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Revised Form ADV: What CCOs Need to Know

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On Aug. 25, 2016, the **Securities and Exchange Commission** adopted final rules intended to update and enhance the disclosure requirements promulgated under the Investment Advisers Act of 1940—primarily by revising Form ADV. The final rules, which became effective on October 31, 2016 and have a compliance date of Oct. 1, 2017, are substantial and wide-ranging, and chief compliance officers should take note both of their provisions and the potential implementation issues they raise. **INCREASE IN SMA DISCLOSURES** Among the most significant amendments to Form ADV are those related to the disclosure of assets held in separately managed accounts. Advisers will now be required to disclose the approximate percentage of SMA assets that are invested in 12 broad asset categories, including exchange-traded equity securities, U.S. government bonds and derivatives. This classification requirement presents a practical concern as certain SMA assets may not fit squarely within a single category. The SEC will allow advisers to use their own classification methodology for such assets, "so long as their methodologies are consistently applied and consistent with information the advisers report internally." But what sounds like well-intentioned deference may not be as beneficial to advisers as it seems. In fact, it may trap unwary advisers, leaving them unable to change internal classification methodologies later. Perhaps more surprisingly, the new SMA disclosure requirements may be of marginal utility with respect to SMAs holding significant interests in funds, such as exchange-traded funds, mutual funds, hedge funds and private equity funds. Indeed, despite the wide variations among fund asset allocations, the amendments only require advisers to disclose the amount of fund assets held in SMAs. Advisers are expressly told not to look through such funds with respect to the underlying exposure to the various asset categories. The lack of a look-through mechanism means that the SEC and current and potential advisory clients may garner little information from the new disclosure requirements. This is particularly true with respect to advisers that primarily use funds in SMAs. For example, if nearly all of an adviser's SMA assets are invested in funds, the new disclosure requirements will provide almost no meaningful insight regarding the risk, diversification or strategies used by the adviser in SMAs. This issue will only grow more pronounced as advisers increasingly use ETFs and other fund-based strategies. **UMBRELLA REGISTRATION** Another noteworthy amendment to Form ADV tries to make umbrella registration more efficient. The SEC first allowed umbrella registration through no-action letter guidance in response to the new adviser registration requirements set forth in the Dodd-Frank Act. Today, around 743 filing advisers and 2,587 relying advisers are using umbrella registrations. The SEC believes this represents nearly all advisers entitled to use umbrella registration. With umbrella registration already in extensive use, the true effect of these amendments is to codify the conditions that must be met before it can be employed. According to the SEC, this was done "to limit eligibility for umbrella registration to groups of private fund advisers that operate as a single advisory business." The Commission received a number of comment letters regarding umbrella registration that favored relaxing the requirements. Specifically, some objected to the condition that the filing adviser and relying advisers operate under a single code of ethics and a single set of written policies and procedures administered by a single CCO. But the SEC did not alter its position. The agency's focus on limiting the applicability of umbrella registration did not address a surprisingly popular practice whereby one or more advisers under common control, but organized as distinct entities, avoid registration entirely. In such circumstances, advisers specifically do not meet the requirements for umbrella registration and each adviser tries to rely on its own exemption from registration. This seems like a missed opportunity by the SEC to address a practice that one could argue is simply doing indirectly what is prohibited from being done directly. **SOCIAL MEDIA DISCLOSURE** Nestled among the amendments that will impact advisers immediately is one that, although somewhat significant today, will likely become even more important over time. Form ADV now requires disclosure of the adviser's social media accounts and the address of each of the adviser's social media pages. The SEC plans to use this information to prepare for examinations of advisers and compare information that advisers disseminate across different platforms. We anticipate that SEC examiners will have heightened interest in advisers' use of social media. Moreover, we believe this additional disclosure will lead to significantly more deficiencies and, potentially, enforcement related to the adviser recordkeeping and performance marketing rules. **CLARIFYING AMENDMENT AND TECHNICAL CHANGES** In addition to the changes discussed above, the SEC has made numerous amendments designed to clarify Form ADV and its instructions. Although the clarifying and technical amendments are too numerous to cover adequately here, an overview of the changes to Item 7, which the SEC revised significantly, provides an illustrative example. Item 7.A., which requires advisers to disclose whether their related persons fall within certain financial industry categories, will now state that advisers need not disclose that some of their employees perform investment advisory functions or are registered representatives of a broker/dealer, since this information is reported elsewhere in Form ADV. In a similar vein, Item 7.B asks whether an adviser serves as an adviser to a private fund and Section 7.B.(1) is where further information is provided. The SEC has added an explanation that Section 7.B.(1) of Schedule D should not be completed for a fund if another registered adviser or SEC-exempt reporting adviser reports the information. These amendments are likely to improve the overall quality of disclosure in Form ADV by making it more consistent among advisers. **BOOKS AND RECORD RULES** The SEC has also amended Rule 204-2, the books and records rule, under the Advisers Act. Rule 204-2(a)(16), which at present requires advisers to maintain records supporting performance claims in communications that are distributed to 10 or more persons, will now require records to be maintained for any performance claims distributed to any person. In addition, Rule 204-2(a)(7) will now require advisers to maintain originals of all written communications received and copies of all written communications sent by an adviser relating to the performance or rate of return of any managed accounts or other securities recommendations. We believe these amendments to the books and records rule will have a limited impact on advisers because most advisers already maintain this information. ***John Sanders*** *is an associate based in the firm's Winston-Salem, North Carolina office.*