Feeling your Pain: Advice on Answering Form ADV's Trickier Questions

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Working through the Form ADV update has been especially challenging this year for many investment advisers. Aside from the traditionally confusing questions, the Form has been updated to include some new questions and "clarify" (and I use that term loosely) existing ones.

It's hard to say which questions are the most confusing but based on the sheer number of questions we've received, this year's winner is Section 5, calculating regulatory assets under management (with added complications regarding how to classify clients and types of securities). The winner of most tortured wording is, without question, Section 9 on Custody. Section 8 on participation or interest in client transactions retains its long-term standing as one of the most indecipherable questions.

Discussing all areas of confusion on the Form ADV would require a lengthy tome. So I will focus on the more troublesome questions resulting from the most recent updates to the form. I have also provided some practice tips at the end to help make completing the Form ADV easier next time.

Item 5.D. Types of Clients and Counting Clients

This year Form ADV asks for the actual number of clients and amount of regulatory assets under management attributable to each category. The questions I and the other consultants at Hardin Compliance Consulting get asked most often include how to define "client", and how to categorize clients. The SEC's most recent FAQs on this topic provide little guidance, aside from stating:

> *When answering Item 5.D, count clients the way you normally count them for your firm. Some advisers, for example, treat multiple members of the same family (and a family trust) as a single client, and other advisers treat multiple members of the same family (and a family trust) as separate clients. Similarly, an adviser could reasonably treat an individual and the individual's IRA account as one--or two--clients, depending on the circumstances. (Updated September 29, 2017)*

The FAQs also discuss how portfolio managers to wrap fee programs should count clients, stating that "Each wrap fee program participant to whom you provided investment advisory services should be counted as a client." Additionally, the FAQs say that for determining types of clients, each wrap fee program participant should be treated as a client.

The SEC did not provide much additional guidance on the various categories of clients. The exception is an update to the instructions to Form ADV that defines "High Net Worth Individual", as an "individual who is a ***qualified client*** or who is a "***qualified purchaser***" as defined in section 2(a)(51)(A) of the Investment Company Act of 1940." Qualified Client under Rule 205-3 of the Advisers Act is a person who has at least $1 million in assets under management with the investment adviser, or a net worth (including assets held jointly with a spouse) of more than $2,100,000. A Qualified Purchaser (as defined under the Investment Company Act) is a person who has at least $5 million in investments.

As with any disclosure requirement, the best approach to responding is to develop a process for classifying clients, apply it consistently and have documentation to support your results. As indicated in the directions to this item, do not double-count clients. As noted in the instructions on Form ADV, if a client fits into more than one category, select the one that best represents the nature of that client. Keep in mind that the regulatory assets under management set forth in this item have to match the RAUM reported in Item 5.F.(2)(c). As with many SEC requirements, there may be more than one correct answer. The best way to handle this type of question is to have a reasonable process in place to show how you arrived at the answer.

Item 5. Regulatory Assets Under Management: What Does "Continuous and Regular" Mean?

Item 5.F. asks whether you "provide continuous and regular supervisory or management services to securities portfolios?" Determining the meaning of "continuous and regular supervisory or management services" is where a great divide between advisers and the SEC staff exists. Most advisers consider having trading authority, performing periodic monitoring and having annual review meetings with the client as meeting the definition of "continuous and regular supervisory or management services." The SEC staff, however, can disagree. The SEC's instructions on how to complete Form ADV state that an adviser *does not* provide "continuous and regular supervisory or management services" if the adviser:

- makes an initial asset allocation, without continuous and regular monitoring and reallocation; or
- provides advice on an intermittent or periodic basis (such as upon client request, in response to a market event, or on a specific date (e.g., the account is reviewed and adjusted quarterly)).

So how do you prove to the SEC that your firm is providing "continuous and regular supervisory or management services?" The instructions to the Form ADV identify three factors that help determine whether you are meeting the continuous and regular standard. First, look at the contract - make sure your standard investment management agreement specifically states that your firm provides "continuous and regular management services. " Second, look at the form of compensation. If you receive a fee based on the average value of the client's assets you manage over a specified period of time (i.e., a periodic fee based on a percentage of assets under management), this is indicative of continuous and regular services. Third, look at how the account is managed, (i.e., how often are accounts reviewed and advice provided).

This third factor is where some firms stumble. For many, “reviewing client accounts” refers to that annual process when an investment adviser representative (IAR) sits down to discuss account performance with his/her clients. But this limited review will not meet the definition of “continuous and regular supervisory or management services.”

Many firms perform more frequent supervision and management of client accounts outside of the client review process. Accounts may be subject to an initial review by a supervisor to ensure that the funds are being managed in accordance with the stated investment objectives. Accounts may be periodically reviewed to ensure excess cash gets invested promptly, to determine whether rebalancing is required, to respond to requests to raise cash, or to revise the investment strategy based on a change in the client’s status. Accounts may be reviewed on a firm-wide basis when there is a material market or economic event, when changes are made to model investment strategies, or when investment products are removed from a firm’s approved list. These practices should be disclosed in Form ADV Part 2A in Item 13, Review of Accounts, and in a firm’s policies and procedures. The disclosures and standard operating procedures provide evidence of “continuous and regulatory supervisory or management services” to client accounts. Firms should review their disclosures and policies to ensure that they reflect the practices for management and supervision of client accounts.

Non-Discretionary Assets and “Arranging or Effecting”

According to the Form ADV Part 1A instructions, investment advisers can also count assets where they don’t have discretion, but do have an ongoing responsibility to make recommendations of investments based on the needs of the client, and, if the client accepts the recommendation, the adviser is responsible for arranging or effecting the purchase or sale.

This is another area where there is a disconnect between how the SEC defines “arranging and effecting,” and how advisers view the term. For example, if an adviser is providing investment advice for a 401(k) plan sponsor as a 3(21) investment fiduciary under ERISA, that adviser has “discretion” over those plan assets under ERISA, even if the adviser does not implement the trades or make the final selection of investment products for the plan. Alternatively, an adviser might have discretion to select the investments for a 401(k) plan as a 3(38) investment fiduciary under ERISA. In either of those situations, the adviser might consider those assets as regulatory assets under management. The SEC, however, disagrees. The Staff may argue (and does) that these assets should not be counted as regulatory assets under management, since the adviser does not “arrange or effect” the trades. This seems an incongruous result, since the adviser managing these assets has fiduciary liability for these assets that is not mitigated by the fact that it does not have trading authority.

At the end of the day, the SEC has narrowed the definition of “arranging or effecting” to trading authority. If the adviser is not pushing the button on the trade, then the firm cannot count the assets in the account.

Based on that definition, the following assets cannot be counted as an adviser’s Regulatory Assets under Management:

- assets reviewed as part of a financial plan;

- assets managed by a third party money manager where the adviser does not have discretion to hire or fire the money manager;
- fixed annuities and fixed-indexed annuities (these are not securities);
- assets in non-managed accounts (assets that may be held at the same custodian and included in the client's account for reporting purposes, but the firm does not actually advise on);
- assets in 401(k) plans where the adviser provides recommendations, but does not have the authority or capability to effect trades; and
- assets reviewed or consulted only at the specific request of the client and the final implementation decision is left to the client.

The SEC comes down hard on investment advisers that inflate their regulatory assets under management, so it's important to have the evidence supporting your calculation. If you have doubts about certain assets, it may be best not to include them. Generally advisers that under report regulatory assets under management are not referred to the SEC's enforcement division.

Item 5.K. Separately Managed Account Clients

The next area of confusion is the new section 5.K., which asks about "Separately Managed Account Clients". Some advisers view "separately managed accounts" as a type of investment product, like a unified managed account ("UMA"). For Form ADV purposes, however, a separately managed account simply means an account managed for an advisory client that is not a mutual fund or another type of pooled investment vehicle. The instructions bear this out -- the SEC asks whether you have assets under management attributable to separately managed account clients, meaning clients other than those listed in Item 5.D.(3)(d)-(f), which include investment companies (aka mutual funds), business development companies and pooled investment vehicles. Given this more expansive definition, almost all accounts are separately managed accounts ("SMAs"). Specifically, retail investment advisers managing client accounts using mutual fund asset allocation models are managing separate accounts. Unfortunately, this means that many advisers have to complete Section 5.K.(1) of Schedule D.

Item 9.A. Custody

This section of Form ADV Part 1A is just as confusing as ever. Item 9.A. asks whether a firm has custody of any advisory clients (a) cash or bank accounts, and/or (b) securities. Custody is a defined term on the form, and includes "[a]ny 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." Many firms deduct advisory fees directly from client accounts, and therefore have custody of client assets. However, the form states that you should answer "no" if you have custody solely because you deduct advisory fees directly from your clients' accounts. Keep in mind that an adviser that deducts its advisory fee from client accounts must still comply with other provisions of the custody rule, i.e., use of qualified custodian, quarterly account statement delivery, and "due inquiry" by the adviser that the custodian is sending out account statements directly to client.

But that's not the end of the issue. If a client signed a "standing letter of authorization" ("SLOA") with his/her custodian, instructing the custodian to transfer funds to a designated third party upon the request of the adviser, this could also be considered custody (see our blog post for more details).

In 2017, however, this vague reference in the definition of "custody" to an arrangement where the adviser is authorized to give instruction to a custodian to withdraw client funds or securities has taken on much greater significance. In February 2017, the SEC's Division of Investment Management issued a no-action letter, an IM-Guidance Update, and an update to the custody rule FAQs, which significantly changed prior interpretations of "custody". In sum, the SEC found that an adviser that has authority to disburse money to a third-party on the client's behalf pursuant to a SLOA constitutes custody.

What affect does this mean for advisers completing Form ADV? It means that advisers that have third-party SLOA disbursement authority now have to report the assets in those client accounts with SLOAs under Item 9.A.(1) and (2). And that is still not the end. Unless seven specific conditions set forth in the no-action letter, the adviser will have to arrange for an annual surprise examination for those assets.

Hopefully this does not come as a surprise to many investment advisers. The larger custodians such as Charles Schwab, TD Ameritrade and Fidelity have been working on policies, procedures and changes to standardized forms to help advisers to comply with the seven conditions. But advisers will still need to determine if there is an SLOA on client accounts, and whether that SLOA is broad enough to confer custody on the adviser, in order to respond this Item 9.A.(1) and (2). Custodians have allowed differing levels of authority under SLOAs, so for some advisers, this means reviewing all custody agreements to determine the amount of client funds and assets for which they have custody.

Item 8. Participation or Interest in Client Transactions

In the proposing release for the most recent updates to Form ADV, the SEC acknowledged that it received frequent questions from filers on Item 8.B.(2) of Part 1A. To address this, the SEC said:

> Item 8.B.(2) of Part 1A of Form ADV currently asks whether the adviser or any related person of the adviser recommended purchase of securities to advisory clients for which the adviser or any related person of the adviser serves as underwriter, general or managing partner, or purchaser representative. The current wording has caused confusion regarding the treatment of purchaser representatives. …. This proposed 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 adviser or any related person of the adviser serves as underwriter, general or managing partner. (footnotes omitted)

This revision may cause more confusion, not less. In any event, here's how it looks on the form:

> Do you or any *related person: …* (2) recommend to advisory *clients*, or act as a purchaser representative for advisory *clients* with respect to, the purchase of securities for which you or any *related person* serves as underwriter or general or managing partner?

The purpose of Item 8 is to require advisers to disclose potential conflicts of interest involving interest in client transactions. Keeping that in mind, our best guess is that this question is asking whether the adviser or its related persons (which include any of its officers, partners, directors, or employees, or any entities under common control with the adviser) recommends that clients purchase securities where the adviser acts as underwriter, general partner or managing member. For an adviser that manages private funds (such as hedge funds and private equity funds), this question is asking whether the adviser's officer or employees recommend that clients purchase shares of private fund managed by the firm.

The problem is that the clients of many private fund managers are the funds they manage. The investors in these funds are technically not clients of the adviser. So if a private fund manager has no affiliated entities, and only sells interests in its fund, the answer should be no.

If, however, the private fund manager has affiliates, including another registered investment adviser that recommends that its clients invest in the private fund, then the answer would be yes.

Item 7. Financial Industry Affiliations and Private Fund Reporting: Do I need to File Schedule R?

Another change to Form ADV that seems to raise more questions than it answers relates to the new Schedule R for "relying advisers." By way of background, in a no-action letter to the American Bar Association issued back in 2005, and again in another no-action letter issued in 2012 (the ABA 2012 No-Action Letter),, the SEC provided relief to allow a special purpose vehicle ("SPV") that acts as a private fund's general partner or managing member to essentially rely upon its parent adviser's registration rather than separately register as an investment adviser. The relief allowed an adviser to file one Form ADV on behalf of itself and other advisers that were controlled by or under common control with the filing adviser (the "relying advisers"), assuming that they conducted their advisory business as a single entity. In the ABA 2012 No-Action Letter, the SEC set forth specific conditions and a process for allowing this "umbrella registration."

The SEC seemingly formalized the process for "umbrella registration" by amending Form ADV to include a new Schedule R to be filed for each "relying adviser".

Schedule R filings are not mandatory, however, and only apply to certain relying advisers, specifically those that were discussed in the response to Question 4 of ABA 2012 No-Action Letter, summarized briefly below:

1. The filing adviser and each relying adviser advise only private funds and separate account clients that are qualified clients (as defined in Advisers Act Rule 205-3 and whose accounts pursue investment objectives and strategies that are substantially similar or otherwise related to those private funds.
2. Each relying adviser, its employees and the persons acting on its behalf are subject to the filing adviser's supervision and control.
3. The filing adviser has its principal office and place of business in the United States.
4. The filing adviser and each relying adviser operate under a single code of ethics adopted in accordance with Advisers Act Rule 204A-1 and a single set of written policies and procedures adopted and implemented in accordance with Advisers Act Rule 206(4)-(7) and administered by a single chief compliance officer in accordance with that rule.
5. The filing adviser discloses in its Form ADV (Miscellaneous Section of Schedule D) that it and its relying advisers are together filing a single Form ADV in reliance on the position expressed in this letter and identifies each relying adviser by completing a separate Section 1.B., Schedule D, of Form ADV for each relying adviser and identifying it as such by including the notation "(relying adviser)."

Other investment advisers with affiliated entities can still take advantage of umbrella registration, without having to file Schedule R. In the most recent FAQs on Form ADV, the SEC noted that advisers that set up special purpose vehicles ("SPVs") to act as a private fund's general partner or managing member can still rely on the registered investment adviser's registration with the SEC under the no-action letters from 2005 and 2012. As discussed above, this requires that the filing adviser disclose in the Miscellaneous Section of Schedule D that it and its relying advisers are relying on the 2012 ABA No-Action Letter, and identifying each relying adviser by completing a separate Section 1.B., Schedule D.

Practice Tips for your next Form ADV Update

Here is some advice on making the process easier next time around.

1. Make it a repeatable process. Document how you counted clients and how you classified them. Write down the process you went through to classify the types of investments. Develop a standard operating procedure that documents the source of the information, how the reports were created and what fields were used to pull the data, and how the data was scrubbed. Document the reasons for your answers, especially for questions that might have more than one interpretation, such as items 7, 8 and 11.

2. Trust the data. The SEC expects to see evidence supporting your responses to the Form ADV and that evidence should be credible. As a result, there should be reports to substantiate the number of clients, types of investments and assets under management. Instead of assuming that you have no non-United States clients, run a report of client addresses to confirm.

3. Don't go it alone. The Form ADV is a public document that discloses important information about the firm. Firm management should be engaged in the process and aware of what it says. Many chief compliance officers require the president or chief executive officer to sign the Form ADV filing to ensure that he or she takes ownership of the document, and it's an approach we endorse. It's important to get others in the firm to review the document to ensure its accuracy. And just as importantly, you do not want managers to be surprised when clients or prospects ask about certain disclosures.

4. Answer the questions to the best of your knowledge and ability and then move on. Form ADV has been a source of confusion and consternation for years. During an examination, the SEC may question your responses and if, in the staff's view, you responded incorrectly, you will be asked to revise the Form ADV. In many situations, if a firm has a reasonable explanation for the response and had no intent to defraud, the issue will not go any further.

5. Ask for help. The SEC has been much more willing to respond to questions in recent years. For answers to interpretive questions, you can send an email to IARDLIVE@sec.gov or call the Investment Adviser Regulation Office at (202) 551-6999. You can also review other Forms ADV or ask your colleagues at other firms how they are dealing with the same questions.

If you want help completing Form ADV or any other compliance matters, please feel free to contact Hardin Compliance Consulting at 724-935-6770, or contact me directly at jhummel@hardincompliance.com.

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