

2018 Washington, DC Investment Management Conference –  
November 8, 2018

# Private Funds and Adviser Regulation

Beth Clark, Of Counsel, Washington, DC  
Cary J. Meer, Partner, Washington, DC and New York  
Kristina M. Zanotti, Partner, Washington, DC

# AGENDA

- CFTC Proposal to Expand and Clarify CPO and CTA Exemptions and Certain Other Requirements
- Cayman Anti-Money Laundering Developments
- Socially Responsible Investing and ERISA
  - ERISA Assets
  - EU Parliament Proposed ESG Initiative



# CFTC Proposal to Expand and Clarify CPO and CTA Exemptions and Certain Other Requirements

# CFTC PROPOSAL TO EXPAND AND CLARIFY CPO AND CTA EXEMPTIONS AND CERTAIN OTHER REQUIREMENTS – NEW CPO EXEMPTION

- New Proposed Exemption – Regulation 4.13(a)(4)
  - Codifies Advisory 18-96
  - Conditions:
    - Non-US pool
    - No meetings or administration in the United States
    - No shareholder/participant in the pool is or will be within the United States
    - The pool will not receive, hold or invest any capital directly or indirectly contributed from sources within the United States
    - No marketing in the United States
    - Notice within 30 days of registering or claiming exemption

# CFTC PROPOSAL TO EXPAND AND CLARIFY CPO AND CTA EXEMPTIONS AND CERTAIN OTHER REQUIREMENTS – NEW CPO EXEMPTION (CONT'D)

- Can combine CPO exemptions in Regulations 4.13(a)(3) and (4)
- Registered CPO can rely on exemption in Regulation 4.13(a)(4) for some pools
- Raises issue as to whether Regulation 4.13(a)(3) and 3.10(c)(3) exemptions can be combined



## CFTC PROPOSAL TO EXPAND AND CLARIFY CPO AND CTA EXEMPTIONS AND CERTAIN OTHER REQUIREMENTS – OTHER ITEMS

- All CPO exemptions in Regulation 4.13(a) would require no statutory disqualifications under Commodity Exchange Act Sections 8a(2) and 8a(3)
- Non-U.S. persons added to list of Regulation 4.13(a)(3) pool investors
- Requires communication of conditions of relief to pool participants

# CFTC PROPOSAL TO EXPAND AND CLARIFY CPO AND CTA EXEMPTIONS AND CERTAIN OTHER REQUIREMENTS – OTHER ITEMS (CONT'D)

- Jobs Act relief codified
- Codification of family office relief in Regulations 4.13(a)(7) and 4.14(a)(11)
- BDCs added to Regulation 4.5 with *de minimis* and marketing restrictions
- Codification of investment adviser as CPO for registered funds and BDCs but not for private funds

# CFTC PROPOSAL TO EXPAND AND CLARIFY CPO AND CTA EXEMPTIONS AND CERTAIN OTHER REQUIREMENTS – OTHER ITEMS (CONT'D)

- Recordkeeping relief for CPOs to allow records to be held other than at CPO's main business office – still requires filing from third-party recordkeeper
- No Form CPO-PQR and CTA-PR reporting for CPOs with only exempt pools and CTAs with only exempt accounts and non-directed accounts





# Cayman Anti-Money Laundering Developments



# AML REGULATIONS – PURPOSE AND SCOPE

- Purpose: to close gaps between the Cayman Islands' previous AML regime and FATF recommendations
- Scope of AML Regulations expanded: specifically includes all unregulated entities (e.g., funds not registered with CIMA), as well as regulated investment entities, insurance entities and financing entities
  - A regulatory body will likely be appointed to monitor compliance with the AML Regulations by entities not subject to monitoring by CIMA
- Risk-Based Approach: financial service providers (“FSPs”) are required to take steps appropriate to size/nature of business to identify, assess and understand the FSP’s money laundering and terrorist financing risks in relation to a customer, the country or geographic area in which the customer resides/operates, the FSP’s products and the FSP’s delivery channels

# AML REGULATIONS – OLD VS. NEW

- Previous AML regulations required procedures for:
  - Customer identification (“KYC”)
  - Record-keeping
  - Internal reporting (appointment of a money laundering reporting officer)
  - Other internal control (e.g., appropriate internal audit function) and communication
  - Designating management-level person to be a compliance officer with responsibility for monitoring and ensuring internal compliance with money laundering laws
  - Employee training and awareness regarding AML regime and transactions by persons engaged in money laundering
- New AML Regulations retain these procedures and require additional mandatory procedures:
  - Natural persons designated as anti-money laundering compliance officer (“AMLCO”), money laundering reporting officer (“MLRO”) and deputy money laundering reporting officer (“DMLRO”)
  - Employee screening procedures (for FSPs that have employees) upon hire
  - Conducting sanction and FATF non-compliant territory checks

# NEW AML REGULATIONS – AML OFFICERS

- AML Officers are natural persons
  - Can be directors of the fund or employees of the investment manager, administrator or third-party service provider
  - Must be individuals operating at managerial level
  - Must have specific knowledge of Cayman AML requirements
  - AMLCO is responsible for making sure fund has systems, controls and procedures in place to comply with the 2018 AML Regulations; recordkeeping responsibilities; risk assessment of fund
  - MLRO is final decision-maker as to whether SAR is filed -- must be autonomous from and independent of fund and manager to make the decision
  - DMLRO is “backup” MLRO
  - AMLCO can be MLRO or DMLRO but MLRO and DMLRO must be different

# NEW AML REGULATIONS – DUE DILIGENCE

- Simplified due diligence: low risk customers no longer exempt
  - Eligible introducer's letter still applies, but enhanced written assurances from eligible introducer required
  - No unilateral finding by FSP that a customer is lower risk – only valid if consistent with Cayman Islands' Proceeds of Criminal Law (2017 Revision)
  - Bank account of customer in the Cayman Islands or at an AML-equivalent jurisdiction still acceptable
    - Detailed verification not required at time of subscription
    - Basic customer details must be obtained upon receipt of payment – evidence identifying branch/office of bank, verification account is in applicant's name, retention of written record of details required
    - Verification of customer due diligence may be collected later – before onward payment to customer



## NEW AML REGULATIONS – DUE DILIGENCE

- Enhanced due diligence: must be applied to
  - High risk customers, politically exposed persons, their families and associates
  - Customers/businesses from a country identified as having AML/counter-terror financing deficiencies or prevalence of corruption
  - Correspondent banking relationships and shell banks

## NEW AML REGULATIONS – BENEFICIAL OWNERS

- KYC checks on “beneficial owners” required
  - Definition aligned with FATF Recommendations (and FATCA and CRS)
  - The natural person who ultimately owns or control the customer:
    - For an unlisted company, the person who ultimately owns/controls 10% or more of the shares or voting rights
    - Exercise of ultimate effective control over management
    - Other legal arrangement, the trustee or other person who exercises ultimate control over the arrangement

# NEW AML REGULATIONS

- Penalties increased (was C\$5,000)
  - Summary conviction = fine C\$500,000 (US\$600,000)
  - Conviction on indictment = unlimited fine plus two years imprisonment
  - CIMA's power to impose administrative fines for non-compliance expanded
  - Director, member, partner, manager can be liable with a firm but no new/specific liability as AMLCO, MLRO, DMLRO
- Schedule 3 (list AML-equivalent countries) deleted
  - List maintained electronically on CIMA website
- Into effect as of October 2, 2018

# NEW AML REGULATIONS -- CONSIDERATIONS

- Biographical information/expertise of individuals to be designated as AML officers, *e.g.*, does AMLCO have access to service providers?
- How will AML processes be carried out?
- If using a non-Cayman third-party service provider, gap analysis required, even if service provider is in an Equivalent Jurisdiction
- Consider liability caps
- Funds registered with CIMA must file basic details of their AML Officers through CIMA's REEFS portal
- Agreement between the fund and the entity providing the AML Officers (*e.g.*, manager, administrator, third-party provider)
- PPM must reference that AML Officers designated and further details available – names and biographical details not necessary
- Requirements to appoint AML Officers for a fund extended from September 30, 2018 to December 31, 2018 – registered funds file on REEFS portal



# Socially Responsible Investing - ERISA Assets; European Commission Proposals



# SOCIALLY RESPONSIBLE INVESTING

- U.S. based institutional investors considered environmental, social and governance (“ESG”) factors on about \$4.7T in investments in 2016, up by 14% since 2014
- The use of ESG factors has also grown considerably outside of the U.S. as the amount of global assets invested using ESG factors increased from \$18.3T in 2014 to \$22.9T by 2016
- Institutional investors subject to ERISA (e.g., corporate defined benefit plans) are increasingly focused on ESG factors

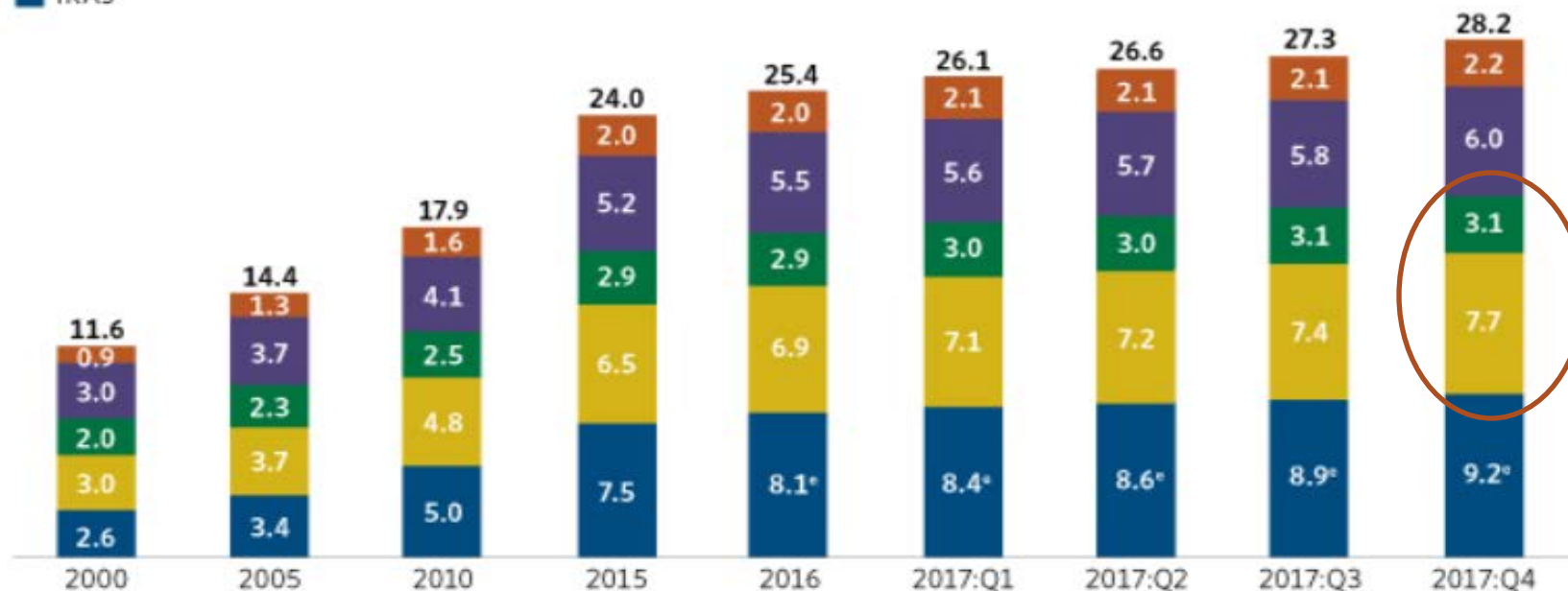
Source: GAO Report 18-398 “Retirement Plans’ Use of ESG Factors”

# ERISA INVESTORS

## US Total Retirement Market Assets

Trillions of dollars, end-of-period, selected periods

- Annuity reserves
- Government DB plans
- Private-sector DB plans
- DC plans
- IRAs



<sup>e</sup> Data are estimated.

Source: Investment Company Institute, “Retirement Assets Total \$28.2 Trillion in Fourth Quarter 2017.”

[www.ici.org/research/stats/retirement/ret\\_17\\_q4](http://www.ici.org/research/stats/retirement/ret_17_q4)

# ERISA CONSIDERATIONS

- The Department of Labor has a longstanding position that ERISA fiduciaries may not sacrifice investment returns or assume greater risks as a means of promoting collateral social policy goals
- Series of guidance, most recently in April (Field Assistance Bulletin 2018-01)
  - Clarification?
  - ESG factors may be a “tie-breaker”
  - ERISA fiduciaries must not too readily treat ESG factors as economically relevant; rather, an evaluation of an investment opportunity should be focused on financial factors that have a material effect on return and risk
- Investment policy statement considerations
  - May address ESG matters
  - Manager has a fiduciary duty to disregard, if the policy is inconsistent with ERISA
- Documentation is ultimately the key

# EUROPEAN COMMISSION PROPOSALS

- **January** – European Commission High-Level Expert Group published a report that identified as an imperative, incorporating ESG factors into investment decision-making
- **March** – Commission’s Action Plan on Financing Sustainable Growth laid out a roadmap to deliver on this commitment
- **May** – Commission issued a package of proposals, including:
  - Provide clarity on what is a sustainable investment (i.e., an EU-wide classification system)
  - Ensure asset managers, as part of their duty to act in the best interest of investors, include ESG factors in their investment decisions and advisory processes
  - Asset managers that claim to pursue sustainability objectives have to disclose how their investments are aligned with those objectives

K&L GATES