

Alerts & Publications

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SEC Amends the Form ADV, Significantly Increasing Advisers' Disclosure Obligations

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In the wake of the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “**Dodd-Frank Act**”), on July 28, 2010, the Securities and Exchange Commission (“**SEC**”) released amendments to Part 2 of Form ADV and certain related rules under the Investment Advisers Act of 1940, as amended (the “**Advisers Act**”) (collectively referred to herein as the “**Amendments**”). The Amendments are intended to provide new and prospective advisory clients with heightened disclosure on Form ADV regarding, among other things, business practices, conflicts of interest, and the background of investment advisory personnel. Registered advisers and those advisers required to register under the Dodd-Frank Act now face significantly increased disclosure obligations and will need to spend more time and resources amending or preparing their Form ADV.

The Amendments will require unregistered U.S. and foreign advisers who submit their initial Form ADV to register with the SEC after January 1, 2011 to comply with more extensive disclosure requirements, and existing registered advisers to make significant revisions to their current Form ADV to comply with the more extensive disclosure requirements in the course of their annual update, which for most firms must be filed no later than March 31, 2011.[1] The pertinent compliance deadlines are as follows:

- **Unregistered Advisers:** Unregistered advisers applying for initial registration with the SEC after January 1, 2011 must file Part 2A of Form

ADV (the “**Brochure**”) with the SEC and deliver a Brochure and Part 2B of Form ADV (the “**Brochure Supplement**”) to current and prospective clients in accordance with Rule 204-3 of the Advisers Act (the “**Brochure Rule**”).

- **Registered Advisers:** Advisers with a fiscal year end of December 31, 2010 must file a Brochure with the SEC no later than March 31, 2011 and deliver to current and prospective clients a Brochure and Brochure Supplement within 60 days of filing.

Due to the extensive disclosures required by the Amendments, both registered advisers and unregistered advisers planning to register with the SEC after January 1, 2011, should begin taking steps to adapt (or prepare an initial draft of) their Form ADV to comply with the new form. A list of recommendations and best practices is included at the conclusion of this alert.

The Brochure and the Brochure Supplement

Prior to the SEC adopting the Amendments, Part 2 of Form ADV consisted of a series of multiple choice and fill-in-the-blank questions organized in a “check-the-box” format, supplemented in some cases with brief narrative responses. Part 2 of Form ADV was deemed filed if the registered adviser retained a completed form in its files available for SEC inspection.

Registered advisers were required to deliver Part 2 to advisory clients under circumstances prescribed by the Brochure Rule, but Part 2 was not generally available to the public through the SEC’s website. Further, while Part 2 included a narrative section, the SEC did not mandate the style, content, or level of detail of disclosure that was required to be included.

The Brochure

The Amendments replace the current Part 2 of Form ADV with a Brochure and a Brochure Supplement. The Brochure contains 18 disclosure items about the advisory firm. While certain disclosure items mirror requirements of the current Part 2 of Form ADV, other items will require advisers to craft significant disclosure and devote additional attention to the identification of conflicts of interest. Highlights of the disclosure requirements applicable to the Brochure include:

- **“Plain English” Narrative:** The Brochure must be completed entirely in narrative format and advisers are required to complete the Brochure (and the Brochure Supplement) in plain English, taking into consideration their clients’ level of financial sophistication. The new instructions to Part 2 provide that, in drafting the Brochure, advisers, among other things, should use short sentences; definite, concrete, everyday words; and the active voice.
- **Public Availability:** Both the Brochure and annual and interim updates to the Brochure must be filed with the SEC electronically via the Investment

Adviser Registration Depository (IARD) system, making them publicly available through the SEC website.

- **Material Changes:** Advisers amending a Brochure must identify and discuss material changes since the last annual update on the cover page (or page immediately following the cover page). Advisers will need to devote additional time to determine the manner in which their advisory practices have changed since the previous update in order to provide accurate and complete disclosure to clients.
- **Fees and Compensation:** Advisers are required to provide detailed information regarding advisory fees and other compensation received by the adviser or its supervised persons in connection with their advisory services, including a fee schedule and disclosure of whether fees are negotiable.[2] Advisers must, among other things, (i) disclose whether they bill clients or deduct fees directly from clients' accounts, (ii) describe the types of other costs, such as brokerage, custody fees and fund expenses that clients may pay, (iii) disclose whether the adviser or its personnel receive compensation attributable to the sale of a security or other investment product (e.g., brokerage commissions) along with the conflicts of interest such practice creates and how the adviser addresses this conflict, and (iv) disclose whether the adviser (or its personnel) receives transaction-based compensation (e.g., transaction fees and/or merger and acquisition fees) and describe the conflicts of interest such compensation creates and how the adviser addresses these conflicts. Further, advisers that charge performance-based fees or that have a supervised person who manages an account that pays such fees must disclose this fact. If an adviser also manages accounts that are not charged a performance fee, the Amendments also require the adviser to discuss the conflicts of interest that arise from the simultaneous management of these accounts, and to describe how the adviser addresses these conflicts.
- **Methods of Analysis, Investment Strategies, and Risk of Loss:** The adviser must describe its methods of analysis and investment strategies and disclose the risk of loss associated with such strategies. The adviser should also include specific disclosure for strategies including by way of example whether the strategy involves frequent trading or heightened risk of loss.
- **Disciplinary Information:** The adviser must disclose material facts about any legal or disciplinary event that is material to a client's evaluation of the integrity of the adviser or its management personnel.[3] Events that reflect on the integrity of the adviser and its management personnel are presumptively material and must be disclosed unless the adviser rebuts such a presumption (for which documentation must be maintained).
- **Other Financial Industry Activities and Affiliations:** The adviser must describe material relationships or arrangements it (or any of its management persons) has with related financial industry participants, any material conflicts of interest that such relationships or arrangements create, and how such conflicts are addressed. Also, if an adviser selects

or recommends other advisers for clients, then it must disclose compensation arrangements or other business relationships and related conflicts of interest and describe how such conflicts are addressed.

- **Participation or Interest in Client Transactions and Personal Trading:** If the adviser (or a related person) recommends to clients, or buys or sells for client accounts, securities in which the adviser has a material financial interest, the adviser must disclose this practice and the related conflicts of interest that arise and describe how such conflicts are addressed. The adviser must also disclose whether it (or a related person) invests in the same securities that it recommends to clients, or in related securities (such as options or other derivatives) and if so, describe any conflicts of interest that arise and how such conflicts are addressed.

In addition, the adviser must describe specific conflicts it has when it or a related person trades in the same securities at the same time as a client. The adviser should explain how its internal controls prevent the firm and its staff from trading securities contemporaneously with client transactions.

- **Brokerage Practices:** The adviser must describe how it selects brokers for client transactions, determines the reasonableness of the brokers' compensation and addresses conflicts arising from soft dollars.
 - *Client Referrals.* The adviser must disclose using client brokerage to compensate brokers for client referrals, conflicts of interest created, and any procedures used by the adviser to direct client brokerage to referring brokers during the last fiscal year.
 - *Directed Brokerage.* An adviser that permits clients to direct brokerage must describe its practices in this area.
 - *Trade Aggregation.* The adviser must describe whether and under what conditions it aggregates trades. If it does not aggregate trades when it has the opportunity to do so it must explain that clients may incur higher brokerage costs.
- **Client Referrals and Other Compensation:** The adviser must describe any arrangements under which it or its related persons compensate another party for client referrals and describe the compensation. The adviser must also describe any arrangement under which it receives any economic benefit (e.g., sales awards or prizes) from a person who is not a client for providing advisory services to clients.
- **Financial Information:** The adviser must disclose certain financial information about itself when material to clients. An adviser that requires prepayment of fees must provide clients with an audited balance sheet showing the assets and liabilities of its firm. The item also requires an adviser to disclose any financial condition reasonably likely to impair its ability to meet contractual commitments to clients if the adviser has discretionary authority over client assets, has custody of client funds or securities, or requires clients to prepay fees. The adviser must also disclose if it has been the subject of a bankruptcy petition during the past ten years.

Delivery of the Brochure to Clients

Prior to the SEC adopting the Amendments, the Brochure Rule required registered advisers to provide a copy of Part 2 of Form ADV (or a written disclosure document that included at least the information set forth in Part 2 of Form ADV) to current and prospective clients (i) at least 48 hours prior to entering into an advisory agreement, or (ii) at the time the advisory agreement is entered into, so long as the client could terminate the advisory agreement without penalty during the next five business days. For current clients, the registered adviser was required to annually deliver, or offer to deliver Part 2 of Form ADV (or a written disclosure document that included at least the information in Part 2 of its Form ADV) upon a client's written request.

The SEC has substantially revised the Brochure Rule and the delivery requirements as follows:

- **Initial Delivery:** A current Brochure must be delivered by the adviser to the client before or at the time the adviser enters into an advisory contract with the client. Advisers are no longer required to provide the Brochure to a client 48 hours prior to entering into an advisory contract with such client.
- **Annual Delivery:** Advisers must annually, and no later than 120 days after the end of their fiscal year, deliver to each client to whom they are obligated to deliver a Brochure either: (i) a copy of the current (updated) Brochure that includes or is accompanied by a summary of material changes; or (ii) a summary of material changes that includes an offer to provide a copy of the current Brochure.
- **Interim Delivery:** An adviser is required to deliver an updated Brochure to clients promptly whenever it amends its Brochure to add a disciplinary event or to change material information regarding any legal or disciplinary event previously disclosed.
- **Exception to Delivery Requirement:** Advisers are not required to deliver a Brochure to clients who (i) are registered investment companies or business development companies, (ii) receive only impersonal investment advice; or (iii) are officers, employees or other persons related to the adviser who are "qualified clients" for purposes of Rule 205-3 of the Advisers Act.

Updating the Brochure

An adviser must update its Brochure annually, and promptly when any information in the Brochure (except the summary of material changes and amount of assets under management, which need only be updated annually) becomes materially inaccurate.

The Brochure Supplement

Under the Amendments, a registered adviser is now required to deliver to existing and prospective clients Brochure Supplements that include certain information about the specific individuals who will provide advisory services

to particular clients. The Brochure Supplements will contain disclosure about the educational background, business experience, other business activities, and the disciplinary history of each supervised person who provides advisory services to, or has direct contact with, clients. The following requirements of the Brochure Supplement will be of particular importance to advisory firms:

- **Disciplinary Information:** The Brochure Supplement requires disclosure of any legal or disciplinary event that is material to a client's evaluation of the supervised person's integrity. While the Brochure Supplement generally requires disciplinary events from the last ten years to be disclosed, the adviser must disclose earlier disciplinary events if such events are so serious that they remain material to a client's or prospective client's evaluation of that supervised person.
- **Other Business Activities:** Advisers are required to describe other business activities of their supervised persons and to disclose (i) whether the supervised person is actively engaged in any investment-related business or occupation (e.g., acting as a broker-dealer), (ii) any relationship between the advisory business and the supervised person's other financial industry activities that creates a material conflict of interest with clients and how such conflict is addressed, (iii) information related to commissions, bonuses or compensation paid to supervised persons based on the sale of securities or investment products, and (iv) any other business activities or occupations of the supervised persons if they involve a substantial amount of time or pay. The adviser must also describe arrangements whereby supervised persons receive an economic benefit from a third party for providing advisory services.