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INVESTMENT ADVISER NEWS UPDATES

SEC Proposed Changes to Form ADV and Recordkeeping Requirements

The Securities and Exchange Commission ("SEC") proposed new rules this past May that would update the Form ADV, as well as the rules issued under the Investment Adviser's Act of 1940—specifically the Books and Records Rule (Rule 204-2).[1]

The SEC's proposed rules updating the ADV Part 1A include:

1. **New Reporting Requirements for Separately Managed Accounts ("SMAs")**
   Under the proposed rules, advisers would be required to provide the approximate percentages of their SMA assets across several asset categories (exchange-traded equities; US government bonds; US state and local bonds; sovereign bonds; corporate bonds - investment grade; corporate bonds - non-investment grade; derivatives; securities issued by registered investment companies and business development companies; securities issued by other pooled investment vehicles; and other).[2]Advisers with at least $10 billion in regulatory assets under management ("RAUM") attributable to SMAs would have to report this information twice per year.Advisers with less than $10 billion RAUM would only report this item once a year, as part of their annual ADV amendment.[3]

   Additionally, the SEC's proposed rules would require additional disclosure surrounding SMA derivatives and borrowing activities.These reporting obligations are triggered at different RAUM thresholds:

- **Advisers to SMAs with at least $150 million RAUM** - Report information on use of derivatives and borrowing.[4]
- **Advisers to SMAs with $150 million but below $10 billion RAUM** -Advisers must categorize their SMAs annually based on the net asset value and gross notional exposure percentage of each account. This would also be required to calculate and report the weighted average amount of borrowing within each category.[5]

- **Advisers to SMAs with over $10 billion RAUM** – In addition to the above, these advisers would also be required to report average derivatives exposures within six different types of derivatives (interest rate; foreign exchange; credit; equity; commodity; and other) for each category of SMA.[6] Reporting would also be required twice per year.

  Finally, the SEC's proposed rules would also require advisers to identify any custodian that accounts for at least 10 percent of the total RAUM attributable to an adviser's SMAs, as well as the asset amount held at each such custodian.[7]

2. **Additional Disclosures about Investment Adviser Business Activity**
   The SEC has also proposed changes to require more identifying information with respect to the adviser's Internet presence, physical office locations, chief compliance officer status, and asset amounts.

   First, the proposed rules would require the inclusion of all social media platforms used in the adviser's business (e.g. Twitter, Facebook, LinkedIn, etc).[8]Second, advisers would also be required to provide the total number of offices from which they conduct their business.[9]Third, the proposed rules will expand Item 1.J. on the current Form ADV, requiring more information as to whether the chief compliance officer is employed by someone other than the adviser or a related person.[10]The SEC's proposed amendments would also require an adviser to disclose the range of their asset amounts if their RAUM is over $1 billion.

3. **Registration on a Single Form ADV for Multiple Fund Advisers Functioning as a Single Advisory Business ("Umbrella Registration")**
   Under the SEC's proposed amendments, the Form ADV would be updated to better facilitate "Umbrella Registration" for multiple advisers functioning as a single advisory business.[11]The proposed rules would only affect registered investment advisers, effectively codifying the SEC's current guidance on Umbrella Registration.[12]

4. **Other Clarifying and Technical Changes**
   The SEC's proposed rules would also clarify a number of areas of the Form ADV. There are two areas of particular note with respect to solicitation and audited financial statements.

   First, the amendment would address Question 19 of Section 7.B(1), Schedule D—clarifying that advisers should not include feeder funds as clients of the adviser to a private fund when determining if the adviser's clients are solicited to invest in the private fund.[13]Second, the SEC's proposed amendments would address Question 23(g) of Section 7.B.(1), Schedule D—clarifying that advisers should comment on the distribution of a private fund's audited financial statements for the most recent fiscal year. [14]

Additionally, the SEC's proposed rules would also update portions of the Books and Records Rule (Rule 204-2):

1. **No 10-Person Limitation**
   The SEC's proposed rules would abolish the Rule 204-(a)(16) 10-person threshold requiring advisers to maintain records supporting performance claims that are distributed to at least 10 or more persons.[15]Instead, the SEC's amendment would mandate that advisers maintain records supporting

performance claims that are distributed to "any person."[16]Ultimately, the proposed change would require that all communications demonstrating performance calculations, or a rate of return, be maintained by an adviser.

2. **Written Material Related to Performance Information**
   Under the proposed SEC rules, advisers would have to maintain all sent and received communications using performance data of any SMAs or security recommendations.[17]

Comment period for these SEC proposed rules closes 60 days after publication in the *Federal Register*.

[1] Securities and Exchange Commission, *Release No. IA-4091* (May 2015)

[2] *SEC Proposes Amendments to Form ADV and Recordkeeping Rule,* Ropes & Gray LLP (June 1, 2015) (the "Ropes & Gray Release")

[3] *Id.*

[4] *Id.*

[5] *Id.*

[6] *Id.*

[7] *Id.*

[8] Securities and Exchange Commission, *Release No. IA-4091* (May 2015).

[9] *Id.*

[10] *Id.*

[11] *Id.*

[12] The Ropes and Gray Release

[13] Securities and Exchange Commission, *Release No. IA-4091* (May 2015)

[14] *Id.*

[15] *Id.*

[16] *Id.*

[17] *SEC Proposes Amendments to Form ADV and Recordkeeping Rule,* Ropes & Gray LLP (June 1, 2015)

SEC Joins in Issuing Interagency Final Standards for Assessing Diversity Policies and Practices of Regulated Entities

On June 9, 2015, the SEC, alongside the Board of Governors of the Federal Reserve System and other federal agencies, issued a final interagency policy statement establishing joint standards for assessing the diversity policies and practices of the entities they regulate.[1]

"The final standards, which are generally similar to the proposed standards, provide a framework for regulated entities to create and strengthen their diversity policies and practices—including their organizational commitment to diversity, workforce and employment practices, procurement and business practices, and practices to promote transparency of organizational diversity and inclusion within the entities' U.S. operations."[2]

Specifically, the final interagency policy statement provides standards and guidance on how SEC regulated entities can establish strong diversity practices with respect to an organization's commitment to diversity, workforce profile, procurement and business practices regarding supplier diversity, practices in promoting transparency of organizational diversity, and regulated entities' self assessment of their diversity policies.[3]

Comment period for these SEC proposed rules closes 60 days after publication in the *Federal Register*.

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[1] Board of Governors of the Federal Reserve System, et. al, *Joint Release 2015-114* (June 9, 2015)

[2] *Id.*

[3] Securities and Exchange Commission, *Release No. 34-75050* (June 2015)

SEC Proposes Pay for Performance Rules

On April 29, 2015, the SEC proposed new rules to implement Section 953(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.[1] Section 953(a) permits the SEC to promulgate rules to require public companies to provide a clear description of any compensation required to be disclosed under Regulation S-K, Item 402. Disclosure under Item 402 typically covers information that shows the relationship between executive compensation "actually paid" and the registrant's financial performance, taking into account any change in the value of the shares of stock and dividends and any distributions.

The SEC's new proposed rule would add a new paragraph (v) to Item 402, requiring disclosure of compensation "actually paid" to the principal executive officer and an average of the compensation "actually paid" to any other named executive officers and the corresponding "total compensation."[2] In addition, Item 402(v) would require disclosure of the relationship between (1) compensation "actually paid" and the registrant's total shareholder return ("TSR") on an annual basis and (2) the registrant's TSR and a peer group TSR on an annual basis.[3]

If accepted, the SEC's proposed Item 402(v) would require registrants to compare executive compensation against a single performance metric, though registrations are allowed some limited flexibility in how the relationship of pay for performance is presented.[4]

Comment period for these SEC proposed rules closes 60 days after publication in the *Federal Register*.

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[1] Securities and Exchange Commission, *Release No. 34-74835* (April 29, 2015)

[2] Shearman & Sterling LLP, *SEC Proposes Long Awaited Pay for Performance Rules* (May 4, 2015)

[3] *Id.*

[4] *Id.*

SEC Adopts Regulation A+

Effective June 19, 2015, non-SEC reporting US and Canadian companies may now raise up to $50 million in a 12-month period under an expanded exemption to the registration requirements of the Securities Act of 1933 (the "Securities Act") often referred to Regulation A+.

Regulation A+ permits offerings of up to $50 million with reduced disclosure and compliance requirements as compared to a typical registered public offering in hopes of providing a new capital raising alternative.
The amended rule creates two tiers of offerings:

- **Tier 1** offerings of up to $20 million in any 12-month period of which no more than $6 million may be sold by affiliated shareholders; and
- **Tier 2** offerings of up to $50 million in any 12-month period, of which no more than $15 million may be sold by affiliated shareholders.

Eligible Securities

The securities that may be offered under Regulation A+ are limited to equity securities, including warrants, debt securities and debt securities convertible into or exchangeable into equity interests, including any guarantees of such securities. Asset-backed securities are excluded from the final rule.

Pre-Approval by the SEC

Issuers who have not previously sold securities in a Regulation A+ offering or pursuant to registration statement under the Securities Act must submit a draft offering statement for non-public review by the SEC. All confidential filings and related correspondence must eventually be filed publicly, unless confidential treatment of particular materials has been separately requested and approved by the SEC.

Tier 1 Offerings

Tier 1 offerings will be subject to both federal and state registration and qualification requirements as "Blue Sky" registration requirements are not preempted for Tier 1 offerings.

Tier 1 issuers must file a balance sheet and related financial statements – which need not be audited statements unless audited statements are available – for the preceding two fiscal years, prepared in accordance with GAAP.

Tier 2 Offerings

Companies considering a Tier 2 offering should note that the following requirements:

- The amount of securities that a non-accredited investor can purchase in a Tier 2 offering is limited to no more than 10% of the greater of the investor's annual income or net worth unless the securities are listed on a national securities exchange.

- Audited financial statements in the offering statement are required.
- Tier 2 offerings are subject to ongoing reporting obligations.

Purchasers of securities in Tier 2 offerings must either be accredited investors or, if they are not accredited investors, such purchasers are not allowed to invest more than 10 percent of the greater of their annual income or net worth if a natural person, or not more than 10 percent of the greater of their revenue or net assets for the previous fiscal year if a non-natural person. Tier 2 issuers may rely on a purchaser's representation about income and net worth for the purposes of these limitations.

The ongoing reporting requirements for Tier 2 offerings are not as comprehensive as those imposed on public companies, though they are not imposed on companies engaging in Regulation D, Rule 144A or other traditional private placements (except where ongoing obligations are required by contract). As such, only time will tell how much of an impact the new Regulation A+ will have.

The complete adopting release can be found here.

SEC IM Guidance Update – Cybersecurity

Cybersecurity continues to be a top priority for the SEC in 2015. This past April, the SEC's Division of Investment management released IM Guidance Update No. 2015-02,[1] which provides investment advisors with additional guidance on how to create and implement effective cybersecurity policies. The SEC's new guidance "discusses a number of measures that funds and advisers may wish to consider when addressing cybersecurity risks."[2] These measures include:

1. **Conducting Periodic Assessments to Identify Cyber Threats**

The SEC stated that advisers should be conducting periodic assessments of "(1) the nature sensitivity, and location of information that the firm collects, processes and/or stores, and the technology systems it uses; (2) internal and external cybersecurity threats to and vulnerably of the firm's information technology systems; (3) security controls and processes currently in place; (4) the impact should the information or technology systems become compromised; and (5) the effectiveness of the governances structure for the management of a cybersecurity risk."[3]

2. **Creating Strategies to Prevent, Detect and Respond to Cybersecurity Threats**

The IM Update also covered several strategies advisers could use in order to mitigate the risk of cybersecurity threats.Chief among them being: controlling access to various data storage systems, data encryption, restricting the use of movable storage media, data backup and retrieval, and—most importantly—the development of an incident response plan.[4]

3. **Implementation of Cybersecurity Policies**

The SEC noted that advisers with clear written policies and procedures, as well as adequate staff training, are in the best position to prevent, detect, and respond to potential cybersecurity threats."Because fund [managers] and advisers are varied in their operations, they should tailor their compliance programs based on the nature and scope of their businesses."[5]

Regulators have continued to raise the bar for investment advisers and fund managers with respect to cybersecurity in 2015. Both advisers and fund managers should take note of this increased emphasis on cybersecurity by reviewing their internal polices and procedures.

Proactive Investment Adviser Responses to Cyber Attacks

While investment advisers are taking steps to develop strong cybersecurity policies in light of the SEC's newly issued guidance, cyber attacks may still be unavoidable. Investment advisers should consider implementing these practices to help mitigate the risk of a potential data breach:

1. **Immediately Change Log-In Passwords**

Once a breach has occurred, outside parties will have unchecked access to an adviser's systems.Changing the log-in passwords for affected accounts will help ensure no further information is disclosed, and will often help prevent further system damage.[6]

2. **Assess Equipment and Contact Counsel**

Advisers should take inventory and evaluate the state of their equipment and accounts, as well as ensuring their back-up systems are still functioning properly.[7]This will help an adviser understand the scope of the cyber breach, and where other vulnerabilities may lie.From there, advisers are encouraged to reach out to counsel as soon as possible, in order to understand the cybersecurity rules within their jurisdiction.

3. **Notify Affected Parties**

After consulting with counsel, advisers should inform those affected by the cyber attack, and work to ensure clients that an action plan is in place to address the breach.[8]

4. **Prioritize Cybersecurity**

By far the most important thing to keep in mind is that advisers should prioritize the creation of a response plan to cybersecurity breaches.Such a plan would also include period review and data assessments, as well as the methods by which the advisers encrypts and backs up private data.[9]

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[1] Securities and Exchange Commission Division of Investment Management, *IM Guidance Update No. 2015-02* (April 2015)

[2] *Id.*

[3] *Id.*

[4] *Id.*

[5] *Id.*

[6] *What Advisers Should do After a Cyberattack?*, Alessandra Malito, Investment News (June 8, 2015)

[7] *Id.*

[8] *Id.*

[9] *Id.*

BROKER DEALER NEWS UPDATES

New SEC Rule Requires FINRA Firms to Investigate Applicants and Verify Registration Information

The SEC has recently approved FINRA Rule 3110(e) in an effort to clarify FINRA members' obligations relating to background investigations for employees at member firms.[1] Most notable change coming from the new rule is a mandate that member firms adopt written background check procedures that include a national search of "reasonably available" public records, as well as a clarification on the timing of the various background check and investigation requirements.[2]

Essentially, Rule 3110(e) establishes two requirements, 1) an investigation requirement and 2) a verification requirement.

1. **Investigation Requirement**

The new Rule clarifies that FINRA members must ascertain by investigation the good character, business reputation, qualifications, and experience of an applicant before the member applies to register the applicant with FINRA.[3]This new rule clarifies that this investigation must take place prior to an applicant's attempt to register with FINRA.

2. **Verification Requirement**

The new Rule requires that member firms "establish and implement written procedures reasonably designed to verify the accuracy and completeness of the information contained in an applicant's initial or transfer Form U4."[4]Such procedures should conduct a search through "reasonably available public records" in order to fulfill this requirement.[5]Examples of "reasonably available public records" may include criminal records, bankruptcy records, judgments, and liens, though this list is non-exhaustive.[6]The verification requirement must be completed 30 days after the Form U4 is filed with FINRA.

FINRA Rule 3110(e) will come into affect on July 1, 2015.

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[1] Financial Industry Regulatory Authority, *Regulatory Notice 15-05* (March 2015)

[2] *Id.*

[3] *New Rule Requires FINRA Firms to Investigate Applicants and Verify Registration Information through Public Record Searches*, Sadeq Khan, NSCP Currents (May 2015)

[4] *Id.*

[5] *Id.*

[6] *Id.*

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