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IN THIS ISSUE

Form ADV and big data: Changes on the horizon

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"Over the last several decades, in particular, the amount of data, and our capacity to store and process it, has grown at an astounding rate. These technologies have touched nearly every endeavor, including science, health care, and, of course, finance."

"Market participants and regulators have new opportunities for developing knowledge. Moreover, this is a qualitatively different kind of knowledge, encompassing entire data sets in one pass rather than slowly accumulating insight from individual experiences."

—Excerpts from SEC Commissioner Kara Stein's keynote address to the Big Data in Finance conference, October 28, 2016

I. Introduction

Keeping your Form ADV up to date, accurate, and complete is a fundamental compliance obligation of a Registered Investment Advisor (RIA). The scope of this obligation has grown over the years as the information required in Form ADV has expanded, and the U.S. Securities and Exchange Commission's (SEC's) recent embrace of big data has set the stage for even more ADV reporting requirements. This will raise both the compliance burden for RIAs and the stakes of a misstep.

Form ADV, Part 1A currently consists of over 100 separate questions while Part 1B for state-registered advisors includes nearly 30 additional questions. Part 2A includes 18 items broken into 39 subparts, and Part 2B covers six items for each person providing advice at the firm.[1] Additional schedules only add to Form ADV data and disclosure.

On October 1, 2017, the information required in Form ADV will further expand. On August 25, 2016, the SEC adopted amendments to Form ADV and Investment Advisers Act rules, requiring advisors to provide additional information about their business, specifically with regard to separately managed accounts (SMAs), their chief compliance officer (CCO), and social media posts.

In addition to providing the public with more information, the most recent amendments will, according to the SEC, continue to add to the "depth and quality of information that we collect on investment advisors, facilitate our risk-monitoring initiatives, and assist our staff in its risk-based examination program."[2]

This white paper will provide a chronology of the many amendments the SEC has made to Form ADV since the year

[1] An additional 19th item covering business backgrounds of management personnel and additional disciplinary questions applies to state-registered advisers also.

[2] U.S. Securities and Exchange Commission, *Form ADV and Investment Advisers Act Rules*, 17 CFR Parts 275 and 279, page 5 (August 25, 2016).

2000 and evaluate the SEC's purposes for this continued expansion of information gathering. We will comment on the potential use of the reported information and the SEC's big data efforts to protect the public through enhanced surveillance.[3] The SEC's use of the data should make it clear that advisors need to take extreme care to complete Form ADV accurately and completely, a voluminous and increasingly burdensome task, especially for small advisors.

II. The critical importance of Form ADV

Nearly 12,000 investment advisory firms are now registered with the SEC. Assets under management (AUM) by RIAs more than tripled from 2001 to 2015, rising from $21.5 trillion to approximately $66.8 trillion.[4] An additional estimated 18,000 more firms are registered with state regulators.[5]

Form ADV, Part 2 must be delivered to all new advisory clients at the start of the fiduciary relationship. In addition, Rule 204-3 under the Investment Advisers Act further requires that each client annually receive, within 120 days of the end of a firm's fiscal year, a summary of material changes since the previous annual updating amendment. (See Item 2 of Form ADV, Part 2A.) The public now has access to Form ADV for all advisors through the Investment Adviser Public Disclosure (IAPD) system.

The failure to have accurate Form ADV information may lead to deficiencies from SEC and state regulators, and more concerning, this failure is frequently the underpinning of enforcement actions. One of the most demonstrative enforcement actions stems from a series of events in the early 1990s.[6] In the action, an account executive's employer was found to have failed to disclose a conflict of interest in then Item 13 of Form ADV, Part 2. The account executive was recommending an investment manager who was the principal means of employment of the account executive's financially dependent son. The investment manager was taking clients on hunting trips operated by a business owned by the account executive's son. The SEC commissioners concluded that these circumstances should have been disclosed in Form ADV.

Some of the most recent actions include an advisor failing to follow his firm's ADV disclosure that "client trades are placed prior to any personal transactions." In the SEC's October 4, 2016, action against the investment research company,[7] the SEC found that the advisor did not follow this practice and cherry-picked profitable transactions. The advisor also failed to follow the firm's ADV disclosure stating that the firm would not charge clients an advisory fee on funds invested in the firm's affiliated mutual fund.

In a recent settlement of an enforcement action, an investment advisor[8] failed to abide by its ADV disclosure stating that the firm would obtain client consent for principal transactions as required by Section 206 of the Investment Advisers Act of 1940 (the Advisers Act).

Enforcement actions, as shown, can arise from the failure to disclose conflicts of interest or from the failure to abide by disclosures of conflicts of interest. Many more examples can be found among enforcement actions, including those in the SEC's recent record-setting year of enforcement actions.[9]

III. The 15-year growth of Form ADV

Section 203(c)(1) of the Advisers Act provides that the SEC may prescribe the information necessary for the registration as an investment advisor. U.S. states and territories likewise use Form ADV for registration of advisors.

Up through the 1990s, Form ADV amounted to a modest document with several pages of check-the-box information and a Schedule F that required a narrative of the firm. On September 12, 2000, the SEC adopted a new electronic Form ADV, Part 1 that substantially expanded the information required to be filed by investment advisors.

At the time, approximately 8,000 advisors were registered with the SEC and an estimated 12,000 more firms were registered with states.[10]

[3] In her fiscal year 2017 budget request, Chair Mary Jo White specifically cited as priorities:
- Increasing examination coverage of investment advisers
- Leveraging cutting-edge technology to keep pace
- Expanding the SEC's enforcement program's investigative capabilities
- Bolstering economic and risk analysis functions
- Hiring market experts to fulfill the SEC's responsibilities

[4] White, Mary Jo, "Testimony on the Fiscal Year 2017 Budget Request of the U.S. Securities and Exchange Commission," U.S. Securities and Exchange Commission (March 22, 2016).

[5] O'Mara, Kelly, "How Many RIAs Are There? No, Seriously, How Many?" RIA Biz (November 11, 2015).

[6] U.S. Securities and Exchange Commission, *In the Matter of Russell W. Stein, Ford D. Albritton, Jr., and Dover and Associates, Inc.*, Investment Advisers Act Rel. No. 2114 (March 14, 2003).

[7] U.S. Securities and Exchange Commission, *In the Matter of Laurence I. Balter d/b/a Oracle Investment Research*, Administrative Proceeding File No. 3-17614 (October 4, 2016).

[8] U.S. Securities and Exchange Commission, *In the Matter of Moloney Securities Co., Inc., et al.*, Administrative Proceeding File No. 3-17604 (September 30, 2016).

[9] U.S. Securities and Exchange Commission, "SEC Announces Enforcement Results for FY 2016" (October 11, 2016).

[10] U.S. Securities and Exchange Commission, "Proposed Rule: Electronic Filing by Investment Advisers; Proposed Amendments to Form ADV," 17 CFR Parts 200, 275, and 279 (April 5, 2000).

The electronic filing of Form ADV, Part 1 began an era in which investors were able to search the Investment Adviser Registration Depository (IARD) system for information about advisors.

Additionally, changes adopted in 2000 required more information in Part 1 about client relationships, services, other business activities, affiliated service providers, and conflicts of interest that had previously only appeared in Part 2.[11]

New Part 1 and IARD (2001)

On September 12, 2000, the SEC began the digital path of gathering Form ADV information when it stated that this rule "implement[s] our statutory mandate to create a one-stop electronic filing system for investment advisers and to provide investors with a readily accessible database of information about investment advisers and persons associated with investment advisers."[12]

Advisors were required to transition to electronic filing of Form ADV, Part 1, though the SEC indicated that electronic filing of Part 2 was being deferred to a later date. The transition streamlined such matters as calculation of notice filing fees and directly paying state registration fees. Additionally, investors were granted public access to information on registered advisors. The Financial Industry Regulatory Authority (FINRA) created and implemented the IARD system, where the SEC mandated its advisor registrants to use the system to make all filings with the Commission (effective January 1, 2001).[13]

New Part 2 proposed, but not adopted, and other related rule changes for advisors

In the Proposed Rule dated April 5, 2000, the SEC proposed to create a new plain English Form ADV, Part 2. The goal of the proposed rule was to improve the quality of information advisors must provide to their clients and prospective clients in their information statements (brochures). The SEC sought to modernize the registration system and ease the burden on advisors by permitting a single electronic filing to satisfy SEC- and state-filing requirements.

The SEC's proposal would also require an advisor acting as a general partner to deliver a brochure to each limited partner. While many private fund advisors have adopted this practice today, SEC rules still do not require brochure delivery to fund investors.

Interestingly enough, the SEC noted the following in the proposed rule:

> Our experience over the 15 years since Uniform Form ADV was adopted has convinced us that we need a better approach to client disclosure. First, the format of Part 2 does not lend itself to meaningful, clear disclosure. In some cases, an advisor's response to a question may be accurate but paint an inaccurate picture of its practices.[14]

The SEC proposed to require advisors to deliver updates to clients in plain English to the Part 2 information whenever it became materially inaccurate. The SEC believed that it was incumbent upon an advisor, as a fiduciary, to keep its clients apprised of material changes in its operations, its fees, key advisory personnel, and other information provided in the advisory brochure. The new Part 2, however, was not adopted for a decade.

New ADV Part 2 (2010)

On July 28, 2010, the SEC adopted a new Part 2 of Form ADV, requiring advisors to provide their clients and prospective clients with a brochure in a plain English narrative format. The SEC's goal of plain English was for clear disclosure by advisors of their business practices so that investors could make informed decisions about whether to engage the advisor to manage their relationship.

With this adopted rule came the requirement to submit Part 2A electronically to the SEC and state regulators. Part 2A was broken into 18 separate items, each covering a different disclosure topic.

As noted, there are significant disclosures required by Form ADV, Part 2 about which much has not been previously written.

We could go through the detail of all of Part 2, but that is not the purpose of this white paper other than to note that Part 2 disclosure requirements are very broad. Most of the data, however, is coming from Part 1 and is being enhanced in 2017 by Part 1 amendments.

[11] Ibid., fn. 75.

[12] U.S. Securities and Exchange Commission, "Final Rule: Electronic Filing by Investment Advisers; Amendments to Form ADV," 17 CFR Parts 200, 275, and 279 (September 12, 2000).

[13] Investment Adviser Registration Depository, "What Is IARD?"

[14] U.S. Securities and Exchange Commission, "Proposed Rule: Electronic Filing by Investment Advisers; Proposed Amendments to Form ADV," 17 CFR Parts 200, 275, and 279 (April 5, 2000).

Part 2A of Form ADV: Firm Brochure

Item 1	Cover page
Item 2	Material changes
Item 3	Table of contents
Item 4	Advisory business
Item 5	Fees and compensation
Item 6	Performance-based fees and side-by-side management
Item 7	Types of clients
Item 8	Methods of analysis, investment strategies, and risk of loss
Item 9	Disciplinary information
Item 10	Other financial industry activities and affiliations
Item 11	Code of ethics, participation in client transactions, and personal trading
Item 12	Brokerage practices
Item 13	Review of accounts
Item 14	Client referrals and other compensation
Item 15	Custody
Item 16	Investment discretion
Item 17	Voting client securities
Item 18	Financial information
Item 19	Requirements for state-registered advisers
Part 2B	Brochure supplement(s)

Most importantly, General Instructions 3 and 4 of Form ADV, Part 2A summed up the new Part 2:

> **3. Disclosure Obligations as a Fiduciary.** Under federal and state law, you are a fiduciary and must make full disclosure to your clients of all material facts relating to the advisory relationship. As a fiduciary, you also must seek to avoid conflicts of interest with your clients, and, at a minimum, make full disclosure of all material conflicts of interest between you and your clients that could affect the advisory relationship. This obligation requires that you provide the client with sufficiently specific facts so that the client is able to understand the conflicts of interest you have and the business practices in which you engage, and can give informed consent to such conflicts or practices or reject them. To satisfy this obligation, you therefore may have to disclose to clients information not specifically required by Part 2 of Form ADV or in more detail than the brochure items might otherwise require. You may disclose this additional information to clients in your brochure or by some other means.
>
> **4. Full and Truthful Disclosure.** All information in your brochure and brochure supplements must be true and may not omit any material facts.

The Dodd-Frank expansion of Part 1 and Form PF: private funds (2011)

For the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), the SEC substantially enlarged Form ADV primarily to accommodate private fund information, including specifically the 28 questions of Section 7.B.(1) of Schedule D for each private fund managed by an advisor. At the same time, also pursuant to Dodd-Frank, the SEC created Form PF to gather portfolio information by fund and strategy across most SEC-registered private fund advisors. In the end, a lesson from PF was that private fund advisors were only a fraction of total regulatory assets under management (RAUM).[15]

New Form ADV amendments in 2017 will capture a larger set of portfolio information from advisors, including information about custodians of advisory client accounts. No sense stopping with data covering trillions of dollars invested by private funds,[16] new Form ADV amendments will apply data gathering to many more trillions in SMAs, as described later on.

See the next page for a summary of new 2017 Part 1 changes that will impact private fund advisors specifically.

IV. Big data and Form ADV

> For hundreds of years, physical paper documents and human beings dominated our securities operations. Today, data dominates. Digital data is part of every aspect of our markets. And this new reality is challenging all of us. The proliferation and reliance on data has disrupted our markets—oversight and regulation need to evolve to keep pace. In this new world, we need new tools.
>
> —Commissioner Kara M. Stein, April 14, 2015[17]

Big data is the term used to refer to the storage, processing, and analysis of large quantities of data. In recent years, the SEC has made data analytics a priority. For the last three years, when discussing annual examination priorities for advisors, the SEC has identified the need to use big data effectively to identify fraud.[18] The SEC has also tied its budget requests to big data.

[15] U.S. Securities and Exchange Commission, *Annual Staff Report Relating to the Use of Data Collected from Private Fund Systemic Risk Reports* (August 15, 2014).

[16] U.S. Securities and Exchange Commission, *Private Funds Statistics: Fourth Calendar Quarter 2014* (December 31, 2015).

[17] Stein, Kara M., "The Dominance of Data and the Need for New Tools: Remarks at the SIFMA Operations Conference" (April 14, 2015).

[18] U.S. Securities and Exchange Commission, "SEC Announces 2016 Examination Priorities" (January 11, 2016).

The 2016 budget request by the SEC devoted significant attention to the importance of big data in facilitating its enforcement efforts:

> Using Big Data to Detect and Investigate Violations: The Division is increasingly leveraging big data to detect and investigate misconduct. As an example, the staff has developed new analytical tools to detect suspicious trading patterns to assist in building insider trading cases. In addition, the Financial Reporting and Audit Task Force is partnering with the Division of Economic and Risk Analysis to refine a tool that will enable the staff to detect anomalous results (and thus potential case leads) in large amounts of public company filing data. Moreover, the recently established Center for Risk and Quantitative Analytics coordinates risk identification, risk assessment, and data analytic activities, with the goals of proactively identifying threats to investors and bringing cutting-edge analysis to bear on the Division's work. The Division expects that these improved information processing and analysis capabilities will yield a steady stream of additional case leads. The Division accordingly needs commensurate technology tools and staff to review and analyze those leads.[19]

Private fund advisors and umbrella registration

Private fund advisors were the driving reason for many of the last set of Form ADV amendments. This sidebar provides some of the more specific information related to private fund advisors' use of Form ADV and related 2017 amendments.

For those advisors that have been relying on the American Bar Association (ABA) no-action letter (relying advisor) guidance with respect to their Form ADV disclosure, the amendments will facilitate and standardize umbrella registrations so long as five certain preconditions are met. These include (1) the advisor and its relying advisors only advise private funds or advise "qualified clients" in SMAs that pursue the same investment objective or substantially similar objective; (2) the principal office and place of business is in the U.S; (3) each relying advisor and supervised person are subject to the advisor's supervision and control; (4) each relying advisor's activities are subject to SEC examination; and (5) the advisor and the relying advisors are subject to a single code of ethics and policies and procedures with a single CCO in accordance with Rule 206(4)-7 of the Advisers Act.

As a result of this amendment, the SEC is adding a new schedule to Part 1A—Schedule R—that will require identifying information, the basis for SEC registration, and ownership information about each relying advisor. This schedule will consolidate in one location information for each relying advisor. Additionally, a new question is being added to Schedule D that requires advisors to identify the filing advisors and relying advisors that manage or sponsor private funds reported on Form ADV.

Schedule D amendments

Section 7.B.(1) of Schedule D will now require an advisor 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. As long as an investor met the definition of a "qualified client" when the client entered into the advisory contract with the advisor, then the investor is considered a "qualified client" even if the client no longer meets the dollar amount thresholds of the rule.

Some other minor revisions to Schedule D include:

- Question 19 of Section 7.B.(1) of Schedule D asks whether the advisor's clients are solicited to invest in the private fund. Text will be added to make clear that the advisor should not consider feeder funds as clients of the advisor to a private fund when answering whether the advisor's clients are solicited to invest in the private fund.
- Question 23.(a)(2) requires advisors to check a box to indicate whether the private fund's financial statements are prepared in accordance with U.S. generally accepted accounting principles (GAAP). Text will be added instructing advisors that they are required to answer Question 23.(a)(2) only if they answer yes to Question 23.(a)(1), which asks whether the private fund's financial statements are subject to an annual audit.
- Question 23.(g) will also clarify that the fund's audited financial statements are distributed to the private fund investors "for the most recently completed fiscal year."
- Question 23.(h) will now ask whether all of the reports prepared by the auditing firm since the date of the advisor's last annual updating amendment contain unqualified opinions.
- There will be a newly added Question 25.(g), which requests the legal entity identifier, if any, for a private fund custodian that is not a broker-dealer or that is a broker-dealer but does not have an SEC registration number. (The legal entity identifier is a unique identifier associated with a single entity and is intended to provide a uniform international standard for identifying parties to financial transactions.)

[19] U.S. Securities and Exchange Commission, *FY 2016 Budget Request by Program* (n.d.).

Among the more prominent big data initiatives by the SEC are:

- The **National Exam Analytics Tool (NEAT)** performs analyses of advisors' trading activities including commissions, cross trades and principal trades, Regulation M, fair allocation of investment opportunities, and other trading patterns including those that may indicate insider trading.
- The **Aberrational Performance Inquiry (API)** identifies fund returns that appear inconsistent with a fund's investment strategy, peer composite, or other benchmark.[20]
- The **Market Information Data Analytics System (MIDAS)** is a cloud-based tool implemented by the SEC to facilitate the tracking of bids and offers for equities, equity options, and futures contracts from multiple data sources. The MIDAS platform enables regulators to develop a complete picture of the overall market stability for a security at any point in time.

Further, the Office of Compliance Inspections and Examinations' (OCIE's) Office of Risk Assessment and Surveillance "aggregates and analyzes a broad band of data to identify potentially problematic behavior":

> In addition to scouring the data [it] collect[s] directly from registrants, [OCIE] look[s] at data from outside the Commission, including information from public records, data collected by other regulators, [self-regulatory organizations] SROs and exchanges, and information that registrants provide to data vendors. This expanded data collection and analysis not only enhances OCIE's ability to identify risks more efficiently, but it also helps ... examiners better understand the contours of a firm's business activities prior to conducting an examination. The Office of Risk Assessment and Surveillance is developing exciting new technologies—text analytics, visualization, search, and predictive analytics—to cull additional red flags from internal and external data and information sources. These tools will help ... examiners be even more efficient and effective in analyzing massive amounts of data to more quickly and accurately home in on areas that pose the greatest risks and warrant further investigation. In an era of limited resources and expanding responsibilities, it is essential to identify and target these risks more systematically.[21]

While a complete technology overhaul at the SEC is far from finished, the SEC has clearly utilized data-driven rulemaking for over a decade. RIAs must adhere to stringent regulatory filing requirements for Form ADV, Form PF, and Schedule 13D, Form 13F, Schedule 13G, and Form 13H. The SEC has also increased its surveillance capabilities with databases containing information obtained from websites, email, and electronic communications, as well as the surveillance of social media use and electronic communications by investment advisory persons.

Commissioner Stein recently noted in her October 28 speech at the Big Data in Finance conference that data analytics had made it possible to sift through millions of trading records to identify retail customers to whom had been sold inappropriate, complex debt instruments.[22]

Newly adopted ADV amendments contain information ripe for analytics

The following subsections provide examples of ADV information ripe for analytics designed to identify fraud and will provide insight into the purpose of the newest ADV amendments. This ranges from the SEC employing analytics to detect unusually and potentially exaggerated patterns of RAUM to leveraging social media connections to identify insider trading.

RAUM

Form ADV, Part 1A instructions for Item 5.F. provide lengthy details about how to calculate RAUM. Advisors should only include securities portfolios to which the advisor provides continuous and regular supervisory management services (see table on the following page).

The exaggeration or misstatement of AUM has been a frequent source of regulatory enforcement actions, but those actions would have resulted from routine examinations. We expect that in the future the SEC may employ data analytics to test for patterns demonstrating exaggerated and fraudulent reports of RAUM. Similar to the Aberrational Performance Inquiry described earlier, regulators will be able to run data logs for significant increases in reported RAUM by each advisor. The SEC may also be able to cross-reference an advisor's Form 13F filings and even track an advisor's transaction volume associated with Form 13H filing identifiers.

Currently, Form ADV, Part 2A instructions to Item 4 allow an advisor to report a separate, broader set of assets as AUM, but require the advisor to describe the difference between that and its reporting in Form ADV, Part 1, Item 5.F. In the coming Form ADV changes, an advisor who reports AUM differently in Part 2 will now be required to check a

[20] The Aberrational Performance Inquiry cited two cases where performance attribution and risk analytics helped bring enforcement actions against investment advisors to private funds. In *SEC vs. Chetan Kapur; Lilaboc, LLC, d/b/a ThinkStrategy Capital Management, LLC*, the SEC found that from at least 2003 through mid-2009, Kapur and ThinkStrategy disseminated false and materially misleading information to investors concerning the performance, longevity, and assets of two private funds. The same complaint also alleges that Kapur used false performance records to raise capital for Fund A and Multi-Strategy Fund B, launched in 2006 and 2007, respectively, and would also later be found to have misstated assets and performance to investors.

In the second complaint, SEC vs. Michael R. Balboa and Gilles T. De Charsonville, the SEC alleged that Balboa, a portfolio manager to the now defunct hedge fund Millennium Global Emerging Credit Fund, conspired with a broker to provide false mark-to-market quotes for illiquid and non-exchange traded securities.

[21] White, Mary Jo, "Chairman's Address at SEC Speaks 2014" (February 21, 2014).

[22] Stein, Kara M., "A Vision for Data at the SEC," Keynote Address to Big Data in Finance Conference (October 28, 2016).

box in Part 1A, Item 5.J.(2), noting that the advisor has elected to report differently. An additional new question, Part 1A, Item 5.F.(3), will also be added in this Item asking the approximate amount of an advisor's total RAUM that is attributable to clients that are "non-U.S. persons." Essentially, this creates more data points by which the SEC may employ analytics to detect unusual patterns.

Services included as RAUM	Services not included as RAUM
Discretionary authority to arrange client transactions and ongoing supervisory or management services	Advice provided on an intermittent or periodic basis (e.g., quarterly account reviews only)
Nondiscretionary services with ongoing supervisory or management services, and the advisor arranges transactions accepted by client	Impersonal investment advice
Discretionary authority to hire and fire other managers on a client's behalf	Nondiscretionary recommendations of third-party managers
	Nondiscretionary pension consulting services in which the advisor does not arrange transactions

Wrap fee programs

Item 5.I. will now ask whether the advisor participates in a wrap fee program, and if so, the total amount of RAUM attributable to acting as a sponsor to or portfolio manager for a wrap fee program. For advisors that also act as sponsors, the SEC is adding a question to Item 5.I. that asks for the total amount of RAUM attributable to the advisor acting as both sponsor to and portfolio manager for the same wrap fee program. Section 5.I.(2) will also include new fields that require an advisor to provide any SEC file number and Central Registration Depository (CRD) number for sponsors to those wrap fee programs, allowing the SEC to more readily cross-reference.

The SEC continued its 2016 focus on wrap fee programs, charging two investment advisory firms with failure to establish policies and procedures necessary to determine the amount of commissions clients were charged when sub-advisors traded away with a broker-dealer outside the wrap fee programs, and whether sub-advisors were suitable for prospective and existing advisory clients.

The SEC said in one of the cases, the investment advisory firm disclosed that sub-advisors may trade away "when necessary to fulfill their duty to seek best execution,"[23] but did not collect information regarding the amount of the equity commission costs, making it impossible to determine whether the amounts paid were material and whether the program was a suitable investment recommendation for the client. It also made it impossible for clients to take the expenses into consideration while negotiating the wrap fee.

In the other case,[24] the SEC said the firm failed to adopt or implement policies or procedures designed to review information received from the sub-advisors in wrap fee programs regarding their trading away practices or provide cost and frequency information regarding sub-advisors' trading away practices to clients or financial advisors.

As a result, clients did not have the necessary information to negotiate wrap fees and determine which sub-advisors to select. (According to the SEC order, the firm's advisory clients select a participating sub-advisor to develop a model portfolio in the client's SMA.) Certain clients were also unaware they were paying additional trading costs beyond the wrap fee they paid for services.

Neither firm admitted or denied the charges, but agreed to pay penalties of $250,000 and $600,000, respectively. Both are also bound to review and update policies and procedures related to wrap fee programs.[25]

More Item 5 amendments

Amendments are being made to Part 1A, Item 5.D. to require an advisor to report more precise information on the number of clients and amount of RAUM attributable to each

Schwab's compliance website includes a searchable database, compliance tools, and many other resources to assist you. Visit schwabadvisorcenter.com > News & Resources > Compliance. (See "Online compliance resources" on back page for more information.)

[23] U.S. Securities and Exchange Commission, *In the Matter of Robert W. Baird & Co., Incorporated*, Administrative Proceeding File No. 2-17532 (September 8, 2016).

[24] U.S. Securities and Exchange Commission, *In the Matter of Raymond James & Associates, Inc.*, Administrative Proceeding File No. 3-17531 (September 8, 2016).

[25] U.S. Securities and Exchange Commission, *In the Matter of Robert W. Baird & Co., Incorporated*, Administrative Proceeding File No. 2-17532 (September 8, 2016) and U.S. Securities and Exchange Commission, *In the Matter of Raymond James & Associates, Inc.*, Administrative Proceeding File No. 3-17531 (September 8, 2016).

category of clients as of the date the advisor determines its RAUM. This will allow the SEC to determine the RAUM attributable to SMAs and assess risks based on client type. Being added to Item 5.C. is a requirement for advisors to report the number of clients for whom they provided advisory services but do not have RAUM. This can assist the SEC with gaining a better understanding of advisors' advisory business and will assist with its risk assessment process. Now is the time for firms to begin to determine if their portfolio management system, client relationship management (CRM) system, or administrator has the functionality to report these data points.

SMAs

New Item 5.K. of Part 1A and Schedule D, Section 5.K. will now require more information on the type of assets held (Item 5.K.(1) and Schedule D, Section 5.K.(1)), the use of derivatives and borrowing (Items 5.K.(2) and (3) and Schedule D, Sections 5.K.(2) and (3)), and the largest custodians of an advisor's SMA accounts (Item 5.K.(1) and Schedule D, Section 5.K.(1)). Look for this recently added Item 5.K. requiring broad, new information.

The amount of additional information will vary depending on an advisor's RAUM attributable to SMAs. On an annual basis, investment advisors will be obligated to indicate the percentage of SMA assets in 12 broad asset categories, including exchange-traded equities, U.S. government and agency bonds, securities issued by investment companies, and derivatives.

Investment advisors with SMA AUM of $10 billion or more will be required to report the information as of two dates (midyear and year-end). Advisors with less than $10 billion in SMA RAUM will only need to report this information as of year-end.

Additionally, advisors will be required in Part 1A, Item 5.K.(4) to identify custodians that hold at least 10% of their SMA AUM, along with the amount of assets held at those custodians and the custodian's office location.

With respect to foreign clients, advisors whose principal office and place of business are outside the U.S. will now be required to report information regarding SMAs for all clients, including clients who are not U.S. persons, a change from the past. For sub-advisors reporting such information, sub-advisors to a SMA should provide information only about the portion of the account that is sub-advised.

Social media

Part 1A, Item 1.I. began requesting addresses of advisors' websites in the 2011 expansion of information. Now, for firms that participate on social media platforms, the SEC wants the web addresses for those social media sites. The required reporting is limited to accounts on publicly available social media platforms where the advisor controls the content. In February 2014, when the SEC introduced NEAT, its staff spoke of the amount of social media data available and how to harness it. Social media connections may be a means to identify insider trading, the sale of unregistered products, or other marketing fraud.

Branch offices

Advisors will be required to disclose in Part 1A, Item 1.F.(5) the total number of offices at which the advisor conducts investment advisory business, and in Section 1.F. of Schedule D the advisor's 25 largest offices in terms of number of employees. Additionally, Schedule D will now require advisors to report each office's CRD branch number (if applicable) and the number of employees who perform advisory functions from each office, identify as applicable other business activities conducted from each office, and describe any other investment-related business conducted from each office. This information will only be required to be updated with the advisor's annual updating amendment filing. For dually registered entities, FINRA will update the IAPD system so that by entering a branch's CRD number, the address, phone number, and facsimile number of all additional offices will automatically populate on Section 1.F. of Schedule D. The SEC and FINRA have focused on recidivist behavior and identifying bad actors in a number of rulemaking contexts for branch offices and private funds.

CCO additional disclosure

Part 1A, Item 1.J. is being amended to require an advisor to report whether its CCO is compensated or employed by any person other than the advisor, or a related person of the advisor, for providing CCO services to the advisor and, if so, to report the name and IRS Employer Identification Number (EIN), if applicable, of that other person. Advisors will not be required to disclose the identity of the other person compensating or employing the CCO if the other "person" is an investment company registered under the Investment Company Act of 1940 advised by the advisor. This added revision matches the SEC's evaluation of the risk of outsourced CCO positions, which follows the SEC's actions against firms with outsourced CCOs and its recent Risk Alert expressing concern that such CCOs may not adequately carry out their responsibilities.[26]

[26] Office of Compliance Inspections and Examinations, "Examinations of Advisers and Funds that Outsource Their Chief Compliance Officers," National Exam Program Risk Alert, Vol V, Issue 1 (November 9, 2015).

Highlighted amendments or new items[27]

Summary of new instructions and data points pursuant to the SEC's new Form ADV rulemaking

Item 1.J.	This item will now require an advisor to report whether its CCO is compensated or employed by any person other than the advisor (or a related person of the advisor) for providing CCO services to the advisor, and if so, to report the name and IRS EIN (if any) of that other person.
Item 2.A.	Deletion of the phrase "newly formed adviser" and replacement with "Investment Adviser Expecting to be Eligible for Commission Registration within 120 Days."
Item 4	Clarification that succeeding to the business of an RIA includes, for example, a change of structure or legal status (e.g., form of organization or state of incorporation).
Item 5.D.	• Revised to require amounts attributable to each category of clients. • Revision to allow advisors with fewer than five clients in a particular category to check 5.D.(2) indicating that fact rather than the actual number of clients. • Clarification will be added to the instructions to state that if a client fits into more than one category, the advisor should select the category that most accurately represents the client in order to avoid double counting clients and assets.
Item 5.I.	Advisors must report total amount of RAUM attributable to the advisor acting as both sponsor to and portfolio manager for the same wrap fee program.
Item 5.J.(2)	A new box to be used for noting that advisors elect to report client assets in Form ADV, Part 2A differently than in Form ADV, Part 1.
Item 5.K.	Advisors that report that they have RAUM attributable to SMAs in response to new Item 5.K.(1) of Part 1A will be required to complete new Section 5.K.(1) of Schedule D, and they may be required to complete new Sections 5.K.(2) and 5.K.(3) of Schedule D regarding those accounts.
Item 7	Revised to clarify that advisors should not disclose in response to this item that some of their employees perform investment advisory functions or are registered representatives of a broker-dealer, because this information is required to be reported on Items 5.B.(1) and 5.B.(2) of Part 1A, respectively.
Item 8	Guidance has been provided that newly formed advisors should answer questions in the item based on the types of participation and interest they expect to engage in during the next year.
Item 8.B.(2)	To clarify confusion around the question, the SEC is rewording the question to ask whether the advisor or any related person of the advisor recommends to advisory clients or acts as a purchaser representative for advisory clients with respect to the purchase of securities for which the advisor or any related person of the advisor serves as underwriter or general or managing partner.[28]
Item 8.H.	With respect to compensation for client referrals, the SEC is breaking this question into two parts: • Revised Item 8.H.(1) will cover compensation to persons other than employees for client referrals. • Revised Item 8.H.(2) will cover compensation to employees, in addition to employees' regular salaries, for obtaining clients for the firm.
Schedule D, Section 5.G.(3)	Requires advisors to report the RAUM of all parallel managed accounts related to a registered investment company (or series thereof) or business development company they advise. With respect to the value of derivatives held in parallel managed accounts, the value should be calculated using the market value of the derivatives rather than the gross notional value, if that is how the value of the account is reported to the account holder.

[27] U.S. Securities and Exchange Commission, "Amendments to Form ADV and Investment Advisers Act Rules," 17 CFR Parts 275 and 279 (August 25, 2016).

[28] This edit is designed to clarify that the question applies to any related person who recommends to advisory clients or acts as a purchaser representative for advisory clients with respect to the purchase of securities for which the advisor or any related person of the advisor serves as underwriter or general or managing partner.

Schedule D, Section 7.A. and 7.B.	Requires an advisor to provide identifying numbers (e.g., Public Company Accounting Oversight Board [PCAOB]-assigned numbers and Central Index Key [CIK] numbers) for financial affiliates.
Schedule D, Section 7.B.(1)	New questions that require an advisor 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. Clarifications provided include the following: ▪ Additionally, Section 7.B.(1) of Schedule D should not be completed if another SEC-registered advisor or SEC-exempt reporting advisor reports the information required by Section 7.B.(1) of Schedule D. ▪ Finally, an advisor should not consider feeder funds as clients of the advisor to a private fund when answering whether the advisor's clients are solicited to invest in the private fund.
Schedule D, Section 9.C.	Added text requiring an advisor to provide the PCAOB-assigned number of the advisor's independent public accountant. With respect to unqualified opinions, now the question will ask whether all of the reports prepared by the independent public accountant since the date of the last annual updating amendment have contained unqualified opinions.
Schedule R (new)	Umbrella registration filers: requires identifying information, basis for SEC registration, and ownership information about each relying advisor.

Umbrella registrations for private funds

Form ADV, Part 1 was designed for a single legal entity and therefore was not conducive to advisors to private funds organized as a group of related advisors that are separate legal entities but effectively operate as—and appear to investors and regulators to be—a single advisory business. After Dodd-Frank required registration of private fund advisors, the SEC provided guidance via the ABA no-action letter for relying advisors, but some advisors may have had to file multiple registration forms. As a result, the instructions to Form ADV are being updated to establish conditions for an advisor to assess whether umbrella registration is available. Many private fund advisors registered before Dodd-Frank also would have found it necessary to register more than one corporate structure involving homogenously operated advisory businesses.

The five conditions, as outlined in the separate private fund section on page 5, are designed to limit eligibility for umbrella registration to groups of private fund advisors that operate as a single advisory business. Umbrella registration not only simplifies the registration process for these advisors, but also provides more consistent data about groups of private fund advisors that operate as a single advisory business. This should ultimately allow for greater comparability across private fund advisors. The instructions will provide advisors using umbrella registration directions on completing Form ADV for the filing advisor and each relying advisor, including details for filing umbrella registration requests and the timing of filings and amendments in connection with an umbrella registration. As a result, the Form ADV Glossary of Terms will now contain the following three terms: *filing advisor, relying advisor, and umbrella registration*.

V. SEC closing ambiguity on recordkeeping of performance calculations

We also note that while amending Form ADV, the SEC also amended books and records rules regarding performance calculations and their delivery to clients and prospects.

Rule 204-2(a)(16) of the Advisers Act currently requires advisors that are registered or required to be registered with the SEC to maintain records supporting performance claims in communications that are distributed or circulated to 10 or more persons. The SEC is removing the "10 or more persons" condition and replacing it with "any person." Advisors will be required to maintain the materials listed in Rule 204-2(a)(16) that demonstrate the calculation of the performance or rate of return in any communication that the advisor circulates or distributes, directly or indirectly, to any person.

Rule 204-2(a)(7) currently requires advisors that are registered or required to be registered to maintain certain categories of written communications received and copies of written communications sent by such advisors. The SEC is amending Rule 204-2(a)(7) to require advisors to also maintain originals of all written communications received and copies of written communications sent by an investment advisor relating to the performance or rate of return of any or all managed accounts or securities recommendations. These amendments will apply to communications circulated or distributed after the compliance date of October 1, 2017.

Advisors will need to amend books and records policies and records requirements based on these rule amendments and implement them with marketing departments and advisory personnel.

VI. Conclusion

SEC Commissioner Stein emphasized in her recent remarks about big data that "the first condition to success is acquiring the right data."[29] The newest and most recent Form ADV amendments adopted by the SEC continue its efforts to capitalize on Form ADV as an important source of data. The amendments impose significant new reporting obligations. Advisors must ensure they have the necessary expertise and resources available, and they must devote an adequate amount of time to complete Form ADV accurately. The new requirements apply to advisors filing amendments after the October 1, 2017, compliance date.

About the authors

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Keith provides consulting, annual compliance program reviews, risk assessments, on-site mock examinations, and registration services to Ascendant's clients, including the investment adviser divisions of regional banks, hedge fund managers, institutional advisers, wrap fee managers, Internet-based advisers, wealth managers, and financial planners. Keith produced Ascendant's free Form ADV, Part 2 template. He regularly speaks to compliance professionals and advisory firm staff at in-house training programs and at various other industry association conferences. In addition, he regularly contributes compliance-related articles for inclusion in industry publications. Before joining Ascendant Compliance Management, Keith was an instructor for the Center for Compliance Professionals and director of investment advisor services at National Regulatory Services (NRS). Keith practiced law previously as an associate with Day, Berry & Howard LLP (now Day Pitney LLP), a Hartford, Connecticut, law firm. Keith served as a law clerk for two years in Connecticut's Supreme Court and Appellate Court. He earned his Juris Doctor degree magna cum laude from Western New England College School of Law, and his Bachelor of Arts magna cum laude from the University of Connecticut. He is a member of the State Bar of Connecticut and is actively involved in raising funds for the Polycystic Kidney Foundation. Separate from his compliance consulting work for Ascendant's industry clients, Keith is general counsel to Ascendant.

Keith also serves as president of the New England Broker Dealer Investment Adviser Association (NEBDIAA), a nonprofit organization incorporated in 1997. The purpose of NEBDIAA is to provide a forum for the professional exchange of information among investment advisers, broker-dealers, and persons who provide services to investment advisers and broker-dealers, and to direct communication among its members that will improve their ability to serve the needs of their respective clients. The forum will help NEBDIAA's members meet the increased regulatory demands placed on investment advisers, broker-dealers, and persons who provide services to investment advisers and broker-dealers.

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Prior to joining Ascendant Compliance Management, Korrine was the chief compliance officer and head of operations at Estabrook Capital Management, where she was responsible for all compliance functions of this SEC-registered, $2.1B investment advisory firm. Korrine began her regulatory career while working at Allied Irish Bank (NY) in the Operations department where she was a key member of AIB's Compliance Committee, responsible for ensuring compliance with federal and state regulations. An active member of the National Society of Compliance Professionals for six years, Korrine earned her Investment Adviser Certified Compliance Professional (IACCP®) designation in 2006, is a member of the Association of Certified Fraud Examiners, and recently obtained her Certified Fraud Examiner designation. In addition to her experience in compliance and banking, Korrine began the 16-week intensive training course in Quantico, Virginia, to become a special agent with the Federal Bureau of Investigation. She has particular experience in creating policies and procedures, developing and implementing compliance programs, conducting on-site compliance reviews, risk assessments, and mock SEC examinations. She routinely counsels clients on various regulatory matters, including SEC registration issues, advertising, developing or refining compliance programs, disclosures, and the annual review process. Korrine is a graduate of St. John's University, where she obtained both her Bachelor of Arts in History and Master of Arts in Government and Politics. Korrine also attended Trinity College, Dublin, pursuing Irish history and literary courses.

[29] Stein, Kara M., "A Vision for Data at the SEC," Keynote Address to Big Data in Finance Conference (October 28, 2016).

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