Official Newsletter of Gordian Compliance Solutions, LLC.

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SEC REGULATORY UPDATES

SEC Adopts New Reporting and Record Keeping Requirements

On August 25, 2016, the United States Securities & Exchange Commission ("SEC") issued a Final Rule to enhance Form ADV reporting obligations and update Books & Records requirements (Rule 204-2) for investment advisers.[1] The SEC's rulemaking focuses on the following areas:

- **Form ADV Reporting for Separately Managed Accounts:** Item 5 and Section 5.K of Schedule D will be updated to include reporting for an investment adviser's separately managed account clients. More specifically, "[a]dvisers will be required to report information about the types of assets held and the use of derivatives and borrowings in separately managed accounts."[2] New reporting will cover 12 broad asset categories, information on an adviser's market exposure with respect to borrowings and derivatives, and identification of custodians that hold at least ten percent of total assets under management in separately managed account assets.[3]
- **Schedule R for Streamlined "Umbrella Registration:"** Form ADV will include a new portion, Schedule R, to allow reporting of identifying information without filing a separate Form ADV for relying advisers. The SEC's decision to codify so-called "umbrella registration" aims to accurately track "private fund advisers that are registered [...] and operate a single advisory business through multiple legal entities."[4] Prior to this Final Rule, the basis for umbrella registration resided in a 2012 no-action letter.[5] With the addition of Schedule R, the SEC is hoping more advisers will take advantage of this consolidated registration practice to provide a clearer picture of the organizational structures for private fund advisers.
- **Record Keeping with Respect to Performance Data:** In addition to Form ADV changes, Rule 204-2 has been amended in the following fashions:
    - Rule 204-2(a)(16): Advisers that are registered or required to be registered will be required maintain records supporting performance claims in communications that are distributed to any person

(previously, this rule only required retention where distribution was to ten or more persons).[6]

- Rule 204-2(a)(7): Advisers will be required to maintain "originals of all written communications received and copies of written communications sent by an investment adviser relating to the performance or rate of return of any or all managed accounts or securities recommendations."[7]

Investment advisers should be in compliance with the above items by October 1, 2017.

[1]*Release No. IA-4509*, United States Securities & Exchange Commission (August 25, 2016)
[2]*Id.*
[32]*Id.*
[4]*Id.*
[5]*American Bar Association, Business Law Section, SEC Staff Letter ("2012 ABA Letter")*, United States Securities & Exchange Commission (January 18, 2012) (Discussion surrounding Form ADV filing conditions for relying advisers and the old regime of "umbrella registration.")
[6]*Release No. IA-4509*, United States Securities & Exchange Commission (August 25, 2016)
[7]*Id.*

Changes to SEC Qualified Client Net Worth Threshold

Investment advisers should be aware of the SEC's change to the qualified client standard, effective as of August 15, 2016. The order amending Rule 205-3 of the Investment Advisers Act of 1940 was issued June 14, 2016, increasing the net worth test from $2 million to $2.1 million for qualified clients.[1] The investment adviser assets under management threshold remains unchanged at $1 million.[2]

"Under the Advisers Act, an investment adviser is generally prohibited from receiving performance fees or other performance-based compensation. Section 205(e) of the Advisers Act provides for an exemption to this prohibition and Rule 205-3 under the Advisers Act permits an investment adviser to receive performance fees only from 'qualified clients.'"[3] Investment advisers that charge performance-based fees should review their advisory contracts, offering documents, and subscription agreements to ensure they include the new qualified client standard.

[1]*Release No. IA-4421*, United States Securities & Exchange Commission (June 14, 2016)
[2]*Id.; See also Higher Qualified Client Net Worth Threshold Effective August 15, 2016*, Pillsbury Winthrop Shaw Pittman LLP (September 21, 2016)
[3] *Higher Qualified Client Net Worth Threshold Effective August 15, 2016*, Pillsbury Winthrop Shaw Pittman LLP (September 21, 2016)

SEC Advisory Committee Recommends Expansion of Accredited Investor Definition

On July 20, 2016, the Advisory Committee on Small & Emerging Companies (ACSEC) provided the United States Securities & Exchange Commission (SEC) with recommendations for rulemaking, focusing on the evolution of the accredited investor definition.[1] Though the SEC has yet to issue any proposed rules or policies, the ACSEC's recommendations reveal some insight into where the SEC might direct its rulemaking focus.

While most of the ACSEC's recommendations center on the SEC's research and methodology, one of the recommendations centers on using financial industry certification as a means to evaluate investor sophistication. According to ACSEC, "[t]he Commission should expand the pool of accredited investors to include individuals who have passed examinations that test their knowledge and understanding in the areas of securities and investing, including the Series 7, Series 65, Series 82 and CFA Examinations and equivalent examinations. The Commission also should explore ways to allow participation by potential investors with specific industry or issuer knowledge or expertise who would not otherwise be considered accredited investors."[2]

ACSEC's recommendation suggests that the method for evaluating investor suitability for products and pooled investment vehicles should also focus on an investor's overall experience and knowledge of the industry, not merely a static net worth threshold. "[ACSEC] would support expanding the definition to take into account measures of non-financial sophistication, regardless of income or net worth, thereby expanding rather than contracting the pool of accredited investors."[3]

[1]*Recommendations Regarding the Accredited Investor Definition*, Advisory Committee on Small & Emerging Companies (July 20, 2016)
[2]*Id.*
[3]*Id.*

NFA REGULATORY UPDATES

NFA Proposes Additional Financial Reporting for CPOs/CTAs

On September 6, 2016, the National Futures Association ("NFA") proposed several new reporting obligations for commodity pool operators ("CPOs") and commodity trading advisers ("CTAs") currently filing Form PQR.[1] The NFA's proposal would require CPOs/CTAs to provide information regarding their firm's financial health in

the form of two financial ratios:[2]

- **Current Assets/Current Liabilities Ratio**: This would measure the firm's "liquidity based on financial information as of the end of the reporting quarter."[3]
    - "NFA defines a current asset to include cash or any asset that can be readily converted to cash within one year."[4]
    - "A current liability includes any obligation that is reasonably expected to be paid within one year, such as accounts payable, accrued expenses, payroll liabilities, income tax liabilities, and interest payable."[5]
- **Totally Revenue/Total Expense Ratio**: This would measure a firm's "operating margin, reflecting total revenue earned and total expenses incurred during the prior 12 months."[6]

Enhanced Form PQR reporting would also require CPOs/CTAs to "maintain records supporting the calculation of the financial ratios, including relevant financial records of its holding company if it elects to report at the parent or holding company level."[7] Compliance with the newly proposed reporting requirements could come as early as July 2017.[8]

[1]*NFA Compliance Rule 2-46 and NFA Interpretive Notice NFA Compliance Rule 2-46: Reporting Financial Information on NFA Forms PQR and PR*, National Futures Association (September 6, 2016); *See also NFA Proposal Would Require CFTC-Registered Asset Managers to Report on Financial Condition*, Morgan, Lewis & Bockius LLP (September 15, 2016)

[2]*NFA Proposal Would Require CFTC-Registered Asset Managers to Report on Financial Condition*, Morgan, Lewis & Bockius LLP (September 15, 2016)

[3]*Id.*

[4]*Id.*

[5]*Id.*

[6]*NFA Proposal Would Require CFTC-Registered Asset Managers to Report on Financial Condition*, Morgan, Lewis & Bockius LLP (September 15, 2016)

[7]*Id.*

[8]*Id.*

Late Fees for Form PQR now in Effect

Effective September 30, 2016, NFA Compliance Rule 2-46 will enforce the following section with respect to late filing fees for Form PQR:

- *"(d) Each NFA Form PQR or NFA Form PR that is filed after it is due shall be accompanied by a fee of $200 for each business day it is late. Payment and acceptance of the fee does not preclude NFA from filing a disciplinary action under the Compliance Rules for failure to comply with the deadlines imposed by NFA Compliance Rules or CFTC rules."*[1]

NFA member firms are required to file Form PQR within 60 days of the end of each quarter, and a year-end report within 90 days of the calendar year end.

[1]*NFA Compliance Rule 2-46*, National Futures Association (2016)

HOT-BUTTON COMPLIANCE TOPICS

Custody: A Primer for Investment Advisers

Custody can be a difficult issue for state and SEC-registered investment advisers alike. The distinction between physical custody and control over client assets, as well as the various reporting requirements at play, often make custody a confusing issue. What follows is a basic primer for registered investment advisers[1] on the items and considerations that regularly come up regarding custody over client assets.

Rule 206(4)-2: Defining Custody

Rule 206(4)-2 of the Investment Advisers Act of 1940 (the “Custody Rule”) defines custody as “holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them. [An adviser has] custody if a related person holds, directly or indirectly, client funds or securities, or has any authority to obtain possession of them, in connection with advisory services [an adviser] provide[s] to clients.”[2] The rule outlines conduct by registered investment advisers that would trigger the Custody Rule, including:

- **Possession of Client Cash or Securities**:[3] Physical possession of client cash or securities by the investment adviser entity. Inadvertent receipt of client cash or securities must be resolved by returning client cash or securities to the client within (3) business days to avoid having physical possession under the Custody Rule.
- **Any Arrangement Where an Adviser is Authorized to Withdraw Client Cash or Securities**:[4] This is typically with respect to a general power of attorney, where an adviser may authorized to withdraw client assets from a custodial account.
- **Any Capacity that Gives an Adviser or Supervised Person Legal Ownership or Access to Client Funds**:[5] This can also include instances where the investment adviser is acting in its capacity as a general partner of a limited partnership for a pooled investment vehicle, trustee, or through another related person to the investment adviser.

For private fund advisers, it is essential to note the “Custody Rule presumes custody when a related party acts as a general partner, managing member, or similar role for a pooled investment vehicle.”[6] This is due to the level of control or access a general partner can exercise over client assets, and the general partner’s ability to direct the movement of those assets to a different broker. Of all the situations implicating custody for private fund advisers, this is by far the most common.

Given the breadth of scenarios mentioned above, investment advisers should be mindful of the requirements that maintaining custody will impose on their firm.

Requirements for Firms with Custody

Registered investment advisers that are deemed to have custody must carry out the

following to remain in compliance with Rule 206(4)-2:

1. **Qualified Custodian**: Client cash or securities must be held at a "qualified custodian"—an FDIC insured bank, SEC-registered broker dealer, a futures commission merchant registered with the Commodity Futures Trading Commission (CFTC), or a foreign financial institution.[7]
2. **Notice to Clients**: When opening an account with a qualified custodian on a client's behalf, either under the client's name or under the adviser's name as agent, the adviser must notify the client in writing of the qualified custodian's name, address, and manner in which the funds or securities are maintained.[8]
3. **Qualified Custodian Account Statements**: A registered adviser must have a reasonable basis to believe that the qualified custodian sends quarterly statements to all client account holders.[9]
4. **Surprise Examination**: Investment advisers subject to the Custody Rule must undergo a surprise audit, annually, at the hands of an independent public accountant.[10]
5. **Internal Controls Report**: If a related party to the investment adviser is the qualified custodian, then the adviser must obtain an internal controls report. [11]

Notice to Clients

If the adviser or a related person is a general partner of a limited liability partnership (or managing member of a limited liability company, or hold a comparable position for another type of pooled investment vehicle), the account statements required under Item 3 above must be sent to each limited partners (or member or other beneficial owner).[12]

The Annual Audit Exception

There is an exception to Items 2 and 4 above for registered advisers that manage pooled investment vehicles. If the pooled investment vehicle is audited at least annually; and distributes its audited financial statements (prepared in accordance with generally accepted accounting principles—GAAP) to all beneficial owners within 120 days of the end of its fiscal year, the SEC will deem the investment adviser as fulfilling the requirements of Items 2 and 4 above.[13]

Control Over Client Assets—Passwords & Client Asset Transfers

As discussed, the determination of custody is not only linked to an investment adviser's ability to maintain physical possession over client assets, but also contemplates an adviser's control and access to client assets. This type of control has come up recently in two distinct areas—passwords and client asset transfers.

With respect to passwords, the SEC has stated an "adviser has custody if password access provides the adviser with the ability to withdraw funds or securities or transfer them to an account not in the client's name at a qualified custodian."[14] Investment advisers should carefully consider what—if any—password access they maintain for client accounts and whether or not it offers the control to move client assets for the purpose of custody.

With respect to client asset transfers (either between accounts at the same custodian or wire transfers to other third-party financial institutions) investment advisers should be careful whether any preauthorization will grant them the authority to transfer client assets without client consent. As a general rule,

investment advisers that obtain authorization for each individual client asset transfer will likely not have the authority needed to implicate the Custody Rule. Nevertheless, investment advisers should carefully review any authorizations they have to transfer assets between client accounts to see if those activities trigger custody.

State Custody Rules & Disclosure

State-registered investment advisers should be mindful of the SEC's custody requirements, as well as the custody requirements put forth by the jurisdiction in which they are registered. For example, investment advisers registered in California must also comply with a minimum net worth requirement and report this information to the state on an annual basis if they maintain custody over client assets.[15]

Additionally, all registered advisers should properly disclose their custodial arrangements on Form ADV Parts 1 & 2. Items 7.B(1) (for private fund advisers) and 9 on the Form ADV 1 detail an investment adviser's custodial arrangement, information about their qualified custodian, and audit practices. Custody is also covered in Item 15 of the Form ADV Part 2A Brochure.

For questions regarding custody, and whether or not your advisory business may be affected by these requirements, please contact your Gordian consultant.

[1]The Custody Rule only applies to registered investment advisers. Investment advisers that file as an exempt reporting adviser are not subject to the Custody Rule. *See also* *Release No. IA-2968* (Footnotes 215, 296), United States Securities & Exchange Commission (December 30, 2009)

[2]17 C.F.R. § 275.206(4)-2(d)(2)

[3]17 C.F.R. § 275.206(4)-2(d)(2)(i): "Possession of client funds or securities (but not of checks drawn by clients and made payable to third parties) unless you receive them inadvertently and you return them to the sender promptly but in any case within three business days of receiving them;"

[4]17 C.F.R. § 275.206(4)-2(d)(2)(ii): "Any arrangement (including a general power of attorney) under which you are authorized or permitted to withdraw client funds or securities maintained with a custodian upon your instruction to the custodian;"

[5]17 C.F.R. § 275.206(4)-2(d)(2)(iii): "Any capacity (such as general partner of a limited partnership, managing member of a limited liability company or a comparable position for another type of pooled investment vehicle, or trustee of a trust) that gives you or your supervised person legal ownership of or access to client funds or securities."

[6]*How the SEC's Custody Rule Impacts Private Funds Advisers*, PricewaterhouseCoopers LLP (2011)

[7]17 C.F.R. § 275.206(4)-2(a)(1); 17 C.F.R. § 275.206(4)-2(d)(6); *See also* *How the SEC's Custody Rule Impacts Private Funds Advisers*, PricewaterhouseCoopers LLP (2011)

[8]17 C.F.R. § 275.206(4)-2(a)(2)

[9]17 C.F.R. § 275.206(4)-2(a)(3); *See also* *How the SEC's Custody Rule Impacts Private Funds Advisers*, PricewaterhouseCoopers LLP (2011)

[10]17 C.F.R. § 275.206(4)-2(a)(4)

[11]17 C.F.R. § 275.206(4)-2(a)(6)

[12]17 C.F.R. § 275.206(4)-2(a)(5)

[13]17 C.F.R. § 275.206(4)-2(b)(4); *See also* *Release No. IA-2176*, United States Securities & Exchange Commission (November 3, 2003)

[14]*Staff Responses to Questions About the Custody Rule*, United States Securities & Exchange Commission (May 20, 2010)

[15]10 CCR § 260.237.2(a): "Every investment adviser who has custody of client funds or securities shall maintain at all times a minimum net worth of $35,000, and every investment adviser who has discretionary authority over client funds or securities but does not have custody of client funds or securities, shall maintain at all times a minimum net worth of $10,000." *See also* *Annual Reports*, California Department of Business Oversight (2016) (Overview of deliverables for annual reporting and compliance with California's investment adviser net worth requirements.)

Trump, Pence, and the SEC Pay-To-Play Rule

Donald Trump's proposed economic policies may create waves in the marketplace, but Vice Presidential running mate Mike Pence is creating waves for Chief Compliance Officers. As Governor of Indiana, Pence's current position "raises potential issues with respect to political contributions by investment advisers under Rule 206(4)-5 under the Investment Advisers Act of 1940"[1] or pay-to-play rule.

Rule 206(4)-5 provides a two-year ban on providing investment advisory services for compensation to a government entity in the event an investment adviser, or covered employee, makes a contribution to a government official.[2] Under the rule, government entity is defined broadly, covering agencies, officers, "[a] pool of assets sponsored or established by the State or political subdivision," or a government plan or program.[3] Pence would meet the definition of a government official in his capacity as governor.[4] Thus, a contribution to the Trump campaign, or election committee for the Trump/Pence ticket, could trigger the two-year time out period for state government entities—such as the Indiana public employee pension system, or other Indiana state endowment programs.

Chief Compliance Officers with politically active employees should monitor this issue until Pence resigns as governor. It's recommended that Chief Compliance Officers take the following steps during the campaign season:

- **Compliance Training**: Revisit your firm's pay-to-play compliance procedures to ensure employees understand how to request approval, and notify your compliance department of any planned campaign contributions.
- **Use Pay-To-Play De Minimis Exceptions**: Rule 206(4)-5 contains de minimis exceptions[5] allowing investment advisers or covered persons to make political contributions without triggering the two-year time out period, so long as the contribution amounts fall under:
    - $350, to any one official, per election, if the individual can vote in the election;
    - $150, to any one official, per election, if the individual cannot vote in the election
- **Follow Up with Employees**: Get specific with your employees about the details of their planned contribution. Certain contributions to the Republican National Committee or Super PACs unrelated to the Trump campaign may not trigger the SEC pay-to-play rule. However, approach these potential contributions on a case-by-case basis, and evaluate if you can trace the receipt of funds indirectly to the Trump campaign.

Please contact your Gordian consultant for questions pertaining to your firm's pay-to-play policies and procedures.

[1]17 C.F.R. § 275.206(4)-5

[2]*Id.*

[3]17 C.F.R. § 275.206(4)-5(f)(5)

[4]17 C.F.R. § 275.206(4)-5(f)(6): "Official means any person (including any election committee for the person) who was, at the time of the contribution, an incumbent, candidate or successful candidate for

elective office of a government entity, if the office: (i) Is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser by a government entity; or (ii) Has authority to appoint any person who is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser by a government entity."

[5]17 C.F.R. § 275.206(4)-5(b)(1)

SEC Whistleblower Program Surpasses $100 Million Mark

On August 30, 2016 the SEC reported awards to whistleblowers have surpassed $100 million throughout the life of the whistleblower program. This milestone comes on the heels of a $22 million August award and over $500 million in enforcement actions remedies since the program's inception.[1]

"'The SEC's whistleblower program has proven to be a game changer for the agency in its short time of existence, providing a source of valuable information to the SEC to further its mission of protecting investors while providing whistleblowers with protections and financial rewards,' said Mary Jo White, Chair of the SEC."[2] Ms. White is not exaggerating. Since 2011, whistleblowers have been instrumental to the SEC in identifying compliance violations within the financial industry:[3]

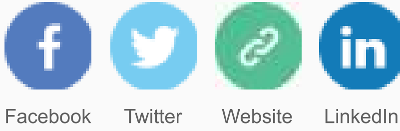
- "The Whistleblower Office has received more than 14,000 whistleblower tips from individuals in all 50 states and the District of Columbia and 95 foreign countries."
- "More than $107 million has been awarded to 33 whistleblowers, with the largest being more than $30 million."
- "Because of the information and assistance provided by these whistleblowers, the SEC was able to bring successful enforcement actions where more than $504 million was ordered in sanctions, including more than $346 million in disgorgement and interest for harmed investors."
- "The SEC also has brought actions to ensure that employees feel secure in reporting wrongdoing to the SEC, without fear of reprisal from their employers, including one enforcement action under the anti-retaliation provisions of the Dodd-Frank Act and four actions against companies for including language in confidentiality and severance agreements that impeded whistleblowers from reporting to the SEC."
- "The Whistleblower Office has returned over 13,000 phone calls from members of the public through the whistleblower hotline."

The ubiquity of the whistleblower program underscores the importance of a strong, firm-wide culture of compliance. Chief Compliance Officers should ensure adequate training for employees on firm-wide compliance policies and procedures, as well as the firm's channels for escalating compliance concerns. As we've discussed in prior newsletters, Chief Compliance Officers should evaluate whether firm whistleblower policies are adequate and properly implemented to afford employees the required protections under Dodd-Frank.

[1]*SEC Whistleblower Program Surpasses $100 Million in Awards*, United States Securities & Exchange Commission (August 30, 2016)

[2]*Id.*

[3]*Id.*



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