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CLIENT MEMORANDUM

SEC Proposes Public Disclosure Regarding Separately Managed Accounts, Changes to Adviser Registration and Enhanced Recordkeeping Around Adviser Performance

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On May 20, 2015, the Securities and Exchange Commission (the "Commission" or the "SEC") unanimously proposed (i) changes to disclosure requirements applicable to SEC-registered investment advisers, (ii) a codification of prior SEC Staff guidance permitting a streamlined "umbrella registration" process for affiliated private fund advisers and (iii) enhanced recordkeeping requirements related to written communications regarding adviser performance under the Investment Advisers Act of 1940 (the "Advisers Act").[1] The SEC noted that state securities authorities intend to consider similar requirements for state-registered advisers.[2] The proposals were published in tandem with new disclosure requirements for registered investment companies about portfolio holdings and risk metrics.

The proposals implement regulatory initiatives described by Chair White, in speeches given in December 2014[3] and February 2014.[4] The Chair expressly alluded to the disclosure proposals in her December speech and noted at that time, as the Commission noted in the Proposing Release, that the new disclosure information would be used to inform examination priorities and monitor risks associated with funds and separately managed accounts.[5] The proposals mark a significant effort by the SEC to collect data and occupy a regulatory area where the Financial Stability Oversight Council and other international coordinating bodies have threatened to encroach on the SEC's jurisdiction and treat asset managers and the products and services they offer as systematically important. At the same time, the SEC is using the adviser proposal to update and streamline several features of Form ADV.

Proposed Amendments to Form ADV

A. Separately Managed Accounts

Investment advisers currently are not required to provide regular reports to the SEC containing specific portfolio information regarding separately managed accounts ("SMAs").

The SEC proposed changes to Schedule D of Form ADV to collect additional data from registered advisers for both institutional and retail SMAs. All accounts other than funds or business development companies must be counted as SMAs, including managed accounts that invest side by side with a fund and follow the same investment objective ("Parallel SMAs"). As noted by the SEC in the past, single-investor funds may be treated as SMAs by the SEC depending upon the particular facts and circumstances. The information would need to be filed only once a year as part of an adviser's annual update to Form ADV.

The level of detail required to be reported under the proposal would depend upon the amount of the adviser's regulatory assets under management ("RAUM").[6] The proposed requirements are as follows:

SMA RAUM	Reporting Requirements	Reporting Period(s)
Less than $150 million	• Approximate percentage of SMA RAUM invested in each of 10 asset categories[7] • Name of any custodian that accounts for at least 10% of SMA RAUM • Amount of SMA RAUM held with each custodian	Adviser's Fiscal Year-End
$150 million to less than $10 billion	• Approximate percentage of SMA RAUM invested in each of 10 asset categories • Number of accounts by gross notional exposure category[8] • Weighted average amount of borrowings[9] (as a percentage of net asset value) by gross notional exposure category • Name of any custodian that accounts for at least 10% of SMA RAUM, and the amount of SMA RAUM held with each custodian	Adviser's Fiscal Year-End
$10 billion or more	• Approximate percentage of SMA RAUM invested in each of 10 asset categories • Number of accounts by gross notional exposure category • Weighted average amount of borrowings (as a percentage of net asset value) by gross notional exposure category • Weighted average gross notional value of derivatives (as a percentage of net asset value) in six categories of derivatives[10] • Name of any custodian that accounts for at least 10% of SMA RAUM, and the amount of SMA RAUM held with each custodian	Adviser's Fiscal Mid-year and year-end periods[11]

The proposed changes would affect most registered investment advisers since approximately 73% of all investment advisers registered with the Commission reported managing assets attributable to SMAs.[12] Although the Proposing Release does not include any detail, the disclosure requirements appear to include both retail wrap account sponsors and

wrap account portfolio managers.[13] We would expect that it may be difficult for some sponsors and portfolio managers to collect the portfolio information required under the new rules given the large number of accounts managed under the programs. As a result, as part of the comment process, it may be useful for retail sponsors and wrap account managers to seek to limit the reporting obligations applicable to retail wrap account sponsors and portfolio managers to the information included in Section 5.I.(2) of Schedule D, *i.e.*, identifying information about the sponsor and manager and listing total SMA RAUM,[14] without requiring a breakout of portfolio holdings across the accounts by asset category. In the alternative, if the SEC were to require portfolio breakout by asset category for the wrap program accounts, it may be possible to provide sufficient disclosure by reflecting the composition of a single, representative SMA for each investment strategy together with disclosure of total SMA RAUM held on a sponsor-by-sponsor basis.

Although the information required to be disclosed would be aggregated across clients[15] and would not include specific portfolio holdings or names of derivatives counterparties, it would be publicly available upon filing (*i.e.*, within 90 days after the investment adviser's fiscal year-end)—in contrast to the comparable information required to be reported in respect to private fund advisers on Form PF, which is not publicly available. Depending upon the variety of strategies managed by the reporting adviser, the Form ADV disclosures could provide information to the market about changes in asset composition and adviser focus (*e.g.,* a shift from equities to fixed income), which may have a signaling effect to other market participants and, thereby, betray trading strategies, depending upon the public profile of the investment adviser. The potential commercial implications of these disclosures would be heightened for investment advisers that manage a very small number of SMAs (such as a single Parallel SMA).

The SEC's proposal regarding disclosure of derivatives exposure has the benefit of being simple and provided on an aggregated basis. However, the approach taken by the SEC may result in increased concern about derivatives exposures and provide inaccurate information to the public about the scope of systemic risk. For example, because the disclosure would be based on notional value as opposed to mark-to-market exposure, the size of the positions will look significantly larger than the actual exposures held by accounts. In addition, the disclosure may also result in overstating outstanding exposures under derivatives because the requirements do not appear to eliminate offsetting positions. In order to provide an accurate picture of credit risk and counterparty risk due to derivatives, it arguably would also be important to require disclosure of collateral posted or received by an SMA. Finally, the systemic risks inherent in derivative positions vary considerably depending upon the duration of the derivatives held by the SMA and the intended use by the SMA of the derivatives. As a general matter, short-term derivatives used solely for hedging purposes (such as one-month currency forwards) present a significantly different level of risk than long-term (*e.g.*, 30-year) speculative, unhedged positions. This lack of specificity in the disclosure may mislead investors and cause the SEC to focus on the less risky segments of the market rather than those that the Commission seeks to target. The release invites comment on these and other features of the SMA-related disclosure proposals.

B. Additional Identifying Information Regarding the Operations of Investment Advisers and Clarifying Changes

The proposed amendments to Form ADV would require investment advisers to provide additional information to the investing public as well as to the Commission about their businesses, clients and proprietary assets. The disclosure

focuses on ways to identify the scope of an adviser's operations. The SEC indicated that the information is intended to assist the SEC's own risk assessment process and conduct more effective examinations.[16] The SEC also suggested that it would focus on the scope of an adviser's non-U.S. clients in assessing risks associated with the adviser.[17] Another area of focus underlying the proposed requirements relates to social media and its use by investment advisers. Notably, the release requests comment on whether the disclosure should include information regarding the social media accounts of employees. This suggests that the SEC may be evaluating the need to issue additional guidance regarding use of social media by investment advisers. The proposed changes to the general disclosures about advisers in Form ADV are as follows:

Category	Required Disclosure
Central Index Key ("CIK") Number	All SEC-assigned CIK numbers, regardless of whether the adviser is a public reporting company under Section 12 or 15(d) of the Securities Exchange Act of 1934
Social Media	Disclosure regarding the adviser's websites, including social media platforms such Twitter, Facebook and LinkedIn, and a listing of all such websites
Branch Offices	A listing of the total number of the adviser's offices at which the adviser conducts its advisory business; information about each of the adviser's 25 largest offices (by number of employees), including number of employees, CRD number and business conducted at such office
Chief Compliance Officer ("CCO")	Disclosure regarding whether the adviser's CCO is compensated by any person other than the adviser (or a related person of the adviser) for providing compliance services and, if so, the name and IRS Employer Identification Number for such person
Proprietary Assets (only required if the adviser has $1 billion of more in proprietary assets)	Disclosure of the amount of the investment adviser's proprietary assets, ranged as follows: (i) $1 billion to less than $10 billion, (ii) $10 billion to less than $50 billion, and (iii) $50 billion or more (This information is designed to assist the SEC in establishing methodologies for stress testing investment advisers and funds as required by Section 165 of the Dodd-Frank Act.)
Client Types	A listing of the number of advisory clients and RAUM for each client type[18]
Non-Discretionary Clients	A listing of the number of clients for whom the adviser provides advisory services but does not have RAUM
Client Asset Computations	Whether the adviser uses a different method to compute client assets for Part 2A than the method used to compute RAUM
Parallel SMAs	The RAUM for all Parallel SMAs
Non-U.S. Clients	The approximate amount of RAUM attributable to non-U.S. clients
Wrap Fee Programs	The total amount of RAUM attributable to the adviser acting as a sponsor and/or portfolio manager of a wrap fee program; SEC File Number and CRD number for sponsors to wrap fee programs

The request for information regarding proprietary assets of advisers is interesting in light of the discussion regarding the need for investment advisers and funds to be subject to capital standards. Regulators in other jurisdictions do impose capital requirements on advisers. The U.S. asset management industry has consistently argued against this need in light of the fact that advisers typically do not custody assets and do not invest proprietary funds. The collection of information by the SEC on these data points should better position the Commission, if it so desires, to resist calls for imposition of capital standards on funds and advisers.

C. Umbrella Registration of Private Fund Advisers

The proposed amendments would codify guidance articulated by the Staff in a No-Action Letter provided to the American Bar Association in 2012 (the "ABA No-Action Letter")[19] enabling multiple, affiliated private fund advisory entities that operate within a single advisory business to register using a single Form ADV. The proposal would amend the instructions of Form ADV to set forth the conditions under which the consolidated registration (referred to as "Umbrella Registration") would be available to the separate general partners or other affiliated advisers operating as a single advisory business. The SEC noted that it was taking this action to amend Form ADV to make it better adapted to Umbrella Registration.

These conditions for Umbrella Registration are as follows:

1. The filing adviser and each additional relying adviser manage only private funds and clients that are: (a) qualified clients,[20] (b) eligible to invest in private funds advised by the filing adviser or a relying adviser, and (c) investing with the adviser through an account that is pursuing investment objectives and strategies that are substantially similar to or otherwise related to those followed by private funds advised by the adviser (*e.g.*, Parallel SMAs).

2. The filing adviser has its principal office and place of business in the United States and, therefore, all of the substantive provisions of the Advisers Act and the rules thereunder apply to the filing adviser's and each relying adviser's dealings with each of its clients, regardless of whether any client or the filing adviser or relying adviser providing the advice is a United States person.

3. Each relying adviser and each of its employees and the persons acting on its behalf is subject to the filing adviser's supervision and control and, therefore, each relying adviser, its employees and the persons acting on its behalf is a "person associated with"[21] the filing adviser.

4. The advisory activities of each relying adviser are subject to the Advisers Act and the rules thereunder, and each relying adviser is subject to examination by the SEC.

5. The filing adviser and each relying adviser operates under a single code of ethics adopted in accordance with Advisers Act Rule 204A-1 and a single set of written policies and procedures adopted and implemented in accordance with Advisers Act Rule 206(4)-(7) and administered by a single CCO in accordance with that rule.

Under the proposal, if a group of affiliated advisers choose to file an Umbrella Registration, the filing adviser must file a single Form ADV that contains all of the required information relating to both the filing adviser and the relying advisers. The filing adviser would also be required to file a new Schedule R with respect to each relying adviser. Schedule R includes identifying information regarding the relying adviser, the basis of the SEC registration, the form of organization of the relying adviser, the relying adviser's address and a list of the control persons. The filing adviser would also be required to disclose in Schedule D to Part 1A of Form ADV the name of the adviser or relying adviser that manages or sponsors each specified private fund. Advisers qualifying for Umbrella Registration would be permitted but not required to file consolidated registrations under the proposed amendment. Foreign advisers and exempt reporting advisers (*i.e.*, entities exempt from adviser registration due to the fact that they exclusively advise one or more venture capital funds or advise solely private funds and have assets under management in the United States of less than $150 million) would not be eligible to rely on the Umbrella Registration methodology.

While one of the stated intentions of the proposal is to codify the relief provided in the ABA No-Action Letter and thereby streamline the filing process for private fund advisers operating as a single business through multiple legal entities,[22] the proposal may be more limiting than the no-action relief. In our view, the articulated rationale for this codification would also support making Umbrella Registration available to affiliated foreign advisers and exempt reporting advisers. In order to preserve flexibility, it will be important for the industry to comment on these proposed changes.

The new requirements also would provide additional data to the SEC regarding relying advisers and consolidate information about relying advisers in one place. As is the case with all of the additional data collected by the SEC under the proposals, our expectation is that the SEC will use the information both in connection with the examination process and its enforcement program.

For private fund advisers that also are registered with the Commodity Futures Trading Commission (the "CFTC") as commodity pool operators and/or commodity trading advisors, there is no parallel consolidated registration process. As a result, for advisers to private funds that must also register with the CFTC, it is not clear that the Umbrella Registration will provide a significant benefit.

D. Technical Amendments to Form ADV and Advisers Act Rules

The proposals included several technical and conforming changes to Form ADV in large part to remove expired provisions. The proposals also included amendments to SEC rules under the Advisers Act to remove outdated provisions.

Proposed Amendments to Rule 204-2

The SEC proposed limited amendments to the books and records rule applicable to registered investment advisers to require advisers to retain records substantiating performance claims or rates of return as well as to retain originals of all written communications received and copies of all written communications sent regarding performance and rates of return for any managed account or securities recommendation. The latter requirement originated from a recent failed

enforcement action in connection with which the SEC was unable successfully to bring an action against an adviser due to the lack of records.

Advisers Act Rule	Current Rule	Proposed Changes
204-2(a)(7)	Retention of originals of all written communications received and copies of all written communications sent by such investment adviser relating to (i) any recommendation made or proposed to be made and any advice given or proposed to be given, (ii) any receipt, disbursement or delivery of funds or securities, or (iii) the placing or execution of any order to purchase or sell any security.	Amendment would expand the categories of *written communications* received or sent by an investment adviser and that must be maintained to include communications relating to the performance or rate of return of any or all managed accounts or securities recommendations.
204-2(a)(16)	Retention of records or documents forming the basis for the calculation of performance information regarding a managed account or securities recommendation contained in a communication distributed to 10 or more persons.	Same as the current rule except that investment advisers must retain records supporting performance information included in any communication.

Rule 204-2 relates only to performance information regarding "managed accounts." This term is not defined in Rule 204-2 or in the proposing release, but it may be useful for the SEC to clarify the scope of the term relative to SMAs and private (or registered) funds.

Timing

The release contains over 50 questions relating to the various proposals. Comments are due 60 days after publication of the Proposing Release in the Federal Register.

Potential Areas for Future Reform Relating to Investment Advisers

Chair White indicated in her December 2014 speech that the Staff has been developing recommendations to implement three core initiatives to enhance regulation of investment advisers and funds: (i) expanded and updated data requirements; (ii) enhanced controls for registered funds on risks related to the composition of the portfolio; and (iii) transition planning.[23] The current disclosure and recordkeeping proposals for advisers and the accompanying disclosure requirements for registered funds appear to be designed to address the first "core initiative." Given the expedited rollout of the data reform initiative, it is likely that we will see proposals with respect to the second and third initiatives shortly. Based on the December speech, these likely will include: (i) rulemaking relating to the use of derivatives by registered funds, including measures to limit leverage; (ii) required implementation by registered funds of risk management programs relating to liquidity and derivatives use and "measures to ensure the Commission's comprehensive oversight of those

programs"; (iii) revised liquidity standards; and (iv) requirements for investment advisers to create transition plans to prepare for a major disruption in business. Reforms may also include annual stress-testing requirements for large advisers and large funds.

Implications for Advisers

The current proposals for SMAs and registered investment companies as well as the other "core initiatives" demonstrate a continued reliance by the SEC on the tools provided to it by Congress through the Advisers Act and the Investment Company Act of 1940.[24] Unlike the prudential regulators, the Commission's approach continues to be focused on disclosure, oversight through examination of registered entities and, more ominously, regulation through enforcement. Since the financial crisis, the SEC has greatly expanded its capacity for electronic data gathering and analysis to support all of its programs. The focus by the SEC on data collection in the proposals is another step in this direction, and would provide the Commission with further information that it may use in identifying firms for inspection or supporting enforcement investigations. In order to be in a position to address the SEC's data-based oversight regime, advisers may be required to invest more heavily in internal data collection and aggregation and follow up based on more rigorous review and monitoring of the data.

Although the SEC likely will adopt the current proposals in some form, and publish and adopt proposals relating to transition plans by advisers and, possibly, require some type of stress testing by large advisers as part of a broader risk management program, we do not expect the SEC to advocate for treatment of individual advisers or funds as systematically important financial institutions. Rather, the proposals reflect a principled approach by the SEC to retain and broaden its regulatory jurisdiction over investment advisers and funds and to operate within the current regulatory framework that relies on a combination of disclosure, risk-based examinations and enforcement activity.

If you have any questions concerning the foregoing or would like additional information, please contact Scott A. Arenare (212-728-8252; sarenare@willkie.com), P. Georgia Bullitt (212-728-8250; gbullitt@willkie.com), James R. Burns (202-303-1241; jburns@willkie.com), Benjamin J. Haskin (202-303-1124; bhaskin@willkie.com), Christopher S. Petito (202-303-1117; cpetito@willkie.com), Mark A. Vandehaar (212-728-8720; mvandehaar@willkie.com) or the Willkie attorney with whom you regularly work.

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[1] Amendments to Form ADV and Investment Advisers Act Rules, Investment Advisers Act Release No. 4091 (May 20, 2015) (the "Proposing Release").

[2] *Id.* at n.5.

[3] Chair Mary Jo White, *Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry*, Address at The New York Times DealBook Opportunities for Tomorrow Conference (Dec. 11, 2014) [hereinafter "White December Speech"], *available* here.

[4] Chair Mary Jo White, *Chairman's Address at SEC Speaks 2014* (Feb. 21, 2014) [hereinafter "White February Speech")], *available* here.

[5] *See* Proposing Release at pp. 4-6; White December Speech ("The staff is developing recommendations for the Commission to modernize and enhance data reporting for both funds and advisers. Even the reporting of basic census information should be updated so that we are better able to monitor industry developments and potential compliance issues. Beyond that, the reporting and disclosure of fund investments in derivatives, the liquidity and valuation of their holdings, and their securities lending practices should all be significantly enhanced. Collecting more data on separately managed accounts, where the adviser manages assets owned by a particular client, will also better inform examination priorities and the assessment of the risks associated with those accounts, which are a significant portion of the business of many investment advisers."); White February Speech ("In the past year, the SEC has established a dedicated group of professionals to monitor large-firm asset managers. These professionals who include former portfolio managers, investment analysts, and examiners track investment trends, review emerging market developments, and identify outlier funds. The tools they use include analytics of data we receive….").

[6] The term "regulatory assets under management" was adopted by the SEC in connection with the rules adopted by the Commission to implement the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") in 2011.

[7] The categories are: (i) exchange-traded equity securities, (ii) U.S. government/agency bonds, (iii) U.S. state and local bonds, (iv) sovereign bonds, (v) investment grade corporate bonds, (vi) non-investment grade corporate bonds, (vii) derivatives, (viii) securities issued by registered investment companies or business development companies, (ix) securities issued by pooled investment vehicles other than registered investment companies and (x) other.

[8] Disclosures are divided into four categories of gross notional exposure: (i) less than 10%, (ii) 10-99%, (iii) 100-199%, and (iv) 200% or more. "Gross notional exposure" is the percentage calculated by dividing (i) the sum of (a) the dollar amount of any borrowings and (b) the gross notional value of all derivatives, by (ii) the net asset value of the account.

[9] "Borrowings" is defined, consistent with the definition in Form PF, to include both unsecured and secured borrowings. In an FAQ on Form PF, the SEC Staff has stated that borrowings would include: (i) selling securities short, (ii) securities lending transactions, (iii) reverse repurchase agreements, (iv) transactions in which variation margin is owed, but as a result of not reaching a certain set threshold, has not been paid by a fund, or (v) transactions involving synthetic borrowings (*e.g.*, total return swaps that meet the failed sale accounting requirements). *See* Form PF Frequently Asked Questions, Question 12.1 (posted July 19, 2012).

[10] The categories are: (i) interest rate derivatives, (ii) foreign exchange derivatives, (iii) credit derivatives, (iv) equity derivatives, (v) commodity derivatives, and (vi) other derivatives.

[11] Except that the information regarding the investment adviser's custodian would only need to be reported as of the end of the investment adviser's fiscal year-end.

[12] Proposing Release at p. 51.

[13] The proposal indicates that Item 5.I of Part 1A of Form ADV and Section 5.I.(2) of Schedule D to Form ADV would be amended to require an adviser to report the total amount of regulatory assets under management attributable to acting as a sponsor and/or portfolio manager of a wrap fee program and new Item 5.K of Part 1A would require all advisers to SMAs to breakdown RAUM by asset category. In the case of Item 5.K, the requirement does not appear to be limited to institutional investment advisers.

[14] Proposing Release at p. 24 ("Finally, we propose to amend Item 5 to obtain additional information concerning wrap fee programs. 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. We propose to amend Item 5.I. to require an adviser to report the total amount of regulatory assets under management attributable to acting as a sponsor and/or portfolio manager of a wrap fee program. Section 5.I.(2) of Schedule D currently requires advisers to list the name and sponsor of each wrap fee program for which the adviser serves as portfolio manager. We propose amending Section 5.I.(2) to add questions that would require an adviser to provide any SEC File Number and CRD Number for sponsors to those wrap fee programs.").

[15] In connection with the changes, the SEC redefined the categories of clients required by the Form to add two new categories of clients: "sovereign wealth funds" and "foreign official institutions." The SEC also clarified that government pension plans (*i.e.*, federal, state and local) should be counted as state or municipal government entities and not pension and profit-sharing plans.

[16] Proposing Release at p. 22.

[17] *See* Proposing Release at p. 23.

[18] Client types include: (a) individuals (other than high-net-worth individuals), (b) high-net-worth individuals, (c) banking or thrift institutions, (d) investment companies, (e) business development companies, (f) pooled investment vehicles (other than investment companies), (g) pension and profit sharing plans (but not the participants of government pension plans), (h) charitable organizations, (i) corporations or other businesses not previously listed, (j) state or municipal government entities (including government pension plans), (k) other investment advisers, (l) insurance companies, (m) sovereign wealth funds and foreign official institutions, and (n) other.

[19] American Bar Association, Business Law Section, SEC Staff Letter (Jan. 18, 2012) available here.

[20] As defined in Rule 205-3 under the Advisers Act.

[21] As defined in Section 202(a)(17) of the Advisers Act.

[22] Proposing Release at p. 28.

[23] White December Speech.

[24] *See Investment Trusts and Investment Companies, Hearings on S. 3580 Before a Subcommittee of the Committee on Banking and Currency*, 76th Cong., 3d Sess. 270 (1940) (statement of David Schenker, Chief Counsel of the SEC) ("All we say is that in order to get some idea of who is in this business and what is his background, you cannot use the mails to perform your investment counsel business unless you are registered with [the SEC]. What is this registration requirement? What does it amount to? It discloses their name and address, who are their partners, what is their background, what is their experience, what is their discretion over their customers' accounts, and we ask them if they engage in any other business.").