Running a Global Investment Firm

Schulte Roth & Zabel

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PRIVATE INVESTMENT FUNDS SEMINAR

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Practices

Investment Management

Financial Institutions

Hedge Funds

Regulatory & Compliance

Christopher Hilditch

Chris is the co-head of the firm's London office, of which he was one of the two founding partners in 2002. He has over 20 years of experience advising on the launch and operation of many of the highest profile hedge funds, having been active since the earliest days of the European hedge fund industry. He advises a wide range of both institutional and entrepreneurial investment managers, other financial services firms and investment funds of all types, especially hedge funds, hybrid funds, co-investment funds and distressed funds. He advises investment manager clients located in the United Kingdom, France, Switzerland, Malta and other European countries, as well as the United States, Sub-Saharan Africa and Asia. He provides legal and business advice on the structuring and operation of funds, including fundraising, investor issues, investment transactions and prime brokerage agreements. He has advised on a large number of seed and strategic investments as well as spinoffs of investment teams from banks and existing investment managers. His practice also includes advising clients on regulatory and compliance matters and finding practical solutions to the many issues clients face on a day-to-day basis.

Chris has been named as a leading funds lawyer in *Chambers UK*, *Chambers Europe*, *Chambers Global*, *The Legal 500 UK*, *The Expert Guide to the Best of the Best* (which named him as one of the top 25 funds lawyers worldwide), *Expert Guide to the World's Leading Banking*, *Finance and Transactional Law Lawyers*, *IFLR1000*, *PLC Cross-Border Investment Funds Handbook*, *Who's Who Legal: The International Who's Who of Private Funds Lawyers and Who's Who of Professionals*. He was recognized at The Hedge Fund Journal Awards 2017 for his "Outstanding Contribution" to the industry. In addition, Chris was invited to participate in the U.K. Financial Services Authority's Legal Experts Group in respect of AIFMD and has been an active participant on various AIMA and other industry committees on matters relating to the hedge fund industry. He is a frequent speaker at industry conferences and seminars, including invitation-only conferences for clients of prime brokers and other industry participants. He has also written on a wide range of hedge fund and regulatory topics. Chris recently co-authored "MiFID II: Final FCA Rules Published" and "Brexit: What Alternative Asset Managers Can Expect," both published in *The Hedge Fund Journal*. He also authored a chapter on "Conflicts of Interest" in Investment Management, Law and Practice, published by Oxford University Press, and co-authored a chapter on "United Kingdom Considerations" in *Hedge Funds: Formation, Operation and Regulation*, published by ALM Law Journal Press.

Chris attended law school at the College of Law, Guildford and graduated with an M.A., *with honors*, from Oxford University.

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Practices

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Anna Maleva-Otto

Anna concentrates her practice on advising asset managers on a range of U.K. financial services regulatory matters, including the impact of EU directives and regulations. She advises clients on the establishment of regulated businesses, financial crime (including market abuse, money laundering and bribery), financial promotion and offers of securities, regulatory reporting and disclosure obligations, regulatory capital and conduct of business rules. Prior to joining SRZ, Anna gained substantial experience advising hedge fund managers, brokers, insurance firms and investment banks on a wide spectrum of regulatory matters in her roles in private practice and as an in-house counsel and compliance officer of a hedge fund manager. She frequently participates in industry working groups in connection with new and emerging regulatory initiatives, and has advised asset managers on several key pieces of recent EU legislation (including the Short Selling Regulation, Alternative Investment Fund Managers Directive, MiFID II, MAR, EMIR and SFT Regulation). Anna began her career as a regulatory consultant assisting clients in the financial services sector with the design and implementation of compliance procedures, conduct of internal compliance investigations, compliance audits and remediation exercises. She is admitted to practice in England and Wales and New York.

A “Recommended” lawyer recognized in *The Legal 500 UK*, Anna was named among the world’s “50 Leading Women in Hedge Funds” by *The Hedge Fund Journal*. Anna frequently speaks on a wide range of topics, including MiFID II, market abuse and insider dealing, as well as systematic and quantitative strategies for funds. A sought-after thought leader, Anna recently worked with AIMA to produce “MiFID2 – A Guide for Investment Managers” and authored the “Insider Trading Law in the United Kingdom” chapter in *Insider Trading Law and Compliance Answer Book* (Practising Law Institute). She also co-authored “Brexit: What Alternative Asset Managers Can Expect,” and “Cross-Border Implementation of MiFID II Research Provisions — SEC No-Action Relief to Investment Advisers and Broker-Dealers and European Commission Guidance,” both published in *The Hedge Fund Journal*.

Anna received her J.D. from Emory University School of Law and her M.A. from Saint Petersburg State University (Russia).

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Julian Rainero

Julian is co-chair of the Broker-Dealer Regulatory & Enforcement Group. He advises broker-dealers and alternative trading systems on compliance with SEC, self-regulatory organization (SRO) and Federal Reserve Board rules. His practice involves all aspects of broker-dealer regulation, with a focus on cash equities trading practices, alternative trading systems, net capital, customer asset segregation, prime brokerage, correspondent clearing and margin and securities lending. Julian represents many of the leading electronic market makers and alternative trading systems and serves on the best-execution committees of several major broker-dealers. In addition to regularly advising broker-dealers on regulatory compliance and best practices, Julian represents clients in response to examination findings and enforcement proceedings. He also provides legal counsel to financial institutions in connection with acquisitions of or investments in broker-dealers, credit facilities collateralized by securities and transactions subject to Regulation M.

Recognized by *Chambers USA* and *The Legal 500 US* as a leading financial services regulatory lawyer, Julian recently co-authored “Cross-Border Implementation of MiFID II Research Provisions – SEC No-Action Relief to Investment Advisers and Broker-Dealers and European Commission Guidance” and was featured in “Execution Enforcement Actions Escalate,” both published in *The Hedge Fund Journal*.

Julian earned his J.D. from American University Washington College of Law and his B.A. from Dickinson College.

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Holly H. Weiss

Holly focuses her practice on the representation of employers, primarily in financial services, in all aspects of employment law and employee relations. She also serves as co-head of the firm's Cybersecurity Group. Holly litigates disputes involving restrictive covenants, ERISA claims, executive compensation, employment agreements, statutory employment discrimination claims, and common law tort and contract claims in federal and state courts, before administrative and government agencies and in arbitral forums. She advises employers on employment law compliance, best practices, human resources matters, hiring and termination, and litigation avoidance; drafts and negotiates employment agreements, separation agreements, data security and privacy policies and other employment-related agreements; and provides training and conducts investigations.

Holly is ranked as a leading lawyer by *The Best Lawyers in America* and as one of the "Top Women Attorneys in the New York Metro Area" by *New York Super Lawyers*. She also serves as a member of the Labor and Employment Law Section of the New York State Bar Association. A recognized thought leader, Holly has authored or co-authored numerous articles of interest to employers, recent examples of which include "SCOTUS to Tackle Interaction of FAA, NLRA on Arbitration Agreement Issue" and "'Scrollwrap' Agreement to Arbitrate Held Enforceable While 'Clickwrap' Is Not," both appearing as part of the regular column she co-authors for the *New York Law Journal.* She co-authored *Hedge Funds: Formation, Operation and Regulation*, published by ALM Law Journal Press and wrote a Practice Note for *Practical Law* on "Hedge Fund Employee Compensation." A highly sought-after speaker, Holly recently discussed "Labor Law – Overview Regarding Intro 1253 from an Attorney's Perspective" at the McLagan Alternative Asset Management Fall Conference, covered "Employment-Related Developments Impacting Hiring: Ban on Inquiries Relating to Compensation History, Ban the Box, and Credit History" at Goldman Sachs 12th Annual Hedge Fund Human Capital Management Seminar and discussed "Avoiding Litigation in Workforce Cases" at Benchmark Women in Litigation East conference.

Holly earned a J.D. from the University of Virginia School of Law and a B.A. from Emory University.

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Running a Global Investment Firm

I. Establishing a London Office

A. Conducting Regulated Activities

1. The U.K. regulatory regime imposes a general prohibition on any person carrying on a "regulated activity" from an establishment in the United Kingdom unless it is authorized to carry on that activity by the appropriate regulator (e.g., the Financial Conduct Authority ("FCA")), or an exemption or exclusion is available.

2. Examples of regulated activities include investment activities such as making investment management decisions, placing trades with brokers for execution or executing OTC transactions on behalf of a client, arranging transactions in unlisted investments, as well as certain types of marketing activities. Investment activities are regulated when carried on in relation to "specified investments," a term which includes equities, fixed income and derivatives.

3. A "U.K. establishment" for these purposes will include any place of business of the firm, including, for example, the private residence of an employee of the firm if the firm's business is conducted from such a private residence.

B. Formation of a Subsidiary

1. U.S. managers that wish to establish U.K. operations and hire local staff typically choose to establish a subsidiary (rather than a branch office of the U.S. firm). Such subsidiary usually takes the form of a private limited company or a limited liability partnership ("LLP"). The key distinction between a limited company and an LLP is that an LLP is a "pass-through" structure for U.K. taxation purposes.

2. Where the LLP structure is chosen, the more senior members of the U.K. subsidiary (e.g., investment professionals) typically become members (i.e., partners) of the LLP, with some of the junior members of staff becoming employees of the LLP.

II. Differences Between U.S. and U.K. Employment Laws

A. Governing Law

1. In the United States, various laws at the federal, state and municipal levels govern employment matters. In the United Kingdom, there is one set of laws that govern employment matters (with some minor differences in Scotland and Northern Ireland).

2. In the United States, many employers have different classifications of workers (i.e., exempt, non-exempt, independent contractors, partners, etc.). In the United Kingdom, all employees are classified the same for purposes of access to the same basic statutory employment rights. Note that if the U.K.-based staff become members of an LLP, they would not be categorized as employees for the purposes of these employment rights.

B. Hiring Process

1. In the United States, there is no legal requirement for a written employment contract evidencing the employment relationship. Most U.S. states follow the employment-at-will doctrine. Employers typically issue only an offer letter to new employees, accompanied by an employee handbook setting forth the employer's policies. In the United Kingdom, employment is not at-will. While an employment contract need not be in writing, employees in the United Kingdom who have been employed for at least one month must be provided a written statement setting forth certain statutorily required, fundamental details of their employment relationship. These details include remuneration and pension benefits, hours of work, leave entitlement, length of notice required to terminate employment, disciplinary and

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grievance procedures, holidays and sick pay. While not required, it is customary in the United Kingdom for employers to provide a more detailed document at the beginning of the employment relationship.

2. In the United States, recent developments in the state and local laws governing background checks have caused employers to change their interviewing and hiring policies and procedures. These limitations are driven by legislators' concerns that more expansive background checks could limit equal employment opportunities. New York City, for example, now prohibits credit checks for most employees and criminal checks before extending an offer to a potential employee. In addition, employers in New York City are not allowed to ask job applicants about their past or current compensation.

3. In the United Kingdom, firms regulated by the FCA are required to assess whether their employees and partners are "fit and proper" persons prior to lodging an application with the FCA for such individuals to be approved in a "controlled function" (e.g., director, partner or customer function). Such an assessment is generally expected to include background checks (including criminal and credit checks) as well as obtaining "regulatory references" from previous firms in the financial sector. The rules related to regulatory references require FCA-regulated firms to provide accurate and complete information in response to a request from other FCA-regulated firms. These obligations apply notwithstanding any compromise agreements entered into between the firm and the individual.

C. Pension and Health Benefits

1. In the United States, employers are not required to offer their employees access to a pension or 401(k) plan. In the United Kingdom, in 2018, all employers will be required to automatically enroll their eligible employees in a qualifying pension scheme (a pension plan) and contribute towards that scheme. Because these employers can require eligible employees to contribute to the pension scheme as well, employees can elect to opt out of participating in the pension scheme (similar to U.S. automatic enrollment 401(k) plans). In 2018, employers will be required to contribute 3 percent of salary to pension schemes.

2. In the United States, under the Patient Protection and Affordable Care Act, large employers (generally employers with at least 50 full-time employees) must offer their full-time employees employer-sponsored health coverage that meets certain requirements or potentially face a penalty. In the United Kingdom, aside from statutory rights to sick pay, family leave and vacation days, employers can choose whether to offer their employees' health benefits, and will not face a penalty if they choose not to do so.

D. Termination of Employment

1. In the United States, employers and employees can terminate the employment relationship at any time without notice, unless they agree otherwise in a contract. In addition, discrimination claims in the United States are heard before a civil jury with the possibility of an uncapped award for a victorious plaintiff, unless the parties agree to another forum, such as arbitration. In the United Kingdom, employees are statutorily entitled to a minimum of one week's notice of termination after the first month of employment, which increases to a maximum of 12 weeks' notice after 12 years of service. If an employee in the United Kingdom does not receive a written document evidencing his or her employment relationship, the employee is entitled to the longer of the statutory minimum notice or "reasonable" notice. Whether notice is "reasonable" is determined based on a facts and circumstances test, including a comparison to the notice period for comparable employees in the same business and the industry in which they are employed. In addition, in the United Kingdom, employees with two years of service have the right not to be "unfairly" terminated. For a termination to be "fair," the employer must establish that a fair reason for termination, under the applicable statute, exists and that the employer carried out the termination process in a fair and equitable manner. Awards for unfair termination are capped at £78,962, or 52 weeks' gross pay, whichever is lower. Discrimination awards, like in the United States, are uncapped.

2. In the United States, non-compete clauses may not be enforceable, depending on the state in which the employer and employee are located and whether the clause is reasonable in scope and duration. In the United Kingdom, for senior and/or key employees, it is common to impose restrictions on competition

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after the employment relationship has ended. Generally, in the United Kingdom, a restriction on post-termination employment will be unenforceable unless a court determines that it goes no further than necessary to protect a legitimate business interest. In addition, if an employer in the United Kingdom terminates an employment contract without the necessary notice, the employee will have a claim for wrongful termination, which will likely invalidate any restriction on post-termination competition.

3. If the leaver is approved by the FCA in a controlled function, the employer is required to disclose the reasons for termination to the FCA on Form C. This obligation covers information on any disciplinary investigations by the firm or any factors that may affect the FCA's assessment of the approved person's fitness and propriety. As noted above, this information must also be disclosed to other FCA-regulated firms in response to requests for regulatory references.

E. Dispute Resolution

In the United States, employment disputes will be heard in a court of appropriate jurisdiction unless the employer and employee agree, in writing (for example, in the employee's employment agreement), to mandatory alternative dispute resolution (i.e., mandatory and binding arbitration). In the United Kingdom, an employee has the right to be heard before the Employment Tribunal. If an employer and employee in the United Kingdom agree, in writing, to an alternative form of dispute resolution, such agreement is unlikely to preclude the employee from being heard before the Employment Tribunal. Instead, such agreement merely provides an additional method of dispute resolution, but not the only method of dispute resolution.

F. Remuneration

1. In the United States, investment professionals' compensation is regulated by the Internal Revenue Code Section 409A, solely with respect to the timing of certain deferred compensation payments. The amount and ratio of such payments, however, is unregulated.

2. In the United Kingdom, certain firms are required to meet standards and policies contained in the applicable Remuneration Code when setting pay and bonuses for staff. The Remuneration Codes were established as a response to the financial crisis of 2008, when the United Kingdom determined that inappropriate remuneration policies were widely identified as a contributing factor to the global recession. The Remuneration Codes were established to (i) ensure greater alignment between risk and individual reward; (ii) discourage excessive risk taking and short-termism; (iii) encourage more effective risk management; and (iv) support positive behaviors and a strong and appropriate conduct culture within firms.

3. Under the Remuneration Codes, all in-scope firms (including hedge funds) must make sure their remuneration policies and practices are consistent with, and promote, sound and effective risk management. This includes:

   (a) Ensuring that guarantees are given only in exceptional circumstances to new hires for their first year of employment; and

   (b) Ensuring that senior management adopts, and periodically reviews, the general principles of the employer's remuneration policy, and ensures its implementation. Details of the policy must also be disclosed at least annually.

4. In addition, the following "pay-out process" rules apply to the extent the investment manager concludes, following an assessment, that it would be appropriate to its size, internal organization and the nature, scope and complexity of its activities to apply these rules.

   (a) Requiring that at least 40 percent of a bonus be deferred over a period of at least three years. At least 60 percent must be deferred for the most senior management or when an individual's bonus is a particularly high amount.

   (b) Requiring that at least 50 percent of a bonus be made in shares, share-linked instruments or other equivalent non-cash instruments, subject to an appropriate retention period.

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(c) Ensuring that any variable remuneration, including deferred remuneration, is paid or vests only if it is sustainable according to the financial situation of the employer as a whole, and is justified based on both the employer's and employee's performances.

G. U.K. Senior Managers and Certification Regime ("SMCR")

1. On July 26, 2017, the FCA published its consultation paper on the extension of SMCR to all FCA-regulated firms, including hedge fund managers. The final rules are expected to be published in the summer of 2018 with them coming into operation thereafter. The extended SMCR will replace the current approved persons regime.

2. The key aspects of the SMCR are as follows.

(a) Senior Management Functions. Firms will need to allocate six "Senior Management Functions" ("SMFs"): Chief Executive, Executive Director, Partner, Chair, Compliance Oversight and Money Laundering Reporting Officer ("MLRO"). Anyone holding an SMF will be subject to pre-approval and supervision by the FCA ("grandfathering" is expected to apply to individuals currently holding these roles).

(b) Statement of Responsibilities. Certain prescribed responsibilities will need to be allocated amongst the senior managers and their individual responsibilities will need to be set out in a "Statement of Responsibilities" which must be submitted to the regulator with the senior manager's approval application.

(c) Duty of Responsibility. Senior managers will have a statutory "Duty of Responsibility" and will potentially be accountable if they fail to take reasonable steps to prevent a breach by a firm in their area of responsibility as set out in their statement of responsibilities.

(d) Certification Functions. Firms are required to identify "Certified Persons" who fulfil one or more "Certification Functions." Firms must ensure that senior managers, non-executive directors (who are not senior managers) and certified persons are at all times fit and proper, and must certify them as such at least annually.

(e) Conduct Rules. Firms must also ensure that employees comply with certain "Conduct Rules," in respect of which firms will have notification, training and recordkeeping obligations.

H. Data Protection and Privacy

1. In the United States, data protection and privacy is governed by state and local law. New York State, for example, does not require employers to turn over personal files to employees. In addition, New York State is a "one-party" consent state, so employers do not need to disclose the fact that they are monitoring their employees or recording and/or storing communications made over systems owned by the employer.

2. The General Data Protection Regulation ("GDPR") will take direct effect in all EU member states on May 25, 2018. In the United Kingdom, the GDPR will replace the Data Protection Act of 1998, the law that is currently in effect to protect employees' personal information.

3. Currently, under the Data Protection Act, employers must generally comply with basic standards to ensure they are collecting only the minimum amount of information necessary on job applicants and employees, that such information is maintained securely and that individuals have access to their information upon request (similar to HIPAA in the United States). Employees must be aware of the nature and source of any information that is stored about them, how it will be used and to whom it will be disclosed.

4. Some of the key components of the GDPR include: (i) requiring the express consent of individuals for data processing or other lawful grounds for processing data; (ii) requiring firms to establish detailed policies and controls for collecting, storing and processing personal data to enable them to demonstrate

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compliance with GDPR to their supervisory authorities; (iii) requirements applicable to collection and storage of data, such as data minimization (i.e., limiting data storage to what is necessary for the purposes of processing) and storage limitation (keeping personal data in identifiable form only for as long as necessary for the relevant purpose); (iv) data breach notifications regime; and (v) requiring certain companies to appoint a data protection officer to oversee GDPR compliance (also very similar to HIPAA in the United States). A non-EU company that offers its goods or services to EU ''data subjects'' (i.e., individuals) or monitors behavior of such EU data subjects is subject to the GDPR.

5. The GDPR also drastically increases fines for breaches. Under the current Data Protection Act, an employer can be fined up to £500,000 for a breach (although the majority of fines imposed have been significantly lower). Under the GDPR, an employer can be fined an amount which is the higher of €20 million or 4 percent of total worldwide turnover for a breach.

I. MiFID II — Telephone Recording

From Jan. 3, 2018, FCA-authorized investment managers are required to record all telephone calls and electronic communications relating to execution of investment transactions (subject to limited exemptions applicable to certain private equity business). In addition, such firms are required to monitor the telephone and electronic communications for, among other things: (i) compliance with the internal policies on recording; and (ii) any evidence of market abuse. Firms subject to these obligations may wish to review their HR policies or compliance manuals to ensure that their staff members have notice of such recording and monitoring and have no expectation of privacy when using the equipment that the firm has permitted to be used for such communications.

III. Trading Compliance — Short Sale Marking Requirements

A. Regulation SHO

1. Rule 200(a) of Regulation SHO defines a "short sale" as any sale of a security which the seller does not own or which is consummated by the delivery of a security borrowed by, or for the account of, the seller.

2. Rule 200(c) further provides that a person shall be deemed to own a security only to the extent that the person has a net long position in such a security.

3. Marking Done at Asset-Owner Level. The term "seller" generally refers to the titled owner of the asset and not the manager making investment decisions.

   (a) An investment adviser to more than one fund should mark sales as "long" or "short" based on the relevant fund's position in the security on a fund-wide basis, without considering the position of other entities also managed by the adviser.

   (b) In marking sales as "long" or "short," a seller must aggregate, and thus calculate on a net basis, its various long and short positions across all strategies in the fund and across multiple prime brokers (unless intending to make delivery of borrowed securities) in order to determine whether the seller has a net long or short position in the subject security.

4. Short Against the Box. A sale in connection with the establishment of a boxed position or the sale of the long portion of a boxed position would each constitute a short sale for purposes of Regulation SHO.

5. Borrowed Securities Determine Marking. Even where a seller is net long the securities sold, it will be required to be marked short where the seller intends to make delivery with borrowed securities.

6. Broker-dealers are required to mark all sell orders as "long" or "short" under Rule 200(g). While the order marking requirements of Rule 200(g) apply to broker-dealers and not their customers, SEC Rule 10b-21 states that it shall be a "manipulative or deceptive device or contrivance" for any person to submit an order to sell an equity security if such person deceives a broker-dealer, a participant of a registered clearing agency, or a purchaser about its intention or ability to deliver the security on or

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before the settlement date, and such person fails to deliver the security on or before the settlement date.

B. EU Short Selling Regulation

1. The EU Short Selling Regulation ("SSR") implemented a harmonized regime to regulate the short selling of shares of companies with shares admitted to trading on an EU trading venue (other than certain dual-listed shares primarily traded on a non-EU venue), EU sovereign debt instruments and sovereign credit default swaps.

2. The disclosure/transparency regime under the SSR applies to any person anywhere in the world holding a short position in EU shares or sovereign debt and covers net short positions held through derivatives and indices references to shares and sovereign debt.

3. Net short positions of 0.2 percent (and each 0.1 percent above that) of the share capital of the issuer must be notified to the local EU regulator for the market. Net positions of 0.5 percent (and each 0.1 percent above that) must be disclosed publicly.

4. Net short positions in sovereign debt of EU issuers must be disclosed to the relevant EU regulator if the following thresholds are crossed: (i) 0.1 percent if the total amount of outstanding debt is less than €500 billion; and (ii) 0.5 percent if the outstanding debt is more than €500 billion. Thresholds for each issuer are published on ESMA's website on a quarterly basis.

C. MiFID II Transaction Reporting

1. MiFID II expands the scope of instruments that are subject to the transaction reporting obligation, as well as the information to be reported. The transaction reporting obligations will apply to all EU firms authorized under MiFID.

2. The number of data fields in transaction reports has increased from 23 to 65. This includes a designation of whether a transaction is a short sale under the SSR. Note, however, that the Short Selling Indicator is not applicable where the traded instrument is an index or a derivative, such as a CFD, an options/futures contract, a CDS, etc.

IV. Payments for Research

A. General

1. MiFID II will eliminate the ability of certain EU asset managers to pay for research services together with executions through a bundled commission payment and, instead, requires them to pay for research separately from execution services, either through direct payments from asset managers' own funds, separate research payment accounts ("RPA") funded by clients assets, or a combination of the two.

2. On Oct. 26, 2017, the SEC, after consulting with European regulators and the European Commission, published three temporary no-action letters providing U.S. broker-dealers and investment advisers relief in the conduct of their business activities with entities subject to MiFID II, which went into effect on Jan. 3, 2018.

B. Implications for Investment Advisers

1. The no-action relief allows investment advisers to continue to rely on the "soft dollar" safe harbor provided by Section 28(e) of the Exchange Act when the adviser makes payments for research to an executing broker out of client assets — alongside payments to the executing broker for execution — with the research payments credited to an RPA, administered either by the executing broker or a third-party administrator.

2. This no-action relief will only apply if the following four conditions are satisfied:

(a) The asset manager makes payments to the executing broker-dealer out of client assets for research alongside payments through an RPA to that executing broker-dealer for execution;

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(b) The research payments are for research services that are eligible for the safe harbor under Exchange Act Section 28(e);

(c) The executing broker-dealer effects the securities transaction for purposes of Exchange Act Section 28(e); and

(d) The executing broker-dealer is legally obligated by a contract with the asset manager to pay for research through use of an RPA.

3. In coordination with the SEC no-action relief, the European Commission provided the following additional clarifications:

(a) EU managers and Third-Country Delegates may continue making combined payments for research and execution as a single commission to third-country broker-dealers, as long as the payment attributable to research can be identified separately; and

(b) In the absence of a separate research invoice from a third-country broker-dealer, the EU manager or Third-Country Delegate should consult with the broker-dealer or other third parties with a view to determining the charge attributable to the research. In this case, the manager must also ensure that the supply of and charges for those benefits or services should not be influenced or conditioned by the levels of payment for execution services.

V. U.S. Customer Protection Rules

A. Regulatory Framework

1. The Customer Protection Rule. SEC Rule 15c3-3 requires a broker-dealer to maintain possession or control of the customer's fully paid and excess margin securities with a value greater than 140 percent of the customer's debit balance and segregate those securities from the broker-dealer's proprietary securities. In addition, U.S. broker-dealers are required to deposit the excess of free credit balances over margin loans receivable in a special customer reserve account.

2. Rehypothecation. 15c3-3 limits the extent to which a broker can rehypothecate a client's assets. Brokers can rehypothecate assets to the value of 140 percent of a client's liability to a prime broker, but all of the funds borrowed that are secured by a customer's securities is a credit in the reserve formula, increasing the amount on deposit in the reserve account.

B. Securities Investor Protection Act and Bankruptcy Protection

1. The Securities Investor Protection Act ("SIPA") created the Securities Investor Protection Corporation ("SIPC"), which is responsible for restoring funds and securities to investors from financially troubled broker-dealers. The value of the insurance isn't the critical function of SIPA, rather it's that SIPA provides that customer claims have a priority over segregated securities and the reserve account deposits.

2. Under a SIPA liquidation, the broker's customer assets are divided on a pro rata basis, with assets distributed in proportion to the size of claims. If there are insufficient assets in the customer estate to satisfy claims, SIPC's reserve funds are used to supplement the distribution, up to a maximum of $500,000 per customer.

3. SIPA proceedings favor the return of securities to customers, whereas liquidation under Chapter 7 requires the trustee to sell the securities and distribute cash to customers. In either case, customer property is pooled, and if the total pool is not sufficient to pay the customers' aggregate net equity claims, customers share pro rata in the proceeds based on their respective net equity claims.

VI. U.K. Customer Protection Rules

A. Regulatory Framework

1. Protection of Client Assets. When assets are held by the broker-dealer but the client retains title, firms cannot comingle customer assets with firm assets. However, if title is transferred under a title transfer

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collateral arrangement ("TTCA"), the broker-dealer may use the assets subject to any contractual limitations.

2. No Rehypothecation Limits. There are no statutory limits on the value of assets that the prime broker can rehypothecate or how much money it can raise from using those assets, although the Client Asset Sourcebook ("CASS") rules require explicit contractual rights to use assets that remain client assets.

B. Prime Broker Default

1. Assuming a TTCA is in place, customers only have to have unsecured contractual claims for their assets to be returned.

2. Unsecured liabilities are either canceled or converted to equity under a Prudential Regulation Authority bail-in.

C. Client Money Rules

1. Asset managers, brokers, custodians and other types of investment firms must comply with the FCA's custody rules to the extent they hold non-cash assets for clients.

2. Investment firms conducting regulated activities that could have them holding cash for clients (e.g., subscription or redemption proceeds) must comply with the FCA's client money rules.

D. Critically, local insolvency regimes control EU bank insolvency claims processes, so a German or French bank operating from a London branch will still be subject to a German or French insolvency regime.

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