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SEC Update

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SEC Form ADV Amendments and Investment Adviser Recordkeeping Rules: Compliance Deadline Quickly Approaching

The US Securities and Exchange Commission (SEC) adopted amendments to Form ADV and to Rule 204-2 (recordkeeping rule), as well as technical amendments to other rules under the Investment Advisers Act of 1940 (Advisers Act) (collectively, final rule) on August 25, 2016.[1] As a result of the final rule, advisers registering on Form ADV will be required to report additional information—with a focus on separately managed accounts (SMAs)—which will be made available to the general public. In addition, multiple private fund advisers operating as a single advisory business will be able to register using a single Form ADV. Finally, advisers will be required to comply with certain recordkeeping requirements related to written communications of performance or securities recommendations to any person. The final rule is designed to: fill what the SEC believes are certain data gaps regarding SMAs, assist the SEC in carrying out its risk-based examination program, and further other monitoring activities.

In preparing for the October 1, 2017 compliance date, advisers may need to begin collecting and retaining information now and should consider whether any changes should be made to their policies and procedures related to recordkeeping for written communications and Form ADV reporting, particularly for SMAs. This article focuses on record retention efforts that may need to take place in anticipation of the compliance date as well as SMA reporting.

Amendments to Form ADV

Disclosures Regarding Separately Managed Accounts

The final rule requires advisers to annually report in Item 5 of Form ADV and Section 5 of Schedule D the percentage of SMA regulatory assets under management (RAUM) invested in each of 12 broad asset categories that are similar to those reported by advisers to private funds on Form PF.[2] Advisers with at least $10 billion in SMA RAUM will be required to report both mid-year and end-of-year data points[3] regarding SMA RAUM invested in each of the 12 asset categories. Advisers with less than $10 billion in SMA RAUM will only be required to report end-of-year data points.

As a result of the reporting required by these form revisions, an adviser may need to report data points from before the compliance date. Advisers to SMAs will be required to provide SMA information on an aggregate basis, which means that the

adviser is required to report data based on all SMAs advised by the adviser. Advisers may use their own consistently applied internal methodologies and the conventions of their service providers to categorize assets.[4] However, advisers should not look through funds or ETFs to report the underlying asset type.

Additionally, the final rule requires that advisers identify any custodians that account for at least 10 percent of SMA RAUM and the amount held at each custodian.

Derivatives and Borrowings

Certain advisers, based on asset levels, will need to provide information for derivatives and borrowings in Section 5.K. of Schedule D:

- *Advisers with at least $500 million*. The final rule requires advisers[5] to report the amount of SMA RAUM and dollar amount of borrowings attributable to those assets, based on three categories of gross notional exposure: less than 10 percent, 10–149 percent, and 150 percent or more.
- *Advisers with at least $10 billion*. In addition to the reporting described above, the final rule requires these advisers to report (based on SMA RAUM) the derivatives exposure in each of six categories of derivatives.[6] Information regarding borrowings must be reported based on the total dollar amount of borrowings that corresponds to the different ranges of gross notional exposure. An adviser also may include a narrative description of how the adviser uses derivatives and borrowings in its management of SMAs. These advisers will be required to report both mid-year and end-of-year information.

Item 5 FAQs

On June 12, 2017, the SEC published updated Frequently Asked Questions on Form ADV (FAQs).[7] The FAQs address a number of aspects of Form ADV, including Item 5.D. reporting requirements. With respect to Item 5.D. relating to reporting client categories, the FAQs state that where an advisory firm acts as a subadviser to an investment company, business development company, or pooled investment vehicle, the firm is considered, for purposes of Form ADV, to be providing advice to such company or vehicle and should report those relationships as such, rather than reporting those relationships as "other investment advisers." The FAQs also clarify that when an adviser does not have any clients in a particular category, the adviser should report "0" in column 5.D.(1), "Number of Client(s)" instead of checking the box in Item 5.D.(2), "Fewer than 5 Clients."

Additionally, with respect to Item 5.D., the FAQs state that "pooled investment vehicles" are not limited to private funds. Whether other types of funds (aside from investment companies or business development companies) should be considered pooled investment vehicles depends on the facts and circumstances. In the Final Rule Release, the Staff stated that advisers should classify funds in a manner that is consistent with reporting internally and in regulatory filings.[8] The FAQs state that the following would be considered pooled investment vehicles: funds that would be investment companies but for Sections 3(c)(5) or 3(c)(11),[9] UCITS,[10] and a fund of one (in certain circumstances).[11] While the FAQs explicitly reference 3(c)(5) and 3(c)(11) funds, a 3(c)(3) common trust fund, a charitable fund (3(c)(10)), and a securitization relying on rule 3a-7 also could be considered pooled investment vehicles.

The FAQs state that, with respect to borrowing transactions on behalf of an adviser's SMA clients, the following should be considered borrowings in connection with reporting on Item 5.K.(2) and Schedule D, Section 5.K.(2): traditional lending activities, secured and unsecured borrowings, synthetic borrowings, transactions selling securities short, and transactions in which variation margin is used but has not been paid by the client. The FAQs further note that the adviser should not report as borrowings leverage resulting from the use of derivatives, securities lending, or repurchase agreements. The FAQs clarify, however, that advisers are not required to report client borrowings of which they

are not aware (for example, when a client borrows money to invest in an SMA). However, it is not clear if the FAQs take a position on an adviser's reporting obligations when the adviser is aware of, but not involved in, a borrowing. Depending on the facts and circumstances, the Staff may consider an adviser's awareness (that account assets contain borrowing proceeds) sufficient to warrant a "yes" response to Item 5.K.(2), which asks whether the adviser engages in borrowing transactions on behalf of an SMA client.

With respect to Item 5.K.(3), the FAQs note that an adviser is not required to report a sub-custodian when a custodian that holds 10 percent or more of an SMA client's RAUM has arranged to use a sub-custodian for some custodial services.

Amendments to Investment Advisers Act Rules

Amendments to the Recordkeeping Rule

The final rule includes two amendments to the recordkeeping rule. First, Rule 204-2(a)(16) now requires advisers to document and preserve calculations that support performance claims made in materials distributed, directly or indirectly, to *any person*. Previously this reporting only applied to claims distributed or circulated to 10 or more persons.

Second, the SEC amended rule 204-2(a)(7) to add that advisers must maintain originals of all written communications received and copies of written communications sent relating to the performance or rate of return of any or all managed accounts or securities recommendations. Previously rule 204-2(a)(7) required advisers to maintain only certain categories of written communications received and sent.[12] The amendments add another category: "[t]he performance or rate of return of any or all managed accounts or securities recommendations."

Other FAQs

The updated FAQs also address certain issues with respect to Item 1 of Form ADV. The final rule requires disclosure of any social media accounts used by the adviser where the adviser controls the content, including the addresses of the adviser's social media pages. The FAQs caution that, in certain circumstances, an adviser thus may be required to disclose the addresses of websites or accounts on publicly available social media platforms, even when the parent company of the adviser creates and maintains the account. Additionally, with respect to Item 1.O. (which requires an adviser to indicate whether it had $1 billion or more in total assets shown on the adviser's balance sheet as of the last day of the adviser's most recent fiscal year end), the FAQs state that non-proprietary assets, such as client assets under management, should be excluded, regardless of whether they appear on an adviser's balance sheet. In a series of FAQs regarding new Schedule R, the Staff indicates that it is withdrawing its response to Question 4 of the 2012 ABA letter relating to relying advisers.[13]

Conclusion

The compliance date for Form ADV amendments is October 1, 2017. For communications or materials circulated or distributed after October 1, 2017, advisers must comply with the above recordkeeping requirements.[14]

Advisers filing an initial Form ADV, an annual updating amendment, or an other than annual updating amendment on or after October 1, 2017, will be required to provide responses to the form revisions indicated in the final rule. Despite the fact that the General Instructions state that Item 5 does not need to be updated if an adviser is submitting an other than annual amendment, we understand that completeness checks will require the completion of all new questions. However, we understand that it is possible for an adviser filing an other than annual updating amendment on or after October 1, 2017 to use placeholder values of "0" or other placeholder values to pass completeness checks, and that the miscellaneous section of Schedule D can be used to clarify the use of such placeholder values.

Pre-release testing of the CRD/IARD system will take place from July 17 until September 29 and Release Notes will be posted on the Financial Industry Regulatory Authority website in September. The last day filers will be able to submit the old Form ADV will be September 29; however, pending Form ADV filings will not be invalidated due to the release. The new Form ADV will be deployed on Sunday, September 30 with a go-live date of Monday, October 1.

NOTES

1 Form ADV and Investment Advisers Act Rule, Rel. No. IA-4509 (Aug. 25, 2016) (Final Rule Release). The amendments were proposed on May 20, 2015 with a comment period ending August 11, 2015.

2 The categories are: (i) exchange-traded equity securities, (ii) non-exchange-traded equity securities, (iii) US government/agency bonds, (iv) US 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), (xi) cash and cash equivalents, and (xii) other. Final Rule Release, Appendix D, Amended Form ADV, Part 1A, Schedule D, Section 5.K.(1).

3 Section 5.K.(1) and (2) clarify that "[e]nd of year refers to the date used to calculate your regulatory assets under management for purposes of your *annual updating amendment*. Mid-year is the date six months before the end of year date." (Emphasis added). *See also* Final Rule Release, Section II.A.1.b at n.12; Section II.A.1.e at n.63; Section VI.E. at n.449.

4 Final Rule Release, Section II.A.1.b at n.22; Comment Letter of Dechert LLP to Proposal (Aug. 11, 2015) (Dechert Letter), Section I.B.

5 Notably, advisers may, but are not required to, complete the table with respect to SMAs with RAUM of less than $10 million. Final Rule Release, Section II.A.1.c at n.34; Dechert Letter, Section III.C.

6 The six types of derivatives are: (i) interest rate derivatives, (ii) foreign exchange derivatives, (iii) credit derivatives, (iv) equity derivatives, (v) commodity derivatives, and (vi) other derivatives.

7 Division of Investment Management: Frequently Asked Questions on Form ADV and IARD (as of the date of this publication, last modified June 12, 2017); IM Information Update, Division of Investment Management, "Updates to Form ADV Frequently Asked Questions," No. 2017-04 (June 2017).

8 Final Rule Release, Section II.A.1.b.

9 FAQ Item 5.D. provides that "funds that would be investment companies as defined in section 3 of the Investment Company Act but for sections 3(c)(5) or 3(c)(11) of that Act would typically be considered pooled investment vehicles in Item 5.D."

10 FAQ Item 5.D. provides that "UCITS funds that are regulated by the European Commission and that are not registered under the Investment Company Act would also typically be considered pooled investment vehicles in Item 5.D."

11 The FAQs also provide guidance regarding the extent to which an adviser should treat a single-investor fund as a pooled investment vehicle. In particular, the FAQs state that an adviser generally should not consider a single-investor fund to be a pooled investment vehicle if that entity in fact operates as a means for the adviser to provide individualized investment advice directly to the investor in the fund.

12 Advisers are currently required to maintain the originals of all written communications received and copies of all written communications sent relating to: (i) any recommendations made/proposed and any advice given or proposed, (ii) any receipt, disbursement or delivery of funds or securities, and (iii) the placing or execution of any order to purchase/sell. Rule 204-2(a)(7). *See also* Final Rule Release, Section II.B.1.

13 American Bar Association, Business Law Section, SEC Staff No-Action Letter (Jan. 18, 2012).

14 Final Rule Release, Section II.B.1.