Robinson+Cole

Investment Management

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# 2018 Investment Adviser Update—When it Comes to Regulatory Environment, It's "Meet the New Boss, Same as the Old Boss"

Private equity and hedge fund advisers continue to be subject to an increasing degree of supervision by the Securities and Exchange Commission (SEC) and other governmental agencies and self-regulatory organizations. The degree of supervision has not abated despite the generally lighter regulatory stance of the Trump administration. Let's first reflect on some significant statutory and regulatory changes in 2017 and then consider some recently adopted as well as potential changes and their impact in 2018 and beyond.


- Significant 2017 Changes
- Other Annual Reminders for RIAs and ERAs
- Some 2018 Considerations
- Other Recent Regulatory Developments and Guidance That May Affect an Adviser's Compliance Program
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## SIGNIFICANT 2017 CHANGES

*Recently Effective SEC Amendments to Form ADV Part 1A.* In August 2016, the SEC adopted substantial amendments to Form ADV Part 1A. As of October 1, 2017, any adviser filing an initial Form ADV or an ADV amendment must use the revised version of Form ADV. Among other things, the amendments: (a) require registered investment advisers (RIAs), state-registered advisers and applicants for registration 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 in SMAs; (b) streamline and standardize the process of "umbrella" registration ADV of related private fund advisers that conduct a single advisory business on one Form; (c) require new disclosure regarding social media, outsourced compliance officers and multiple office locations; and (d) revise or add certain other Form ADV items and instructions. Most of the substantive changes to Form ADV Part 1A appear under Item 1 and Item 5 or relate to umbrella registration. Only certain of the ADV revisions exempt reporting advisers (ERAs). Most RIAs and ERAs have a fiscal year end of December 31 and will likely first address the revised Part 1A requirements when preparing and filing their annual updating amendment.

*Annual Updating Amendment.* Each RIA is required to file an annual updating amendment to its Form ADV within 90 days of its fiscal year end. Part 1A and Part 2A (the adviser's brochure) are filed

electronically with the SEC via the Investment Adviser Registration Depository (IARD) and are publicly available. Part 2B, the brochure supplement, is not required to be filed with the SEC but is to be preserved by the adviser and made available, if requested, to the SEC for examination.

IARD will not accept an annual Form ADV updating amendment without (a) an updated Part 2A brochure, (b) a representation by the adviser that the brochure on file does not contain any materially inaccurate information or (c) a representation that the adviser is not required to prepare a brochure because it is not required to deliver it to any clients. In addition, IARD collects annual fees associated with Form ADV filings. An adviser should ensure proper funding is set up electronically prior to filing its annual amendment. An RIA must update its Form ADV Part 1A more frequently if required, as specified in General Instruction 4 to Form ADV, by filing an other-than-annual amendment. The adviser also is required to update and file its Part 2A brochure promptly when any information in the brochure becomes materially inaccurate.

*Annual Delivery of Brochure to Clients*. Within 120 days of its fiscal year end, an RIA will deliver to each client for which delivery is required either (a) its updated Part 2A brochure and a summary of material changes to the brochure, if any, or (b) a summary of material changes, if any, accompanied by an offer to provide the updated brochure, which, if requested, must be mailed within seven days or delivered electronically in accordance with SEC guidelines. The brochure is required to be delivered to “clients,” which the SEC staff has acknowledged does not include fund investors; however, many fund advisers voluntarily deliver the brochure to fund investors. Inaccurate, misleading or omitted Form ADV disclosure is a frequently cited deficiency in SEC examinations. Moreover, Form ADV and Form PF are linked electronically, and disclosure in the two forms must be consistent.

*Form ADV Annual Updating Amendment for ERAs*. ERAs relying on the “private fund adviser” exemption or the “venture capital fund adviser” exemption from SEC registration are required to file reports on Form ADV Part 1A with the SEC through IARD. An ERA, like an RIA, is required to amend its Form ADV at least annually, within 90 days of its fiscal year end, and more frequently if required, as specified in General Instruction 4 to Form ADV.

An ERA relying on the private fund adviser exemption is required to calculate annually the private fund regulatory assets under management (RAUM) it manages and report the amount in its annual Form ADV amendment. If a U.S.-based ERA reports in its annual amendment that it has U.S. $150 million or more of private fund RAUM or has accepted a client that is not a private fund, the adviser is no longer eligible for the private fund adviser exemption. A private fund adviser that has complied with all ERA reporting requirements but is no longer eligible for the private fund adviser exemption[1] because its RAUM meets or exceeds U.S. $150 million must apply for registration with the SEC within 90 days after filing the annual amendment. It may continue advising private fund clients during this period. This transition period is not available to an adviser that otherwise would not qualify for the private fund adviser exemption, such as an adviser that accepts a managed account. Rather, an adviser relying on this exemption is required to be registered with the SEC (or, if pertinent, with one or more states) prior to accepting a non-private fund client. The transition period also is not available to advisers relying on the venture capital fund adviser exemption; such an adviser (whether based in or outside of the United States) is required to register under the Advisers Act before accepting a client that is not a venture capital fund, unless the adviser is eligible for another exemption from registration.

*Annual Compliance Program Review*. Rule 206(4)-7 under the Advisers Act (the Compliance Rule) requires an RIA to designate a Chief Compliance Officer (CCO) and adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules thereunder by the adviser and its supervised persons. The Compliance Rule does not enumerate specific elements that must be included in the compliance policies and procedures. Rather, the SEC staff have indicated that they expect an RIA’s policies and procedures to be based on an assessment of the regulatory and compliance risks present in the adviser’s business that result in violations of the

Advisers Act (a risk assessment) and a determination of controls needed to manage or mitigate these risks.

A February 2017 Risk Alert issued by the SEC's Office of Compliance Inspections and Examinations (OCIE) described examples of deficiencies or weaknesses in connection with the Compliance Rule frequently identified in OCIE examinations. Examples include: (a) compliance manuals that are not reasonably tailored to the adviser's business practices; (b) an annual review was not performed or did not address the adequacy of the adviser's policies and procedures; (c) the adviser does not follow its compliance policies and procedures; and (d) compliance manuals that are not up-to-date.

*Periodic and Annual Review.* The Compliance Rule also requires an RIA to review at least annually the adequacy of its policies and procedures and the effectiveness of their implementation. The required annual review may be conducted in stages throughout the year or all at once, depending upon what works best for the adviser. The SEC staff have stated that an adviser's compliance program should continue to evolve in conjunction with an ongoing risk assessment (and re-evaluation) process. The annual review should include consideration of any developments during the year that might suggest a need to revise those adviser's compliance program.

*Training and Annual Certification.* The SEC staff have emphasized the importance of advisers educating their supervised persons concerning the general principles as well as the specific requirements of the adviser's compliance program. It is advisable that pertinent training take place on at least an annual basis, and more frequently as convenient or necessary, such as when an employee joins the firm or when the testing of policies and procedures demonstrates a lack of understanding of the policies and procedures.

*Exempt Reporting Advisers*. An ERA, as an unregistered adviser, is not required to adopt a comprehensive compliance program pursuant to the Compliance Rule or to comply with most other rules under the Advisers Act. Unregistered advisers, however, are still subject to the antifraud provisions of the Advisers Act. An ERA, therefore, should adopt reasonable compliance policies, procedures, and oversight to avoid even the appearance of a violation of the antifraud provisions or the ERA's fiduciary duty to clients. Like an RIA, an ERA is subject to the pay-to-play rule under the Advisers Act as well as the Advisers Act requirement that an adviser adopt policies and procedures reasonably designed to prevent insider trading. It is advisable that an ERA review at least annually the adequacy of its policies and procedures and make any needed revisions.

**Other Annual Reminders for RIAs and ERAs**

*Review of Disclosure and Offering Documents.* It is advisable for an adviser to review all disclosure documents (including fund-offering materials) at least annually to ensure that content and disclosure are accurate, up-to-date, and consistent across documents (including filings with the SEC and other regulators) and with the adviser's compliance policies and procedures. Advertising materials, pitch books and standard due diligence questionnaire responses should also be reviewed.

*Annual Personal Securities Holdings Report.* On an annual basis, an RIA is required to collect from each "access person" [by a date specified by the adviser] an annual personal securities holding report containing certain required information regarding securities holdings and all securities accounts. The information is required to be current as of a date no more than 45 days prior to the date the report is submitted.

*Annual Delivery of Privacy Notice.* An adviser is required to provide clients and fund investors who are natural persons with a privacy notice disclosing the adviser's practices for maintaining privacy of non-public personal information, both at or before the establishment of the customer relationship and annually thereafter. This privacy notice should make clients and fund investors aware of the right to "opt out" from the sharing of non-public personal information with unaffiliated third parties, if applicable. An adviser is not required to make an annual distribution of its privacy notice if the adviser

(a) only provides non-public personal information to unaffiliated third parties for limited, non-marketing-related purposes and (b) has not changed its policies and practices from those disclosed in the adviser's most recent privacy notice provided to clients and fund investors.

*Annual "Bad Actor" Recertification.* Private funds and other issuers are not permitted to rely on the exemption from Securities Act of 1933 (the Securities Act) registration provided by Rule 506 of Regulation D if the pertinent offering involves certain "bad actors." For continuous or other offerings of long duration, an adviser is required to update, with reasonable care, its factual inquiries (i.e., by email or questionnaire) to determine whether any covered persons have "disqualifying events," which might also require disclosure in Form ADV.

*Annual Eligibility for "New Issues."* An adviser should verify annually the eligibility of clients and fund investors to participate in new issues of publicly offered securities (i.e., initial public offerings, or IPOs) to make sure "restricted persons" are properly identified and their participation is appropriately restricted.

*Form D and "Blue Sky" Filings.* Form D filings for private funds with ongoing offerings lasting longer than one year are required to be amended annually, on or before the first anniversary of the initial Form D filing. On an annual basis, an adviser also should review "blue sky" filings for each state to ensure that any renewal requirements are met.

*Distribution of Audited Financials to Private Fund Investors.* An adviser relying on the "audit provision" of the Advisers Act Custody Rule with respect to its private fund clients is required to deliver audited financial statements of each pertinent private fund to fund investors within 120 days of the fund's fiscal year end or within 180 days of the private fund's fiscal year end, if the private fund is a fund-of-funds.

*BEA and TIC Reporting Requirements for Cross-Border Investments.* Investment advisers and other financial institutions can be required to file reports with the U.S. Bureau of Economic Analysis (BEA) for surveys of cross-border "direct investments" (generally defined as voting interests of 10 percent or more) U.S. entities, among other things[2], and with the U.S. Treasury Department, for Treasury International Capital (TIC) surveys of cross-border "portfolio investments" (generally defined as nonvoting interests and voting interests of less than 10 percent)[3].

Recent developments include a BEA change, in cooperation with the Treasury Department, to its direct investment surveys applicable for investment surveys conducted beginning in 2017. Under these changes, cross-border voting investments of 10 percent or more in, or by, private funds are subject to BEA reporting only if such investments involve, directly or indirectly, a direct investment in an "operating company," which the BEA defines as "companies that are not other private funds or holding companies." The BEA expects that some hedge fund firms that were subject to BEA direct investment reporting as a result of cross-border voting interests are now subject to TIC reporting, to the extent that their total cross-border investments exceed the generally much higher TIC reporting thresholds. Many private equity funds, however, remain subject to BEA direct investment reporting.[4]

The BEA Form BE-12 benchmark report on foreign direct investment in the United States will be due by May 31, 2018. The BE-12 requires proactive filing with respect to domestic operating entities directly owned by foreign persons.

**SOME 2018 CONSIDERATIONS**

The number of investment advisers examined by OCIE has increased significantly in recent years. The OCIE National Exam Program examined 15 percent of RIAs during FY 2017, exceeding its target level of 13 percent for the period, and up from 11 percent in FY 2016. Just five years ago, only 8 percent of RIAs were examined. In 2016, the SEC reassigned approximately 100 broker-dealer examiners to conduct investment adviser exams.

*SEC Examination Priorities.* On February 7, 2018, OCIE released its list of examination priorities for 2018 (Exam Priorities), highlighting certain concerns and risks SEC officials have expressed in the past few years. The Exam Priorities can serve as a roadmap for advisers to assess their policies, procedures and compliance programs; test for and remediate any suspected deficiencies related to the Exam Priorities; and prepare for OCIE exams. OCIE's current examination priorities, as outlined in the February 7 release, are organized around five themes: (a) retail investors, including seniors and those saving for retirement; (b) compliance issues and risks associated with entities that provide critical market infrastructure, including clearing agencies, national securities exchanges, transfer agents and Regulation Systems Compliance and Integrity (SCI) entities; (c) SEC oversight of the Financial Industry Regulatory Authority (FINRA) and the Municipal Securities Rulemaking Board (MSRB); (d) cybersecurity; and (e) anti-money laundering programs of financial institutions that are required by regulations adopted under the Bank Secrecy Act to establish such programs.

*EU Update.* On January 3, 2018, the second EU Markets in Financial Instruments Directive (MiFID II) and the Markets in Financial Instruments Regulation (MiFIR) came into effect across the EU. MiFID II reforms the way in which EU markets and their participants operate. Non-EU investment advisers, even if they do not have any direct EU presence, are advised to consider the direct and indirect obligations and resulting changes to their compliance programs based on the MiFID II framework. Non-EU investment advisers already may have received new documentation from their brokers and requests for information from distribution partners as a result of changes introduced by MiFID II. In addition, the EU PRIIPs Regulation on Packaged Retail and Insurance-based Investment Products (PRIIPs) came into effect January 1, 2018. The PRIIPs Regulation introduces an EU-wide regime for the promotion of investment products to retail investors in the EU. Non-EU investment advisers fall within the scope of the PRIIPs Regulation if they allow their products to be made available to retail investors (even if as a result of a "reverse solicitation"). The principal requirement under the PRIIPs Regulation is to publish a "key information document" (KID) for retail investors. Non-EU investment advisers should consider whether the time and costs associated with producing a KID make it unviable to promote their investment products to retail investors in the EU. If so, such firms should consider taking steps to ensure that their products are not distributed to retail investors.

**Other Recent Regulatory Developments and Guidance That May Affect an Adviser's Compliance Program**

The following selected regulatory developments may affect the compliance programs of certain advisers. Advisers should consider reviewing these and other changes in applicable laws, rules, regulations and/or SEC staff guidance to determine whether compliance policies and procedures need to be added or revised.

*Recordkeeping Rule Amendments*. Amendments to Advisers Act Rule 204-2 (the Books and Records Rule) that the SEC adopted in August 2016 became effective as of October 1, 2017, requiring RIAs to maintain additional documentation related to the calculation and distribution of performance information. In accordance with the amended rule, any adviser subject to the rule that distributes performance-related communications after October 1, 2017 is required to maintain additional records as follows:

- Rule 204-2 historically required advisers subject to the rule to maintain records supporting performance claims in communications that were distributed or circulated to 10 or more persons. The amendments remove the "10 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.

- Rule 204-2 historically required advisers subject to the rule to maintain certain categories of written communications received and copies of written communications sent. The amendments add a new category of communications that must be maintained — e.g., 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. The release noted that the SEC staff believe most advisers currently maintain this information.

These changes require an adviser subject to the Books and Records Rule that circulates or distributes any communication after October 1, 2017, and which includes performance information generated prior to that date, to maintain the materials listed in the Books and Records Rule that are necessary to form the basis for, or demonstrate the calculation of, such prior performance or rate of return.

**Enforcement Initiatives and Proceedings**

In September 2017, the SEC announced the establishment of a Retail Strategy Task Force, which will leverage data analytics and technology to identify large-scale misconduct affecting retail investors. The task force will include SEC Enforcement Division personnel from around the country and will work with staff across the SEC, including from the National Exam Program and the Office of Investor Education and Advocacy.

The Enforcement Division issued a report in November 2017 highlighting its priorities for the coming year, quoting SEC Chairman Jay Clayton's statement that the SEC's mission "starts and ends with the long-term interests of the Main Street investor." However, the report also included a message from the Enforcement Division's Co-Directors, who stated that "[a]s we enhance our focus on retail investors, we will continue to vigorously pursue cases against financial institutions and intermediaries. We do not face a binary choice between protecting Main Street and policing Wall Street."

Recent enforcement actions involved the improper allocation by an RIA of fees and expenses to private equity fund clients and improper allocation of broken-deal expenses by an RIA that manages private equity funds.

In addition, the SEC settled an enforcement action involving multiple charges that reflect several current SEC compliance concerns, including the Custody Rule and the Compliance Rule.

**Form PF Reporting Requirements**

Most RIAs that advise private funds are required to file Form PF on either a quarterly or an annual basis; advisers that are exempt from SEC registration, including ERAs, are not required to file Form PF. Form PF, which is a joint form between the SEC and the Commodities Futures Trading Commission (CFTC) with respect to Sections 1 and 2 of the form, is filed with the SEC via the Private Fund Reporting Depository (PFRD) electronic filing system and is not publicly available.

Given the volume and complexity of the work involved, many private fund advisers face a number of challenges in preparing Form PF, including making decisions regarding (and documenting) assumptions and methodologies, due to the ambiguous or subjective nature of a number of Form PF's instructions, definitions and questions. The SEC staff have provided assistance with respect to these issues and other Form PF questions, both directly in response to private inquiries and in FAQs posted (and periodically updated) on the SEC's website.

*Who Must File.* An RIA is required to file Form PF if it (a) advises one or more private funds and (b) collectively, with related persons (other than related persons that are separately operated), had RAUM of $150 million or more (calculated in accordance with Form PF aggregation requirements) attributable to private funds as of the end of its most recently completed fiscal year.

To avoid duplicative reporting, Form PF information regarding sub-advised funds should be reported by only one adviser. The adviser that completes information in Form ADV Schedule D Section 7.B.1 with respect to any private fund is also required to report that fund on Form PF. If, however, the adviser reporting the private fund on Form ADV in Section 7.B.1 is not required to file Form PF (i.e., because it is an ERA), then another adviser, if any, to the fund, if required to file Form PF, must report the fund on Form PF.

*Determining an Adviser's Filing Category.* The scope of required Form PF disclosure, the frequency of reporting, and the filing deadlines differ based on the RAUM of the adviser attributable to different types of private funds—in particular, hedge funds, liquidity funds and private equity funds. Accurately determining an adviser's filing category is a critical first step. Specific definitions of fund types are provided in the Form ADV Part 1A Instructions and the Form PF: Glossary of Terms.

Please refer to our newsletter regarding the Tax Cuts and Jobs Act (H.R. 1) and its effect on the private equity and venture capital industry.

Finally, please also refer to our newsletter for annual calendar-related filing dates, ongoing and compliance requirements, and additional annual considerations that private fund advisers may wish to consider.

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1. An ERA based outside of the United States will lose the exemption if it (i) manages private fund assets of U.S. $150 million or more at a place of business in the United States; (ii) advises a U.S. client other than a private fund (*e.g.*, a managed account for a U.S. institution or pension plan); or (iii) manages any non-private-fund assets at a place of business in the United States. For purposes of this exemption, a single investor fund or "fund of one" generally will be deemed to be a managed account.
2. These include both surveys for foreign direct investment in the United States such as BE-13, BE-605, BE-12 and BEE-15, and surveys of U.S. direct investment abroad, such as BE-577, BE-10 and BE-11.
3. These TIC surveys include the TIC Form S, TIC Form SLT, and for 2017, the TIC Form SHC.
4. Further information on these changes is available on the BEA website.

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If you have any questions, please contact the author, Shant H. Chalian, or another member of Robinson+Cole's Investment Management Group.

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