SEPTEMBER 9, 2016

SIDLEY UPDATE

SEC Adopts Form ADV Amendments to Require Reporting on Separately Managed Accounts and Clarify "Umbrella" Registration

On August 25, 2016, the Securities and Exchange Commission ("SEC") adopted amendments to Form ADV and to the books and records rule under the Investment Advisers Act of 1940 (the "Amendments").[1] The Amendments, among other things:

- Require advisers to provide specific information about separately managed accounts ("SMAs") (i.e., advisory accounts that are not pooled investment vehicles), including the types of assets held and the use of derivatives and borrowings to fill in existing data gaps;
- Streamline and standardize the process of "umbrella" registration of related advisers on one Form ADV;
- Require advisers to maintain additional materials related to the calculation and distribution of performance information to better protect investors from fraudulent investment performance claims; and
- Provide ADV disclosure regarding social media, outsourced compliance officers and multiple office locations.

In addition, the SEC made amendments to certain ADV items and instructions and several technical amendments to other Advisers Act rules.

The Amendments were proposed on May 20, 2015[2] and have a compliance date of October 1, 2017.

Amendments to Form ADV Part 1A

Information Regarding SMAs

As noted in the Release, advisers to private funds report detailed information on Form PF about the private funds they manage, but the SEC staff currently collects only a small amount of specific information regarding SMAs. The Amendments require all registered advisers to provide aggregate information regarding the SMAs

[1] "Form ADV and Investment Advisers Act Rules," Investment Advisers Act Release No. 4509 (August 25, 2016) (the "Release"), available at: https://www.sec.gov/rules/final/2016/ia-4509.pdf.

[2] "Amendments to Form ADV and Investment Advisers Act Rules," Investment Advisers Act Release No. 4091 (May 20, 2015) (the "Proposing Release"), available at: http://www.sec.gov/rules/proposed/2015/ia-4091.pdf. *See also*, Sidley Update, "SEC Proposes Form ADV Amendments to Require Reporting on Separately Managed Accounts and Clarify 'Umbrella' Registration" (June 2, 2015), available at: http://www.sidley.com/en/news/06-02-2015-investment-funds-advisers-and-derivatives-update.

they advise. Sub-advisers are required to provide information only about the portions of SMAs that they sub-advise. Each adviser whose principal office and place of business is outside of the United States is required to report information regarding all of its SMAs, including SMAs owned by non-U.S. persons.[3]

According to the Release, the SEC believes that collecting additional information about SMAs will assist the staff's risk-based examination program and other risk assessment and monitoring activities. The SEC also believes that including such information about SMAs in the publicly available Form ADV may improve the ability of clients and potential clients to make more informed decisions about the selection and retention of investment advisers.

Asset Categories. SMA advisers will be required to report the approximate percentage of SMA regulatory assets under management ("RAUM") invested in 12 broad asset categories, such as exchange-traded equity securities, U.S. government/agency bonds, derivatives, cash and cash equivalents. The SEC will permit advisers to use reasonable methodologies in selecting a category in which to report a particular asset if the correct category is uncertain, as long as those methodologies are consistent with the adviser's internal and client reporting.

Borrowings and Derivatives. Advisers with at least $500 million in SMA RAUM (increased from $150 million as proposed) are required to provide additional information, on an aggregate basis, on the use of borrowings and derivatives in individual SMA accounts with at least $10 million in RAUM.[4]

- Advisers with at least $500 million but less than $10 billion in SMA RAUM are required to report the RAUM and the dollar amount of borrowings attributable to those assets that correspond to three levels of gross notional exposure.[5]
- Advisers with at least $10 billion in SMA RAUM are required to report the gross notional exposure and borrowing information described above, as well as the derivatives exposure across six different categories of derivatives.

According to the Release, some commenters raised questions and concerns regarding the use of gross notional metrics for assessing the use of derivatives and borrowings in SMAs. In supporting the use of that measure, the SEC staff noted that gross notional metrics are commonly used and are comparable to the information collected on Form PF regarding private funds. The SEC staff also stated its belief that for most types of derivatives, gross notional metrics generally provide a measure that is sufficient for the intended regulatory purpose, which is to collect information about the scale of an account's derivatives activities, rather than to collect specific risk metrics or more granular information regarding the ways in which derivatives are used in an SMA.

Form ADV, as amended, also provides advisers the option of including a narrative description of the strategies and/or manner in which borrowings and derivatives are used in SMA management. The Release noted that to the extent an adviser is concerned that disclosure of gross notional metrics would be misleading, the adviser

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[3] Although such an adviser is not generally required to report on funds in Form ADV Schedule D or in Form PF that are not (1) United States persons, (2) offered in the United States, or (3) beneficially owned by any United States persons, the Release noted that Form ADV Item 5 does not exclude these funds from the adviser's reporting regarding regulatory assets and client types. The Release further indicated that excepting SMAs owned by non-U.S. persons and advised by non-U.S. advisers would "hamper the utility of the data collection in Item 5, which collects aggregate, census-type information regarding the adviser's total business," and that the data is needed "to better inform the SEC staff and the public about this segment of the investment adviser industry."

[4] Advisers in this category also may elect to report on the use of borrowings and derivatives in SMA accounts with less than $10 million in RAUM.

[5] The three categories of gross notional exposure are: less than 10%, 10—149% and 150% or more.

could provide, in the space provided, an additional narrative description regarding the use of derivatives in those accounts.

Annual Reporting. Advisers with at least $10 billion in RAUM attributable to SMAs are required to annually provide both mid-year and year-end data regarding asset categories and borrowings and derivatives, while advisers with less than $10 billion in RAUM will report only year-end information.

Custodians. SMA advisers also are required to identify any custodians that account for 10 percent or more of their SMA RAUM, as well as the amount of RAUM attributable to SMAs held at the custodian. The Release stated that if, for example, concerns arise regarding a particular custodian, this information will allow the SEC to identify advisers whose clients use the same custodian.

Reporting of Additional Information Regarding Investment Advisers

The SEC also added several new, and amended certain existing, items regarding advisers and their advisory businesses and made other clarifying and technical amendments to Form ADV. The revisions and additions require an adviser (including exempt reporting advisers as to certain of the additions), among other things, to:

- Provide information regarding the adviser's use of social media platforms such as Twitter, Facebook and LinkedIn, including the adviser's social media addresses, where the adviser controls the content. The Release noted that the SEC may use this information to help prepare for adviser examinations and compare information that advisers disseminate across different social media platforms.
- Report the total number of offices at which the adviser conducts investment advisory business and information about the adviser's 25 largest offices in terms of number of employees.
- Report the RAUM of all parallel managed accounts related to a registered investment company (or series thereof) or business development company that is advised by the adviser and which follow substantially the same investment strategy. According to the Release, this requirement will permit the SEC to consider how an adviser manages conflicts of interest between parallel managed accounts and the registered investment companies or business development companies it advises.
- Provide information regarding outsourced chief compliance officers. Advisers must report whether the adviser's chief compliance officer is compensated or employed by any third party for providing such services, and, if so, provide the name of the third party. The Release notes that the SEC has observed a wide spectrum of both the quality and effectiveness of outsourced chief compliance officers. According to the Release, identifying information for these third-party service providers will allow the SEC to identify all advisers relying on a particular outsourced chief compliance officer or firm and could be helpful in assessing potential risks.

Umbrella Registration

The SEC also adopted amendments to Form ADV addressing the requirements and process for "umbrella" registration for certain advisers to private funds, as previously outlined in SEC staff guidance provided in 2012.[6]

[6] American Bar Association, Business Law Section, SEC Staff Letter (January 18, 2012), available at: http://www.sec.gov/divisions/investment/noaction/2012/aba011812.htm. *See also* Sidley Update, "SEC Issues Much Anticipated Investment Adviser 'Umbrella' Registration Guidance" (January 26, 2012), available at: http://www.sidley.com/en/news/sec-issues-much-anticipated-investment-adviser-umbrella-registration-guidance-01-26-2012.

Under Form ADV, as amended, a private fund adviser (the "filing adviser") may elect to file a single Form ADV on behalf of itself and one or more other advisers (each, a "relying adviser"), provided that they conduct a single advisory business. According to the Release, the umbrella registration concept was designed to consolidate multiple registration forms otherwise required of advisers conducting a single advisory business advising private funds and certain "qualified clients,"[7] but not to alter the eligibility requirements for SEC registration.

The conditions for umbrella registration set forth in the previous guidance are reflected in the revised Form ADV instructions. These conditions include:

- Each relying adviser is controlled by, or under common control with, the filing adviser, and the filing adviser and the relying adviser(s) conduct a single advisory business;
- The filing adviser and each relying adviser advise only private funds and SMA clients that are qualified clients 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;
- The filing adviser's principal office and place of business is in the United States, so that all of the substantive provisions of the Advisers Act and its rules apply to the filing adviser's and each relying adviser's dealings with each of its clients;[8]
- 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;[9]
- The advisory activities of each relying adviser are subject to the Advisers Act and each relying adviser is subject to examination by the SEC; and
- The filing adviser and each relying adviser operate under a single code of ethics and a single compliance program, administered by a single chief compliance officer, subject to differing obligations with respect to relying advisers operating in different jurisdictions.

A new Schedule R must be filed for each relying adviser, including identifying information, the adviser's basis for SEC registration and information regarding the adviser's owners and executive officers.

No "Adviser Lite" Treatment for Relying Advisers. To qualify for umbrella registration, the filing adviser must be a U.S.-based adviser. Moreover, while non-U.S. registered advisers that file separately are not required to comply with the full panoply of Advisers Act requirements with respect to their non-U.S. clients, non-U.S. relying advisers under umbrella registration are subject to the full scope of Advisers Act requirements with respect to all of their clients. The SEC also stated that umbrella registration is not applicable for an organization where all of the advisers have their principal offices and places of business outside of the United States because the staff would not have access to, nor be able to readily examine, the filing and relying advisers.

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[7] As defined in Advisers Act Rule 205-3.

[8] This condition may subject a non-U.S. relying adviser to Advisers Act requirements with respect to its non-U.S. clients that such adviser would not be required to meet if it registered using its own separate Form ADV.

[9] As defined in Section 202(a)(17) of the Advisers Act.

Although requested by some commenters, the SEC did not expand the scope of umbrella *registration* to include "umbrella *reporting*" by exempt reporting advisers.[10]

Amendments to Books and Records Rule

The amendments to Rule 204-2, the Advisers Act books and records rule, require advisers that are registered or required to be registered with the SEC to maintain additional materials related to the calculation and distribution of performance information.

- The rule currently requires advisers to maintain records supporting performance claims in communications that are distributed or circulated to ten or more persons. The amendment removes the "ten or more persons" condition, requiring advisers to retain the required materials demonstrating the calculation of the performance or rate of return in any communication that is circulated or distributed, directly or indirectly, to *any* person.
- The rule currently requires advisers to maintain certain categories of written communications received and copies of written communications sent. The amendment adds a new category of communications that must be maintained — all communications relating to the performance or rate of return of all managed accounts or securities recommendations. The Release noted that the SEC staff believes most advisers currently maintain this information.

Compliance Dates

Any adviser filing an initial Form ADV or an amendment to a Form ADV on or after **October 1, 2017** (the "Compliance Date") will be required to complete the revised Form ADV, to the extent applicable. Most advisers will likely first address the revised Form ADV requirements when filing their annual updating amendments in 2018.

The Rule 204-2 amendments will apply to communications circulated or distributed after the Compliance Date. Advisers that distribute performance-related communications after the Compliance Date that include information on performance generated prior to the Compliance Date are required to maintain the materials listed in amended Rule 204-2 demonstrating the calculation of such prior performance.

If you have any questions regarding this Sidley Update, please contact the Sidley lawyer with whom you usually work, or

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[10] The Form ADV Amendments regarding umbrella registration do not appear to affect previous SEC staff guidance regarding combined use by a registered adviser or an exempt reporting adviser of a single Form ADV filing for both the adviser and its affiliated advisory entities that are special purpose vehicles or special purpose entities (in the case of, for example, affiliated advisers that act as managing member and investment manager of a limited liability company private fund).

Investment Funds, Advisers and Derivatives Practice

Sidley has a premier, global practice in structuring and advising investment funds and advisers. We advise clients in the formation and operation of all types of alternative investment vehicles, including hedge funds, fund-of-funds, commodity pools, venture capital and private equity funds, private real estate funds and other public and private pooled investment vehicles. We also represent clients with respect to more traditional investment funds, such as closed-end and open-end registered investment companies (*i.e.*, mutual funds) and exchange-traded funds (ETFs). Our advice covers the broad scope of legal and compliance issues that are faced by funds and their boards, as well as investment advisers to funds and other investment products and accounts, under the laws and regulations of the various jurisdictions in which they may operate. In particular, we advise our clients regarding complex federal and state laws and regulations governing securities, commodities, funds and advisers, including the Dodd-Frank Act, the Investment Company Act of 1940, the Investment Advisers Act of 1940, the Securities Act of 1933, the Securities Exchange Act of 1934, the Commodity Exchange Act, the USA PATRIOT Act and comparable laws in non-U.S. jurisdictions. Our practice group consists of approximately 120 lawyers in New York, Chicago, London, Hong Kong, Singapore, Shanghai, Tokyo, Los Angeles and San Francisco.