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SEC Proposes Amendments to Form ADV and Rules under the Investment Advisers Act with Important Implications for Private Fund Advisers

The staff of the US Securities and Exchange Commission ("***SEC***") proposed amendments last week designed, among other things, to permit multiple private fund advisers operating a single advisory business to register with the SEC on a single registration form or "***Form ADV***", and to collect more information about investment advisers and their affiliates. The proposed amendments are detailed in a "***Proposing Release***" available here. The proposed revisions to Form ADV Part 1A ("***Part 1A***") can be found here, proposed General Instructions to Form ADV are available here, proposed Instructions for Part 1A can be found here, and the proposed revisions to Form ADV's Glossary of Terms are here (the proposed changes in these documents together with those in the Proposing Release, the "***Proposed Amendments***"). The SEC will accept comments on the Proposed Amendments for 60 days after the Proposing Release appears in the Federal Register.

Umbrella Registration

Background

Large investment managers – particularly those with multi-national operations – are often comprised of many legal entities conducting a single advisory business. These multi-entity structures are driven by tax, legal, regulatory, and other considerations.

Prior to 2010, most entities in multi-entity structures relied on the "private adviser exemption" to avoid registering with the SEC as investment advisers. The private adviser exemption allowed advisers with less than 15 clients not to register with the SEC as investment advisers. In the private fund context, a "client" referred to the private fund itself rather than its underlying investors.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "***Dodd-Frank Act***") called for the repeal of the private adviser exemption. The SEC staff ultimately replaced it with a more confusing exemption regime including a complete exemption for “foreign private advisers”, and a conditional exemption for investment advisers who act solely as advisers to private funds and who have less than US$150 million of assets under management in the United States. Advisers who rely on the conditional exemption are referred to as "***Exempt Reporting Advisers***" or "***ERAs***".

Multi-entity managers analyzed their structures under the new regime and realized that many entities exempt from registration under the old private adviser exemption were not exempt under the new regime. Faced with a precautionary flood of registrations for thousands of entities within multi-entity managers – many of which existed only on paper – the SEC issued interpretive relief to the American Bar Association in 2012 (the "***2012 ABA Letter***").[1] This letter reaffirmed prior guidance exempting certain special purpose vehicles from registration as investment advisers (*e.g.*, certain general partners to private funds controlled by an SEC-registered adviser) (the "***SPV Guidance***"). The 2012 ABA Letter also created a new way for certain multi-entity managers to register with the SEC. The new approach permitted a single "***filing adviser***" to register with the SEC on behalf of affiliates deemed "***relying advisers***". The "umbrella registration" approach discussed in the Proposing Release stems directly from the 2012 ABA Letter.

Proposed Umbrella Registration Regime

Umbrella registration would be available to a narrow category of multi-entity managers who can already rely on the 2012 ABA Letter guidance. To qualify:

- The filing adviser and each relying adviser must advise only private funds[2] or sophisticated clients with separately managed accounts that pursue investment objectives and strategies substantially similar or otherwise related to the private funds advised by the advisers.
- The filing adviser must have its principal office and place of business in the United States, so that all of the substantive provisions of the Investment Advisers Act of 1940, as amended (the "***Advisers Act***"), and the rules thereunder, apply to the filing adviser’s and each relying adviser’s dealings with all of their clients, whether the client is located inside or outside United States.
- Each relying adviser, its employees and the persons acting on its behalf must be subject to the filing adviser’s supervision and control.
- The advisory activities of each relying adviser must be subject to the Advisers Act and the rules thereunder, and each relying adviser must be subject to SEC examination.
- The filing adviser and each relying adviser must operate under a single code of ethics adopted in accordance with Rule 204A-1 under the Advisers Act, and a single set of written supervisory 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 multi-entity manager taking advantage of umbrella registration would complete portions of Form ADV with information about itself, and then complete other portions of Form ADV with respect to itself and its relying advisers. The Proposed Amendments would also add Schedule R to Part 1A. Schedule R would require identifying information about each relying adviser, as well as

[1] SEC No-Action Letter to the American Bar Association, Business Law Section (Jan. 18, 2012).

[2] As defined in the Dodd-Frank Act, a “private fund” is a fund that would be regulated as an “investment company” but for Section 3(c)(1) (excluding funds with not more than 100 owners) or Section 3(c)(7) (excluding funds owned by qualified purchasers only) of the U.S. Investment Company Act of 1940, as amended.

the basis for its registration and its ownership information. Schedule R would also identify the filing adviser and relying advisers that manage or sponsor any private funds reported in Part 1A.

Investment advisers may decide against relying on the 2012 ABA Letter and the new umbrella registration for many reasons. Non-US entities with SEC-registered US affiliates may, for example, object to complying with Advisers Act requirements that contradict local privacy or other laws. US compliance personnel may also be unwilling to take on compliance responsibility for the offshore activities of non-US personnel.

Implications for Multi-Entity ERAs

The Proposing Release includes troubling interpretive guidance for multi-entity ERAs – many of which operate from outside the United States. A private fund adviser with a principal office and place of business outside the United States must only count the assets it manages from a place of business in the United States toward the US$150 million ceiling for ERAs. This permits, for example, non-US advisers that market private funds to US investors to claim ERA status because they do not manage assets from a US place of business.

ERAs are "exempt" from most provisions of the Advisers Act, but they must complete portions of Part 1A. Many non-US multi-entity ERAs file a single Part 1A reflecting information for all of the special purpose vehicles and other advisory entities within their structures. Footnote 56 of the Proposing Release would prohibit this practice. The SEC staff justifies the prohibition by stating that the "conditions of a single advisory business", including adoption of supervisory policies and procedures, are requirements that only apply to SEC-registered advisers.

This conclusion does not, however, articulate a clear policy reason for prohibiting multi-entity ERAs from filing a single Part 1A. Non-US multi-entity ERAs exhibit many indicia of operating a single advisory business. For example, they: (i) advise private funds only; (ii) often subject employees to a compliance structure under the laws of one or more other countries; (iii) are often subject to examination by other regulatory authorities; (iv) use the same or similar names in marketing and other materials; and/or (v) hold themselves out to current and prospective private fund investors and advisory clients as conducting a single advisory business by, for example, sharing personnel and resources.

The SEC staff accurately states that ERAs do not adopt supervisory policies and procedures designed to comply with the Advisers Act and the rules thereunder. The SEC, however, chose to exempt ERAs from both the rules requiring advisers to adopt supervisory policies and procedures, and from most of the provisions on which these procedures are based. Thus, it seems odd to fault ERAs for not having these procedures in place.

The Proposing Release also fails to consider the consequences of prohibiting multi-entity ERAs from filing a single Part 1A. Every entity in multi-entity ERA structures whose advice flows to a US fund may have to complete and file its own Part 1A. On top if this, thousands of special purpose vehicles (*e.g.*, fund general partners) may have to file as ERAs – even though they only exist on paper. This is because the SPV Guidance contains compliance policies and procedures requirements similar to the requirements for umbrella registration, which calls application of the SPV Guidance to multi-entity ERAs into question as well.

Excessive precautionary filings by ERAs will impose unnecessary costs on non-US advisers that are not discussed in the Proposing Release's economic impact analysis. Excessive filings will also result in data distortion, which the SEC staff specifically tried to avoid by issuing the 2012 ABA Letter and creating the new umbrella registration regime.

Separately Managed Accounts

Many investment advisers advise or manage non-pooled investment vehicles or accounts containing a client's assets. These so-called "separately managed accounts" or "***SMAs***" may hold the assets of pension plans, endowments, foundations, and other institutional or retail clients. The Proposed Amendments would add new questions to Form ADV to collect information about three aspects of an adviser's SMA business.

First, advisers would have to report the approximate percentage of SMA regulatory assets for ten asset categories. The asset categories would include exchange-traded equity securities, various types of bonds, derivatives, and assets issued by registered and unregistered funds. The SEC staff believes this information will help it identify advisers who specialize in certain asset classes and to monitor specialized advisers.

The Proposed Amendments would also establish a two-tiered scheme for reporting the derivatives and borrowings used in connection with SMAs. Advisers with more than US$150 million but less than US$10 billion in SMA assets would have to submit annual reports reflecting: (i) the number of accounts corresponding to certain categories of gross notional exposure; and (ii) the weighted average amount of borrowings in SMA accounts (as a percentage of net asset value).

Advisers with at least US$10 billion in SMA assets would also have to report detailed information about their specific use of borrowings and derivatives. This additional information would include the weighted average gross notional value of derivatives (as a percentage of net asset value) in six categories of derivatives (*i.e.*, interest rate derivatives, foreign exchange derivatives, credit derivatives, equity derivatives, commodity derivatives, and other derivatives). Advisers in this second category would have to update their submissions twice a year. The SEC staff believes that the information collected by this two-tier system will help it understand how advisers use derivatives and borrowings in SMAs.

The Proposed Amendments would also require investment advisers to identify all custodians accounting for at least 10% of their SMA assets, and to report the amount of SMA assets held by each custodian. The SEC staff believes this information will help it to understand who advisers use as custodians for SMA assets, and to notify advisers if concerns arise about specific custodians.

The Proposed Amendments are likely to have a material operating expense impact on advisers with extensive SMA businesses, by requiring them to report detailed information on their SMA business.

Other Proposals

The Proposed Amendments would also amend Form ADV to collect additional information about advisers and their operations. New questions would ask about an adviser’s use of social media and identify advisers whose chief compliance officers provide compliance services to multiple advisers. The Proposed Amendments would also seek additional information about an adviser’s offices other than its principal office and place of business. This information would include the number of other offices, the number of employees who perform advisory functions from each office, and the securities-related activities conducted from each office. The Proposed Amendments also seek to gather additional information about the amount of assets each adviser manages for different client types, and the amount of an adviser’s regulatory assets under management attributable to non-US clients. The SEC staff intends to use this new information to better understand each adviser’s operations and to enhance the SEC’s risk monitoring capabilities.

The Proposed Amendments would also adjust Advisers Act recordkeeping rules related to performance information. The Proposed Amendments would require advisers to make and keep supporting documentation that demonstrates performance calculations or rates of return in any written communications the adviser circulates or distributes to any person. The Proposed Amendments would also require advisers to maintain originals of all written communications received, and copies of written communications sent, by an adviser related to the performance or rate of return of any or all managed accounts or securities recommendations. The SEC staff believes these new requirements will better protect investors from fraudulent performance claims.

Finally, the Proposed Amendments would adjust the contents of Form ADV, its instructions, and its glossary, to facilitate the changes noted in this briefing, and to clarify how advisers should respond to certain questions.

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