SEC ADOPTS NEW PART 2 OF FORM ADV

A decade after amending and adopting electronic filing of Part 1 of Form ADV but deferring changes to Part II, the Securities and Exchange Commission (the "SEC") has adopted a new electronically filed ADV Part 2 and amendments to related rules under the Investment Advisers Act of 1940 (the "Advisers Act").[1] Part II, renamed "Part 2," is the document that registered advisers typically use in communicating information to their clients and now consists of three separate sections: (i) Part 2A (the "Brochure"), (ii) Appendix 1 to Part 2A (the "Wrap Fee Program Brochure") and (iii) Part 2B (the "Brochure Supplement"). New ADV Part 2 significantly changes the way investment advisers registered with the SEC provide disclosure to clients and to the general public, including:

- replacing the current Part II, which is prepared using a check-the-box format with related discussion on Schedule F, with an entirely narrative format drafted in plain English covering topics such as the adviser's business, fees and other compensation, investment strategies and risks, disciplinary events involving the firm and its personnel,[2] and various conflicts of interest. The new Part 2 will require the adviser to not only describe the nature of the various conflicts of interest but to explain *how it addresses* such conflicts;

- filing the Brochure with the SEC electronically, and thus making it available to the general public through the SEC-sponsored Investment Adviser Public Disclosure website ("IAPD").[3] Currently, only ADV Part 1A is required to be filed with the SEC;

- annually delivering an updated Brochure with a summary of material changes, or a summary of material changes and the offer to send the updated Brochure, to clients and, should there be material changes to disciplinary information, promptly delivering to clients an updated Brochure with a summary of any such material changes; and

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[1] *Amendments to Form ADV*, Investment Advisers Act Release No. IA-3060 (July 28, 2010) (the "Release"), *available at* http://www.sec.gov/rules/final/2010/ia-3060.pdf. The SEC originally proposed revisions to Part II of Form ADV in 2000 but deferred its adoption after receiving a number of critical comments. *Electronic Filing by Investment Advisers; Proposed Amendments to Form ADV*, Investment Advisers Act Release No. 1862 (April 5, 2000); *Electronic Filing by Investment Advisers; Proposed Amendments to Form ADV*, Investment Advisers Act Release No. 1897 (September 12, 2000). The SEC proposed revisions to Part II in 2008. *Amendments to Form ADV*, Investment Advisers Act Release No. 2711 (March 3, 2008), *available at* http://www.sec.gov/rules/proposed/2008/ia-2711.pdf. The new Part 2 as adopted incorporates most of what was proposed in 2008.

[2] Similar disciplinary information is currently only required to be included in Part 1A.

[3] With respect to advisers to private funds that rely on private offering exemptions in the Securities Act of 1933, the SEC stated that such advisers could provide information required by the new Part 2 without jeopardizing reliance on those exemptions; however, the inclusion of private fund information beyond that required by the new Part 2 such as subscription instructions, performance information and financial statements may jeopardize such reliance by constituting a public offering or conditioning the market for the securities issued by those funds. *See* Release at Section II.C.

- preparing a Brochure Supplement for each supervised person who provides investment advice to clients of the adviser and delivering it to clients. Unlike the Brochure, the adviser will not be required to file the Brochure Supplement with the SEC or annually deliver the Brochure Supplement to clients with respect to a supervised person. However, the Brochure Supplement must be updated and delivered to clients should there be material changes to any disciplinary information.

Effective Date and Transition Compliance Dates

The new ADV Part 2 and related rule amendments are effective October 12, 2010.

Advisers registered with the SEC with fiscal years ending on or after December 31, 2010 will be required to include the new Part 2A Brochure with their next annual updating amendment filed with the SEC (such amendments are due within 90 days of the adviser's fiscal year end) and deliver the new Part 2 to new and prospective clients. The adviser must deliver to its existing clients its new Part 2 within 60 days of filing such amendment.

Advisers applying for SEC registration on or after January 1, 2011 will be required to include a Brochure in their application and deliver the new Part 2 to their existing and prospective clients upon the approval of their registration.

Part 2A (the "Brochure")

The Brochure has 18 separate items, each of which requires disclosure on a distinct topic, and must be presented in the order of the items in the form, using headings in the form to facilitate comparison of advisers by clients and potential clients. Generally, these items are drawn from the current Form ADV Part II. The major items are highlighted below:[4] Click here for a link to the Form ADV Part 2A.

Item 2. Summary of Material Changes. An adviser amending its Brochure will be required to summarize any material changes to the Brochure since the last annual update. The summary should inform clients of the substance of the changes to the adviser's policies, practices or conflicts of interest, so that clients can determine whether to review the Brochure in its entirety or to contact the adviser with questions about the changes. The summary may be delivered to clients in a separate document apart from the Brochure but must be filed as an exhibit to the Brochure when filing an annual update to the Brochure.

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[4] For purposes of this memorandum, the discussion of the disclosure items contained in the Brochure, Wrap Fee Program Brochure and Brochure Supplement is limited to the requirements applicable to advisers registered with the SEC. Advisers registered with one or more state securities authorities would be subject to additional disclosure items not discussed herein.

Item 4. Advisory Business. Currently, Part II requests information concerning an adviser's advisory services in a check-the-box format. An adviser will now be required to describe in greater detail its advisory business including the types of advisory services offered, whether the adviser holds itself out as specializing in a particular type of advisory service, and the amount of client assets that it manages. An adviser may use a method to compute the assets it manages that differs from the method used in Part 1A of Form ADV to report "assets under management."[5] An adviser opting to use a different method must keep documentation describing the method used.

Item 5. Fees and Compensation. Similar to the current Part II, an adviser will be required to disclose information about its fees including, for example, fee schedules, whether fees are negotiable, whether and how often it bills or deducts fees directly from client accounts, and, if it charges fees in advance, how it calculates refunds when a client terminates the relationship. The new Brochure will also require disclosure of certain details about other costs that clients may pay in connection with advisory services such as brokerage costs, custody fees and fund expenses, and any compensation attributable to the sale of securities or other investment products (*e.g.*, brokerage commissions), whether received by the adviser or by any of its personnel. In addition to disclosing the compensation information and the conflicts of interest thereby created, the adviser will be required to describe how it addresses such conflicts.

Item 6. Performance-Based Fees and Side-By-Side Management. An adviser will be required to disclose whether it charges performance-based fees,[6] or whether a supervised person manages an account that pays such fees. If the adviser or supervised person manages accounts that are not charged performance-based fees, the adviser will also be required to disclose the conflicts that arise from simultaneous management of these accounts and describe how it addresses such conflicts.

Item 8. Methods of Analysis, Investment Strategies and Risk of Loss. Currently, Part II requests information concerning investment strategies and analytical methods in a check-the-box format. An adviser will now be required to describe its methods of analysis and investment strategies and state that investing in securities involves risk of loss. An adviser will also be required to discuss the material risks involved with each significant investment strategy or method of analysis and particular type of recommended security and to provide additional detail concerning any significant or unusual risks associated with a particular strategy or security that otherwise would not be apparent to the client from the Brochure.

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5 The SEC explained that advisers are permitted to use a different methodology for Part 2A disclosure because the methodology for calculating assets required under Part 1A is designed for a particular purpose (*i.e.*, for making a determination as to whether an adviser should register with the SEC or with the states) rather than to convey meaningful information about the scope of the adviser's business. *See* Release at note 45.

6 "Performance-based fees" would be any fees an adviser receives based on a share of the capital gains on, or capital appreciation of, the assets of a client.

Item 9. Disciplinary Information. An adviser will be required to disclose in the Brochure material facts about any legal or disciplinary event that is material to a client's or potential client's evaluation of the integrity of the adviser or its management. This item provides a non-exhaustive list of disciplinary events that are presumed to be material if they occurred during the previous ten years. The adviser may rebut the materiality presumption, in which case no disclosure to clients would be required; however, such adviser will be required to document its determination in a memorandum and retain that record for SEC staff review.[7]

Item 10. Other Financial Industry Activities and Affiliations. Currently, Part II requires an adviser to disclose its other financial industry affiliations, but does not specifically mandate a description of the related conflicts of interest and how they are addressed. An adviser will now be required to describe material relationships or arrangements it (or any of its management persons) has with related financial industry participants, any material conflicts of interest arising from such relationships or arrangements, and how such conflicts are addressed.

Item 11. Code of Ethics, Participation or Interest in Client Transactions and Personal Trading. As is the case with the current Part II, an adviser will be required to summarize the provisions of its code of ethics and state that a copy of such code is available upon request. An adviser will now be required to disclose the conflicts arising from its or its related persons' practices in the following areas: (i) participation or interest in client transactions; (ii) investments or potential investments in the same securities recommended to clients or in related securities; and (iii) ability to trade in the same securities at or about the same time as clients. The adviser will be required to describe how it addresses such conflicts.

Item 12. Brokerage Practices. Similar to the current Part II, an adviser will be required to describe how it selects brokers for client transactions and determines the reasonableness of broker compensation.

Soft Dollar Practices - An adviser will be required to disclose its soft dollar practices and the types of products and services it acquires with soft dollars with enough specificity to allow clients to evaluate potential conflicts of interest. An adviser will also be required to provide additional detail for products and services that do not qualify for the safe harbor in Section 28(e) of the Securities Exchange Act of 1934, explain whether it uses soft dollars to benefit all client accounts or only those accounts whose brokerage "pays" for the benefits, and whether the adviser seeks to allocate the benefits to client accounts proportionately to the soft dollar credits those accounts generate. The adviser will also be required to disclose if it causes clients to pay commissions higher than they otherwise would in return for soft dollar benefits.

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[7] Because disciplinary information currently required to be disclosed to clients either orally or in writing under Rule 206(4)-4 under the Advisers Act is being incorporated into the Brochure under this item, the SEC has rescinded Rule 206(4)-4 for each registered adviser effective on the day the adviser must deliver its new Brochure.

Client Referrals - An adviser will be required to disclose if it uses client brokerage to reward brokers for client referrals and the conflicts this practice may create, and describe any procedures used to direct client brokerage to referring brokers.

Directed Brokerage - If clients are permitted to direct brokerage, an adviser will be required to describe its practices in this area, disclose that it may be unable to obtain best execution, and disclose that directing brokerage may cost the client more money.

Trade Aggregation - An adviser will be required to describe whether and under what conditions it engages in trade aggregation practices. If the adviser does not aggregate trades when it has the opportunity to do so, the adviser will be required to explain in the Brochure that clients may pay higher brokerage costs.

Item 14. Client Referrals and Other Compensation. An adviser will be required to disclose any arrangements under which it compensates others for client referrals and describe the compensation. An adviser that accepts any economic benefit from non-clients for providing advisory services to clients will also be required to disclose the arrangement, describe any conflicts of interest that arise, and discuss how the adviser addresses those conflicts. The current Part II requires disclosure of these arrangements but does not specifically require that advisers discuss the associated conflicts of interest.

Item 15. Custody. If the adviser has custody of client funds or securities and a qualified custodian sends account statements directly to clients, the adviser will be required to explain that clients will receive account statements directly from the qualified custodian maintaining those assets, and that the client should carefully review the account statements it receives from the qualified custodian. If the clients also receive account statements directly from the adviser, the explanation must include a statement urging clients to compare such statements to the account statements they receive from the qualified custodian.[8]

Item 17. Voting Client Securities. If an adviser has or will accept authority to vote client securities, it will be required to describe its voting policies and procedures, how the client can direct a vote in a particular solicitation, and how the adviser addresses conflicts of interest that may arise when voting proxies. Advisers will be required to describe how clients may obtain information on how their securities were voted, and explain that clients may obtain a copy of the adviser's proxy voting policies and procedures upon request. Advisers that do not have the authority to vote client securities will be required to explain how clients will receive their proxies or other solicitations.

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[8] This disclosure parallels requirements recently imposed by the amended custody rule under the Advisers Act. *See* Rule 206(4)-2(a)(2).

Item 18. Financial Information. An adviser that requires or solicits prepayment of more than $1,200 (increased from the current threshold of $500) in fees per client, six months or more in advance, will be required to provide clients with an audited balance sheet for its most recent fiscal year. The current Part II does not require that such balance sheets be audited. Additionally, this item provides that an adviser that requires or solicits prepayments over the threshold, or has discretionary authority over or custody of client assets, will be required to disclose in its Brochure any financial condition reasonably likely to impair its ability to meet contractual obligations to clients.

Appendix 1 to Part 2A (the "Wrap Fee Program Brochure")

The disclosure items in the Wrap Fee Program Brochure are substantially similar to those currently set out in Schedule H of Form ADV, but also reflect many of the amendments to the Brochure discussed above. Click here for a link to the Form ADV Part 2A Appendix 1. Advisers that sponsor wrap fee programs will continue to be required to prepare separate, specialized Wrap Fee Program Brochures for clients of the programs.[9] New and additional disclosure items under such Wrap Fee Program Brochures will require an adviser to identify whether any of its related persons are portfolio managers in the wrap fee program and, if so, to explain associated conflicts of interest and how they are addressed. Advisers will also be required to disclose whether related person portfolio managers are subject to the same selection and review as other portfolio managers in the program and, if not, to explain how such portfolio managers are selected and reviewed.

Part 2B (the "Brochure Supplement")

Each Brochure must be accompanied by Brochure Supplements providing information about the "supervised persons"[10] of the adviser that the client receiving the Brochure relies on for investment advice. Click here for a link to the Form ADV Part 2B. The Brochure Supplement must also be written in plain English and the information must be organized in the same order and contain the same headings as provided in the form. Advisers may include the Brochure Supplement information at the end of the firm's Brochure or create separate Brochure Supplements for each supervised person, or separate Brochure Supplements for groups of supervised persons (*e.g.*, all persons in a particular office). The Brochure Supplement contains six disclosure items.

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9 Advisers whose entire advisory business is sponsoring wrap fee programs must prepare a Wrap Fee Program Brochure but will not be required to prepare a standard advisory firm Brochure. An adviser will have to prepare both a Brochure and Wrap Fee Program Brochure if it sponsors a wrap fee program and provides other types of advisory services, and will be required to deliver both brochures to a client that receives both types of services. Wrap fee sponsors would, like other advisers, be required to provide Brochure Supplements to their wrap fee clients. *See* Release at note 183 and Instruction 10 for Part 2A of Form ADV.

10 Amended Rule 204-3 defines "supervised person" as any of the adviser's officers, partners or directors (or other persons occupying a similar status or performing similar functions) or employees, or any other person who provides investment advice on the adviser's behalf.

Item 1. Cover Page. Each Brochure Supplement's cover page must include information identifying the supervised person(s) covered by the Brochure Supplement as well as the advisory firm.

Item 2. Educational Background and Business Experience. The Brochure Supplement must describe the supervised person's formal education and business background for the past five years.

Item 3. Disciplinary Information. Any legal or disciplinary event that is material to a client's evaluation of the supervised person's integrity must be disclosed.[11] Advisers that send Brochure Supplements electronically may satisfy this disclosure item by explaining that disciplinary information can be found on the Financial Industry Regulatory Authority's BrokerCheck system or the IAPD and providing a hyperlink to the relevant system.

Item 4. Other Business Activities. An adviser will be required to disclose other investment-related business activities of the supervised person, any associated material conflicts of interest and how they are addressed. The adviser will be required to provide information about any compensation received by the supervised person that is based on the sale of securities or other investment products, and to explain the incentives this type of compensation creates. Non-investment business activities or occupations of supervised persons must also be disclosed if they involve a substantial amount of time or pay. Non-investment business activities are presumed not to be substantial if they represent less than ten percent of the supervised person's time and income.

Item 5. Additional Compensation. An adviser will be required to disclose if someone who is not a client provides an economic benefit other than regular salary (*e.g.*, bonuses based on sales, client referrals, new accounts or sales awards) to the supervised person for providing advisory services.

Item 6. Supervision. An adviser will be required to explain how the firm monitors the advice the supervised person provides to clients, and provide the name, title and telephone number of the person responsible for supervising the supervised person's activities on behalf of the firm.

Delivery and Filing Requirements

The SEC adopted several amendments to Rules 204-1 and 204-3 that will increase an adviser's obligations to deliver updated Brochures and Brochure Supplements to clients and to file the Brochure and amendments with the SEC.

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[11] This list parallels the list of disciplinary and legal events that must be disclosed in Item 9 of Part 2A and is derived from the prior disclosure requirements set out in Rule 206(4)-4. The list is also substantially similar to the list of disciplinary events that must be disclosed by advisers and their advisory affiliates in Item 11 of Form ADV Part 1A.

Initial Delivery. The amendments to Rule 204-3 require that an adviser deliver its Brochure *before or at the time* it enters into any advisory contract with a client.[12] Wrap Fee Program Brochures are subject to the same delivery requirement, and must be delivered to a client before or at the time a client enters into a wrap fee program contract.

An adviser will be required to deliver to each client or prospective client a Brochure Supplement for each supervised person who: (i) formulates investment advice for that client and has direct client contact; or (ii) makes discretionary investment decisions for such client's assets, even if the supervised person has no direct client contact. The Brochure Supplement must be delivered *before or at the time* that the supervised person begins to provide such services to the client. If investment advice is provided for a client by a team comprised of more than five supervised persons, a Brochure Supplement need only be delivered for each of the five supervised persons with the most significant responsibility for the day-to-day advice provided to that client.

Annual Delivery. Rule 204-3 as amended will require an adviser to deliver to each client, *annually within 120 days after the end of its fiscal year:* (i) a copy of an updated Brochure that includes or is accompanied by a summary of material changes; or (ii) the summary of material changes that includes an offer to provide a copy of the current Brochure.[13] If an adviser has not had any material changes to its Brochure since filing its last annual updating amendment, the adviser will not be required to deliver a summary of material changes or a Brochure to its existing clients that year. The same annual delivery requirements apply to Wrap Fee Program Brochures. However, with respect to the Brochure Supplements, an adviser will not be required to deliver Brochure Supplements to existing clients on an annual basis.

Interim Delivery. Amended Rule 204-3 will require an adviser to deliver an updated Brochure (or a document describing the material facts relating to the change in disciplinary information) promptly whenever there is a new disciplinary event or a material change to disciplinary information already disclosed in response to Item 9 of the Brochure. Similarly, an adviser must promptly deliver a revised Wrap Fee Program Brochure and/or a Brochure

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[12] Currently, Rule 204-3 requires that an adviser deliver brochure information to a client or prospective client (i) at least 48 hours prior to entering into any investment advisory contract, or (ii) at the time of entering into such contract, if the client has the right to terminate the contract without penalty within five business days thereafter.

[13] Currently, an adviser is required to annually deliver, or offer in writing to deliver upon written request, brochure information to each of its advisory clients. Advisers may electronically deliver to clients a Brochure that includes the summary of material changes or the summary of material changes along with the offer to provide the Brochure in accordance with the SEC's guidelines regarding electronic delivery of information. *See Use of Electronic Media by Broker-Dealers, Transfer Agents, and Investment Advisers for Delivery of Information*, Investment Advisers Act Release No. 1562 (May 9, 1996).

With respect to filing requirements, an adviser that does not include a summary of material changes in its Brochure must file its summary as an exhibit to its Brochure, when filing an annual updating amendment with the SEC. Furthermore, if an adviser includes the summary of material changes in its Brochure, and amends its Brochure on an interim basis between annual updating amendments, the adviser should but is not required to update its summary of material changes at such times in order to avoid confusing or misleading clients reading the updated Brochures. *See* Instruction 6 for Part 2A of Form ADV.

Supplement, as applicable, when there is a new disciplinary event or a material change to disciplinary information already disclosed in such documents.[14]

Exceptions to Delivery. Similar to the current exceptions, under the amended rule, an adviser will not be required to deliver its Brochure to a client that is an investment company registered under the Investment Company Act of 1940 (the "1940 Act") or that receives only impersonal investment advice for which the adviser charges less than $500 per year (the current threshold is $200). The amended rule expands these exceptions to include a business development company as defined in the 1940 Act that is subject to section 15(c) of that Act. *If an adviser does not have any clients to whom a Brochure must be delivered, the adviser will not be required to prepare or file a Brochure with the SEC*. With respect to the Wrap Fee Program Brochure, if an adviser is a sponsor of a wrap fee program with multiple sponsors, and another sponsor prepares and delivers the adviser's Wrap Fee Program Brochure, *the adviser will not be required to prepare or deliver a separate Wrap Fee Program Brochure to its wrap fee program clients*.

While the SEC did not adopt a specific exception for advisers to hedge funds and other private funds, it did note in the Release that Rule 204-3 requires only that Brochures be delivered to "clients" which, pursuant to the decision in *Goldstein v. SEC*, is the fund itself and not investors in the fund.[15]

Advisers will not be required to deliver Brochure Supplements to: (i) clients to whom an adviser is not required to deliver a Brochure (*i.e.*, registered investment companies and business development companies); (ii) clients who receive only impersonal investment advice; or (iii) officers, directors, employees and other persons related to the adviser that would be "qualified clients" of the advisory firm as defined under Rule 205-3.[16] *An adviser that does not*

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14 If an electronically delivered Brochure Supplement refers to BrokerCheck or IAPD for disclosure of a supervised person's disciplinary information, an adviser will be required to electronically deliver an updated Brochure Supplement, or "sticker," to clients whenever BrokerCheck or IAPD is updated with new disclosure of a disciplinary event or with a material change to disciplinary information that is already disclosed; such Brochure Supplement or sticker must indicate that the disciplinary information for the supervised person has changed and provide a hyperlink to BrokerCheck or IAPD. *See* Release at Section II.B.3.b.

15 *See* Release at note 192. It should also be noted that under the Dodd-Frank Wall Street Reform and Consumer Protection Act, signed into law on July 21, 2010, the SEC is authorized to, and may in the future, define "client" to mean investors in a fund for purposes of the Part 2 delivery requirements. The SEC doing so would result in advisers being required to deliver Part 2 to hedge fund and other private fund investors. *See* Pub. L. No. 111-203, §406 (2010).

16 Rule 205-3(d)(1)(iii) defines certain related persons as "qualified clients," including: (A) any executive officer, director, trustee, general partner, or person serving in a similar capacity, of the investment adviser; or (B) an employee of the investment adviser (other than an employee performing solely clerical, secretarial or administrative functions with regard to the investment adviser) who, in connection with his or her regular functions or duties, participates in the investment activities of such investment adviser, provided that such employee has been performing such functions and duties for or on behalf of the investment adviser, or substantially similar functions or duties for or on behalf of another company, for at least twelve months.

have any clients to whom it must deliver a Brochure Supplement will not have to prepare any Brochure Supplements, and an adviser will not have to prepare a Brochure Supplement for any supervised person who does not have clients to whom the adviser must deliver the Brochure Supplement.

Updating and Filing. An adviser will be required to amend its Brochure and Wrap Fee Program Brochure, if applicable, with any updates at least annually, *within 90 days after the adviser's fiscal year end*, and in between annual updating amendments when any information in the Brochure (or Wrap Fee Program Brochure) becomes materially inaccurate. All annual and interim updating amendments must be filed with the SEC.[17]

As with the Brochure, an adviser will be required to amend a Brochure Supplement promptly if it becomes materially inaccurate, but will not be required to update the Brochure on an annual basis. Neither the Brochure Supplements nor any amendments to the Brochure Supplements will be required to be filed with the SEC, and neither will be publicly available. Advisers must, however, maintain in their files copies of all Brochure Supplements and any amendments.

New Recordkeeping Requirements

The SEC also amended its adviser recordkeeping rule, Rule 204-2, to require advisers to keep copies of all Brochures, Wrap Fee Program Brochures, Brochure Supplements, all related amendments including the summaries of material changes, documentation concerning the method used to calculate the amount of client assets managed, and memoranda concerning legal or disciplinary events.

Conclusion

New Part 2 will impose substantial additional obligations on currently registered advisers and on firms preparing to register as investment advisers. Although disclosure and discussion typically included in Schedule F of the current Form ADV Part II would provide a starting point for completing the new Brochure Part 2A, additional topics and discussion of conflicts and, particularly, how the firm addresses such conflicts will be required for the first time. Given the new requirements and public filing obligations, advisers should allow enough time to properly draft and organize the information for the Brochure, Wrap Fee Program Brochure and any Brochure Supplements prior to the upcoming deadlines.

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17 *See* amended Rule 204-1(a) and (b) and Instruction 4 for Part 2A of Form ADV. It should be noted that a change in the amount of a client's assets under management or fee schedule would not require an adviser to update its Brochure between annual updating amendments. However, if the adviser is amending its Brochure for a separate reason between annual updating amendments and this information becomes materially inaccurate, the adviser should amend this disclosure.

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