

Form ADV Gets an Overhaul

On August 25, 2016, the Securities and Exchange Commission (“SEC”) modernized the reporting regime for investment advisers by adopting amendments to the Investment Advisers Act of 1940, as amended (the “Advisers Act”) and Form ADV (Uniform Application for Investment Adviser Registration and Report by Exempt Reporting Advisers).¹ According to the Adopting Release, the amendments were designed to fill certain data gaps and enhance current reporting to improve the depth and quality of the information collected by the SEC and to facilitate risk monitoring objectives. Along with a number of technical and clarifying changes,² the amendments to Form ADV require additional information regarding separately managed accounts (“SMAs”) and codify the “umbrella registration” method for private fund adviser registration. Indeed, the changes are so significant that the text of the General Instructions, Glossary and almost every Item of Part 1A and its related section of Schedule D will change.

The amendments also include changes to the Advisers Act books and records rule 204-2 that will require advisers to make and keep supporting documentation that demonstrates performance calculations or rates of return in any written communications that the investment adviser circulates or distributes.

The SEC adopted the amendments and revised Form ADV substantially as proposed in May 2015.³ Highlights of the amendments and the significant differences from the proposal are discussed below.

Separately Managed Accounts

The amendments include new Item 5.(K) of Part 1A and its corresponding section of Schedule D which require additional information on an aggregate basis regarding the types of assets held and the use of derivatives and borrowings in SMAs. New Item 5.K.(i) and its corresponding section of Schedule D require advisers to report the approximate percentage of SMA regulatory assets under management (“RAUM”) that are invested in twelve broad asset categories.⁴ The Adopting Proposal included ten asset categories;

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however, the final version includes a category for “Cash and Cash Equivalents” (i.e., bank deposits, certificates of deposit, bankers’ acceptances, and similar bank instruments) and “Non-Exchange-Traded Equity” in response to commenters. On an annual basis, advisers with at least \$10 billion RAUM attributable to SMAs must provide such information as of mid-year and end of year. Advisers with less than \$10 billion in RAUM attributable to SMAs must only provide such information as of end of year. According to the instructions in Section 5.K.(1). of Schedule D, advisers may use their own internal methodologies and the conventions of their service providers in determining how to categorize assets, so long as their methodologies are consistently applied and consistent with information reported internally and to current and prospective clients, but should not double count assets. Investments in derivatives, registered investment companies, business development companies, and pooled investment vehicles should be reported in those categories rather than the categories of their underlying investments.

Perhaps the most significant changes to Form ADV are found in new Section 5.K.(2) of Schedule D, which requires information regarding SMAs’ use of borrowings and derivatives. Advisers with at least \$500 million in SMA RAUM will be required to annually report the amount of SMA RAUM and the dollar amount (rather than the proposed average amount) of borrowings that correspond to three (rather than four levels proposed) levels of gross notional exposures (i.e., less than 10%, 10-149% and 150% or more) as of the date the adviser used to calculate its RAUM for purposes of the adviser’s annual updating amendment. Advisers with at least \$10 billion in SMA RAUM must annually report that same information as of the date that is six months before that date. Advisers with at least \$10 billion in SMA RAUM also must annually report, for both periods, average derivatives exposures across six categories of derivatives. As proposed, advisers may limit their reporting in Section 5.K.(2) to individual accounts of at least \$10 million. The SEC did make a few modifications from the proposal to address commenters’ concerns, but largely adopted the changes as proposed. Importantly, the SEC increased the proposed \$150 million threshold to \$500 million.

To the dismay of many commenters who expressed concern regarding the public disclosure of SMA information, the SEC still believes that public disclosure is appropriate in the public interest as well as for the protection of investors. The Adopting Release dismisses claims that SMA reporting would compromise investment strategies since the required SMA disclosure includes a limited number of data points that are presented both in aggregate and in broad categories with and time lag between those data points and any public reporting. The SEC did, however, make several changes to the proposal to address these concerns, including requiring less granular information. To avoid disclosure of client-specific information and related competition concerns, Item 5.D., which lists the number of advisory clients in categories, as adopted includes a “fewer than 5 clients” column and Section 5.K.(2) no longer requires reporting of the number of accounts.

To identify advisers who use the same custodian in the event the SEC staff becomes concerned about a particular custodian, new Section 5.K.(3) of Schedule D requires

advisers to provide identifying information for each custodian that holds 10% or more of the adviser's aggregate SMA RAUM. This disclosure is similar to the current requirement for private fund custodian's set forth in Section 7 of Schedule D.

Additional Information Regarding Advisers

The amendments to Form ADV Part 1A include several new questions and changes to existing questions in Item 1 regarding identifying information, Item 5 regarding an adviser's advisory business, and Item 7 regarding affiliations.

Item 1

In addition to Item 1 changes to accommodate the umbrella registration method discussed below, Item 1 includes a number of new inquiries regarding the adviser's identifying information. As adopted, Item 1.I. requires disclosure of whether the adviser has one or more accounts on social media platforms, such as Twitter, Facebook or LinkedIn, and the address of each of the adviser's social media pages. The required reporting is limited to accounts on social media platforms where the adviser controls the content and to accounts on publicly available social media platforms.

As instructed in the revised text of Item 1.F.(1), Section 1.F. of Schedule D will require disclosure of the 25 largest offices in terms of the number employees as of the end of the most recent fiscal year, rather than the 5 largest offices currently required. New Item 1.F.(5) also requires disclosure of the total number of offices at which the adviser conducts investment advisory business as of the end of the most recently completed fiscal year. In addition, advisers must disclose each office's CRD branch number (if applicable) and the number of employees who perform advisory functions from each office, identify from a list of securities-related activities the business activities conducted from each office, and describe any other investment-related business conducted from each office. Unlike other parts of Item 1, Item 1.F. needs to be updated only on an annual basis. As requested by a commenter, certain information for dual registrants will automatically populate by entering a branch's CRD number.

Both the Proposing and Adopting Releases highlight the SEC's increased interest in the outsourcing of advisers' compliance functions as the staff has observed a wide spectrum of both quality and effectiveness of these service providers. To enable the SEC to identify all advisers relying on a particular compliance service provider and to address potential risks associated with that service provider, the amendments include increased disclosure requirements regarding outsourced Chief Compliance Officer's ("CCO"). New Item 1.J.(2) was adopted largely as proposed to require advisers to disclose whether the adviser's Chief Compliance Officer is compensated or employed by any person other than the adviser or a related person. Based on commenters' suggestions, the adopted version also excludes any person employed by a registered investment company advised by the adviser for providing CCO services to the adviser. If the CCO is compensated by someone else, the new Item 1.J.(2) requires the adviser to provide the CCO's name and IRS Employer Identification Number (if any). Importantly, the revised

item does not require disclosure of an adviser's third party compliance consultant unless such person is designated as the CCO. As stated in the Adopting Release, based on commenter's responses to the Proposing Release requests, the SEC is not requiring advisers to report information regarding third-party compliance auditors in this final version.

Amended Item 1.O. requires advisers with assets of \$1 billion or more to report their assets within three ranges: (i) \$1 billion to less than \$10 billion; (ii) \$10 billion to less than \$50 billion; and (iii) \$50 billion or more. As stated in the Adopting Release, the purpose of this change is to provide more precise data for use in SEC rulemaking on incentive-based compensation and stress testing arising from ongoing Dodd-Frank Act implementation. In fact, the SEC staff is currently working on a recommendation to propose new requirements for stress testing by large investment advisers and large investment companies, as required by the Dodd-Frank Act.⁵

Item 5

In addition to the new SMA requirements discussed above, the amendments include numerous changes and additional disclosure in Item 5, such as (i) the approximate amount of advisory clients not included in the adviser's RAUM, (ii) whether the adviser elects to report client assets in Part 2A of Form ADV differently from RAUM reported in Part 1A, and (iii) more information regarding wrap fee programs. Significantly, the amendments replace the current requirements disclosure of approximate ranges with more precise responses for the number of advisory clients, the types of advisory clients, and RAUM attributable to client types. As discussed above, to address disclosure of client-specific information and related competition concerns, advisers with fewer than five clients in a particular category may indicate that fact rather than report the actual number of clients in the particular category for Item 5.D. Advisers will also need to provide the approximate amount of an adviser's total RAUM attributable to non-U.S. person clients to give the staff a better idea of the adviser's relationship with non-U.S. clients for risk assessment purposes.

Item 7

Item 7 includes a number of additional technical and clarifying changes regarding financial affiliates, fund of funds and distribution of audited financial statements, among other items. In particular, Question 21 of Schedule D, Section 7.B.(1) has been clarified to ask if the private fund has ever relied on Securities Act Regulation D. Now the adviser must provide the fund's Form D filing number in Question 22 if a Form D was ever filed regardless of whether the fund currently relies on the Regulation D's safe harbor.

New Question 15(b) of Schedule D, Section 7.B.(1) requires disclosure regarding "qualified client" status of private fund investors.⁶ As proposed, an adviser would have been required to report the approximate percentage of its private funds beneficially owned by qualified clients. As adopted, the question is now limited to ownership of private funds relying on Investment Company Act Section 3(c)(1) because each investor

in a private fund relying on Section 3(c)(7) of that act is required to meet the higher “qualified purchaser” standard. As adopted, the question now requires a simple yes or no response as to whether the adviser limits sales of a fund to qualified clients. Commenters expressed concerns regarding the application of this question to exempt reporting advisers (“ERAs”) who are not subject to the Advisers Act prohibitions on performance-based compensation, and therefore, do not need to rely on the rule 205-3 exemption from such prohibition. According to the Adopting Release, ERAs may respond “No” to this new question. As also clarified in the Adopting Release, advisers do not need to re-certify the qualified client status of their investors annually as long as an investor met the definition of a qualified client when it entered into the advisory contract.

Umbrella Registration

Significantly, the amendments to Form ADV better accommodate the method of filing a single umbrella registration as established in a 2012 SEC staff no-action letter for multiple private fund advisers under common control with the filing adviser; provided they conduct a single advisory business and satisfy other conditions set forth in letter.⁷ The Adopting Release notes that most advisers eligible to rely on umbrella registration are doing so, with approximately 743 filing advisers and approximately 2,587 relying advisers filing umbrella registrations. The Adopting Release also confirms the conditions for umbrella registration will continue to be those set forth in the 2012 ABA Letter.⁸ Additionally, the Adopting Release states that for purposes of umbrella registration, the SEC considers the following factors as indicia of a single advisory business: (i) commonality of advisory services and clients; (ii) a consistent application of the Advisers Act and the rules thereunder to all advisers in the business; and (iii) a unified compliance program. The conditions for umbrella registration, when satisfied together, are meant to be a strong indication of the existence of a single private fund advisory business operating through the use of multiple legal entities. Importantly, the Adopting Release confirms the requirement to determine asset-based eligibility for umbrella registration on an entity-by-entity, rather than consolidated, basis. Accordingly, the filing adviser and each relying adviser must individually have sufficient RAUM to qualify for SEC registration or qualify for an exemption from Advisers Act section 203A's prohibition (e.g., Advisers Act rule 203A-2(b), which permits an adviser to register with the SEC that would otherwise be prohibited from doing so under section 203A if the adviser is in a control relationship with a registered adviser and has the same principal office and place of business as the registered adviser).

To alleviate some of the confusion created by filing an umbrella registration on current Form ADV, new Schedule R will require the following information for each relying adviser: (i) identifying information; (ii) basis for SEC registration; (iii) form of organization and (vi) control persons. A new question to Schedule D will also require advisers to identify the filing advisers and relying advisers that manage or sponsor private funds.

The SEC declined to expand the concept of umbrella registration to ERAs because they are not required to comply with all of the conditions for umbrella registration (such as, maintaining written compliance policies and procedures and Codes of Ethics). However,

the Adopting Release clarifies that the set of Frequently Asked Questions that permits certain exempt reporting advisers to file a single Form ADV on behalf of multiple special purpose entities has not been withdrawn.⁹

Performance Advertising Books and Records

The amendments also include changes to the Advisers Act books and records rule 204-2(a)(7) and (16). Advisers that are registered or required to be registered with the SEC must maintain additional materials related to the calculation and distribution of performance information. In addition to maintaining records of the types of written communications currently listed in rule 204-2(a)(7), the amended rule will require advisers to also maintain originals of all written communications received and copies of written communications sent by the adviser relating to the performance or rate of return of any or all managed accounts or securities recommendations.

Rule 204-2(a)(16) currently requires advisers to maintain records supporting performance claims in communications that are distributed or circulated to ten or more persons. As amended, advisers will be required to maintain such records for performance claims in communications that are distributed or circulated to any person. The SEC declined to provide exclusion for one-on-one communications that are customized responses from investors or communications with sophisticated investors or clients.

Important Compliance Dates

The first time most advisers will need to file on the new Form ADV will be for their annual updating amendments in the first quarter of 2018. However, initial Form ADV filers and those filing amendments to an existing Form ADV must begin using the new Form ADV on or after October 1, 2017. Despite the voluminous changes to the Form ADV, the only material changes that should impact ERAs include certain amendments to Item 1, including the use of social media and the reporting of information on up to 25 offices, and Item 7. State registrants should note that state securities authorities are expected to consider similar changes to Form ADV Part 1B.

Although the Adopting Release includes estimates on the additional time and cost burden for completing the new Form ADV, our experience indicates preparing for the first filing on a revamped form can require significant lead-time. We highly recommend clients prepare well in advance for the additional disclosures as some advisers may need to update computer systems to obtain the newly required data.

The amendments to the books and records rule 204-2 will apply to communications circulated or distributed after October 1, 2017. However, advisers that circulate or distribute communications after October 1, 2017 that include performance information, including information on performance that predates October 1, 2017, will be required to maintain records supporting those performance claims.

In light of the multitude of the amendments, this summary does not address each and

every change adopted. For a more in depth conversation on the amendments, we invite you to join Dorsey & Whitney LLP's Private Funds Symposium on September 28, 2016. For more information, please contact Genna Garver.

¹See SEC Release No. IA-4509, August 25, 2016 (the "Adopting Release").

²Many of the technical changes are merely a reflection of the passage of time since the implementation of the Dodd-Frank Act and remove references to the special one-time transition filings for SEC registered advisers required in 2012 among other changes. Also noteworthy, Item 2.A.(9) and Section 2.A. of Schedule D has been revised to remove the term "newly formed" adviser in response to inquiries as to whether Rule 203A-2(c) is available only to those advisers who are newly formed.

³See SEC Release NO. IA-4091, May 20, 2015 (the "Proposing Release").

⁴The categories include: (i) Exchange-Traded Equity Securities; (ii) Non Exchange-Traded Equity Securities; (iii) U.S. Government/Agency Bonds; (iv) U.S. State and Local Bonds; (v) Sovereign Bonds; (vi) Investment Grade Corporate Bonds; (vii) Non-Investment Grade Corporate Bonds; (viii) Derivatives; (ix) Securities Issued by Registered Investment Companies or Business Development Companies; (x) Securities Issued by Pooled Investment Vehicles (other than Registered Investment Companies or Business Development Companies); (xi) Cash and Cash Equivalents; and (xii) Other.

⁵See <https://www.sec.gov/news/speech/andrew-donohue-investoregulation-conf-london.html>.

⁶Advisers Act Section 205(a)(1) prohibits an investment adviser from entering into, performing, renewing or extending an investment advisory contract that provides for compensation to the investment adviser on the basis of a share of the capital gains upon, or the capital appreciation of, the funds, or any portion of the funds, of a client. Advisers Act rule 205-3 provides an exemption from such prohibition provided that the client entering into the contract is a "qualified client" as defined in such rule. For purposes of the rule, each equity owner of a private fund is considered a client.

⁷See American Bar Association, Business Law Section, SEC Staff Letter (Jan. 18, 2012), available at <http://www.sec.gov/divisions/investment/noaction/2012/aba011812.htm> (the "2012 ABA Letter").

⁸To be eligible for an umbrella registration on Form ADV, the following conditions must be satisfied: (i) the filing adviser and each relying adviser advise only private funds and clients in separately managed accounts that are qualified clients (as defined in rule 205-3 under the Advisers Act) and 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 has its principal office and place of business in the

U.S.; (iii) each relying adviser, its employees and the persons acting on its behalf are subject to the filing adviser's supervision and control and, therefore, each relying adviser, its employees and the persons acting on its behalf are "persons associated with" the filing adviser (as defined in section 202(a)(17) of the Advisers Act); (iv) the advisory activities of each relying adviser are subject to the Advisers Act and the rules thereunder, and each relying adviser is subject to examination by the SEC; (v) the filing adviser and each relying adviser operate under a single code of ethics adopted in accordance with rule 204A-1 under the Advisers Act and a single set of written policies and procedures adopted and implemented in accordance with rule 206(4)-(7) under the Advisers Act and administered by a single CCO in accordance with that rule.

⁹Frequently Asked Questions on Form ADV and IARD, Reporting to the SEC as an Exempt Reporting Adviser (Mar. 2012), available at <https://www.sec.gov/divisions/investment/iard/iardfaq.shtml#exemptreportingadviser>.