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ALERT

Asset Management

August 29, 2016

SEC Adopts Amendments to Form ADV and Recordkeeping Rule

On August 25, 2016, the Securities and Exchange Commission (the "SEC") adopted rules, proposed in May 2015,[1] to modernize and enhance the disclosure requirements promulgated under the Investment Adviser Act of 1940, as amended (the "Advisers Act") and to amend Form ADV (collectively, the "Amendments"). The Amendments are intended to improve the quality of information that clients and the SEC receive, fill data gaps that the SEC has identified and facilitate the SEC's risk monitoring initiatives. More specifically, the Amendments modify the requirements under Part 1A of Form ADV to require (among other things), (1) additional reporting requirements with respect to separately managed accounts; (2) registration on a single Form ADV of multiple private fund advisers operating as a single advisory business in a "relying adviser" structure ("Umbrella Registration"); (3) additional disclosures about investment advisers and their businesses; and (4) certain clarifying and technical changes. Additionally, the Amendments include a revision to Rule 204-2 of the Advisers Act (relating to recordkeeping), requiring investment advisers to maintain additional records of performance calculations and performance-related communications.

The Amendments will be effective 60 days after publication in the Federal Register, and investment advisers will need to comply with the Amendments on October 1, 2017. For firms with a December 31 fiscal year end, which describes the majority of investment advisers, this means compliance with respect to Form ADV updates no later than the annual amendment filing in March 2018. The Adopting Release is available here.

The most noteworthy requirements of the Amendments are described below in more detail:

1) Increased Disclosure of Separately Managed Accounts ("SMAs")

While the SEC declined to specifically define "separately managed account" in the Adopting Release, for purposes of Form ADV, the SEC deems SMAs to be advisory accounts other than those that are pooled investment vehicles, including (i) investment companies; (ii) business development companies; and (iii) other pooled investments vehicles (such as private funds).[2] Prior to the effectiveness of the Amendments, Part 1A of Form ADV only required investment advisers to disclose minimal information about their SMAs in Item 5 (e.g., percentage of clients and regulatory assets under management that represent SMAs).

The Amendments require increased information concerning SMAs by adding specific questions in Item 5 of Form ADV with respect to (a) the type of asset(s) held by the SMAs; (b) the use of derivatives and borrowing; and (c) the role of custodians. The amount of information requested varies based upon an investment adviser's total regulatory assets under management ("RAUM") attributable to SMAs, with threshold levels set at $0, $500 million and $10

[1] "Amendments to Form ADV and Investment Advisers Act Rules," Investment Advisers Act Release No. 4091 (May 20, 2015) available here.

[2] We note that the SEC did not specifically address "funds of one" in the Adopting Release. Generally, we would expect that investment advisers will either report such funds as pooled investment vehicles in Item 5 and complete a corresponding Section 7.B.(1) in Schedule D or, alternatively, report such funds as SMAs in Item 5. See "Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers," Investment Advisers Act Release No. 3222 (noting that whether a single-investor fund could be a "private fund" depends on the facts and circumstances) available here.

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billion.[3] In the Adopting Release, the SEC noted that it believes this information will improve its ability to conduct risk assessments and risk-based examinations effectively.[4]

a. *Disclosure of SMA Asset Categories*

The Amendments require investment advisers to report the approximate percentage of their SMA assets invested in twelve broad asset categories: exchange-traded equity securities; non-exchange traded equity securities; U.S. government bonds; U.S. 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; cash and cash equivalents; and "other". The SEC declined to provide definitions of these terms in Form ADV and instead, permits investment advisers to use their own methodologies in determining appropriate asset categories.

Investment advisers with **at least $10 billion** in RAUM attributable to SMAs will be required to report this information as of two dates per year (mid-year and year-end).[5] Investment advisers with **less than $10 billion** in RAUM attributable to SMAs will be required to report this information only as of year-end.

b. *Disclosure of SMA Derivatives and Borrowing*

The Amendments require investment advisers with **at least $500 million** in RAUM attributable to SMAs to report information in Item 5.K.(2) on the use of borrowing and derivatives in such SMAs. More specifically, investment advisers with RAUM attributable to SMAs of:

i. **Between $500 million and $10 billion** are required to report the amount of RAUM attributable to SMAs and the dollar amount of borrowings attributable to those assets that correspond to three levels of gross notional exposures; and

ii. **At least $10 billion** must report the same information as above, as well as the derivatives exposures within six different types of derivatives for each category of SMA.[6] Such borrowing and derivatives information must be reported for two dates per year (mid-year and year-end).

Investment advisers may, but are not required to, limit their reporting to individual accounts of at least $10 million.

[3] In the Adopting Release, the SEC clarified that an investment adviser should only report with respect to SMAs for which it provides continuous and regular supervisory or management services. Furthermore, the SEC clarified that a subadviser to an SMA should only provide information about the portion of an account that it subadvises. The SEC recognized that this instruction may require both advisers and subadvisers to report on the same RAUM (i.e., assets they both manage in an account), but believed this was consistent with the current reporting structure of RAUM in Form ADV.

[4] It should be noted that non-U.S. investment advisers, with their principal place of business outside of the United States must provide information about all of their SMAs and may not exclude SMAs beneficially owned by non-U.S. persons. Thus, there is no carve-out for SMAs that would be analogous to the exclusion provided for in Item 7.B.(1) in Form ADV, which allows a non-U.S. adviser whose principal offices and place of business are outside the United States to exclude reporting on private funds that (i) are not themselves US persons, (ii) are not beneficially owned by US persons and (iii) are not offered in the U.S.

[5] An investment adviser will not be required to make two separate filings. Information about both dates will be reported on the same annual amendment filing.

[6] The six types of derivatives include interest rate, foreign exchange, credit, equity, commodity and "other".

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c. *SMA Custodian Identification*

Item 5.K.(3) requires investment advisers to (i) identify any custodian that accounts for at least 10 percent (10%) of total RAUM attributable to such investment adviser's SMAs and such custodian's office location and (ii) disclose the amount of RAUM held at each such custodian.

2) Umbrella Registration

In 2012, the SEC issued guidance with respect to Umbrella Registration whereby one investment adviser (a "Filing Adviser") would be permitted to file a single Form ADV on behalf of itself and other investment advisers (each, a "Relying Adviser"), provided that the Filing Adviser and each Relying Adviser were controlled by one another or under common control of a parent entity and conducted a single advisory business.[7] Similar to the SEC's prior guidance, the Amendments only allow Relying Advisers to use Umbrella Registration where their advisory business involves private funds.

The Amendments facilitate and standardize Umbrella Registration by codifying the requirements as set out in the existing SEC guidance, while updating certain portions of Form ADV to require additional disclosure.

a. *Requirements to Rely on Umbrella Registration*

The Amendments update Form ADV's General Instructions and establish five preconditions (consistent with those set forth in the previous guidance) that must be satisfied in order for a group of private fund advisers that operate as a single advisory business to qualify for Umbrella Registration:[8]

i. The Filing Adviser and each Relying Adviser advise only private funds and/or "qualified clients" in SMAs that are otherwise eligible to invest in the private funds advised by the Filing Adviser or a Relying Adviser and whose accounts pursue investment objectives and strategies that are substantially similar or otherwise related to those private funds;

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

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

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

v. The Filing Adviser and each Relying Adviser operate under a single code of ethics and written policies and procedures adopted and implemented in accordance with rule 206(4)-7 of the Advisers Act and administered by a single chief compliance officer in accordance with the rule.

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[7] See American Bar Association, Business Law Section, SEC Staff Letter (Jan. 18, 2012), available here. Please see our Client Alert "SEC Releases Guidance on Whether Entities Related to a Registered Adviser Need to Register", available here.

[8] For purposes of Umbrella Registration, the SEC noted that it did consider the following factors as indicia of a "single advisory business": commonality of advisory services and clients; a consistent application of the Advisers Act and rules thereunder to all advisers in the business; and a unified compliance program. Further, the Adopting Release suggested that satisfaction of the factors set forth in the "*Ellis Test*" for purposes of determining whether two separate investment advisers are "operationally integrated" could be indicative of operating as a single advisory business. The 1981 No Action Letter given to Richard Ellis is available here.

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Umbrella Registration is not applicable to exempt reporting advisers, including investment advisers that are exempt from registration under Section 203(m)-1 (the "private fund adviser exemption"). However, the Adopting Release notes that the previously released "Frequently Asked Questions" allowing certain exempt reporting advisers to file on a single Form ADV on behalf of multiple special purpose vehicles was not withdrawn as a result of the Amendments.

b. *Schedule R: Contents of Form ADV Umbrella Registration Filing*

Umbrella Registration generally requires the Filing Adviser to include information in Form ADV concerning itself, and it must similarly include information with respect to each Relying Adviser in any filing it makes pursuant to the Advisers Act. To obtain the necessary information and to clarify and distinguish to which investment adviser certain information pertains, the Amendments establish a new Schedule R of Form ADV. Schedule R must be filed for each Relying Adviser and would consolidate in one location important information about each Relying Adviser, including identifying information (Section 1); the basis for SEC registration (Section 2); form of organization (Section 3); and control persons and information regarding the Relying Adviser's owners and executive officers (Section 4). Additionally, a Filing Adviser must distinguish whether it or any of its Relying Advisers manage or sponsor the private funds that are reported in Section 7.B.(1) of Schedule D on Form ADV.

c. *Reporting on Form ADV*

The Amendments revise the instructions to Form ADV to clarify that all information in Form ADV should be answered on behalf of the Filing Adviser and each Relying Adviser, unless otherwise indicated. For instance, Item 1 (identifying information); Item 2 (SEC registration), Item 3 (form of organization) and Item 10 (control persons) and corresponding schedules should be answered with respect to the Filing Adviser only (with the same information about each Relying Adviser to be provided on Schedule R, as described above).

3) Additional Information on Form ADV

The Amendments require investment advisers to disclose the following additional information on Form ADV:

a. *Adviser's Internet Presence*

Item 1.I, which previously only required that investment advisers provide their website address, now requires disclosing all websites of the adviser and all publicly available social media platforms where the adviser has a presence for which it controls the content (*e.g.*, Twitter, Facebook, LinkedIn).[9] Social media platforms must be disclosed even if they are not used to promote the investment adviser's business in the United States or are targeted towards non-U.S. clients. However, the Adopting Release clarified that neither of (i) an investment adviser's employees' social media accounts, nor (ii) the social media account of an investment adviser's unregistered affiliate that is used solely to promote the business of such affiliate, are required to be disclosed.

b. *Adviser's Physical Office Locations*

Item 1.F, which previously requested general information about an adviser's principal office and place of business, now requires advisers to provide the total number of offices in which they conduct business as well as information about their 25 largest offices, based on the number of personnel. Such information includes (i) each office's CRD branch number (if applicable); (ii) the number of employees performing advisory functions from such office; (iii) the identity from a categorical list of securities-related activities that are conducted from such

[9] The Adopting Release clarified that "[a]n adviser may control its social media content, notwithstanding the fact that a social media platform has the policy to edit or remove content (such as offensive content) across the platform."

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office; and (iv) a narrative description of any other investment-related business conducted from such office. Unlike other questions in Item 1, the changes of which require an other-than-annual amendment, Item 1.F must only be updated as a part of an investment adviser's annual updating amendment and not more frequently.

c. *Chief Compliance Officer*

Item 1.J, which previously requested the name and contact information of an investment adviser's chief compliance officer, now requires confirmation of whether the chief compliance officer is employed by someone other than the investment adviser or a related person of the investment adviser (unless it is a registered investment company advised by the investment adviser), and if so, the name and EIN (if any) of that person.

d. *Balance Sheet Assets*

Item 1.O, which previously required advisers to indicate whether they had assets of greater than $1 billion (*i.e.*, assets on the adviser's own balance sheet, not assets under management), now requires investment advisers with assets of $1 billion or more to provide a range for their total assets: $1-10 billion; $10-50 billion; or $50 billion or more.

e. *Additional Information about Advisory Business*

In addition to the new requirements set forth in Item 5 regarding SMAs (as described above), the Amendments also require investment advisers to report the number of clients and the amount of RAUM attributable to each category of clients,[10] instead of providing ranges for such information. Additionally, Item 5 will add a new requirement for an investment adviser to report the number of clients for which it provides advisory services but do not have RAUM, for instance, in the case of a non-discretionary account. The Amendments also revise the instructions to Form ADV to clarify that to the extent an investment adviser advises pooled investment vehicles, investment companies or business development companies, it should also include in its Item 5 calculations those assets that it sub-advises as well.

Finally, an investment adviser that reports its client assets in Part 2A of Form ADV differently than RAUM reported in Item 5 must now check a box noting that election.

f. *Financial Industry Affiliations; Private Fund Updates*

The Amendments require investment advisers to (i) provide identifying numbers of their related persons listed in Section 7.A of Schedule D (*e.g.*, CIK numbers and Public Accounting Oversight Board registration numbers); and (ii) with respect to any private fund listed in Section 7.B.(1) of Schedule D that is relying on the exemption set forth in Section 3(c)(1) of the Investment Company Act of 1940, confirm whether sales of the private fund are limited to "qualified clients".

4) Clarifying Amendments and Technical Changes

The Amendments also make several technical and clarifying amendments to Form ADV. Two notable clarifying changes relate to solicitation of an investment adviser's clients and audited financial statements:

[10] Due to confidentiality concerns, the SEC noted that investment advisers with fewer than five clients in a particular category (other than investment companies, business development companies and other pooled investment vehicles) may indicate that fact, instead of reporting the actual number of clients in a particular category.

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a. *Soliciting Adviser's Clients to Invest in a Private Fund*

The Amendments clarify that when answering whether the investment adviser's "clients" are solicited to invest in the private fund in Question 19 in Section 7.B.(1) of Schedule D, investment advisers **should not** consider feeder funds as "clients" of the investment adviser (*i.e.*, the master fund in a master-feeder structure).

b. *Audited Financial Statements*

The Amendments clarify that when answering whether a private fund's audited financial statements are distributed to the fund's investors in Question 23(g) in Section 7.B.(1) of Schedule D, investment advisers should answer considering the private fund's audited financial statements from the most recently completed fiscal year. Additionally, the Amendments clarify that when answering whether a report prepared by an auditing firm contains an unqualified opinion in Question 23(h) in Section 7.B.(1) of Schedule D, investment advisers should answer considering the reports prepared by the auditing firm since the investment adviser last filed its annual amendment.

5) Advisers Act Books and Records Rule Amendments[11]

Finally, the Amendments require investment advisers to maintain additional written materials related to the calculation and distribution of performance information:

a. *Removal of the 10-Person Limitation for Communication Record Retention*

The Amendments modify Rule 204-2(a)(16) of the Advisers Act to provide for the retention of all communications (whether distributed directly or indirectly) to any person demonstrating calculation of performance or rate of return. Prior to the effectiveness of the Amendments, investment advisers were only required to maintain records supporting performance claims that were distributed to 10 or more persons.

b. *Written Material Related to Performance Information*

The Amendments also require investment 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 communications received and sent relating to the performance of managed accounts or securities recommendations to be maintained. The Amendments effectively expand Rule 204-2(a)(7) of the Advisers Act, which previously only required certain categories of written communications to be maintained. Therefore, investment advisers will now be required to ensure that all communications by the investment adviser and its employees are retained on the investment adviser's recordkeeping system and that any e-mails or other communications by employees that use performance information have appropriate books and records back-up so as to comply with the Amendments.

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

[11] Investment advisers will need to comply with these recordkeeping requirements with respect to any communications or materials that are circulated or distributed after October 1, 2017, that includes performance information, including performance information that predates October 1, 2017.

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