



## Form ADVs: Dragnets of Due Diligence

*Trust, but verify.*

— Russian proverb

The often mundane jobs of compliance officers and detectives just got more exciting. Effective Oct. 1, 2017,<sup>1</sup> investment advisers registered with the Securities and Exchange Commission (SEC), with few exceptions, must use a newly expanded Form ADV to report on their businesses. With these changes, this ubiquitous publicly available document has become an even more valuable tool for investors and fiduciaries seeking to evaluate their advisers. Managers of unregistered funds, like private hedge funds, make relatively few public filings, so the Form ADV is particularly helpful in learning more about and comparing such advisers.

*This essay includes:*

- A quick overview of the Form ADV and its role in the investor's due diligence process
- A description of the recent changes to the form and their implications for investors
- An explanation of what an investor should consider among the form's sweeping disclosures to selectively monitor or

systematically review the adviser's organization, people, regulatory and compliance activities, client assets, private funds, and related service providers

- A review of key issues to consider when analyzing Form ADVs

*All we want are the facts, ma'am.*

— Joe Friday, "Dragnet"

### Hidden in Plain Sight

Under the Investment Advisers Act of 1940,<sup>2</sup> advisers with \$150 million or more in assets under management are required to register with the SEC. For such registered investment advisers (RIAs), the Form ADV<sup>3</sup> is one of the most important required public disclosures. Given its highly structured format, the Form ADV is not a marketing document. It is, more or less, a representation of facts about a firm's business and its ecosystem of clients, investment products, and service providers.

<sup>1</sup> [www.sec.gov/rules/final/2016/ia-4509.pdf](http://www.sec.gov/rules/final/2016/ia-4509.pdf)

<sup>2</sup> [www.sec.gov/about/laws/iaa40.pdf](http://www.sec.gov/about/laws/iaa40.pdf)

<sup>3</sup> [www.sec.gov/about/forms/formadv.pdf](http://www.sec.gov/about/forms/formadv.pdf)

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The Form ADV has two parts for advisers registered with the SEC.

- Part 1 is a “check-the-box, fill-in-the-blanks” form that identifies the adviser’s business, controlling stakeholders, possible conflicts of interest, compliance information, client base, compensation structure, and disciplinary matters, among other attributes. Part 1’s structure leaves little room for creative writing by RIAs. Its interpretation, in turn, becomes a formulaic exercise.
- Part 2 has two sections. Part 2A (known as the Brochure) requires the adviser to explain in plain English its advisory services being rendered, range of fees charged, any conflicts of interest, risks associated with its management style, relationships with third parties, client reporting and proxy voting practices, and other items that may be material to investors and fiduciaries. Given that the RIA’s responses in Part 2A are relatively free-form, the process of reviewing its data for significant insights is less mechanical and more labor intensive.

Part 2B, known as the Brochure Supplement, provides biographical sketches of the firm’s key professionals expected to serve the investor, defined as any “supervised person” who “formulates investment advice for a client and has direct client contact” or is otherwise deemed to have material discretionary authority over that client’s assets. The supplement also lists who supervises these people.

Part 1 and Part 2A are available at [www.adviserinfo.sec.gov/IAPD/Default.aspx](http://www.adviserinfo.sec.gov/IAPD/Default.aspx), searchable under the firm’s name or ZIP code. The RIA must file updated versions of Part 1 and Part 2A annually with the SEC and make Part 2A available to its clients annually. Amended filings may occur more frequently if any information in these disclosures becomes “materially inaccurate.” Although an adviser’s Part 2B is not on the SEC website, it is generally available from the RIA upon request. It is normally delivered to the client before or at the time a “supervised person” begins to provide advisory services to that client.

*Sunlight is said to be the best of disinfectants.*

— Louis D. Brandeis, U.S. Supreme Court justice

### What’s New in the Form ADV?<sup>4</sup>

Form ADVs filed on or after Oct. 1, 2017, must comply with the new format. Advisers with a December 31 fiscal year end need to comply with the Form ADV amendments no later than their annual amendment filing due date of March 31, 2018. Below is a summary of key changes in the new format:

- One of the most significant additions is a disclosure regarding the firm’s **separately managed accounts**. In the prior format, client account disclosures focused only on the adviser’s private funds.
- The form now requires more disclosures regarding the firm’s **non-discretionary client relationships** and **wrap fee programs**, if any.
- The new form includes disclosures about the firm’s **social media activity**, **branch offices**, and **chief compliance officer** (CCO).
- Affiliated private fund advisers operating as a single advisory business can now register using the “relying adviser” method that is linked to an “**umbrella**” registration under which a single Form ADV is filed.

*Whoever is careless with the truth in small matters cannot be trusted with important matters.*

— Albert Einstein

### Form ADV Rehashed

Given its ubiquity and uniformity, the Form ADV is a beautiful thing for due diligence, with information about the adviser’s organization, fees and compensation, key personnel, affiliates, governance, regulatory matters, compliance, disciplinary disclosures, assets under management, skin in the game, private funds, and related service providers. Unless otherwise indicated, information below is found in Part 1.

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<sup>4</sup> [www.sec.gov/rules/final/2016/ia-4509-form-adv-summary-of-changes.pdf](http://www.sec.gov/rules/final/2016/ia-4509-form-adv-summary-of-changes.pdf)



## Organization

The Form ADV provides basic information about an adviser's business, highlighting its legal structure, asset size, number of employees, and types of advisory activities, as well as other business activities. While this standardized profile is helpful as an initial step of due diligence, changes to the firm's people, assets, clients, and other attributes from one year to the next convey whether the business is unexpectedly growing, shrinking, or evolving to a degree that may be a red flag.

In addition to the principal office at which the firm conducts its advisory business, the firm provides identifying information on its largest 25 offices (ranked by number of employees) and the types of services provided in each location. In the previous Form ADV format, only the top five offices needed to be identified. Also new to the Form ADV is a listing of all of the adviser's websites and accounts on Twitter, Facebook, LinkedIn, and any other publicly available social media platform on which it controls the content. Social media disclosures pertain only to the adviser, not its employees. These online references enable more due diligence on how the firm conducts itself.



## Fees and Compensation

How a firm is compensated helps to highlight whether agency risks or alignment of interests may be an important motivator or distraction for its employees. While Part 1 (Item 5) discloses types of compensation arrangements used with clients (e.g., percentage of assets managed, fixed fees, commissions, performance-based fees), the adviser provides a more detailed explanation of its fees and compensation in Part 2A (Item 5). Compensation paid to the firm by sources other than clients, such as an underlying manager, must be disclosed. Financial relationships with third-party marketers are also disclosed.



## Key Personnel

Under Schedule A of Part 1, the adviser provides identifying information about the firm's direct owners and executive officers, including

their ownership interests. Schedule B shows the firm's indirect owners and their ownership interests with a view toward drilling up to controlling individuals. Although these disclosures address who has controlling stakes, profits or other economic interests of the entities may be distributed via shadow equity agreements to other key professionals not disclosed on Schedule A or B. The Form ADV provides answers to many questions but not all.

In addition to stakeholders listed in Schedule A and B, the professionals profiled in the Brochure Supplement might be the most important reason for an investor to consider a particular firm. Getting comfortable with their integrity, skills, and energy to deliver the quality results you seek is a step beyond the scope of any Form ADV review, but that list is a starting point for any reference and background checks.



## Regulation

The Form ADV provides disclosures of the adviser's registrations with regulatory authorities besides the SEC, which can then be sources of additional disclosures in related public filings. New to the Form ADV is a provision for affiliated private fund advisers to reference an "umbrella registration" upon which they can rely for their registration disclosures. Each affiliated adviser then is linked to a single Form ADV that has the full set of disclosures. This enhancement makes the registration process for affiliated private fund advisers more efficient, but investors and fiduciaries doing their due diligence need to focus on the Form ADV of the umbrella adviser, not just that of the affiliated adviser.



## Compliance

The Form ADV now requests more identifying information regarding the firm's chief compliance officer (CCO), a position required under Rule 206(4)-7 of the Advisers Act. The CCO's role should not be understated in an investor's due diligence process. As explained in an SEC announcement,<sup>5</sup> "An adviser's chief compliance officer should be competent and knowledgeable

<sup>5</sup> [www.sec.gov/rules/final/ia-2204.htm](http://www.sec.gov/rules/final/ia-2204.htm)

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regarding the Advisers Act and should be empowered with full responsibility and authority to develop and enforce appropriate policies and procedures for the firm. Thus, the compliance officer should have a position of sufficient seniority and authority within the organization to compel others to adhere to the compliance policies and procedures.”

New to the Form ADV is a question related to whether the CCO is compensated or employed by someone other than the firm. If the CCO’s role is outsourced to another firm, such as a third-party vendor that provides compliance-related services, this disclosure should prompt the investor or fiduciary to inquire further into the scope and manner of the adviser’s compliance process.



### Disciplinary Disclosures

While this part of Form ADV was not changed, Item 11 of Part 1 outlines important information regarding any regulatory, criminal, or civil judicial disciplinary actions against the firm or advisory affiliates over the prior 10 years, such as:

- Findings by the SEC or Commodity Futures Trading Commission (CFTC) that the RIA or its advisory affiliates made a false statement or omission
- Violations of SEC or CFTC regulations or statutes
- Convictions for a felony or investment-related misdemeanor in a judicial court
- Current civil court proceedings regarding investment-related activities, domestic or foreign, against the firm or its advisory affiliates

The answers to these issues are usually “No,” but any “Yes” is an unambiguous flag signaling the need for further understanding.

In the case of a “Yes” response, the registrant needs to file a Disclosure Reporting Page (DRP) detailing the nature of the action and its resolution. A summary of this disciplinary information is provided again in Item 9 of Part 2A. If any disciplinary history involves a key individual at the firm overseeing a client’s

investment, Part 2B will also include those disclosures under that individual’s profile.

Callan’s review of all recorded Form ADV filings from Jan. 1 to Oct. 31, 2017,<sup>6</sup> yielded notable highlights about disciplinary history (detailed on the following page). The most common event cited was a violation of investment-related regulations or statutes under any federal, state, or foreign financial regulatory authority, as disclosed by 6.6% of respondents under Item 11.D(2). The next most common disclosure was a rule violation related to self-regulatory organizations (e.g., FINRA or a stock or commodity exchange), as disclosed by 5.2% of respondents under Item 11.E(2). Many of these violations involve indirect affiliates (think big bank with extensive trading operations) that might not be controlled directly by the RIA. However, roughly 6.5% of RIAs or their “supervised persons” had some form of DRP required, as disclosed under Item 11. While the size of a fine or settlement is indicative of the severity of the violation, the nature of the violation may be more revealing as to whether the organization’s actions are undermining its words of integrity or aligned interest on behalf of clients.



### Assets Under Management

A firm’s regulatory assets under management (RAUM) is defined as the “securities portfolios for which you provide continuous and regular supervisory or management services.” New to the Form ADV is more specific detail for each type of client being advised regarding the number of accounts and dollar amount of assets under management, including an overall percentage exposure to non-U.S. clients. Previously, the form only requested a percentage range attributable to each client type. This additional detail enables a more precise metric to monitor. How these reported numbers change over time in absolute and relative terms can indicate the health and direction of that adviser’s business development and its aligned interests. The additional RAUM and client information makes it easier to compare the focus of advisers’ client development and retention trends.

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<sup>6</sup> [www.sec.gov/help/foiadocsinvafoiahtm.html](http://www.sec.gov/help/foiadocsinvafoiahtm.html)

## Form ADV Item 11 Disclosures: % of Registrants Indicating "Yes"

Item 11	Do any of the events below involve you or any of your supervised persons?	<b>6.5%</b>
11.A(1)	In the past 10 years, have you or any advisory affiliate: been convicted of or pled guilty or nolo contendere ("no contest") in a domestic, foreign, or military court to any felony?	<b>0.4%</b>
11.A(2)	In the past 10 years, have you or any advisory affiliate been charged with any felony?	<b>1.0%</b>
11.B(1)	In the past 10 years, have you or any advisory affiliate been convicted in a court of a misdemeanor involving investments?	<b>0.3%</b>
11.B(2)	In the past 10 years, have you or any advisory affiliate been charged with a misdemeanor involving investments?	<b>0.3%</b>
11.C(1)	Has the SEC or CFTC ever found you or any advisory affiliate to have made a false statement or omission?	<b>1.3%</b>
11.C(2)	Has the SEC or CFTC ever found you or any advisory affiliate to have been involved in a violation of regulations or statutes?	<b>4.3%</b>
11.C(3)	Has the SEC or CFTC ever found you or any advisory affiliate to have been a cause of an investment-related business having its authorization to do business denied, suspended, revoked, or restricted?	<b>0.1%</b>
11.C(4)	Has the SEC or CFTC ever entered an order against you or any advisory affiliate in connection with investment-related activity?	<b>3.8%</b>
11.C(5)	Has the SEC or CFTC ever imposed a civil money penalty or cease-and-desist order on you or any advisory affiliate?	<b>4.3%</b>
11.D(1)	Has any regulatory authority besides the SEC and CFTC ever found you or any advisory affiliate to have made a false statement or omission, or been dishonest, unfair, or unethical?	<b>1.8%</b>
11.D(2)	Has any regulatory authority besides the SEC and CFTC ever found you or any advisory affiliate to have been involved in a violation of investment-related regulations or statutes?	<b>6.6%</b>
11.D(3)	Has any regulatory authority besides the SEC and CFTC ever found you or any advisory affiliate to have been a cause of an investment-related business having its authorization to do business denied, suspended, revoked, or restricted?	<b>0.2%</b>
11.D(4)	Has any regulatory authority besides the SEC and CFTC in the past 10 years entered an order against you or any advisory affiliate in connection with an investment-related activity?	<b>5.1%</b>
11.D(5)	Has any regulatory authority besides the SEC and CFTC ever prevented you or any advisory affiliate, by order, from associating with an investment-related business or restricted your or any advisory affiliate's activity?	<b>1.6%</b>
11.E(1)	Has any self-regulatory organization or commodities exchange ever found you or any advisory affiliate to have made a false statement or omission?	<b>0.5%</b>
11.E(2)	Has any self-regulatory organization or commodities exchange ever found you or any advisory affiliate to have been involved in a violation of its rules?	<b>5.2%</b>
11.E(3)	Has any self-regulatory organization or commodities exchange ever found you or any advisory affiliate to have been the cause of an investment-related business having its authorization to do business denied, suspended, revoked, or restricted?	<b>0.1%</b>
11.E(4)	Has any self-regulatory organization or commodities exchange ever disciplined you or any advisory affiliate by restricting your or the advisory affiliate's activities?	<b>1.7%</b>
11.F	Has an authorization to act as an attorney, accountant, or federal contractor granted to you or any advisory affiliate ever been revoked or suspended?	<b>0.3%</b>
11.G	Are you or any advisory affiliate now the subject of any regulatory proceeding that could result in a "yes" answer to any part of Item 11.C, 11.D, or 11.E.?	<b>0.9%</b>
11.H(1)(a)	Has any court in the past 10 years enjoined you or any advisory affiliate in connection with any investment-related activity?	<b>0.7%</b>
11.H(1)(b)	Has any court ever found you or any advisory affiliate in a violation of investment-related statutes or regulations?	<b>0.9%</b>
11.H(1)(c)	Has any court ever dismissed an investment-related civil action brought against you or any advisory affiliate by a financial regulatory authority?	<b>0.9%</b>
11.H(2)	Are you or any advisory affiliate now the subject of any civil proceeding?	<b>1.2%</b>

Source: <http://www.sec.gov/help/foiadocsinvafoiahtm.html>

Data collected from Jan. 1, 2017-Oct. 31, 2017

Supplementing the adviser's disclosed RAUM is the firm's exposure to clients for which the firm provides advisory services without attribution under RAUM. The disclosure of significant business here indicates a potential firm distraction being compensated at a lower rate than that of RAUM. Look for a disclosure of such advisory business under Item 4 of Part 2A. However, firms may omit the actual dollar amount of these assets under advisement because if they reveal that figure, the SEC requires the methodology behind calculating such assets be disclosed and substantiated.

New to the Form ADV are disclosures regarding the firm's separately managed accounts (SMAs). The amendments include a new Item 5.K of Part 1A and its corresponding section in Schedule D that details the aggregate exposures of these separate accounts across 12 broad asset categories<sup>7</sup> as well as a summary of derivatives and borrowings used in SMAs. Advisers with at least \$10 billion in RAUM attributable to separately managed accounts are required to report these asset category exposures at both mid-year and end-of-year, while advisers with less than that RAUM threshold only need to report end-of-year exposures. Names of the SMA custodians are also disclosed, along with the amount of assets they hold. The degree to which the adviser directly holds custody of assets is also disclosed—if any, that can be a conversation starter.



### Private Funds

In Part 1's Private Fund Reporting section (Schedule D, Section 7.B), detailed disclosures on hedge funds and other unregistered pooled investment vehicles provide a myriad of insights as of the filing date and over time, such as:

- Are disclosed fund assets consistent with other sources?
- How much of the private fund assets continue to be owned by related persons of the adviser?
- Was the fund's annual financial statement qualified by the auditor?

- Who is the auditor?
- Are the fund's prime broker, auditor, custodian, and fund administrator known entities with good industry reputations?
- Have any of them been replaced since the last Form ADV filing?

*Transparency is not about restoring trust in institutions. Transparency is the politics of managing mistrust.*  
— Ivan Krastev, political scientist

### Converting Information to Insight

Transparency per se is not an end, or even the means to an end. Public disclosures in Form ADVs represent the inputs of an investor's due diligence process. And updates to the Form ADV are the prompt for a detailed and systematic review to identify whether new information about the adviser's key attributes warrant any change of an investor's opinion regarding the adviser's qualification to manage money.

The process of evaluating Form ADV data involves a series of steps to achieve proper due diligence:

#### 4 Key Steps to Evaluate Form ADVs

1. Identify the most important information in the form
2. Outline how it will be reviewed
3. Decide which issues can be resolved, and which escalated
4. Document resolution of the most important issues

1. **Define the criteria and their priorities** in the Form ADV review process. What are key observations in disclosed data to consider as appropriate catalysts for further review? While individual changes are unlikely to trigger a pass/fail switch, they can impart a positive or negative cumulative effect on the adviser's evaluation. Such thresholds defined

<sup>7</sup> The 12 covered asset categories are: exchange-traded equity securities; non-exchange-traded equity securities; U.S. government/agency bonds; U.S. state and local bonds; sovereign bonds (as defined in the Form ADV); investment grade corporate bonds; non-investment grade corporate bonds; derivatives; securities issued by registered investment companies or business development companies; securities issued by other pooled investment vehicles; cash and cash equivalents; and "other" assets, which must be described separately.

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in advance create a more objective process for reviewing advisers where a pre-existing bias by an investor might let a favored manager escape a more critical assessment.

2. With those criteria established, **formalize a consistent and comprehensive process of reviewing that data**. When is each review to be completed? Is the individual responsible for the review appropriately trained and qualified? Are the resources available sufficient to perform the desired scope of review?
3. When issues deemed to be material are identified during the Form ADV review process, **document the issue** to resolve. Address it internally—or with the adviser if appropriate—in writing. If the issue is deemed acceptable upon further review, the individual responsible for that review then confirms such conclusion in a documented process. If still unresolved, the concern is then escalated to a supervisor or oversight body, like an investment committee, responsible for acting upon such issues.
4. Issues escalated to the highest appropriate authority are then resolved with **accountability in writing**. Issues raised in a Form ADV review are usually not black-and-white matters of judgment. The final decision on whether to hire or retain an adviser can be influenced by the Form ADV review process but it may be predicated on other concerns related to changes in performance, key personnel, or the firm's organization. However, a consistent and thorough Form ADV review process helps to insure that material issues are not overlooked by key decision-makers.

*There is strong shadow where there is much light.*

— Johann Wolfgang von Goethe

### **Beyond the Form ADV**

The Form ADV discloses a lot of helpful information. With these new amendments, more light is shining on the adviser's business. The process of reviewing these disclosures is important, but the structured format of required disclosures has inherent limitations that leave possible issues unanswered for investors. The goal of the Form ADV review process is to help the investor make informed decisions in which all material facts are consistently and appropriately considered, not necessarily to retain only advisers with clean records and boxes checked correctly. A fiduciary's informed judgement begins with a fact-finding process and ends with a defensible investment result.

Public disclosures can still be misrepresented, but a web of lies soon tangles itself. Bernard Madoff would have had a more uncomfortable experience completing his firm's Form ADV today, as the additional disclosures would have exposed him to more questions about his firm—but only if someone is reviewing the Form ADV!

***Author's Note:** This summary should not be interpreted as a legal opinion but rather as an opportunity to begin a dialogue examining the impact of this enhanced transparency of Form ADVs.*

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### **Do you know about Callan's hedge fund advisory services?**

- **Education**—Determining if hedge funds are appropriate for a client's overall strategy
- **Investment policy**—Documenting hedge fund goals and guidelines
- **Asset allocation**—Defining the appropriate strategic mix
- **Manager structure**—Assessing a manager's fit within a portfolio
- **Manager search**—Following a defined process for identifying qualified managers of diversified hedge fund solutions
- **Performance evaluation**—Measuring how well a hedge fund portfolio is adding value relative to its peers

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*For more information, please contact your Callan consultant or Jim McKee at 415.974.5060 or [mckee@callan.com](mailto:mckee@callan.com).*

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*Hedge Fund Monitor* is a quarterly newsletter that gives our clients a current view of industry trends affecting this popular alternative investment.

### **Author**



**Jim McKee** is the director of Callan's Hedge Fund Research group. He specializes in hedge fund research addressing related issues of asset allocation, manager structure, manager search, and performance evaluation for Callan's institutional clients.

*Editor – Stephen R. Trousdale*

### **About Callan**

Callan was founded as an employee-owned investment consulting firm in 1973. Ever since, we have empowered institutional clients with creative, customized investment solutions that are backed by proprietary research, exclusive data, and ongoing education. Today, Callan advises on more than \$2 trillion in total fund sponsor assets, which makes it among the largest independently owned investment consulting firms in the U.S. Callan uses a client-focused consulting model to serve pension and defined contribution plan sponsors, endowments, foundations, independent investment advisors, investment managers, and other asset owners. Callan has five offices throughout the U.S. For more information, please visit [www.callan.com](http://www.callan.com).

### **About the Callan Institute**

The Callan Institute, established in 1980, is a source of continuing education for those in the institutional investment community. The Institute conducts conferences and workshops and provides published research, surveys and newsletters. The Institute strives to present the most timely and relevant research and education available so our clients and our associates stay abreast of important trends in the investments industry.

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# Callan

## Corporate Headquarters

600 Montgomery Street  
Suite 800  
San Francisco, CA 94111  
800.227.3288  
415.974.5060

[www.callan.com](http://www.callan.com)

## Regional Offices

Atlanta  
800.522.9782  
  
Chicago  
800.999.3536

Denver  
855.864.3377  
  
New Jersey  
800.274.5878

 @CallanLLC

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