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Legal Update
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Form ADV: New Disclosure Requirements and Additional Disclosures to Consider

The compliance date is fast approaching for the US Securities and Exchange Commission's ("SEC") recently adopted amendments to Part 1A of Form ADV.[1] Initial or amended Form ADVs filed on or after October 1, 2017 (with limited exception, as discussed below) must comply with the amendments. The Part 1A amendments require advisers to provide additional information about their business, including information about their separately managed accounts ("SMAs"), social media activity, branch offices, source of chief compliance officer ("CCO") compensation, and participation in wrap fee programs. The amendments also codify the "relying adviser" method by which private fund advisers operating as a single advisory business can register using a single Form ADV, referred to as "umbrella" registration.

The Form ADV amendments follow other SEC rulemaking initiatives designed to enhance information reporting to the SEC or otherwise in response to the Dodd-Frank Act's focus on the financial stability of the United States (e.g., Form PF (information reporting by registered investment advisers to private funds); Form N-MPF and Form N-CR (money market fund reporting); and Investment Company Reporting Modernization (sweeping changes to information reporting requirements for registered investment companies, including new Form N-PORT and Form N-CEN)[2]). The SEC relies on information reporting to monitor industry trends, inform policy and rulemaking, identify and analyze risks (systemic and otherwise), and assist SEC examination and enforcement staff. The Form ADV amendments are no exception, as discussed in more detail below.

Registrants and their service providers have started to focus on data aggregation, management, storage and analytics, and related technology platforms, not only to meet the increasing demands of the SEC's information reporting requirements, but also to gain insight into their business and to enhance service.

This Legal Update:

- Summarizes the principal amendments to Part 1A of Form ADV;
- Discusses additional disclosures that advisers might want to consider for Part 2A of Form ADV; and
- Reviews certain recent amendments to the recordkeeping requirements under the Advisers Act.

Summary of Form ADV Amendments

SMA DISCLOSURES

General Disclosures. Under amended Item 5.K.(1) of Part 1A, investment advisers must disclose whether any of their regulatory assets under management ("RAUM")[3] are attributable

to SMAs (i.e., advisory accounts other than those that are pooled investment vehicles, such as registered investment companies, business development companies, and private funds).

Any adviser that has any RAUM attributable to SMAs must complete new Section 5.K.(1) of Schedule D. This item asks for the approximate percentage of SMA RAUM invested in twelve asset categories. If the adviser has at least $10 billion in SMA RAUM, the adviser needs to annually report these approximate percentages for both end-of-year (which is the date used to calculate RAUM for annual update purposes) *and* mid-year (six months before the end of year date). If the adviser has less than $10 billion in SMA RAUM, it must annually report only end-of-year percentages.

The twelve covered asset categories are: exchange-traded equity securities; non-exchange-traded equity securities; US government/agency bonds; US state and local bonds; sovereign bonds (as defined in the Form); investment-grade corporate bonds; non-investment grade corporate bonds; derivatives; securities issued by registered investment companies or business development companies; securities issued by other pooled investment vehicles; cash and cash equivalents (the latter of which includes bank deposits, certificates of deposit, bankers' acceptances and similar bank instruments); and "other" assets (which must be described separately on the Schedule).

In reporting these approximate percentages, advisers should not look through derivatives, or registered investment companies, business development companies or other pooled investment vehicles. In addition, SMA subadvisers should only provide information with respect to the subadvised portion of those accounts.

Similar to Form PF, 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 the advisers report internally and to current and prospective clients, but advisers should not double count assets.[4]

Unlike Form PF, but consistent with the reporting of RAUM, the SEC declined to allow an adviser whose principal office and place of business is outside the United States to exclude clients who are not United States persons.

The SEC believes that collecting additional information about SMAs will enhance the staff's ability to effectively carry out the SEC's risk-based examination program and other risk assessment and monitoring activities.

Disclosures About Borrowings and Derivatives. In Part 1A, advisers must indicate whether they engage in borrowing transactions[5] on behalf of SMA clients (Item 5.K.(2)) and whether they engage in derivatives[6] transactions on behalf of those clients (Item 5.K.(3)). If an adviser has a positive response to either item, they must complete Section 5.K.(2) of Schedule D, which requires information regarding the use of borrowings and derivatives in those accounts. Advisers that have at least $500 million but less than $10 billion in SMA RAUM must report, for end-of-year only: (1) the RAUM attributable to SMAs associated with each of the following levels of gross notional exposure (meaning the percentage obtained by dividing the sum of the dollar amount of any borrowings and the gross notional value of all derivatives, the RAUM of the SMA): 10% or less, 10% - 149%, and 150% or more; and (2) the dollar amount of borrowings for the SMAs included in (1) above.

Advisers with at least $10 billion in SMA RAUM also must report the above information, but must do so both mid-year and end-of-year. These advisers also must report, for both mid-year and end-of-year, the aggregate "gross notional value"[7] of derivatives divided by the aggregate RAUM of the accounts included in (1) above with respect to

six categories of derivatives: (1) interest rate derivatives;[8] (2) foreign exchange derivatives;[9] (3) credit derivatives;[10] (4) equity derivatives;[11] (5) commodity derivatives;[12] and (6) other derivatives.[13]

Advisers are not required to provide the above information with respect to any SMA with RAUM of less than $10 million.

The above amendments are designed to provide data to assist SEC staff in identifying and monitoring the use of borrowings and derivatives exposures in SMAs as part of the staff's risk assessment and monitoring programs.

Disclosures About SMA Custodians. Item 1.K asks whether any custodian holds 10% or more of SMA RAUM. If so, the adviser must complete Section 5.K.(3) of Schedule D, which asks for information about each such custodian (e.g., custodian's name; location; any affiliations; any SEC registration number or legal entity identifier;[14] and the amount of RAUM attributable to SMAs held at the custodian). This information will allow the SEC's examination staff to identify advisers whose clients use the same custodian in the event a concern is raised about a particular custodian and advances the SEC's regulatory goal of identifying and obtaining a more complete picture regarding the custodians serving a significant proportion of an adviser's SMAs. Item 1.K must be amended promptly if the information becomes inaccurate in any way.

SOCIAL MEDIA DISCLOSURES

Amended Item 1.1 in Part 1A asks advisers to disclose whether they have a publicly available social media account (e.g., Twitter, Facebook or LinkedIn). If so, the address of each social media account must be reported in Section 1.1 of Schedule D. Disclosure is required even if the account is not used to promote the adviser's business in the United States or is targeted only towards the adviser's non-US clients.

However, disclosure is not required where the adviser does not control the content on the account.[15] Further, if the adviser uses the social media account solely to promote the business of a non SEC-registered affiliate, then the account is not required to be disclosed. Note that this item does not require individual electronic mail (e-mail) addresses of employees or the addresses of employee accounts on publicly available social media platforms.

Unlike the Item 5 SMA disclosures discussed above, Item 1.1 of Part 1A would need to be amended promptly if the information becomes inaccurate in any way (e.g., if the adviser were to create a new social media account).

The SEC staff may use the new social media information to: help prepare for examinations of investment advisers; compare information that advisers disseminate across different social media platforms; and identify and monitor new platforms.

BRANCH OFFICE DISCLOSURES

Under amended Form ADV, advisers will be required to provide information about: (1) the total number of offices, other than the principal office and place of business, at which they conduct their investment advisory business as of the end of the adviser's most recently completed fiscal year (Item 1.F) and (2) under Item 1.F of Schedule D, their 25 largest offices in terms of number of employees (up from the five largest, under the current Part 1A of Form ADV). For each of these offices, advisers will be required to disclose on Schedule D: (1) contact information; (2) number of employees who perform an advisory function at the office; (3) securities-related business activities conducted from the office; and (4) other investment-related business activities conducted from the office.

Item 1.F must be amended promptly if the information becomes inaccurate. However, Section 1.F of Schedule D needs to be updated as part of an adviser's annual updating amendment but does not need to be updated more frequently.

These amendments support the 2017 examination priorities for the SEC's Office of Compliance Inspections and Examinations ("OCIE").[16] One of those priorities was a continued focus on advisers that provide advisory services from multiple locations. OCIE believes that branch office models can pose unique risks to advisers, particularly regarding the design and implementation of the compliance programs and oversight of the advisory services provided at their branch offices.[17] This 2017 examination priority relates to a risk alert released by OCIE in December 2016, in which OCIE said that examination staff will assess, among others, the adviser's compliance program and supervisory controls, particularly as they relate to branch offices.[18]

The new branch office disclosures are intended to help SEC examination staff learn more about an investment adviser's business and identify locations to conduct examinations. It also will help SEC staff assess risk and assess offices that conduct a combination of activities.

CCO COMPENSATION DISCLOSURES

Under amended Part 1A, if the adviser's CCO is compensated or employed by any person other than the adviser, a "related person" of the adviser, or a registered investment company that is advised by the adviser, the adviser must report under Item 1.J the person's name and, if any, the person's Internal Revenue Service Employer Identification Number.

The SEC intends for this information to help it assess the potential risks related to outsourced CCOs and firms.

Item 1.J of Part 1A must be amended promptly if the information becomes inaccurate in any way.

The new CCO compensation disclosures stem from examination staff observations regarding the quality and effectiveness of outsourced chief compliance officers and firms. These observations and related concerns were set out in a 2015 OCIE Risk Alert.[19]

Identifying information for these third-party service providers will allow the SEC to identify all advisers relying on a particular service provider and could be used to improve the SEC's ability to assess related risk.

WRAP FEE PROGRAM DISCLOSURES

Under amended Part 1A, advisers will be required to disclose whether they participate in a wrap fee program and, if so, the total amount of RAUM attributable to acting as a: (1) sponsor of a wrap fee program; (2) portfolio manager for a wrap fee program; and (3) sponsor of and portfolio manager for the same wrap fee program (Item 5.I).[20] If an adviser reports an amount in category (3), the adviser should not report that amount in categories (1) or (2). If an adviser reports an amount in category (2), the adviser must complete Section 5.I.(2) of Schedule D, which has been amended to require additional information.

Currently, under Section 5.I.(2), an adviser must list the name and sponsor of each wrap fee program for which the adviser serves as portfolio manager. Under the amended section, the adviser also must provide any SEC File Number and CRD Number for sponsors to those wrap fee programs.

These amendments support OCIE's 2017 examination priorities, one of which was an expanded focus on registered investment advisers and broker-dealers associated with wrap fee programs.[21]

The new wrap fee program information is intended to help the SEC better understand a particular adviser's business and assist in the SEC's risk assessment and examination process by making it easier for SEC staff to identify the extent to which the firm acts as sponsor or portfolio manager of wrap fee programs and collect information across investment advisers involved in a particular wrap fee program.

UMBRELLA REGISTRATION FOR PRIVATE FUND ADVISERS

The SEC amended Form ADV to accommodate permissive "umbrella registration"[22] for certain advisers to private funds. Under umbrella registration, advisers to private funds and certain other qualified clients that operate a single advisory business through multiple legal entities can file a single Form ADV (as well as any other reports under the Advisers Act (e.g., Form PF)) that relates to and includes all information concerning the "filing adviser"[23] and each "relying adviser."[24] The amendments are designed to formalize the approach taken by the SEC staff in a 2012 no-action letter[25] and better accommodate umbrella registrations, given that Form ADV was designed for an adviser structured as a single legal entity.

The amendments add conditions to the General Instructions to Form ADV to help an adviser determine whether umbrella registration is available. These conditions are essentially the same as those from the 2012 no-action letter. More specifically, the conditions are:

- The filing adviser and each relying adviser advise only private funds and qualified clients in SMAs that are otherwise eligible to invest in the private funds and whose accounts pursue investment objectives and strategies substantially similar or otherwise related to the private funds;
- The filing adviser's principal office and place of business is located in the United States and each filing and relying adviser's dealings with clients are subject to the Advisers Act, regardless of whether the client is a US person;
- Each relying adviser and its employees are subject to the filing adviser's supervision and control, and are considered "persons associated with" the filing adviser;
- 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 the relying advisers operate under a single code of ethics 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 chief compliance officer in accordance with that rule.

A filing adviser using umbrella registration is required to file, and update as required, a single Form ADV (Parts 1 and 2) that relates to, and includes all information concerning, the filing adviser and each relying adviser, and must include this same information in any other reports or filings it must make under the Advisers Act or the rules thereunder (e.g., Form PF). The revisions to the form's Instructions and the form itself further specify which questions should be answered solely with respect to the filing adviser and which questions require the filing adviser to answer on behalf of itself and its relying adviser(s).

The SEC also added a new Schedule R to Part 1A of Form ADV, which must be filed for each relying adviser. Schedule R requires identifying information (Section 1); basis for SEC registration (Section 2); form of organization

(Section 3); and control persons (Section 4). For basis for SEC registration (Section 2), the Schedule does not include categories that would make the relying adviser ineligible for umbrella registration, such as serving as an adviser to a registered investment company. Finally, the SEC added a new question to Schedule D that requires advisers to identify the filing advisers and relying advisers that manage or sponsor private funds reported on Form ADV.

Notably, the SEC rejected commenters' requests that the second condition above be modified to allow umbrella registration for filing advisers not based in the United States. The SEC was concerned that, without this condition, a group of related US and non-US advisers could designate a non-US filing adviser and assert that the Advisers Act does not apply to the US relying advisers' dealings with non-US clients, under the theory that they were operating as a single advisory business.[26] The SEC explained that it intended umbrella registration to apply only where SEC staff has access to and can readily examine the filing adviser and each relying adviser, and where the Advisers Act fully applies to the advisers and their clients under umbrella registration. The SEC also declined at this time to expand the concept of umbrella registration to exempt reporting advisers.

OTHER PART 1A AMENDMENTS[27]

The SEC amended Item 5.D.(1) to require an adviser to report the approximate number of clients and approximate amount of RAUM attributable to each category of client listed in the Item, as of the date the adviser determines its RAUM, instead of reporting this type of information by asset range as is currently required. If the adviser has fewer than five clients in a particular category (other than investment companies, business development companies and other pooled investment vehicles), the adviser may check Item 5.D.(2) indicating that fact, rather than report the actual number of clients in the particular category in Item 5.D.(1). If a client fits into more than one category, then the adviser should select the category that most accurately represents the client in order to avoid double counting clients and assets.

The SEC also added to Item 5 a requirement for an adviser to report the approximate number of clients for whom the adviser does not have any RAUM but to whom the adviser provided advisory services during the most recently completed fiscal year (Item 5.C).

In addition, an adviser that elects to report client assets in Part 2A of Form ADV differently from the RAUM it reports in Part 1A is now required to check a box noting that election (Item 5.J.(2)).[28]

The SEC added a question (Item 1.F.(3)) asking the approximate amount of an adviser's RAUM that is attributable to clients that are non-United States persons.[29] Current Item 1.C.(2), which will remain in place, asks an adviser to report the percentage of its clients that are non-United States persons. Both of these Items must be updated promptly if the information becomes inaccurate.

In addition, the SEC has added to Section 5.G.(3) of Schedule D a requirement that advisers report the RAUM of all "parallel managed accounts"[30] related to a registered investment company (or series thereof) or business development company that they advise. Section 5.G.(3) of Schedule D currently requires advisers to report the SEC File Number for these types of advisory clients.[31]

Lastly, the SEC added a question to Section 7.B.(1) of Schedule D to require an adviser to a private fund that qualifies for the exclusion from the definition of investment company under Section 3(c)(1) of the Investment Company Act of 1940 (a "3(c)(1) fund") to report whether it limits sales of the fund to qualified clients, as defined in Rule 205-3 under the Advisers Act. The SEC believes that this information will give it a better sense of the financial sophistication and nature of investors in these funds.

COMPLIANCE DATE

The compliance date for the Form ADV amendments is October 1, 2017. Accordingly, an adviser that files an initial Form ADV or an amendment to an existing Form ADV on or after October 1 is required to provide responses to the amended form. However, an adviser might need to file an "other-than-annual" amendment on or after October 1, but before its next annual update to Form ADV. For these filings, it was unclear how the adviser should respond to new or amended items in Item 5 and related Schedule D sections that are required to be filled out on an annual basis. In addition, some advisers might not have the newly required information at the time of the filing, and the Investment Adviser Registration Depositary system does not permit incomplete responses (which means that the adviser would not be able to file its amendment).

The SEC's Division of Investment Management ("Division") addressed these questions in a recent Information Update.[32] Division staff said that if an adviser files an other-than-annual amendment to Form ADV on or after October 1, 2017, but before its next annual amendment would be due, and the adviser does not have the data available to provide a complete response to a new or amended question in Item 5 or related Schedule D sections, then the adviser should respond with "O" as a placeholder so that it can file its amendment, and add a corresponding note in the Miscellaneous section of Schedule D to identify that a "O" was entered as a placeholder.

Disclosures to Consider for Part 2A of Form ADV

As advisers prepare to comply with the amendments and start to consider disclosure changes in anticipation of their annual Form ADV amendments, advisers might also want to consider the following disclosure topics, which continue to be areas of interest for the SEC and its staff:

ROBO ADVISERS[33]

In February 2017, Division staff issued a guidance update, IM Guidance Update No. 2017-02, focusing on robo-advisers that provide services directly to clients over the Internet using an algorithm or similar electronic advisory system (the "Update").[34] In the Update, the staff identified certain key disclosures for clients regarding the limitations, risks and other aspects of the investment advisory services being offered, such as disclosures regarding:

- The scope of the advisory service being offered;[35]
- The algorithm that is used in the service, and how the adviser uses it;
- The algorithm's function, assumptions, limitations and, in particular, risks;
- Whether and under what circumstances the adviser has the ability to override or disregard the algorithm;
- Any third parties involved in the development, management or ownership of the algorithm and any related actual or potential conflicts of interest;[36]
- The fees charged directly by the robo-adviser and any other costs that the client may bear, directly or indirectly;
- The degree and type of human involvement (and related limitations);
- How client-provided information is used, and whether the adviser has access to and uses in the robo service other client information or accounts; and
- Whether and under what circumstances clients have the opportunity to select investments other than those recommended by the robo-adviser, and the risks and limitations of doing so.

Although the Update specifically addresses robo-advisers, the staff's guidance is instructive for any adviser—quant managers in particular.

MUTUAL FUND SHARE CLASS SUITABILITY AND CONFLICTS

OCIE and the SEC's Division of Enforcement continue to focus on mutual fund share class suitability and best execution obligations, and related disclosures regarding advisers' practices and conflicts of interest in this area.[37] A recent enforcement action demonstrates the disclosure subtleties.[38] In this proceeding, the SEC found that an adviser's disclosures did not adequately inform its advisory clients of the conflict of interest presented by its share class selection practices. The adviser did disclose in its Form ADV that it "may" receive 12b-1 fees as the result of investments in certain mutual funds and that such fees created a conflict of interest due to a financial incentive for advisory employees to select or recommend investments that maximized this compensation. But the SEC pointed out that the adviser did *not* disclose that many mutual funds offered a variety of share classes, including some that did not pay 12b-1 fees and were, accordingly, less expensive for eligible investors. The SEC found that the adviser's "general" disclosures regarding its *potential* receipt of 12b-1 fees were inadequate to advise advisory clients that the adviser could, *and did*, select or recommend mutual fund share classes that paid 12b-1 fees to the adviser even though those clients were eligible for less expensive share classes that did not pay fees to the adviser.[39] In addition, the SEC found that the adviser did not disclose in relevant Part 2Bs that those employees received 12b-1 fees from the mutual funds, which created an incentive for those individuals to recommend the higher cost share class that paid those fees rather than less costly share classes.

On the same theme, an enforcement action from earlier this year demonstrates that disclosure failures related to mutual fund shares are not limited to fees or other compensation from the fund itself. In this case, the adviser failed to disclose that it received compensation from a clearing broker in connection with transactions in mutual funds in the clearing broker's no-transaction-fee mutual fund program, and that the receipt of this compensation created an incentive to favor those mutual funds in making recommendations to clients.[40] The adviser had disclosed its relationship with the clearing broker.

Mutual fund share class cases often focus on dual registrants or 12b-1 payments. However, given the various types and sources of compensation from funds and their service providers, or other sources, such as clearing firms/platforms, all advisers should carefully consider their disclosure and related obligations.

PRIVATE FUND EXPENSES

The SEC continues its intense focus on expenses, expense allocations and related conflicts of interest in the private fund space, and has brought numerous enforcement actions in this area.[41] While these cases do not necessarily focus on Form ADV disclosure failures, they demonstrate how important it is to *clearly* disclose to fund investors the specific fees that the adviser receives or retains, and the specific manner in which the fund's adviser or sponsor treats and otherwise allocates expenses, whether between or among the adviser, the fund, other funds of the adviser, co-investors, or fund portfolio companies. Therefore, if the fund's governing document is vague, subject to interpretation or otherwise unclear or silent, the adviser should seek out other venues for providing clarifying

disclosures to investors, such as the offering memorandum, or its Form ADV (delivered to fund investors as a best practice).

The SEC interprets private fund documents and similar disclosures in a manner **most favorable** to fund investors, and **least favorable** to the fund's adviser.

ADVISORY SERVICE DESCRIPTIONS

The SEC recently brought an enforcement action against an adviser for "falsely representing" to its advisory clients that it was performing certain advisory services when it was not in fact doing so.[42] In this case, the adviser served as adviser and fiduciary to its advisory clients in the wrap fee programs it sponsored and administered, and charged clients a single inclusive wrap fee for each program, which covered due diligence, investment advisory, custody, administrative and execution services.

The adviser represented to its advisory clients that it performed initial due diligence and ongoing monitoring of third-party managers it recommended to manage its clients' assets. Specifically, the adviser told clients that it used a variety of qualitative and quantitative factors to determine if a third-party manager met the adviser's minimum standards for inclusion in the program.

The adviser also stated that it would review managers and their respective investment strategies "on an ongoing basis based on various quantitative and qualitative factors, including performance, adherence to investment strategies and investment objectives, and material business changes," to determine whether they continue to remain suitable to be recommended to clients.

Over time, however, gaps in the adviser's due diligence process appeared, and then widened, due to limited resources, causing the disclosures to become inaccurate.

ADVISORY EMPLOYEE BIOGRAPHIES/CREDENTIALS

The SEC has brought enforcement actions over the years for inaccurate or misleading biographies or credential information in Form ADV and other client communications.[43] For example, in a recent enforcement action, the SEC found that an adviser misrepresented on its Form ADV brochure supplements that the principal *earned* a marketing degree from a particular university.[44] In fact, however, the principal had *attended* the university, but did *not* graduate. In addition, the adviser misrepresented to clients and prospective clients that the principal held the Certified Financial Planner credential. But in fact, the principal had only taken the coursework but *never earned* the credential.

FINANCIAL CONDITION

Item 18 of Form ADV, Part 2A requires disclosure of any financial condition that is reasonably likely to impair the adviser's ability to meet contractual commitments to its clients. Recently, the SEC brought an enforcement action against an adviser for, among other things, failure to disclose in its Form ADV the adviser's or its principal's deteriorating financial condition.[45] This adviser and its principal started to experience substantial financial difficulties, with the adviser becoming unable to pay salaries, payroll taxes or rent.

Soon thereafter, the principal began borrowing significant amounts of money from family, friends and business associates (including an advisory employee) to fund the adviser's business. In addition, the landlord for the adviser's office space demanded rent, threatened legal action, then started the eviction process, and a few months later successfully evicted the adviser from its office space.

The adviser continued to accrue debt and legal judgments, including liens by the Internal Revenue Service, warrants by state department of

revenue, and judgments in favor of the landlord and other business providers and associates.

The adviser did not disclose its financial condition in Part 2.

WRAP PROGRAMS

In its 2017 Exam Priorities, OCIE renewed and expanded its examination focus on wrap programs from prior years, specifically referencing the effectiveness of wrap program disclosures as an area of interest.[46] A 2016 recent enforcement action provides a helpful example.[47] In this action, a registered adviser served as one of the advisers in a wrap fee program sponsored by a third party. The adviser's Part 2A disclosed that it "might" trade away in an effort to obtain best execution, and that in such instances clients "may" pay transaction costs not covered by the annual wrap fee. The adviser also stated in Part 2A that (i) it would "typically" trade through the sponsor-designated broker-dealers, (ii) clients would not be charged a commission on those trades, (iii) a portion of the wrap fee was considered to be in lieu of brokerage commissions, and (iv) the adviser therefore "generally" directed trades to the designated broker-dealer "in order to enjoy the greatest cost benefits of the wrap fee program."

The adviser's practice was consistent with these disclosures for a few years. But then the adviser *significantly* increased its trading away activity. The adviser did not revise its Form ADV disclosures at the time to reflect the change.

CYBERSECURITY[48]

OCIE recently announced the results of its second cybersecurity examination initiative.[49] This announcement follows OCIE's 2017 examination priorities, which include a focus on firms' cybersecurity compliance procedures and controls. Cybersecurity has been a priority at the SEC over recent years, and remains so to date, despite the change in leadership at the SEC.[50]

The SEC's focus on cybersecurity has not been limited to registered firms, such as investment advisers and broker-dealers. The SEC has also addressed cybersecurity for issuers of public securities. In 2011, the SEC's Division of Corporation Finance ("Corp Fin") released guidance to assist public issuers in assessing their disclosure obligations regarding cybersecurity.[51] This guidance explained that existing disclosure requirements may impose an obligation on issuers to disclose significant cybersecurity risks and incidents.

The SEC and its staff have not publicly issued guidance regarding disclosure obligations, if any, of registered advisers. However, given that advisers must disclose to clients all material facts relating to the advisory relationship, and based on the guidance from Corp Fin, advisers might consider the merits of including cybersecurity risk and incident disclosures in Part 2A of Form ADV.

CERTAIN CONFLICTS OF INTEREST

Advisers should evaluate transactions, practices, arrangements and relationships that might raise actual or apparent conflicts of interest, and consider appropriate disclosures for each. Conflict examples include:

- The adviser's selection and use of affiliated service providers, or service providers with which the adviser or its affiliates or principals have other business dealings or relationships, for clients (or their portfolio companies);
- The adviser or its principals or affiliates receiving compensation or other benefits (including accelerated fees or other payments) from investments (including portfolio companies) selected or recommended by the adviser for its advisory clients;
- The adviser or its principals or affiliates receiving fee discounts or other benefits from service providers to private fund or other clients (e.g., legal fees);
- Transactions between private fund or other clients (or their portfolio companies) and the adviser or its principals or affiliates; and

- The adviser causing its clients to invest in the same company but at differing capital structures that provide one client with capital structure or other priority over the other.

CERTAIN AMENDMENTS TO ADVISERS ACT RECORDKEEPING RULE[52]

In the same rulemaking as the Form ADV amendments, the SEC amended the books and records rule under the Advisers Act to require that advisers maintain materials that demonstrate the calculation of the performance or rate of return in any communication that the adviser circulates or distributes, directly or indirectly, to *any* person, not just to 10 or more persons as in the prior version of the rule. Additionally, the SEC amended the rule to require advisers to 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.

These amendments apply to communications distributed **after October 1, 2017**.

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Endnotes

1 Form ADV and Investment Advisers Act Rules, 81 Fed. Reg. 60418 (Aug. 25, 2016) [hereinafter Form ADV Adopting Release], *available at* https://www.gpo.gov/fdsys/pkg/FR-2016-09-01/pdf/2016-20832.pdf.

2 Investment Company Reporting Modernization, 81 Fed. Reg. 81870 (Nov. 18, 2016), *available at* https://www.gpo.gov/fdsys/pkg/FR-2016-11-18/pdf/2016-25349.pdf.

3 "Regulatory assets under management" is different from assets under management. Form ADV defines RAUM as the value of those "securities portfolios" for which the adviser provides "continuous and regular supervisory or management services" as of the date of filing the Form ADV. Put differently, the amount of an adviser's RAUM is determined by a three-step process: (1) determine whether the account is a securities portfolio; (2) determine whether the adviser provides "continuous and regular supervisory or management services" to the securities portfolio; and (3) determine the value of the portfolio. Special counting instructions apply with respect to accounts of clients that are "private funds," as defined. *See* Form ADV: Instructions for Part 1A, Appendix B, at 7, *available at* https://www.sec.gov/rules/final/2011/ia-3221-appb.pdf.

4 Notably, the SEC declined to define "investment grade" and similar terms, given that advisers may use their own internal methodologies.

5 The term "borrowings" is defined in the Glossary to include secured borrowings and unsecured borrowings, collectively. Secured borrowings are obligations for borrowed money in respect of which the borrower has posted collateral or other credit support and should include any reverse repos (i.e., any sale of securities coupled with an agreement to repurchase the same (or similar) securities at a later date at an agreed price). Unsecured borrowings are obligations for borrowed money in respect of which the borrower has not posted collateral or other credit support. Form ADV: Appendix C, Glossary of Terms [hereinafter Form ADV: Glossary of Terms],

available at https://www.sec.gov/rules/final/2016/ia-4509-appendix-c.pdf.

[6] The SEC declined to define "derivative" at this time, noting that the term is not defined in Form PF. However, the SEC amended the Glossary to include definitions of specific types of derivatives, as discussed below.

[7] Gross notional value is defined in the Glossary as "The gross nominal or notional value of all transactions that have been entered into but not yet settled as of the reporting date. For contracts with variable nominal or notional principal amounts, the basis for reporting is the nominal or notional principal amounts as of the reporting date. For options, use delta adjusted notional value." *Id.*

[8] Interest Rate Derivative is defined in the Glossary as "Any derivative whose underlying asset is the obligation to pay or the right to receive a given amount of money accruing interest at a given rate. Cross-currency interest rate swaps should be included in foreign exchange derivatives and excluded from interest rate derivatives. This information must be presented in terms of 10-year bond equivalents." *Id.*

[9] Foreign Exchange Derivative is defined in the Glossary as "Any derivative whose underlying asset is a currency other than US dollars or is an exchange rate. Cross-currency interest rate swaps should be included in foreign exchange derivatives and excluded from interest rate derivatives." *Id.*

[10] Credit Derivative is defined in the Glossary as "Single name credit default swap, including loan credit default swap, credit default swap referencing a standardized basket of credit entities, including credit default swap indices and indices referencing leveraged loans, and credit default swap referencing bespoke basket or tranche of collateralized debt obligations and collateralized loan obligations (including cash flow and synthetic) other than mortgage backed securities." *Id.*

[11] Equity Derivative is defined in the Glossary as including "both listed equity derivative and derivative exposure to unlisted securities. Listed equity derivative includes all synthetic or derivative exposure to equities, including preferred equities, listed on a regulated exchange. Listed equity derivative also includes a single stock future, equity index future, dividend swap, total return swap (contract for difference), warrant and right. Derivative exposure to unlisted equities includes all synthetic or derivative exposure to equities, including preferred equities, that are not listed on a regulated exchange. Derivative exposure to unlisted securities also includes a single stock future, equity index future, dividend swap, total return swap (contract for difference), warrant and right." *Id.*

[12] Commodity Derivative is defined in the Glossary as "Exposures to commodities that you do not hold physically, whether held synthetically or through derivatives (whether cash or physically settled)." *Id.*

[13] The SEC declined to include a definition of "derivative."

[14] Legal entity identifier is defined in the Glossary as a "legal entity identifier" assigned by a utility endorsed by the Global LEI Regulatory Oversight Committee (ROC) or accredited by the Global LEI Foundation (GLEIF). *Id.*

[15] The exact parameters of this "exclusion" are unclear. An obvious circumstance would seem to be where the account is controlled by an unrelated third party, and independently and on an unsolicited basis, the third party includes information about the adviser on its site.

[16] OCIE, National Exam Program, Examination Priorities for 2017 (Jan. 12, 2017) [hereinafter OCIE 2017 Exam Priorities], *available at* https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2017.pdf. Please see our Legal Update on this topic: On the Radar for 2017 Exams of US-Regulated Investment Advisers and Broker-Dealers, Mayer Brown (Feb. 13, 2017) [hereinafter Legal Update: On the Radar for 2017], https://www.mayerbrown.com/files/Publication/fd1b4b8b-a26d-4468-9e21-ccdaafd103b8/Presentation/PublicationAttachment/6b1e46a1-3f82-43bc-9d7f-e970a78824ba/170213-UPDATE-PIF-IM-PE-FSRE-CS-PEFIM.pdf.

[17] *See* OCIE 2017 Exam Priorities, *supra*.

[18] OCIE, National Exam Program, Multi-Branch Adviser Initiative (Dec. 12, 2016), *available at* https://www.sec.gov/ocie/announcement/risk-alert-multi-branch-adviser-initiative.pdf.

[19] OCIE, National Exam Program, Examinations of Advisers and Funds That Outsource Their Chief Compliance Officers (Nov. 9, 2015), *available at* https://www.sec.gov/files/ocie-2015-risk-alert-cco-outsourcing.pdf.

[20] Item 5.I of Part 1A currently requires an adviser to indicate whether it serves as a sponsor of or portfolio manager for a wrap fee program.

[21] OCIE 2017 Exam Priorities, *supra*. OCIE stated that it will likely review whether investment advisers are acting in a manner consistent with their fiduciary duty and whether they are meeting their contractual obligations to clients, and may focus on wrap account suitability, effectiveness of disclosures, conflicts of interest, and brokerage practices,

including best execution and trading away. *Id.* at 2; *see also* Legal Update: On the Radar for 2017, *supra*.

[22] The Glossary was amended to include the following definition of "umbrella registration": A single registration by a filing adviser and one or more relying advisers who collectively conduct a single advisory business and that meet the conditions set forth in General Instruction 5. *See* Form ADV: Glossary of Terms, *supra*.

[23] The Glossary was amended to include the following definition of "filing adviser": An investment adviser eligible to register with the SEC that files (and amends) a single umbrella registration on behalf of itself and each of its relying advisers. *Id.*

[24] The Glossary was amended to include the following definition of "relying adviser": An investment adviser eligible to register with the SEC that relies on a filing adviser to file (and amend) a single umbrella registration on its behalf. *Id.*

[25] American Bar Association, Business Law Section, SEC No-Action Letter (Jan. 18, 2012), *available at* https://www.sec.gov/divisions/investment/noaction/2012/aba011812.htm.

[26] Form ADV Adopting Release, *supra*, at 60435.

[27] The SEC made various technical and clarifying amendments to Part 1A, which are not discussed here.

[28] In Part 2A, an adviser must disclose the amount of client assets it manages on a discretionary basis and on a non-discretionary basis. The adviser's method for computing the amount of client assets it manages can be different from the method used to compute RAUM for Part 1A.

[29] The Glossary to Form ADV provides that "United States person" has the same meaning as in rule 203(m)-1 under the Advisers Act, which includes any natural person that is resident in the United States. Form ADV: Glossary of Terms, *supra*.

[30] The Glossary to Amended Form ADV includes "parallel managed account," which is defined as: "With respect to any registered investment company or series thereof or business development company, a parallel managed account is any managed account or other pool of assets that you advise and that pursues substantially the same investment objective and strategy and invests side by side in substantially the same positions as the identified investment company or series thereof or business development company that you advise." *Id.*

[31] These sections correspond with Item 5.G of Part 1A, which asks whether the adviser provides portfolio management services to investment companies (including business development companies).

[32] Division of Investment Management, SEC, Information Update for Advisers Filing Certain Form ADV Amendments, IM-INFO-2017-06 (Aug. 2017), *available at* https://www.sec.gov/divisions/investment/imannouncements/im-info-2017-06.pdf.

[33] Please see our Legal Update on this topic, Legal Update: US Securities and Exchange Commission's Division of Investment Management Issues Guidance Regarding Robo-Advisers, Mayer Brown (Apr. 5, 2017) [hereinafter Legal Update: Robo-Adviser Guidance], *available at* https://www.mayerbrown.com/files/Publication/8fabfb73-56a7-48b2-859d-0b4e5366b6de/Presentation/PublicationAttachment/cc80fecc-180c-4057-8641-10466c5f9ccc/170405-UPDATE-IM-PIF-CS-CFS-FSRE.pdf; Webinar: Robo-Advisers and Advisers Act Compliance, Mayer Brown (Mar. 30, 2017).

[34] *See* IM Guidance Update 2017-02, Robo-Advisers (Feb. 2017), *available at* https://www.sec.gov/investment/im-guidance-2017-02.pdf. The Update followed the announcement of OCIE's examination priorities in January 2017. *See also* Legal Update: Robo-Adviser Guidance, *supra*.

[35] *See also* Advisory Service Descriptions below.

[36] On the topic of reliance on third parties, see also Release No. IA-3988 (Dec. 22, 2014), *available at* http://www.sec.gov/litigation/admin/2014/ia-3988.pdf; Release No. IA-4266 (Nov. 16, 2015), *available at* https://www.sec.gov/litigation/admin/2015/ia-4266.pdf; Release No. IA-4338 (Feb. 23, 2016), *available at* https://www.sec.gov/litigation/admin/2016/ia-4338.pdf and related proceedings (*see* Release No. IA-4508 (Aug. 25, 2016), *available at* https://www.sec.gov/litigation/admin/2016/ia-4508.pdf; Release No. IA-4506 (Aug. 25, 2016), *available at* https://www.sec.gov/litigation/admin/2016/ia-4508.pdf; Release No. IA-4499 (Aug. 25, 2016), *available at* https://www.sec.gov/litigation/admin/2016/ia-4499.pdf; Release No. IA-4507 (Aug. 25, 2016), *available at* https://www.sec.gov/litigation/admin/2016/ia-4507.pdf; Release No. IA-4505 (Aug. 25, 2016), *available at* https://www.sec.gov/litigation/admin/2016/ia-4505.pdf; Release No. IA-4503 (Aug. 25, 2016), *available at* https://www.sec.gov/litigation/admin/2016/ia-4503.pdf; Release No. IA-4502 (Aug. 25, 2016), *available at* https://www.sec.gov/litigation/admin/2016/ia-4502.pdf; Release No. IA-4501 (Aug. 25, 2016), *available at* https://www.sec.gov/litigation/admin/2016/ia-4501.pdf; Release No. IA-4498 (Aug. 25, 2016), *available at*

https://www.sec.gov/litigation/admin/2016/ia-4498.pdf; Release No. IA-4504 (Aug. 25, 2016), *available at* https://www.sec.gov/litigation/admin/2016/ia-4504.pdf; Release No. IA-4497 (Aug. 25, 2016), *available at* https://www.sec.gov/litigation/admin/2016/ia-4497.pdf; Release No. IA-4496 (Aug. 25, 2016), *available at* https://www.sec.gov/litigation/admin/2016/ia-4496.pdf).

[37] *See* OCIE 2017 Exam Priorities, *supra*; OCIE, National Exam Program, Risk Alert: Share Class Examination Initiative (July 13, 2016), *available at* https://www.sec.gov/ocie/announcement/ocie-risk-alert-2016-share-class-initiative.pdf; Release No. IA-4351 (Mar. 14, 2016), *available at* https://www.sec.gov/litigation/admin/2016/34-77362.pdf; Release No. IA-4314 (Jan. 14, 2016), *available at* https://www.sec.gov/litigation/admin/2016/34-76897.pdf.

[38] Release No. IA-4678 (Apr. 5, 2017), *available at* https://www.sec.gov/litigation/admin/2017/34-80373.pdf; *see also* Release No. IA- 4673 (Mar. 29, 2017), *available at* https://www.sec.gov/litigation/admin/2017/34-80335.pdf.

[39] Release No. IA-4566 (Nov. 7, 2016), *available at* https://www.sec.gov/litigation/opinions/2016/ia-4566.pdf (opinion of the SEC reversing the ALJ's initial decision); Initial Decision Release No. 806 (June 4, 2015), *available at* https://www.sec.gov/alj/aljdec/2015/id806jeg.pdf (initial decision of the ALJ); Release No. IA-3907 (Sept. 2, 2014), *available at* https://www.sec.gov/litigation/admin/2014/34-72950.pdf (SEC enforcement action).

[40] Release No. IA-4730 (July 19, 2017), *available at* https://www.sec.gov/litigation/admin/2017/34-81169.pdf; *see also* Release No. IA-4661 (Mar. 8, 2017), *available at* https://www.sec.gov/litigation/admin/2017/34-80177.pdf.

[41] *See, e.g.*, Release No. IA-4604 (Jan. 10, 2017), *available at* https://www.sec.gov/litigation/admin/2017/ia-4604.pdf; Release No. IA-4529 (Sept. 14, 2016), *available at* https://www.sec.gov/litigation/admin/2016/ia-4529.pdf; Release No. IA-4494 (Aug. 24, 2016), *available at* https://www.sec.gov/litigation/admin/2016/ia-4494.pdf; Release No. IA-4493 (Aug. 23, 2016), *available at* https://www.sec.gov/litigation/admin/2016/ia-4493.pdf; Release No. IA-4411 (June 1, 2016), *available at* https://www.sec.gov/litigation/admin/2016/34-77959.pdf; Complaint, No. 1:16-cv-01752-LMM (May 31, 2016), *available at* https://www.sec.gov/litigation/complaints/2016/comp-pr2016-98.pdf; Release No. IA-4276 (Nov. 23, 2015), *available at* https://www.sec.gov/litigation/admin/2015/ia-4276.pdf; Release No. IA-4258 (Nov. 5, 2015), *available at* https://www.sec.gov/litigation/admin/2015/ia-4258.pdf; Release No. IA-4253 (Nov. 3, 2015), *available at* https://www.sec.gov/litigation/admin/2015/ia-4253.pdf; Release No. IA-4219 (Oct. 7, 2015), *available at* https://www.sec.gov/litigation/admin/2015/ia-4219.pdf; Release No. IA-4131 (June 29, 2015), *available at* https://www.sec.gov/litigation/admin/2015/ia-4131.pdf; Release No. IA-3927 (Sept. 22, 2014), *available at* https://www.sec.gov/litigation/admin/2014/ia-3927.pdf. Also, see Release No. IA-4746 (Aug. 16, 2017), *available at* https://www.sec.gov/litigation/admin/2017/ia-4746.pdf.

[42] Release No. IA- 4705 (May 10, 2017), *available at* https://www.sec.gov/litigation/admin/2017/33-10355.pdf.

[43] Release No. IA-1868 (Apr. 14, 2000), *available at* https://www.sec.gov/litigation/admin/ia-1868.htm.

[44] Release No. IA-4702 (May 5, 2017), *available at* https://www.sec.gov/litigation/admin/2017/ia-4702.pdf.

[45] Release No. IA-4673 (Mar. 29, 2017), *available at* https://www.sec.gov/litigation/admin/2017/34-80335.pdf; *see also* Complaint, No. 3:16-cv-00438-PK (D. Or. Mar. 10, 2016), *available at* https://www.sec.gov/litigation/complaints/2016/comp-pr2016-49.pdf.

[46] Enforcement actions in this arena continue. *See, e.g.*, Release No. IA-4665 (Mar. 13, 2017), *available at* https://www.sec.gov/litigation/admin/2017/ia-4665.pdf.

[47] Release No. IA-4453 (July 14, 2016), *available at* https://www.sec.gov/litigation/admin/2016/ia-4453.pdf.

[48] *See* Legal Update: US Securities and Exchange Commission's Office of Compliance Inspections and Examinations Announces Results of Cybersecurity Examination Initiative, Mayer Brown (Aug. 15, 2017) [hereinafter Legal Update: OCIE Cybersecurity Initiative], https://www.mayerbrown.com/US-Securities-and-Exchange-Commissions-Office-of-Compliance-Inspections-and-Examinations-Announces-Results-of-Cybersecurity-Examination-Initiative-08-15-2017/; Legal Update: New Heads of Enforcement at the US Securities and Exchange Commission Continue Agency's Focus on Cybersecurity, Mayer Brown (July 12, 2017) [hereinafter Legal Update: Focus on Cybersecurity], https://www.mayerbrown.com/New-Heads-of-Enforcement-at-the-US-Securities-and-Exchange-Commission-Continue-Agencys-Focus-on-Cybersecurity-07-12-2017/; Legal Update: OCIE and FINRA Announce the Results of Cybersecurity Initiatives, Mayer Brown (Mar. 25, 2015), https://www.mayerbrown.com/files/Publication/7c1a373a-b348-497b-a6ec-dc9dde98d1be/Presentation/PublicationAttachment/517460

88-fdfa-4aa4-abc8-8b49c5cb80f7/150325-UPDATE-Privacy.pdf.

[49] *See* Legal Update: OCIE Cybersecurity Initiative, *supra*.

[50] *See* Legal Update: Focus on Cybersecurity, *supra*.

[51] Division of Corporation Finance, SEC, CF Disclosure Guidance: Topic No. 2: Cybersecurity (Oct. 13, 2011), https://www.sec.gov/divisions/corpfin/guidance/cfguidance-topic2.htm.

[52] The SEC adopted additional Advisers Act rule amendments, which are not discussed here.