June 1, 2015

SEC Proposes Amendments to Form ADV and Recordkeeping Rule

In late May, the Securities and Exchange Commission (the "SEC") proposed rules that would amend portions of Form ADV and rules promulgated under the Investment Adviser Act of 1940 (the "Advisers Act"). The proposed amendments are intended to improve the quality of information that investors and the SEC receive, fill data gaps that the SEC has identified and facilitate the SEC's risk monitoring initiatives. The proposed amendments relate to Part 1A of Form ADV and address: 1) additional reporting requirements with respect to Separately Managed Accounts ("SMAs"); 2) additional disclosures about investment advisers and their businesses; 3) registration on a single Form ADV of multiple fund advisers operating as a single advisory business ("Umbrella Registration"); and 4) certain clarifying and technical changes. The SEC has also proposed amendments to the Advisers Act Books and Records Rule (Rule 204-2) to require advisers to maintain additional written materials related to the calculation and distribution of performance information. The comment period closes 60 days after publication in the *Federal Register*. We have summarized the proposed amendments below.

Separately Managed Accounts

For purposes of Form ADV, SMAs are advisory accounts other than pooled investment vehicles (*e.g.*, private funds, registered investment companies).[1] Form ADV currently requires much less information about SMAs than for pooled investment vehicles. The proposed amendments would increase the amount of information requested under Item 5 of Part 1A and Section 5 of Schedule D of Form ADV concerning SMAs.

The proposed amendments would add specific questions with respect to an adviser's SMAs about: 1) the type of assets held; 2) the use of derivatives and borrowing; and 3) the role of custodians. The level of information requested would vary based upon an adviser's total regulatory assets under management ("RAUM") attributable to SMAs, with threshold levels set at $0, $150 million and $10 billion. The SEC believes this information will improve their ability to effectively conduct risk assessments and risk-based examinations.

Disclosure of SMA Asset Categories

Under the proposed amendments, each adviser would have to report the approximate percentage of its SMA assets invested in ten broad asset categories (exchange-traded equities; US government bonds; US state and local bonds; sovereign bonds; corporate bonds – investment grade; corporate bonds – non-investment grade; derivatives; securities issued by registered investment companies and business development companies; securities issued by other pooled investment vehicles; and other). Advisers with at least $10 billion in RAUM attributable to SMAs would be required to report this information as of two dates per year, although information about both dates would be provided in the same annual update filing. Advisers with less than $10 billion in RAUM attributable to SMAs would only be required to provide this information with respect to one date per year (the date on which the adviser calculates its RAUM for purposes of its annual amendment to Form ADV).

[1] Based on the definition of separately managed accounts in the proposed rules and prior SEC guidance on "funds of one" (i.e., funds with a single investor), advisers may be required to report certain "funds of one" as separately managed accounts.

Disclosure of SMA Derivatives and Borrowing

The proposed amendments would require advisers with at least $150 million in RAUM attributable to SMAs to report information on the use of borrowing and derivatives in such SMAs. Advisers with RAUM attributable to SMAs of at least $150 million and below $10 billion would be required to categorize their SMAs annually based on the net asset value and gross notional exposure percentage of each account, and would be required to calculate and report the weighted average amount of borrowing within each category. Advisers with at least $10 billion in RAUM attributable to SMAs would have to report the same information, and would also be required to report average derivatives exposures within six different types of derivatives (interest rate; foreign exchange; credit; equity; commodity; and other) for each category of SMA. In addition, as with the asset category information described above, advisers at or above the $10 billion RAUM threshold would be required to report borrowing and derivatives information for two dates per year (mid-year and end of year).

SMA Custodian Identification

Advisers would also be required to identify any custodian that accounts for at least 10 percent of total RAUM attributable to an adviser's SMAs and the amount held at each such custodian.

Additional Identifying Information

The SEC has proposed multiple amendments to increase the amount of identifying information collected on Form ADV, including with respect to the adviser's: 1) internet presence; 2) physical office locations; 3) chief compliance officer status; and 4) amount of assets.

Adviser's Internet Presence

Currently Item 1.I only requires that advisers provide their website address. The proposed amendment would expand that question to include all websites of the adviser and all social media platforms where the adviser has a presence (*e.g.*, Twitter, Facebook, LinkedIn).

Adviser's Physical Office Locations

Currently Item 1.F generally requests information about an adviser's principal office and place of business. The proposed amendment would require an adviser to provide the total number of offices in which they conduct business as well as information about their 25 largest offices (determined by number of personnel).

Chief Compliance Officer Status

The SEC reports that while conducting examinations, SEC staff has found varying levels of quality and effectiveness of outsourced chief compliance officers. In order to better assess the potential risks associated with outsourcing, the proposed amendment requires advisers to indicate whether their CCO is employed by someone other than the adviser or a related person, and if so, by whom. The proposed amendment expands the question which is currently asked in Item 1.J.

Balance Sheet Assets

Currently Item 1.O requires an adviser to indicate whether it has assets (*i.e.*, assets on the adviser's own balance sheet, not assets under management) of greater than $1 billion. Under the proposed amendment, advisers with assets of $1 billion or more would be required to provide a range for their total assets ($1-10 billion; $10-50 billion; or $50 billion or more).

Financial Industry Affiliations

Currently Section 7.A of Schedule D requires that an adviser provide information about its industry affiliations and Section 7.B.(1) requires information on private funds managed by the adviser. The new proposed amendments pertaining to these sections would require advisers to provide identifying numbers of their affiliates (*e.g.*, Public

Accounting Oversight Board registration numbers and CIK numbers). This proposed amendment would also require advisers to report the percentage of each of their private funds owned by "qualified clients" for purposes of Advisers Act Rule 205-3.[2]

Umbrella Registration

In many cases groups of related advisers, which are all separate legal entities, are organized as a group and effectively operate as a single advisory business. The current Form ADV is designed to address registration of an advisory business that is organized as a single legal entity, but the SEC has previously issued guidance[3] that allowed one adviser (a "Filing Adviser") to file a single Form ADV on behalf of itself and other advisers ("Relying Advisers"), provided that they were controlled by or under common control with the Filing Adviser and conducted a single advisory business. The SEC has now proposed amendments to Form ADV intended to further facilitate "Umbrella Registration" by an advisory business consisting of a Filing Adviser and one or more Relying Advisers. The proposed amendment only applies to registered advisers, so Umbrella Registration is not applicable to exempt reporting advisers. While the proposed amendment does not substantially alter the Umbrella Registration requirements as set out in the SEC guidance, it does alter portions of Form ADV to allow for better data collection with respect to Umbrella Registrations. The proposed amendment would codify the existing SEC guidance on Umbrella Registration.

Requirements to Rely on Umbrella Registration

The proposed rules amend Form ADV's General Instructions and establish five main criteria that must be met in order to qualify for Umbrella Registration. These criteria are the same ones that many advisers have relied on since the SEC guidance in 2012 concerning Relying Advisers, except the SEC guidance also included disclosure conditions for Form ADV, the substance of which is covered by these proposed amendments:

1. The Filing Adviser and each Relying Adviser advise only private funds and "qualified clients" in SMAs;

2. The Filing Adviser's principal office and place of business is in the United States, and all of the substantive provisions of the Adviser Act and rules apply to the Filing Adviser and each Relying Adviser;

3. Each Relying Adviser, its employees, and persons acting on its behalf are subject to the Filing Adviser's supervision and control;

4. Each Relying Adviser's advisory activities are subject to the Advisers Act and rules, and subject to SEC examination; and

5. The Filing Adviser and each Relying Adviser operate under a single code of ethics and a written policy administered by a single chief compliance officer in accordance with the Advisers Act.

Contents of Form ADV Umbrella Registration Filing

Umbrella Registration requires the Filing Adviser to include information called for by Form ADV concerning itself and each Relying Adviser, and the Filing Adviser must similarly include information with respect to its Relying Advisers in any filing it makes pursuant to the Advisers Act (*e.g.*, Form PF). The SEC has proposed amending the instructions to Form ADV to specify whether a question pertains solely to the Filing Adviser or to the Filing Adviser and each Relying Adviser. To facilitate Umbrella Registration the proposed amendment creates a new Schedule to

[2] Rule 205-3 defines "qualified client" to include any "qualified purchaser" as defined in Investment Company Act section 2(a)(51)(A), as well as persons with a net worth of at least $2 million, persons with at least $1 million under the management of the applicable investment adviser, and certain "knowledgeable employees" of the investment adviser (in each case, as calculated or defined for purposes of Rule 205-3 and related statutes and rules).
[3] See American Bar Association, Business Law Section, SEC Staff Letter (Jan. 18, 2012), available here.

Form ADV that must be completed for each Relying Adviser that would require identifying information, the basis for SEC registration, and ownership information. A new question would require the Filing Adviser to indicate whether it or any of its Relying Advisers manage or sponsor private funds that are reported on Form ADV.

Clarifying Amendments and Technical Changes

The proposed rule would also make many technical and clarifying amendments to Form ADV, including certain proposed amendments which have implications for interpreting existing questions on the form. Two clarifying amendments of note relate to the adviser's clients being solicited and audited financial statements:

Soliciting Adviser's Clients to Invest in a Private Fund

The proposed amendment would clarify for purposes of Question 19 of Section 7.B(1), Schedule D that advisers should not consider feeder funds as clients of the adviser to a private fund (*i.e.*, the master fund in a master-feeder structure) when answering whether the adviser's clients are solicited to invest in the private fund. The SEC has confirmed that it was not the intent of Question 19 to capture affiliated feeder funds. Advisers should presumably act accordingly when amending their current Form ADV, even prior to the proposed rule being adopted.

Audited Financial Statements

Question 23(g) of Section 7.B.(1), Schedule D inquires about the distribution of a private fund's audited financial statements. The proposed amendment would add language clarifying that this refers to the financial statements from the most recent fiscal year. A separate proposed change to Question 23(h), which inquires about unqualified audit opinions, would clarify the applicable time period by asking whether all reports prepared by the auditing firm since the adviser last filed its annual update contain unqualified opinions.

Advisers Act Book and Record Rule Amendments

The proposed amendments would require advisers to maintain additional written materials related to the calculation and distribution of performance information.

Removal of the 10-Person Limitation

Currently Rule 204-2(a)(16) requires advisers to maintain records supporting performance claims that are distributed to 10 or more persons. The proposed amendment eliminates the 10-person threshold and results in a requirement that all communications (whether distributed directly or indirectly) demonstrating calculation of performance or rate of return must be kept.

Written Material Related to Performance Information

The proposed amendment requires advisers to maintain communications relating to the performance or rate of return of any or all managed accounts or securities recommendations; this requires originals of all received communications and copies of sent communications to be maintained. The proposed amendment expands the current rule, Rule 204-2(a)(7), which only requires certain categories of written communications to be maintained.

If you would like to learn more about the issues in this Alert, please contact your usual Ropes & Gray attorney.