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Form ADV

The SEC's Recent Revisions to Form ADV and the Recordkeeping Rule: What Investment Advisers Need to Know About Retaining Performance Records and Disclosing Social Media Use, Office Locations and Assets Under Management (Part Two of Two)

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On August 25, 2016, the SEC adopted much-anticipated amendments to Form ADV, Part 1A and to Rule 204-2 (recordkeeping rule) under the Investment Advisers Act of 1940 (Advisers Act). These amendments further the SEC's agenda to gather more information about its registrant base to inform the agency's risk-based approach to adviser examinations. See "OCIE Director Marc Wyatt Details Use of Technology and Coordination With Other Agencies to Execute OCIE's Four-Pillar Mission" (Nov. 3, 2016).

Although the compliance date for the amendments is October 1, 2017 (Compliance Date), advisers should take steps to update their recordkeeping policies and procedures in advance of the Compliance Date.

This two-part series will review the amendments to Form ADV and the recordkeeping rule and provide practical guidance to SEC registered investment advisers on the steps to take prior to the Compliance Date to ensure their firms are prepared to comply with the amended rules. This second article in the series discusses the new disclosure requirements relating to an adviser's use of social media; office locations; the amount of an adviser's proprietary assets and assets under management; the sale of 3(c)(1) fund interests to qualified clients; and the recordkeeping requirements regarding performance claims in communications that are distributed to any person. The first article reviewed the detailed disclosures that advisers will be required to provide with respect to managed account clients and the firm's chief compliance officer (CCO), as well as factors to consider when pursuing an umbrella registration.

For more on Form ADV, see "How Can Hedge Fund Managers Rebut the Presumption of Materiality of Certain Disciplinary Events in Form ADV, Part 2?" (Jan. 5, 2012); and "Recent SEC Enforcement Action Demonstrates the SEC's Focus on the Accuracy and Consistency of Disclosures by Hedge Fund Managers in Form ADV" (Jan. 5, 2012).

Amendments to Form ADV

Social Media Platforms

The revisions to Form ADV will require an investment adviser to report information regarding its use of social media platforms. According to the adopting release, the information may be helpful to the SEC in preparing for adviser examinations and comparing information disseminated across different social media platforms.

While identifying "Twitter, Facebook [and] LinkedIn" as examples of social media, the SEC did not provide a definition of the term "social media platform." Accordingly, investment advisers will need to remain cognizant of their reporting obligations in light of the ever-developing area of electronic media. See "How Can Fund Managers Address the Regulatory, Compliance, Privacy and Ethics Issues Raised by Social Media?" (Nov. 21, 2012).

An adviser will only be required to report those social media platforms where it controls the content. See "Does Social Media Have a Place in the Hedge Fund Industry?" (Feb. 9, 2012). The adopting release did not specify whether an adviser using its social media account to generate content on a platform administered by another party would need to provide information regarding that platform on the revised Form ADV.

In addition, the adopting release specifies that social media accounts of an adviser's employees will not be required to be identified. This line, however, can become blurred where the principal of an eponymous investment advisory firm uses his or her personal social media account(s) in connection with the firm's business.

In light of these new reporting requirements, to the extent that they have not already done so, investment advisers should consider strictly segregating business-related content to social media platforms branded, maintained and controlled by the firm.

While only social media accounts that are publicly available will be required to be reported, the adopting release does not expressly articulate whether closed-group, invitation-only forums are specifically excluded from identification. Given the myriad customized accessibility options for electronic platforms, advisers will be well advised to consider whether to disclose social media platforms that offer broad-based accessibility across a diverse user set, even where those platforms are not thought to be truly open-source.

To the extent it has not already done so, an adviser should also determine which employee or employees will be assigned to monitor and update the firm's social media accounts. It will be advisable for these employees to familiarize themselves with the Guidance Update from the SEC's Division of Investment Management that discusses advisers' use of social media in light of the prohibitions on the use of client testimonials for promotional purposes under the Advisers Act. See "SEC Issues Guidance for Investment Advisers on the Interplay of the Testimonial Rule and Social Media" (Apr. 18, 2014).

In addition, given the recordkeeping complexities inherent in the dynamically changing environment that is social media, it is prudent for investment advisers to ensure that all social media content is captured, arranged and indexed in a way that will permit easy location, access and retrieval of any particular social media record. This should include reviewing any arrangements with specialized outside vendors retained for electronic recordkeeping purposes. See "K&L Gates Investment Management Seminar Provides Guidance for Hedge Fund Managers on Social Media, Pay to Play Rules, ERISA Rule Changes, AIFMD, SEC Examination and Enforcement Priorities, Form PF, the JOBS Act, CPO Regulation and FATCA" (Jan. 24, 2013).

Office Locations

The revised Form ADV will require advisers to report information about the 25 largest offices at which they conduct their investment advisory businesses. As the adopting release notes in a footnote that approximately 98% of advisers reported having 25 or fewer offices, this will result in the vast majority of advisers being required to report all of their office locations.

While the adopting release does not define the scope of the term "investment advisory business," Form ADV does include research within the term "investment advisory functions" in Item 5.B.(1). Additionally, Rule 222-1 of the Advisers Act defines an investment adviser's place of business to include "[a]n office at which the investment adviser regularly . . . solicits, meets with, or otherwise communicates with clients."

Given the broad and undefined nature of the term, advisers will need to determine whether "home office" and other non-traditional work locations should be reported. In addition, as always, SEC-registered investment advisers will need to remain mindful of applicable state notice-filing and investment adviser representative registration requirements. State requirements vary by jurisdiction and investment advisers should consider the local implications of operating a broad-based advisory enterprise.

Reporting Adviser Proprietary Assets

In connection with the SEC's joint proposed incentive compensation rule, the revised Form ADV will require investment advisers to report whether they have assets in three distinct ranges:

1. $1 billion to $50 billion;
2. $50 billion to $250 billion; and
3. $250 billion or greater.

As with the proposed incentive compensation rule, the adopting release notes that an adviser should use the total assets shown on the adviser's balance sheet for the most recent fiscal year-end.

In footnote 64 to the proposing release for the incentive compensation rule, the SEC noted that it will, based on facts and circumstances, treat as a single investment adviser two or more affiliated investment advisers that are separate legal entities but are operationally integrated. Under this interpretation, it appears that the SEC expects the assets reported on the Form ADV of a group of affiliated advisers utilizing umbrella registration to reflect both the filing and relying advisers' total assets.

Provided that the proposed incentive compensation rules are adopted substantially as proposed, an adviser exceeding the $1 billion in proprietary assets threshold would be designated as a "Level 3" covered institution under the proposed incentive compensation rules. Generally, the compliance and reporting requirements applicable to Level 3 covered institutions would be limited to a prohibition against establishing or maintaining any type of incentive-based compensation arrangement, or any feature of any such arrangement, that encourages inappropriate risks by the covered institution: (1) by providing a covered person with excessive compensation, fees or benefits; or (2) that could lead to material financial loss to the covered institution.

A Level 3 covered institution also would be required to create annually, and maintain for a period of at least seven years, records that document the structure of all its incentive-based compensation arrangements and demonstrate compliance with the rule. At a minimum, the records would need to include copies of:

1. all incentive-based compensation plans;
2. a record of who is subject to each plan; and
3. a description of how the incentive-based compensation program is compatible with effective risk management and controls.

Under the proposed incentive compensation rule, Level 3 covered institutions would not be required to report the actual amount of compensation, fees or benefits of individual recipients as part of the disclosure and recordkeeping requirements.

Reporting Adviser Assets Under Management

The revised Form ADV will include a new table in Item 5.D where registered investment advisers will be required to report the number of clients and amount of regulatory assets under management (RAUM) attributable to specified categories of clients. See "Registration, Reporting, Disclosure and Operational Consequences for Hedge Fund Managers of the SEC's New 'Regulatory Assets Under Management' Calculation" (Mar. 1, 2012).

The adopting release lays out a number of areas of guidance in completing this table, including in the areas of sub-advisory relationships and instances where a particular client arrangement could be interpreted to fall into more than one of the categories. When completing this table, advisers should document the internal methodologies used to generate the data to ensure consistency year-over-year, and for any departures to be valid, well reasoned and appropriately memorialized. In addition, the aggregate amount of RAUM reported in the table in Item 5.D will need to equal the total amount of RAUM reported in Item 5.F.(2)(c) of Form ADV.

The revised Form ADV also will require an adviser to indicate in new Item J.(2) whether client assets reported in Item 4.E. of Form ADV, Part 2A are computed using a different method (*e.g.*, a net asset value-based methodology) than the method used to compute RAUM. Advisers are reminded that the existing instructions to Part 2A provide that if an adviser chooses to use a different method to compute client assets it manages for purposes of Part 2A, Item 4 than from Part 1A, it must keep documentation describing the method that it uses.

Finally, as always, advisers to private funds should ensure that assets under management coordinate with the valuations reported to the funds' investors and that such calculations are conducted in accordance with any established valuation polices or provisions in the relevant funds' governing documents.

§3(c)(1) Fund Sales to Qualified Clients

The amendments will add a question to Section 7.B.(1) of Form ADV, Schedule D, requiring advisers to private funds excluded under §3(c)(1) of the Investment Company Act of 1940 to report whether sales of interests in the funds are limited to individuals and entities meeting the definition of a "qualified client" found in Rule 205-3(d)(1) under the Advisers Act. In general, only qualified clients may be charged performance-based fees by a registered investment adviser. For this purpose, an adviser is required to look through an investing entity that itself is a private fund excluded under §3(c)(1) to determine the qualified client status of the underlying beneficial owners of such entity. Responses to this new question may also be used by the SEC staff in connection with its examination program.

In preparing for this new requirement, investment advisers are reminded of the recently increased qualified client net worth thresholds that became effective on August 15, 2016. For

review of the revised thresholds, see "How Developments With California's Pension Plan Disclosure Law, the SEC's Rules and FINRA's CAB License May Impact Hedge Fund Managers and Third-Party Marketers" (Oct. 13, 2016).

Amendments to Advisers Act Rule 204-2

Rule 204-2(a)(16) under the Advisers Act was amended to require registered advisers to maintain records supporting performance claims in communications that are distributed or circulated to any person (changing the requirement from the current 10 or more persons). In addition, Rule 204-2(a)(7) was amended to require registered advisers to maintain a new category of communications – namely, 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.

Most registered investment advisers most likely currently maintain this information. Nevertheless, advisers should take the opportunity to evaluate their policies and procedures for capturing and retaining performance-related communications and provide appropriate training to their investor relations and business development staff highlighting the new recordkeeping requirements when sending or receiving communications containing performance claims.

As noted above, the amendments to Rule 204-2 will apply to any communications distributed after the Compliance Date, and investment advisers that distribute after the Compliance Date communications that contain performance information in respect of the period prior to the Compliance Date will be required to maintain the records required by amended Rule 204-2 supporting the prior performance claims.

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