CORE COMPLIANCE & LEGAL SERVICES, INC.

Risk Management Update
January 2016

FORM ADV – CURRENT DISCLOSURE REQUIREMENTS AND WHAT'S TO COME

It's that time of year again where registered investment advisers ("RIAs") with a fiscal year end of December 31st must file their annual amendments to Form ADV.[1] RIAs have 90 days after their fiscal year end to make the filing,[2] which allow them time to review the current version and make both required and appropriate updates based on business changes.

Disclosure is the cornerstone of an RIA's fiduciary duty to its clients and Form ADV continues to be the key vehicle used by RIAs to provide required disclosure. The instructions for Form ADV outline the topics needing to be covered, which include a number of potential conflict areas.[3] More specifically, Form ADV Part 2A, which is required to be delivered to clients in accordance with Rule 204-3 of the Investment Advisers Act of 1940 (the "Advisers Act"), consists of 18 items (19 for state registered advisers) that must be addressed in a Plain English format. Within the written instructions to Form ADV Part 2A, the SEC has laid out a sampling of circumstances under each of those items that they believe would be relevant and therefore require disclosure. Additionally, there is a paragraph in the instructions that states the following:

> *"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."*

Due to the overall generality of this guidance, there can be a tendency for its importance to go unnoticed. To that end, this Risk Management Update ("RMU") discusses additional disclosures not specifically addressed in the Form ADV instructions that RIAs should consider, as applicable when updating their Form ADV. This RMU also provides a summary of some of the more salient changes to Form ADV that were proposed by the Securities and Exchange Commission

---

[1] This includes exempt reporting advisers ("ERAs"), as such term is defined by state and federal regulators. Noteworthy is that ERAs are only required to complete and file a specifically tailored version of Form ADV Part 1. Form ADV Part 2 is not required.

[2] While this usually falls on March 31st, since 2016 is a leap year the deadline is March 30th.

[3] See https://www.sec.gov/about/forms/formadv.pdf.

("SEC") in May 2015 (the "Proposed Rule").[4] Lastly, it includes compliance steps to help firms ensure a smooth annual amendment process.

Additional Disclosure Considerations

RIAs must analysis all aspects of their business for disclosure purposes, and from there make a judgement call on what constitutes appropriate disclosures. Notwithstanding the guidance in the Form ADV instructions, regulators continue to issue deficiencies and bring enforcement cases against RIAs for lack of disclosures. To assist firms, below is a list of certain risk areas and pertinent disclosures that have been noted in such cases and/or are high on regulators' radar.

Privately Held Securities

- Firm's valuation process
- Conflicts surrounding fair valuation determinations
- Illiquidity issues
- Additional fee layers in fund of fund structures
- Performance/incentive fees charged
- Revenue sharing arrangements

Margin Accounts

- When they are recommended/used
- How advisory fees are calculated for clients with margin accounts
- Conflicts regarding the potential for incentive to recommend margin accounts
- Risks and additional costs pertaining to margin accounts

Outside Business Activities of Senior Executives

- Managing Member activities in unaffiliated Limited Liability Company
- Conflict due to time away from firm duties
- Additional compensation received

Cross Trading Practices

- Conflicts surrounding such activity
- Incentives received, especially when using an affiliated broker
- Potential benefits to clients
- Process for determining execution price
- Required permission from client and ability to withdraw at anytime

Investment Strategies

- Types of clients suitable for the strategy
- Overall objective of the strategy
- Specific risks associated with strategy investments
- Additional costs and fee layering, when applicable

[4] See https://www.sec.gov/rules/proposed/2015/ia-4091.pdf.

Use of Sub-Advisers

- Extent of discretionary authority
- Investment strategy(ies) utilized
- Additional fees charged to client
- Due diligence by adviser

This list is not all inclusive and the extent of disclosures should always be based on facts and circumstances, with a goal toward robust transparency.

In addition to the above, the SEC recently released their 2016 examination priorities, which reflects the regulator's ongoing focus on whether firms have adequate disclosures.[5] Specifically, the SEC states in the release that they will be reviewing, among other things, disclosures surrounding risks and conflicts pertaining to the following priority areas:

- Senior Investors
- Exchange Traded Funds
- Sales of Variable Annuities
- Advisers to Public Pensions
- Private Placements (including EB-5 Programs)
- Private Fund Advisers

Proposed Form ADV Amendments

Below is a summary of additional information that the SEC is looking to collect in three main areas under the Proposed Rule.

Separately Managed Accounts ("SMAs") – (i) SMA regulatory assets under management; (ii) types of accounts that comprise the SMA assets; (iii) use of derivatives and borrowings in SMAs; and (iv) custodian information for custodians that maintain custody of 10% or more of a firm's SMAs, along with the amount held with each custodian.

Additional Information Regarding Investment Advisers – (i) Central Index Key ("CIK") number(s); (ii) listing of all business social media sites used; (iii) range of firm assets; (iv) additional information on branch offices; and (v) whether the firm's chief compliance officer is compensated or employed by any person other than the adviser

Additional Information Regarding Clients - (i) number of clients that obtain advisory services but don't have assets under management; (ii) managed assets of non-U.S. clients; (iii) number of clients and amount of assets attributable to each category of clients; (iv) amount of assets under management for all parallel managed accounts related to registered investment company or business development company clients; and (v) assets under management attributable to wrap fee program clients, along with any SEC File Number and CRD Number for sponsors to the wrap fee program(s).

[5] See https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2016.pdf

Notably, there are additional important proposals in the Proposed Rule, so RIAs are encouraged to read the document in its entirety (if you haven't already) to obtain a full understanding of all contemplated changes and how such could affect the firm's compliance program.

Steps to Assist Compliance Personnel with Annual Form ADV Amendments

1. Confirm the appropriate fee is in the firm's IARD Flex Funding account before filing.[6]
2. Provide operations personnel with a copy of the SEC guidance on calculating regulatory assets under management contained in the Form ADV instructions and confirm backup documentation substantiating the calculation is being maintained as part of the firm's books and records.
3. Discuss with senior management the current and anticipated business changes for purposes of appropriate disclosure and have them review Form ADV Part 1 and Part 2A prior to filing.
4. Have investment adviser representatives review their current Form ADV Part 2B and Form U-4 to determine if changes are necessary.
5. Compare Form ADV Part 1 with ADV Part 2A to confirm consistency of disclosures.
6. Ensure that Form ADV Part 2A contains all applicable disclosures that are required in the instructions.
7. If annual delivery to clients will be made via email, ensure that all clients have provided the firm with the required written permission.
8. If relying on wrap sponsors or other third parties to make the annual delivery to certain clients on the firm's behalf, obtain proof of delivery to ensure compliance with Rule 204-2(a)(14) of the Advisers Act.

Conclusion

In addition to annual amendments, RIAs must update their Form ADV if any information becomes materially inaccurate during the year. Regulators mandate such updates to be made promptly, which generally means within 30 days. Therefore, Chief Compliance Officers should consider performing at least quarterly reviews of Form ADV as an internal control to ensure disclosures remains current and sufficient.

CCLS is happy to assist with reviewing, updating and/or submitting your Form ADV filings. It is important to get an early start on required amendments to ensure deadlines are met, so please do not hesitate to contact us at the number referenced below should you need assistance. Thank you.

Author: Tina Mitchell, Lead Sr. Compliance Consultant. Editor: Michelle Jacko, CEO, Core Compliance & Legal Services, Inc. ("CCLS"). CCLS works extensively with investment advisers, broker-dealers, investment companies, hedge funds, private equity firms and banks on regulatory compliance issues. For more information about this topic and other compliance consultation services, please contact us at (619) 278-0020, info@corecls.com, or visit www.corecls.com.

[6] For filing fee amounts, go to www.iard/fee_schedule.asp**.**