SEWARD & KISSEL LLP

COMPLIANCE FLASH

OCTOBER 2016

A Publication of the Investment Management Group

Amendments to Form ADV and the Investment Advisers Act

On August 25, 2016, the SEC adopted amendments to Form ADV and several rules under the Investment Advisers Act of 1940 ("Advisers Act") in order to enhance the reporting and disclosure of information by an adviser and improve the quality of information that an adviser provides to clients and the SEC. Amended Form ADV will require more extensive reporting on an adviser's separately managed accounts. An adviser will also be required to disclose additional information on, among other things, the adviser's social media platforms, office locations, regulatory assets under management by client type and financial industry affiliations. An adviser filing an initial Form ADV or an amendment to an existing Form ADV on or after October 1, 2017, will be required to use the revised form. The SEC also amended Rule 204-2 of the Advisers Act to require an adviser to maintain additional records of communications relating to performance. Amendments to Rule 204-2 will apply to communications circulated or distributed after October 1, 2017. Seward & Kissel's memorandum summarizing these changes is available here.

Advisers that Employ Persons with Disciplinary History

On September 12, 2016, the SEC's Office of Compliance Inspections and Examinations issued a risk alert on its initiative to examine the supervisory practices and compliance programs of registered investment advisers that employ individuals with a history of disciplinary events in the financial services sector. The examinations will focus on the adviser's hiring process, ongoing reporting obligations, employee oversight, complaint handling, compliance culture, tone at the top, disclosures, conflicts of interests and marketing material with respect to supervised persons with a history of disciplinary events.

New "CAB" Broker-Dealer Registration Category

On August 18, 2016, the SEC approved FINRA's proposal to establish a new "Capital Acquisition Broker" or "CAB" broker-dealer registration category for broker-dealers solely engaged in certain limited capital raising and financing advisory activities. CABs will be subject to a streamlined set of FINRA rules. Of particular relevance to private funds, permitted activities for CABs include identifying, soliciting or acting as placement agent or finder on behalf of an issuer in connection with a sale of newly-issued, unregistered securities to "institutional investors", which is defined to include "qualified purchasers" as defined in the Investment Company Act of 1940. Unlike other registered broker-dealers, CABs will be permitted to use marketing materials that include performance projections, such as targeted returns.

Penalties for Advertising False Performance Claims

On August 25, 2016, the SEC announced penalties against 13 investment advisory firms that disseminated false performance claims made by an investment adviser about one of its investment strategies. The adviser falsely represented that the strategy had been used to manage client assets and that the track record had significantly outperformed the S&P 500 Index. The SEC determined that the 13 advisory firms, which offered investment products based on the strategy, took insufficient steps to confirm the accuracy of the adviser's data; failed to obtain adequate documentation to substantiate the adviser's marketing claims; and lacked a reasonable basis to conclude that the adviser's exceptional performance claims were true.

Use of Hypothetical Assumptions in Backtested Performance

On August 9, 2016, the U.S. Court of Appeals for the D.C. Circuit denied an investment adviser's petition for review of the SEC's determination that the adviser's claim of historically "backtested" performance was materially misleading and violated the anti-fraud provisions of the Advisers Act. While the adviser's marketing presentations stated that it had backtested the performance of its investment strategy over two historical periods, the adviser's actual testing used not only historical data during those periods, but also relied on hypothetical assumptions about the inflation rate and the rate of return of a particular asset class. The backtests also failed to implement a key component of the strategy. As a result, the backtests significantly overstated the historical performance of the strategy. The court noted in its opinion that disclaimers in the presentation that some assumptions would be used in the historical backtests did not alter the overall impression that the adviser had performed backtests showing actual historical performance during the periods referenced.

Qualified Client Net Worth Threshold Increased

The SEC's order approving an increase in the net worth threshold for "qualified clients," as defined in the Adviser Act, from $2 million to $2.1 million became effective on August 15, 2016. SEC-registered investment advisers should update their subscription agreements and advisory contracts that require qualified client representations to reflect the increased net worth threshold for new investors who invest on or after the effective date.

Key Upcoming Compliance Dates

- Quarterly Transactions Reports (October 30)
- Form 13F; Form CTA-PR; Form BE-185 (November 14)
- Form PF (November 29 for "large hedge fund advisers")
- Form CPO-PQR (November 29)

Seward & Kissel LLP offers Compliance Support Services as well as an Online Compliance Subscription Service.

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