SEC PROPOSES NEW PART 2 TO FORM ADV

Several years after revising and adopting electronic filing of Part 1 of Form ADV, but deferring changes to Part II of Form ADV, the Securities and Exchange Commission has again proposed revisions to Part II.[1] Part II provides clients and potential clients with information about business practices, fees and conflicts of interest the adviser may have with its clients, and is often used by investment advisers registered under the Investment Advisers Act of 1940 to satisfy the SEC's "brochure rule." The SEC originally proposed revisions to Part II of Form ADV in 2000 but deferred its adoption after receiving a number of critical comments.[2]

Under the new proposal, a registered adviser would be subject to additional obligations related to completing, updating and delivering the new Part II (renamed as "Part 2"). The SEC proposes to replace the current check-the-box format with a plain English narrative style document discussing the adviser's business, fees and other compensation, investment strategies, financial industry affiliations, soft dollar arrangements, disciplinary events involving the firm and its personnel, risks and various conflicts of interest. The new Part 2 will require the adviser not only to describe the nature of the various conflicts of interest but also to explain *how it addresses* these conflicts.

Unlike Part 1 of Form ADV, Part II is not currently filed electronically with the SEC. The SEC, since the adoption of new Form ADV Part 1 in 2000, has only required that registered advisers complete Part II in paper format, amend it to reflect material changes to the information it contains, and, in addition to providing it to potential clients and offering a copy annually to clients, keep it available for inspection in the firm's records. The current proposal would require filing Part 2 in electronic format with the SEC so that, as with Part 1, the information will be available to the public. Advisers will also be required to deliver Part 2 to clients annually within 120 days of the adviser's fiscal year end.

As proposed, Part 2 would consist of three different sections:

- **Part 2A**, known as the Brochure, would be written in narrative form in plain English and describe, among other specified items, adviser's services, fees, business practices and conflicts of interest with clients.

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1 *Amendments to Form ADV*, Investment Advisers Act Release No. 2711 (March 3, 2008) (Proposing Release), *available at* http://www.sec.gov/rules/proposed/2008/ia-2711.pdf. Registered advisers may as an alternative provide a "brochure" containing all the information in Part II to clients and prospective clients to satisfy this requirement.

2 *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).

- **Appendix 1 to Part 2A**, known as the Wrap Fee Program Brochure, would contain disclosures substantially similar to those in current Schedule H concerning advisers that sponsor wrap fee programs.
- **Part 2B**, known as the Brochure Supplement, would also be written in a plain English narrative and disclose specific information about certain of the adviser's "supervised persons" who provide investment advice to its clients.

Part 2A - The Firm Brochure

As proposed, Part 2A has 19 separate items, each of which requires disclosure on a distinct topic. Generally, these items are drawn from the current Part II. Much of the information that would be required concerns conflicts of interest between an adviser's own interests and those of its clients, which "is disclosure the adviser already must make to clients, as a fiduciary, under the [Advisers Act's] anti-fraud provisions."[3] Provided below is a summary of some of the proposed disclosure items:

- **Fees and Compensation**: An adviser would be required to disclose information about its fees, including fee schedules and whether fees are negotiable. An adviser would also be required to disclose certain details about other compensation it receives for advisory services including any costs borne by clients, such as brokerage, 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 and the conflicts of interest thereby created, the adviser will be required to describe how it addresses such conflicts.

- **Performance Fees and Side-By-Side Management**: An adviser must disclose whether it charges performance fees,[4] and if it also manages accounts that are not charged performance fees, the adviser must disclose the conflicts that arise from simultaneous management of these accounts and describe how it addresses such conflicts. The SEC noted that conflicts may also stem from clients with different investment strategies (*e.g.*, clients, like hedge funds, that pay performance fees who also engage in significant short selling may have a conflict with the interests of other clients like mutual funds that do not pay performance fees and hold long positions).[5]

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3 Proposing Release at 8-9. "Under the Advisers Act, an adviser has an affirmative obligation of utmost good faith and full and fair disclosure of all material facts to its clients, as well as a duty to avoid misleading them." *Id.* at 9, n.15 (citing *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963)).

4 "Performance 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.

5 The SEC also noted that conflicts of interest that result from the simultaneous management of performance fee accounts and other accounts are not limited to hedge fund advisers. For example, an adviser would face conflicts of interest if it were to manage a proprietary account that paid performance fees side-by-side other client accounts that did not pay performance fees.

- **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. Under the proposal, an adviser would be required to describe its methods of analysis and investment strategies, including the effect of frequent trading and cash management. An adviser would now also be required to discuss the associated risks involved, and provide details if the risks are significant or unusual.

- **Disciplinary Information**: An adviser would disclose any material legal or disciplinary events that are "material to a client's evaluation of the integrity of the adviser or its management." Disciplinary information is currently required to be disclosed to clients either orally or in writing under Rule 206(4)-4 under the Advisers Act. The Commission proposes to rescind Rule 206(4)-4 and incorporate the disciplinary disclosure requirements into Part 2A.

- **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. Under the proposal, an adviser would be required to describe material relationships or arrangements it (or any of its management persons) has with related financial industry participants, including any material conflicts of interest arising from such relationships/arrangements and describe how it addresses such conflicts. For example, if the adviser selects or recommends other advisers for clients (such as in wrap fee programs), the advisers would be required to disclose any compensation arrangements or other business relationships between them and the conflicts created by such arrangements or relationships.

- **Code of Ethics**: As required by Rule 204A-1, and as is the case with current Part II, the adviser would summarize the provisions of its code of ethics and state that a copy of such code is available upon request.

- **Participation or Interest in Client Transactions**: An adviser would describe conflicts arising from participation or interest in client transactions and how the adviser addresses such conflicts.

- **Personal Trading**: An adviser would be required to disclose whether advisory personnel invest or are permitted to invest in the same securities it recommends to clients and if they invest in the same securities at or about the same time as clients do. The adviser would also be required to describe the conflicts presented and how such conflicts are addressed.

- **Review of Accounts**: An adviser would indicate whether, and how often, it reviews clients' accounts or financial plans, and identify the individual who conducts the review. Advisers that do not review accounts regularly would be required to explain what circumstances trigger an account review.

- **Brokerage Practices**:

  Soft Dollar - An adviser would 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. Also, an adviser must 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. The SEC is requiring that the adviser 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.

  Client Referrals - An adviser would disclose whether or not it uses client brokerage to reward brokers for client referrals, the conflicts this practice may create, and describe any procedures used to direct client brokerage to referring brokers.

  Trade Aggregation - An adviser would be required to describe whether and under what conditions it engages in trade aggregation practices. If the adviser does not bunch trades when it has the opportunity to obtain discounts, the adviser would be required to explain in the brochure that clients may pay higher brokerage costs.

  Directed Brokerage - If clients are permitted to direct brokerage, an adviser would be required to disclose that it may be unable to obtain best execution and that directing brokerage may cost the client more money.

- **Investment Discretion**: An adviser would disclose arrangements in which it has discretion over client accounts, including any limitations placed on its authority.

- **Voting Client Securities**: As required by Rule 206(4)-6 under the Advisers Act, an adviser would disclose its proxy voting policy and how the adviser addresses conflicts of interest that may arise when voting proxies. The adviser would also be required to disclose its use of third-party proxy voting services, including the names of such services, how its selects among them, whether it permits clients to direct the use of a particular proxy voting service and how the adviser pays for the proxy voting services.

Appendix 1 to Part 2A - The Wrap Fee Program Brochure

The disclosure items in proposed Appendix 1 would be substantially similar to those currently in Schedule H of Part II. Advisers that sponsor wrap fee programs would continue to be required to prepare separate, specialized firm brochures for clients of the program in lieu of the sponsor's standard advisory firm brochure. Some changes and additional disclosure items in the proposal include disclosure as to whether any of an adviser's related persons are portfolio managers in the program, any potential conflicts, and whether related person portfolio managers are subject to the same selection and review as other portfolio managers in the program, and if not, an explanation of how such portfolio managers are selected.

Part 2B - The Brochure Supplement

An adviser would be required to send a brochure supplement containing selective information about certain "supervised persons"[6] who provide investment advice to clients. As compared to the 2000 proposal, the SEC narrowed the scope of persons for whom a brochure supplement would be required and the type of clients to whom the supplement would have to be delivered.

Under the proposal, an adviser must provide a brochure supplement for "supervised persons" who:

- formulate investment advice for a particular client and have direct client contact with that client; or
- make discretionary investment decisions for a particular client's assets, even if that person has no direct client contact.[7]

Exceptions to the Brochure Supplement Requirement - Under the proposal, a brochure supplement would not have to be sent to the following four types of clients: (i) clients to whom an adviser is not required to deliver a brochure (*e.g.*, registered investment companies and business development companies), (ii) clients who receive only impersonal investment advice, (iii) clients who are "qualified purchasers"[8] and (iv) certain "qualified clients"[9] who are also officers, directors and employees and other persons related to the adviser. An adviser that does not have any clients to whom a brochure supplement would have to be delivered would not have to prepare any supplements.

Part 2B would consist of six items about the investment personnel of the adviser who service the clients, including educational background and business experience, disciplinary information, other business activities and additional compensation. An adviser must disclose "any legal or disciplinary event that is material to a client's evaluation of such supervised person's integrity."

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6 Section 202(a)(25) of the Advisers Act defines a "supervised person" as "any partner, officer, director (or other person occupying a similar status or performing similar functions), or employee of an investment adviser, or other person who provides investment advice on behalf of the investment adviser and is subject to the supervision and control of the investment adviser."

7 An adviser would not, however, have to provide a brochure supplement for an individual who provides discretionary advice only as part of a team and has no direct client contact.

8 "Qualified purchasers," as defined under section 2(a)(51)(A) of the Investment Company Act of 1940, include, among others, natural persons who own $5 million or more in investments and persons who manage $25 million or more in investments for their account or other accounts of other qualified purchasers.

9 Rule 205-3(d)(1)(iii) defines certain related persons of an adviser as "qualified clients," including: (i) any executive officers, directors, trustees, general partners, or persons serving in a similar capacity, of the advisory firm; and (ii) any employees of the advisory firm (other than employees performing solely clerical, secretarial or administrative functions) who, in connection with their regular functions or duties, participate in the investment activities of the firm and have been performing such functions or duties for at least 12 months.

Public Availability

Currently, an adviser is not required to file Part II with the SEC. Under the proposal, registered advisers would be required to file Part 2 in electronic format with the SEC so that, like Part 1, the information will be available to the public. The brochure supplement, however, will not be required to be filed with the SEC. However, if an adviser chooses to include the brochure supplement information in its brochure, it would effectively be filing its brochure supplement with the SEC, making such information publicly available.

Delivery Requirements

Initial Delivery - Currently, Rule 204-3 requires that the adviser provide Part II to potential clients either (i) 48 hours before entering into any advisory contract, or (ii) upon entering into such contract, if the adviser allows the advisory client the option to terminate the contract without penalty within five business days after entering into the contract. Under the proposal, an adviser would simply be required to deliver the brochure before or at the time of entering into the agreement. The brochure supplement would need to be delivered at the time a supervised person begins to provide advisory services to that client.

When proposing changes to Form ADV in 2000, the SEC indicated that an adviser needed to deliver its brochure to each investor in a pooled investment vehicle managed by the adviser. The new proposal contains no such requirement and we understand informally from the SEC staff that the omission of the requirement was intentional and the SEC will follow the definition of "client" in Rule 203(b)(3)-1 for purposes of the brochure or brochure supplement delivery requirements and would not "look through" pooled investment vehicles or other entity clients to require delivery of the brochure or brochure supplement to underlying owners unless the adviser also provided advice to such underlying owners based on their individual investment objectives.

Annual Delivery - In addition to the initial delivery requirement, an adviser would be required to send an updated brochure to existing clients annually within 120 days after the end of the adviser's fiscal year. Currently advisers must only offer Part II to clients annually. Furthermore, the SEC proposes that an adviser create a summary of any material changes to the brochure since the last annual update and provide such summary to clients who have already received the brochure. The SEC noted that the summary can be provided as a separate communication to clients or can be included in the brochure. If the summary is in a separate communication, it will not be required to be filed with the SEC. The SEC believes that a summary of material changes will provide existing clients with a way to easily identify changes from one annual brochure to the next. The brochure supplements, however, are not subject to the same annual delivery requirements.

Interim Delivery - The SEC proposes to require an adviser to deliver to clients interim updates when the adviser amends its brochure to either add a disciplinary event or to materially change disciplinary information already disclosed. The SEC noted that interim updates can be in the form of a "sticker." In a footnote, the SEC suggests that delivery of interim updates would be required for *any material change* even if such material change does not trigger the interim update delivery

requirement.[10] The SEC provides very little guidance on this point except to say it believes that this obligation arises because fiduciaries have an ongoing obligation to inform their clients of any material information that could affect the advisory relationship.

Transition Schedule

New applicants do not have to file brochures until six months after the effective date of the proposed amendments. Investment advisers currently registered with the SEC would be required to comply with the revised Part 2 by the date of their next annual updating amendment to Form ADV following the date the revised Part 2 becomes effective. In no case would any adviser be required to comply with the new requirements earlier than six months after the new form becomes effective.

Comments

The SEC is providing an opportunity for all persons interested to comment on the modifications. Comments to the SEC are due by May 16, 2008.

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If you have any questions concerning the foregoing or would like additional information, please contact Roger D. Blanc (212-728-8206, rblanc@willkie.com), Martin R. Miller (212-728-8690, mmiller@willkie.com), Michael S. Didiuk (202-303-1280, mdidiuk@willkie.com), Jane H. Kim (202-303-1242, jkim@willkie.com), or the attorney with whom you regularly work.

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[10] Proposing Release at 50, n.148.