

# **“Participating Affiliates” of an SEC Registered Investment Adviser**

**17 March 2017**

**CompliGlobe Limited**

# When is a person subject to Advisers Act registration?

- An investment adviser is any person who, using the “means of interstate commerce”
  - for compensation
  - gives investment advice about securities
  - to U.S. residents
- Each element is broadly applied
- Is an exemption available?
- Is the entity an affiliate of an SEC registered adviser?
- If no exemption and not an affiliate of an SEC registered investment adviser (and going beyond permissible activity) – must register under the U.S. Investment Advisers Act of 1940

# Fiduciary duties

- Every SEC registered adviser (“RIA”) is a fiduciary

*“[t]he Investment Advisers Act of 1940 reflects a ... congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested.”*

*“[I]nvestment advisers are fiduciaries of their clients, and therefore owe those clients "an affirmative duty of utmost good faith.”*

*SEC v Capital Gains Research Bureau, 375 U.S. 180 (1963)*

- Duties of loyalty and care
  - Disclose fully *all* material facts to clients
  - Avoid conflicts or disclose material conflicts and the means to resolve them
  - Best execution
  - Suitability
  - Reasonable basis for recommendations

## Non-U.S. RIAs non-U.S. clients and affiliates

- A non-U.S. RIA that has both U.S. resident clients and non-U.S. clients may opt not to afford the protections of the Advisers Act to its non-U.S. clients

*Uniao de Bancos de Brasileiros S.A.*, no-action letter (28 July 1992)

- An RIA or a non-U.S. RIA may subject to compliance with conditions, use subsidiaries to provide it with research, advice and recommendations for its U.S. resident clients

*Richard Ellis, Inc.*, no-action letter (18 March 1981)

## Part 2: “Participating Affiliates”

- An affiliate of an RIA that gives research, advice or recommendations to the SEC registered adviser for it to use for or give to its U.S. clients
- Must establish *bona fide* affiliation through “control”
- Cannot “engineer” a participating affiliate relationship to avoid registration – this is doing indirectly what cannot be done directly (Advisers Act Section 208(d))

Participating Affiliates are established through a series of SEC Staff no-action letters, reaffirmed by the SEC itself in 2011 rule making (and the subject of 17 March 2017 guidance)

*Mercury Asset Management plc* (6 April 1993); *Kleinwort Benson Investment Management Limited, et al.* (15 December 1993); *Murray Johnstone Holdings Limited, et al.* (7 October 1994); *ABN AMRO Bank N.V., et al.* (1 July 1997); and *Royal Bank of Canada, et al.* (3 June 1998). See also *União de Banco de Brasileiros S.A.* (28 July 1992)

# Examples

- British-based, FCA registered firm that is an affiliate of an SEC registered investment adviser gives research, advice or recommendations to the SEC registered adviser for it to use for its U.S. clients
- Swiss-based affiliate of Jersey-based SEC registered adviser sits on Investment Committee and proposes ideas for investment decisions taken by the Jersey entity for its U.S. clients

# What is required for Participating Affiliates?

- “Participating affiliate” does not have to register with SEC
  1. Must sign a participating affiliate agreement – *note the Guidance on PAA contents in Annex A*
  2. Personnel that provide research, advice or recommendations are “associated persons” and must comply with certain Code of Ethics requirements – personal account dealing
  3. Must keep records of what the associated persons do for the SEC registered adviser
  4. SEC must have adequate access to trading and other records of the participating affiliate
  5. Must give consent to service of process/appoint agent
  6. Form ADV Part 2 disclosure of associated persons
- RIA must exercise oversight over and supervise the participating affiliate – failure to supervise is actionable under Advisers Act Section 203(e)(6) – *note oversight checklist in Annex B*
- The participating affiliate no-action letters were issued by the Staff of the SEC’s Division of Investment Management (“IM”) pursuant to delegated authority
  - The no-action letters only deal with matters arising under Advisers Act Sections 203 and 208(d)
  - Because the letters were issued by IM pursuant to delegated authority and not the Staff of the SEC’s Division of Market Regulation (“MR”, now Trading and Markets), IM had no authority to pass on matters outside the Advisers Act – in particular, the Exchange Act and brokerage. This would have required action by MR and MR took no position in these letters

# **New! – March 2017 IM Guidance on participating affiliates**

## **IM-INFO-2017-03**

- Noted background to the participating affiliate letters and the giving of “assurances” (no-action) if the conditions of the letters are followed
- IM received “a wide variety of documents” seeking to rely upon the documentation requirement of the no-action letters
- The Guidance stated that documentation of the following “general representations and undertakings” “addresses most clearly the concerns” raised in the no-action letters and the SEC Staff then repeated in detail the points noted in the previous slide (*Annex A*) with an e-mail address where information may be submitted to IM
- What the Guidance *did not do*
  - Did not discuss what could or could not be done – as such, it continues to be the case, absent a further grant of no-action relief, that associated persons may only provide advice, research or recommendations to the RIA and may not exercise discretion over a client portfolio or give the RIA orders to buy or sell securities
  - Did not advance a change in the no-action letters or anticipate rule-making
- Indications
  - OCIE is reviewing participating affiliate arrangements in examinations
  - Enforcement referrals?



# Core compliance requirements for an RIA

## Compliance Programme: Rule 206(4)-7

1. Adopt and implement written policies and procedures reasonably designed to prevent violation by the adviser and its supervised persons of the Advisers Act and the rules thereunder
2. Designate a Chief Compliance Officer
  - Manages the Compliance programme
  - Must be competent and knowledgeable
  - Must be empowered with full responsibility and authority
3. Review “not less than annually” the adequacy and effectiveness of the compliance programme and its policies and procedures – including every PA arrangement

## Code of Ethics: Rule 204A-1

**Comply fully with the Advisers Act and the rules thereunder**

# Failure to supervise

- Under Advisers Act Section 203(e)(6), must supervise with a view to *preventing* violations of the U.S. federal securities laws
  - This includes the adviser’s supervised persons and access persons
  - It extends to participating affiliates in the context of the PAA
- Nearly every violation of the Advisers Act and the rules thereunder
  - Is a violation of the section or rule involved
  - May also involve a failure to supervise
- What the adviser must do
  - Implement and administer procedures and systems reasonably designed to prevent and detect violations of law
  - Evidence that supervisor reasonably discharged the duties and obligations under such procedures without reasonable cause to believe they were not being complied with

# What's included in the “written policies and procedures”?

- Supervising the participating affiliate
- Appropriate disclosure in the Form ADV
- Part of the annual review includes reviewing the relevant activities of the participating affiliate
- Ongoing monitoring and testing
- Acting when and as required

## Annex A – from [IM-INFO-2017-03](#)

- “The name of the participating affiliate and registered adviser, and a representation that the participating affiliate is an associated person of the registered adviser within the meaning of Section 202(a)(17) of the Advisers Act.
- Documentation of the appointment of an agent for service of process by a participating affiliate, including the name and contact information of such agent.
- A representation that the participating affiliate is under the jurisdiction of U.S. courts for actions arising, directly or indirectly, under U.S. securities laws or the securities laws of any state in connection with any of the following for U.S. clients: (1) investment advisory activities; (2) related securities activities arising out of or relating to any investment advisory services provided by the participating affiliate through its registered adviser; and (3) any related transactions. In addition, a representation that the participating affiliate has designated and appointed, without power of revocation, [insert agent] upon whom may be served all process, pleadings, or other papers in
  - a) any investigation or administrative proceeding conducted by the Commission; and
  - b) any civil suit or action brought against the registered adviser or the participating affiliate or in which the participating affiliate has been joined as defendant or respondent,
- in any appropriate court in any place subject to the jurisdiction of any state or of the U.S. or any of its territories or possessions or the District of Columbia in connection with the activities and transactions enumerated in this paragraph.

## Annex A (cont'd)

- A representation that any such civil suit or action or administrative proceeding may be commenced by the service of process upon, and service of an administrative subpoena shall be effective service upon, [insert agent], and such service shall be taken and held in all courts and administrative tribunals to be valid and binding as if personal service has been made.
- A representation that the participating affiliate will appoint a successor agent if the participating affiliate or any person discharges the [insert agent] or the [insert agent] is unwilling or unable to accept service on behalf of the participating affiliate at any time until six years have elapsed from the date of the last investment advisory activity. Additionally, the participating affiliate undertakes to advise the Commission promptly of any change to [insert agent]'s name or address during the applicable period.
- A representation that the participating affiliate will promptly, upon receipt of an administrative subpoena, demand, or request for voluntary cooperation made during a routine or special inspection or otherwise, provide to the Commission or the Commission's staff any and all of the books and records required to be maintained in accordance with staff guidance, and make available for testimony before, or other questioning by, the Commission or the Commission's staff the employees of the participating affiliate (other than clerical or ministerial personnel) involved in the investment advisory activities or related securities transactions, at such place as the Commission may designate in the U.S. or, at the Commission's option, in the country where the records are kept or such personnel reside.
- A representation that the participating affiliate will produce, pursuant to an administrative subpoena or a request for voluntary cooperation, any documents in accordance with staff guidance."

## Annex B – PA oversight checklist

- Ensure that the PAA is in effect and reflects accurately not only the requirements of the SEC Staff no-action letters establishing participating affiliates, but also does not go beyond the terms of these letters
- Confirm or obtain evidence to confirm that the following are satisfied:
  - persons providing advice, research and recommendations to the RIA are identified as “associated persons” – when was this done, by who and what records were made to document this. Also, check when these persons lost their status or when others gained this status and reconcile against Form ADV disclosures. Check that no one else is doing this;
  - ensure that associated persons are not placing orders with the RIA to buy or sell securities;
  - ensure that associated persons do not exercise discretion over the accounts of U.S. persons;
  - validate that associated persons do not contact or interact with U.S. clients, save as expressly provided for in the no-action letters and only as dual hatted employees;
  - identify and address breaches and violations asap;
  - appoint and compliance train local supervisors for associated persons;
  - associated persons received the Code of Ethics (“Code”), signed and returned the acknowledgment, have been compliance trained and are in compliance with the Code’s PAD requirements;
  - associated persons understand their record-keeping requirements – ensure that the participating affiliate has a list of these and monitor and monitor and test to ensure that they are keeping same;

## Annex B (cont'd)

- test and validate that the participating affiliate maintains and provides to you all of the PAD and research, advice and recommendations records;
- ensure that, if the SEC Staff request this, you provide it;
- ensure that associated persons are disclosed in the RIA's Form ADV Part 2A.
- document how you exercise oversight over and supervise the participating affiliate – remember that failure to supervise is actionable under Advisers Act Section 203(e)(6). Perform on site oversight audits annually and conduct a quarterly check (evidence and video call) – document findings in detail
- Review the participating affiliate's written procedures for research and the basis for advice and recommendations (suitability and reasonable basis for recommendations)
- Review PAD records to see how exceptions are identified and addressed – and raised with you
- Review record keeping of research in line with requirements – five years and that such reports and supporting materials are kept in English - if not, can they be translated into English upon reasonable request?
- Review any form of regular monitoring outcome or reporting that the participating affiliate provides. If there is any, assess the frequency and actions taken to rectify issues raised. If not, implement a monitoring system

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