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SEC Registered Investment Advisers—A Review of 2016 and a Look at What's Ahead for 2017

As we near the seventh anniversary of the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), private equity and hedge fund advisers are subject to an ever-increasing degree of supervision by the Securities and Exchange Commission (SEC) and other governmental agencies and self-regulatory organizations. At the same time, the regulations governing advisers and their activities are constantly changing. This annual update serves as a brief snapshot of some U.S. and offshore regulatory changes and proposals. We first reflect on some significant statutory and regulatory changes in 2016 and then consider some recently adopted and potential changes.

SIGNIFICANT 2016 CHANGES

Adjustment of Qualified Client Definition. On June 14, 2016 (effective August 15, 2016), the SEC issued an order increasing the net worth threshold for "qualified clients" under the Investment Advisers Act of 1940 (Advisers Act) from $2 million to $2.1 million. This change reflects the SEC's obligation to revise the qualified client thresholds to account for inflation. It affects investment advisers who contract with clients (including fund investors) for performance-based compensation. The assets-under-management threshold of $1 million is unchanged. Additional information can be found here.

Defend Trade Secrets Act of 2016. On May 11, 2016, President Obama signed into law the Defend Trade Secrets Act of 2016 (DTSA). The DTSA provides companies with a new federal cause of action for the misappropriation of trade secrets. To take advantage of this new cause of action, however, specific language must be included in a company's employment and contractor agreements. As many investment advisers rely on trade secrets to protect their "competitive edge," they may wish to consider consulting with counsel to review and possibly amend their existing agreements in light of the DTSA. Additional information about the DTSA and specific requirements can be found here.

Revisions to Form ADV. On August 25, 2016, the SEC adopted revisions to Part 1A of Form ADV. These revisions become effective on October 1, 2017, meaning that most investment advisers will first encounter the SEC's revised Form ADV and new informational requests when they file their annual Form ADV amendment in the first quarter of 2018. Some of the key revisions are as follows:

- Separately Managed Accounts. Separately managed accounts (each an SMA) are the primary target of the SEC's revisions to Part 1A of Form ADV. While the SEC has collected a significant amount of data on private funds since the adoption of Dodd-Frank, it has collected far less with respect to SMAs. The revised Form ADV is intended to address this

informational gap. The SEC has, however, not provided an explicit definition of an SMA in connection with these revisions. Instead, an adviser is instructed that a "separately managed account" (for the purposes of the Form ADV) is any advisory account other than a pooled investment vehicle (that is, a registered investment company, a business development company, or a private fund). This means an adviser that provides advisory services to a pension plan or a sovereign wealth fund, as well as to other non-pooled investment vehicle advisory accounts, such as to high net-worth individuals, will be required to consider such advisory clients as an SMA with respect to the Form ADV.

- Under the revised Form ADV, advisers will be asked to provide aggregated information about their SMA advisory clients, including the types of assets which they hold and their exposure to derivatives and leverage. The frequency, scope, and detail of information an adviser is asked to provide depends on the total regulatory assets under management (RAUM) of an adviser's SMAs. Those with RAUM greater than $10 billion will have the largest disclosure requirements while those under $500 million will have the least. With respect to reporting the types of assets held by the adviser's SMAs, the SEC has provided 12 categories of assets from which to select. Advisers are instructed to use a reasonable methodology to determine which assets fall within which categories and to avoid double counting any SMA asset. Additionally, all advisers are required to provide information about any custodian who holds more than 10 percent of the adviser's RAUM attributable to SMAs—this is similar to what is requested from private fund custodians.

- Social Media Accounts. While the current Form ADV instructs advisers to provide their firm's website address, the revised Form ADV also requests information about an adviser's social media accounts. The SEC has clarified that an adviser should only include accounts where the adviser is able to control the content associated with the account and explicitly mentioned Facebook, Twitter, and LinkedIn as examples of such accounts. If a website automatically creates a profile for an adviser without the adviser's consent, or the adviser otherwise has no control over the information and content associated with the profile as per SEC guidance, the adviser should not include such account when completing this section of the revised Form ADV. An adviser will not be required to disclose the social media accounts of its employees.

- Umbrella Registration. The SEC has historically permitted related advisers that operate as a single advisory business through multiple legal entities to register as such by filing a single Form ADV. Unfortunately, the filing, which was designed for single rather than multiple legal entities, caused confusion for such related advisers. The revised Form ADV has simplified and clarified who is eligible to qualify for "umbrella registration," as well as the information requested from each adviser in connection with this. The SEC noted that umbrella registration is only available for those advisers who operate as a single advisory business and satisfy each of five conditions evidencing such fact, as further described in the applicable Form ADV instructions. Advisers who believe they may be eligible to qualify for such umbrella registration status may wish to consult with counsel.

- Other Key Revisions to Form ADV. The revised Part 1A of Form ADV includes a variety of other changes, some of which are described below;

    - Item 1.F—An adviser will now be required to disclose its total number of offices, as well as the address and other information for its 25 largest offices in terms of employees. This is an expansion of the scope of the current question, which only asks for the address and contact information of an adviser's principal place of business and its five largest offices.

    - Item 1.J—An adviser must now disclose if its chief compliance officer is employed or compensated by anyone other than the adviser and, if so, disclose the name and other information of such third party. This change was made to help the SEC track the effectiveness of outsourced compliance providers.

- Item 5—An adviser must now report the actual number of clients it advises for each client type and the RAUM attributable to such clients, as opposed to the percentage ranges requested in the current Form ADV.

- Section 7 of Schedule D—Advisers to Section 3(c)(1) private funds must now indicate if the adviser limits sales of interests in such funds to "qualified clients," as defined in the Advisers Act. Those advisers who are exempt-reporting advisers with the SEC, or otherwise not subject to the "qualified client rule" with respect to performance fees, may answer "No" to this question.

- Rule 204-2 of the Advisers Act. In addition to the revised Form ADV Part 1A, the SEC also amended the record-keeping requirements of the Advisers Act. Specifically, SEC-registered investment advisers will now be required under Rule 204-2 of the Advisers Act to maintain the materials described in Rule 204-2(a)(16) of the Advisers Act 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." Under the current Rule 204-2, SEC-registered investment advisers are only required to keep such supporting documentation if the communications are distributed to ten or more persons. These amendments considerably expand the scope of the rule to encompass all performance-related communications, including, but not limited to, custom calculations requested by a single investor or potential investor. Additionally, advisers will now be required to retain original copies of all written communications related to performance or rate of return that are sent to or received from any third party. These amendments to the record-keeping requirements of the Advisers Act will apply to all communications circulated or distributed after October 1, 2017. While investment advisers who are exempt from registration with the SEC are technically not subject to these new record retention rules, all advisers, regardless of registration status, may wish to consider whether to retain such records in any event as part of their best practices.

Additional information about the specific revisions can be found here.

SEC Publishes Guidance on Qualified Institutional Buyer Status. In December 2016, the SEC updated its FAQ regarding an entity's status as a Qualified Institutional Buyer (QIB) under Rule 144A offerings. Under Rule 144A, an entity must have assets of at least $100 million to be considered a QIB. In its updated FAQ, the SEC clarified that securities held in margin accounts count towards the $100 million threshold, but short positions and borrowed securities do not. Relatedly, a limited partnership (such as a private investment fund) can be considered a QIB under Rule 144A if all of its limited partners are QIB. The general partner of the limited partnership need not be a QIB if the general partner is not also a limited partner. See Section 138 of the FAQ, which can be found here.

Cayman Islands Enacts Limited Liability Company Law. On July 18, 2016, the Cayman Islands enacted the Limited Liability Companies Law, 2016 (LLC Law). The LLC Law created a new entity form in the Cayman Islands (a limited liability company) with features similar to a Delaware limited liability company. This new entity form is available to investment advisers with offshore fund operations. Advisers may wish to consider contacting their offshore counsel to determine whether a Cayman limited liability company is appropriate for their current and future fund structuring needs.

Amendment of U.S. Partnership Audit Rules. The rules and procedures used by the IRS when auditing partnerships, including limited partnerships, were recently amended to facilitate the collection of tax payment deficiencies. Under rules enacted as part of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), the IRS was required to audit at the partnership level and to assess and collect any tax underpayment at the partner level. In practice, the foregoing approach has been difficult to administer and enforce, as the number and complexity of tax partnerships (including limited liability companies taxed as partnerships) has grown. In 2015, Congress repealed the TEFRA partnership audit rules for taxable years beginning after December 31, 2017. In place of TEFRA are new rules

intended to ease the administrative burden on the IRS in connection with the assessment and collection of underpayments of income tax. Under the new rules and procedures, any adjustment to items of income, gain, loss, or deduction is determined at the partnership level, and any underpayment attributable to that may be assessed and collected at the partnership level rather than at the partner level. The new approach may cause a portion of the economic burden of any assessed tax to be borne by partners who had no interest in the partnership during the taxable year under audit. Certain partnerships may be able to avoid the foregoing result pursuant to detailed provisions which may allow certain partnerships with 100 or fewer partners, all of which are either individuals or corporations, to elect out of the new rules and may allow partnerships to elect to "push out" the tax liability to the persons who were partners during the audited year. The new rules also include complex provisions governing how partnership adjustments and imputed underpayments will be determined and how interest and penalties will be computed. Given the complexity of the new rules and their potential impact on partners, it may be a good time for partnerships to review their agreements to determine if any amendments are necessary or advisable.

SOME 2017 CONSIDERATIONS

SEC Examination Priorities. On January 12, 2017, the SEC released its National Examination Program Priorities (Priorities). As further described in the Priorities, the SEC will continue its focus on protecting retail investors and minimizing system-wide risks. Specific areas of interest include cybersecurity, anti-money laundering compliance, "roboadvisers," and investment managers who have yet to be examined. Notably, private fund advisers remain on the list of the SEC's examination priorities.

President Trump Orders Further Review of "Fiduciary Rule." In April 2016, the U.S. Department of Labor (DOL) released a new rule (Fiduciary Rule) that expanded who is considered a "fiduciary" under the Employee Retirement Income Security Act of 1972. Under the Fiduciary Rule, which was set to become effective in April 2017, certain investment advisers would be subject to a higher "best interest" standard of care with respect to their retirement plan clients. President Trump's executive order on February 3, 2017, instructed the DOL to prepare additional analyses of the Fiduciary Rule's impact on the availability of retirement savings and financial advice, the pricing of retirement savings services, and related issues. Based on such analyses, the DOL may be required to revise the Fiduciary Rule or eliminate it entirely. It is unclear at this time whether the Fiduciary Rule will ever become effective.

SEC Settles Pay-to-Play Enforcement Actions. In January 2017, the SEC settled enforcement actions against ten separate advisory firms who allegedly received compensation in violation of the pay-to-play rule from public pension funds to which the firms' associates had made political contributions within the prior two years. The pay-to-play rule imposes a two year moratorium on providing advisory services for compensation to a government investor if a "covered associate" of an advisory firm has made political contributions to any candidate who can influence the decision of such government investor to engage such advisory firm. Many of the prohibited contributions in the ten enforcement actions were small (such as $400), indicating that the SEC requires strict compliance with the pay-to-play rule. Advisory firms are encouraged to regularly review their pre-clearance procedures and ensure that all employees are aware of the applicable regulations. Additional information about the enforcement actions can be found here.

Anti-Money Laundering. The U.S. Treasury Department's Financial Crimes Enforcement Network (FinCEN) is expected to publish the final version of a rule that subjects SEC-registered investment advisers (RIAs) to the same anti-money laundering (AML) rules and regulations applicable to banks, broker-dealers, and other financial institutions. The rule is expected to, among other things, require RIAs to develop and implement a written AML program designed to identify and prevent the use of the RIA by its investors for money laundering purposes, as well as require the RIA to submit Suspicious Activity Reports for investor activities involving more than $5,000 in funds. As AML regulations continue to expand, all investment advisers may find it beneficial to continually monitor existing regulations and proactively build out their AML compliance programs in anticipation of

forthcoming requirements.

AIFMD Passport for U.S.-Based Investment Advisers. While EU-based investment advisers may market their investment funds across the European Economic Area (EEA) under a "marketing passport" without having to register under the private placement regimes in each EEA country, US-based investment advisers may not. The European Securities and Markets Authority (ESMA), which regulates the marketing passport program, is actively considering expanding the program to include investment advisers based in Canada, Japan, the United States, and certain other countries. However, it is anticipated that any such expansion to U.S.-based investment advisers will include restrictions on the types of funds that can be marketed under the program, such as funds that only admit institutional investors as opposed to those who also admit high net worth individuals. For the time being, U.S.-based investment advisers will remain subject to the myriad country-specific private placement regimes when marketing their investment funds in the EU.

Taxation of Carried Interest. President Trump has indicated that he would support taxing carried interest at ordinary tax rates, but so far there has not been any indication from the president as to whether this is a priority. We will continue to monitor this closely.

General Reform of Dodd-Frank. President Trump has also indicated a strong desire to amend certain provisions of Dodd-Frank, particularly those provisions such as the Volcker Rule which added lending restrictions on banks. It is unclear at this time what the full extent of any proposed changes will be.

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.

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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