Barclays Group, has been fined a total of £642,430 by the FCA and the PRA for his attempt to identify the author of letters containing concerns that had been sent to the Board - further details of the case can be found in the separate ***Final Notices*** issued by the FCA and PRA.

"Whilst the concept of 'whistleblowing' is applicable in both the UK and the US the rules and requirements are, of course, different."

If nothing else, the Staley case has raised the profile of 'whistleblowing'.

Whilst the concept of 'whistleblowing' is applicable in both the UK and the US the rules and requirements are, of course, different.

UK

The Public Interest Disclosure Act 1998 (PIDA) – which has the effect of amending sections of the Employment Rights Act 1996 - provides protection from victimisation and dismissal to individuals who make certain disclosures ('qualifying disclosures') as set out in PIDA e.g. that a criminal offence has been committed or that a person has failed to comply with a legal obligation.

To be categorised as a 'protected disclosure', which gives a worker the right not to be subjected to any 'detriment' by their employer, the qualifying disclosure must be made in accordance with PIDA and includes such a disclosure being made to an employer or to a 'prescribed person' – the latter includes both the FCA and the PRA.

'Public Concern at Work' is a charity that offers support to both individuals with whistleblowing dilemmas at work and to organisations with their whistleblowing arrangements.

SYSC 18 of the FCA Handbook ('Whistleblowing') contains rules and guidance on the subject.

Whilst not directed at investment managers (other than those that track as principal), they will be expected to follow the requirements as 'best practice' in a proportionate manner (bearing in mind that whilst SYSC 18 may not be binding upon them, PIDA is). For the record, SYSC 18.3.9 – under which the FCA advises that it would call into question the fitness and propriety of any firm, or member of staff, that acted to the detriment of a whistleblower – applies to all firms.

SYSC 18 addresses:

- The establishment of arrangements for the confidential disclosure of concerns by whistleblowers
- Staff training, including on the right of whistleblowers to disclose their concerns to the FCA or PRA
- The appointment of a 'whistleblowers' champion'
- The need for any settlements agreements not preventing a worker from making a protected disclosure.

SYSC 18.6 reminds us that 'whistleblowing' obligations also arise under the following EU Directives and Regulations, albeit that the obligations are limited infringements of the relevant legislation:

- MiFID II (Article 73)
- UCITS (Article 99d)
- SFTR (Article 24(3))
- MAR (Article 32)
- CRD (Article 71)

USA

Pursuant to the provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act, the US Securities and Exchange Commission ("SEC") and the US Commodity Futures Trading Commission ("CFTC") have adopted similar whistleblower programs that provide monetary incentives to individuals who come forward to report possible violations of the federal securities laws and the Commodity Exchange Act. They also provide anti-retaliation protections for whistleblowers.

SEC's Whistleblower Program

Under the SEC's Whistleblower Program, eligible whistleblowers are entitled to an award of between 10% and 30% of the monetary sanctions for information that leads to a successful SEC action resulting in an order of monetary sanctions exceeding $1 million. An 'eligible whistleblower' is a person who voluntarily provides the SEC with original information about a possible violation of the federal securities laws that has occurred, is ongoing, or is about to occur. Employees are eligible for an award for information reported internally if the information is reported to the SEC (by either the employee or the Firm) within 120 days of the employee's internal reporting. The SEC protects the confidentiality of whistleblowers and does not disclose information that might directly or indirectly reveal a whistleblower's identity. The

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SEC's 'Office of the Whistleblower' administers the SEC's Whistleblower Program.

Employers may not 'retaliate' (i.e. discharge, demote, suspend, harass, or in any way discriminate) against an employee for, among other things, (i) providing information to the SEC under the Whistleblower Program, or (ii) assisting the SEC in any investigation or proceeding based on the information submitted. Employees who believe that their employer wrongfully retaliated against them, may report their concerns to the SEC and the SEC may, in appropriate circumstances, bring an enforcement action against a company.

CFTC's Whistleblower Program

Under the CFTC's Whistleblower Program, the CFTC pays monetary awards to eligible whistleblowers who voluntarily provide the CFTC with original information about violations of the Commodity Exchange Act (CEA) which leads the CFTC to bring a successful enforcement action resulting in monetary sanctions exceeding $1,000,000. The CFTC pays monetary awards to eligible whistleblowers whose information leads to the successful enforcement of a Related Action brought by another governmental entity and certain other entities that is based on original information voluntarily submitted by a whistleblower to the CFTC that led to the successful enforcement of an action brought by the CFTC. The total amount of an award for an eligible enforcement action is between 10% and 30% of the amount of monetary sanctions collected in the CFTC's enforcement action or a Related Action. If multiple whistleblowers are granted awards in an action, the total award amount is still limited to between 10% and 30% of the amount of the monetary sanctions collected. Whistleblowers have certain protections regarding confidentiality of their identity. The CFTC's Whistleblower Office administers the program.

Employers may not take any action to impede would-be whistleblowers from communicating directly with the Commission's staff about possible violations of the Commodity Exchange Act (CEA), including by enforcing, or threatening to enforce, a confidentiality agreement or pre-dispute arbitration agreement with respect to such communications. Nor may employers retaliate against whistleblowers for reporting violations of the CEA through discharge, demotion, suspension, threats, harassment, direct or indirect, or any other discrimination against a whistleblower.

Useful Links
Final Notice - PRA
Final Notice - FCA
Public Concern at Work
PIDA

SEC's Office of the Whistleblower:
www.sec.gov/whistleblower

CFTC's Whistleblower Office:
www.whistleblower.gov/

"Under the CFTC's Whistleblower Program, the CFTC pays monetary awards to eligible whistleblowers who voluntarily provide the CFTC with original information about violations."

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