AKIN GUMP
STRAUSS HAUER & FELD LLP

Investment Funds Alert

SEC Adopts Amendments to Part 2 of Form ADV

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On July 21, 2010, the Securities and Exchange Commission (SEC) voted unanimously to adopt amendments to Part 2 of Form ADV and related rules under the Investment Advisers Act of 1940, as amended ("Advisers Act"). Registered investment advisers are required to deliver Part 2 of Form ADV—commonly referred to as the "brochure"—to clients and prospective clients. Part 2 of Form ADV will be dramatically different from the current form in that (1) information must now be presented in narrative format using "plain English" to describe various aspects of an adviser's business in a prescribed order (the "Brochure"); (2) it must be electronically filed with the SEC through the Investment Adviser Registration Depository (IARD) system, which allows public access to the form; and (3) a supplement to the electronically filed brochure relating to persons providing investment advice or contacting clients or prospective clients must be provided to such persons, subject to certain exceptions (the "Supplement"). The Brochure, described in new Part 2A of Form ADV, includes 18 disclosure items about the adviser's business that must be addressed. The Supplement, described in Part 2B, includes six items regarding the adviser's investment personnel. Registered investment advisers will now be required to annually deliver their Brochures or a summary of changes to the Brochures (along with an offer to deliver the complete Brochure) to current clients.

Currently registered investment advisers whose fiscal years end on or after December 31, 2010 must include the new Brochure with their next annual Form ADV updating amendment (due by March 31, 2011). These advisers will have an additional 60 days to deliver the Brochure and Supplement to their clients. Investment advisers applying for initial registration with the SEC will be required to use the new format beginning on January 1, 2011.

Part 2A: The Firm Brochure

The SEC adopted a narrative format for the Brochure with the goal of providing clearer and more meaningful disclosure to clients and prospective clients of advisers regarding the firm's services and personnel, as well as the relevant conflicts of interest associated with providing services to clients. Advisers are required to use plain English in responding to the required items.[1]

Part 2A contains 18 separate disclosure items. The SEC adopted a standard format for the Brochure, and the instructions to the form direct advisers to respond to each item in the Brochure in the order of the items listed on the form, using the headings provided by the form. If an item is inapplicable to an adviser, the adviser must still include the heading and an explanation that the particular item does not apply to its business. Advisers will have the ability to cross-reference responses. Thus, if information provided in response to one item is also responsive to another item, the response does not have to be included in both places. An instruction to Part 2 states that an investment adviser may be required to disclose more information than is specifically required in the Brochure or the Supplement, as an investment adviser's fiduciary duties obligate it to (1) make full disclosure of all material conflicts of interest between an adviser and its clients that could affect the advisory relationship and (2) obtain informed consent. Some flexibility is allowed in drafting the Brochure, however, in

[1] For further information regarding "plain English" requirements, see (1) A Plain English Handbook, available here; (2) SEC Plain English Disclosure, Securities Act Release 7497, 63 Fed. Reg. 6370 (Feb. 6, 1998), available here; and (3) Staff Legal Bulletin 7A, available here.

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that advisers have the ability to create separate Brochures targeted at different types of clients, and the Brochure can include a summary at the beginning.[2]

Both the Brochure and the Supplement contain several new required disclosures. Many of these new disclosures focus on (1) the conflicts of interest created by a registered investment adviser's practices and the way in which that adviser resolves those conflicts and (2) the risks and costs (including hidden and opportunity costs) related to investing in securities in general and with the advice of that registered investment adviser. In addition, the disciplinary information disclosure previously required by Rule 206(4)-4 under the Advisers Act is now included in the Brochure. To view an item-by-item summary of the Brochure, see Appendix A to this alert by clicking here and to view the revised Part 2 of Form ADV, click here.

Part 2B: Brochure Supplement

As noted above, the Supplement must contain disclosures about certain key investment personnel of the adviser (referred to as "Supervised Persons"). Disclosure is required for each Supervised Person who formulates or provides investment advice to clients, regardless of whether or not they have direct client contact.[3] Similar to the requirements for the Brochure, the Supplement must be written in plain English and follow a specific format. Advisers do, however, have some flexibility to customize the Supplement based on their structure. For example, advisers may include Supplement information within the Brochure or in a separate document. Advisers may also choose to prepare multiple Supplements for different groups of Supervised Persons as long as each supplement follows the same format.

Part 2B consists of six items, including items related to a Supervised Person's educational background and business experience, material disciplinary history, other substantial business activities and any associated material conflicts of interest and sources of additional compensation from someone other than a client (such as sales awards). Advisers are also required to describe their procedures for monitoring Supervised Persons and must identify the person(s) responsible for such oversight.

Delivery and Filing Requirements

Advisers must deliver the Brochure to a prospective client prior to or at the time the adviser enters into an advisory contract with the client.[4] In addition, the Supplement must be delivered to the client before or at the time a specific Supervised Person begins to provide advisory services to that client.[5] Interim updates to the Brochure or Supplement will be required when a material change occurs, such as changes with respect to disciplinary information. Annually, within 120 days of the end of their fiscal year, advisers will be required to deliver either: an updated Brochure and Supplement that includes a summary of any material changes or a summary of any material changes, along with an offer to provide an update Brochure and Supplement. Advisers may deliver the Brochure, summary of material changes and Supplement electronically in accordance with SEC guidance.[6] The Brochure will be required to be filed electronically with the SEC and will be publicly available on the SEC's IARD Web site. Supplements, however, are not filed with the SEC. Rather, advisers are required to maintain copies of all Supplements and amendments in their files.

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[2] Advisers that sponsor wrap fee programs continue to be required to prepare a separate Brochure for clients of the wrap fee program in lieu of the sponsor's standard brochure. The amended form requires such advisers to identify whether any of its related persons is a portfolio manager in the wrap fee program and, if so, to describe the selection and review process for such portfolio managers and any associated conflicts due to the arrangement.

[3] If investment advice is provided by a team larger than five Supervised Persons, Supplements need only be provided for the five Supervised Persons with the most significant responsibility for day-to-day advice provided to the client.

[4] Advisers to registered mutual funds and business development companies are not required to deliver a Brochure to investors in these vehicles.

[5] Advisers are not required to deliver Supplements to: (1) clients to whom they are not required to deliver a firm brochure (e.g., mutual funds and BDCs); (2) clients who receive only impersonal investment advice for which the adviser charges less than $500 per year; and (3) certain "qualified clients," as defined under Rule 205-3(d)(1)(iii) under the Advisers Act, who are also officers, directors, employees and other persons related to the adviser. An adviser that does not have a client to whom a Supplement would have to be delivered does not have to prepare any Supplements. Similarly, an adviser need not prepare a supplement for any Supervised Person who has no clients to whom a supplement must be delivered.

[6] The SEC reviewed various electronic delivery options for the required disclosure notices and rejected proposals to satisfy the requirement by placing a notice on the adviser's Web site or on IARD or by sending clients an e-mail with a link to the brochure, but stated that it will continue to review different options.

In the adopting release, the SEC noted the decision by the Court of Appeals for the D.C. Circuit in *Goldstein v. SEC*[7] with respect to hedge funds, which clarifies that the "client" of an investment adviser to a hedge fund is the fund itself and not an investor in the fund.[8] Thus, fund advisers are not required to deliver the Brochure to prospective fund investors. We note, however, that as a matter of practice, many fund advisers choose to do so.

Conclusion

In order to comply with the requirements of amended Part 2 of Form ADV, advisers will need to conduct a complete overhaul of their existing Form ADV Part 2 and carefully craft narrative responses to each required item in "plain English." It should be noted that, as highlighted by the SEC in the adopting release to the amendments, making the required disclosures alone does not guarantee compliance with the antifraud provisions of the Advisers Act. Advisers continue to have an obligation to disclose all material conflicts of interest to the extent such information is not specifically required by an item on Part 2 of Form ADV.

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[7] *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006).
[8] See note 192 to the adopting release. Amendments to Form ADV, Investment Advisers Act Release No. 3060 (July 28, 2010). For a link to the release, click here.

Appendix A

Summary of the Brochure

Item 1: **Cover Page.** Item 1 requires an adviser to disclose the firm's name, business address, contact information, Web site address (if applicable) and date of the Brochure, in addition to required disclosures.

Item 2: **Material Changes.** Item 2 requires material changes since the last annual update to be identified and discussed on the cover page, the following page or in a separate document. Despite concerns raised by several commenters, the SEC declined to define what constitutes a "material" change. However, the SEC emphasizes in the adopting release that this disclosure should be a summary, rather than a lengthy discussion.

Item 3: Table of Contents. As noted above, the instructions to the form require advisers to use a uniform format (including the order and specific headings).

Item 4: **Advisory Business.** Item 4 requires an adviser to describe its advisory business, including (1) the types of services offered, (2) areas of expertise and (3) amount of assets under management.[9] Advisers making interim amendments to their Brochure are not required to update assets under management unless there has been a material change to the amount reported nor are they required to amend their Brochure solely to report a change in assets under management.

Item 5: **Fees and Compensation.** Item 5 requires advisers to describe the compensation received for advisory services. As in the current form, advisers are required to provide a fee schedule, disclose whether fees are negotiable and, if fees are charged in advance, provide an explanation of how prepaid fees will be refunded when the contract terminates. However, the SEC allows advisers to omit the fee schedule when providing the Brochure only to clients who are "qualified purchasers."[10] Advisers must disclose the types of other costs incurred by clients as well, including brokerage and custody fees and fund expenses. In response to concerns related to the use of affiliated brokers that were the subject of SEC enforcement actions, the SEC included a requirement that advisers who use and receive compensation from an affiliated broker for client transactions must disclose the practice, the conflict of interest that it creates and the way in which the adviser intends to address the conflict.

Item 6: **Performance-Based Fees and Side-By-Side Management.** Item 6 requires all advisers to disclose whether they charge performance-based fees. The SEC is concerned that some clients may be unaware of conflicts of interest that arise from simultaneous management of performance fee and non-performance fee accounts. Accordingly, this item requires advisers with such side-by-side arrangements to disclose the conflicts and the way in which the adviser addresses them.

Item 7: **Types of Clients.** Item 7 requires disclosure of the types of advisory clients and the criteria, such as minimum size, for opening and maintaining an account.

Item 8: **Methods of Analysis, Investment Strategies and Risk of Loss.** Item 8 requires advisers to describe their methods of analysis and investment strategies, including policies and procedures regarding the management of cash balances, and disclose that investing in securities involves risk of loss. In addition, advisers using frequent trading strategies are required to explain how these strategies can affect investment performance. Finally, the material risks of each significant investment strategy must be disclosed, with more detail if those risks are "unusual."

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[9] The form permits advisers to use a different methodology than is required by Part 1A of Form ADV to report assets under management. Thus, if an adviser manages a portfolio that includes commodities or other "non-securities" assets, it may choose to report the value of the entire portfolio in its brochure, even though it is required to exclude such assets in its calculation of assets under management for Part 1A of Form ADV.

[10] "Qualified purchasers," as defined under section 2(a)(51) 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 own account or other accounts of other qualified purchasers.

Item 9: **Disciplinary Information.** Item 9 requires disclosure of material disciplinary events within the previous 10 years relating to the integrity of an adviser or any of its management personnel.[11] The Form provides a list of items that are presumptively material and must be disclosed unless the adviser rebuts such a presumption, for which documentation must be maintained by the adviser. Disciplinary events more than 10 years old must also be disclosed if the event is so serious that it remains material to the evaluation of the adviser and its integrity. The Brochure is not required to include disclosure of arbitration awards unless the adviser determines that the event is material.

Item 10: **Other Financial Industry Activities and Affiliations.** Item 10 requires advisers to describe relationships or arrangements with related financial industry participants that create material conflicts of interest with clients. In addition to this disclosure, advisers are required to explain how these conflicts are addressed by the adviser. In addition, advisers who select or recommend other advisers for clients, such as pursuant to sub-advisory arrangements, are required to disclose the compensation arrangement, any conflicts of interest and the way in which such conflicts are addressed.

Item 11: **Code of Ethics, Participation or Interest in Client Transactions and Personal Trading.** Item 11 requires advisers to include a brief description of their code of ethics and offer to provide a copy upon request. If an adviser or one of its related persons recommends to clients, or buys or sells for client accounts, securities in which the adviser or a related person has a material financial interest, the Brochure must disclose this practice, the conflicts of interest it presents and the way in which those conflicts are addressed. For example, advisers who recommend that advisory clients invest in a private fund for which the adviser serves as the investment manager or general partner must disclose the nature of the conflicts presented and the way in which the adviser addresses the conflicts. Finally, this item requires disclosures regarding each adviser's personal trading policies and procedures.

Item 12: **Brokerage Practices.** Item 12 requires advisers to describe how they select brokers, determine the reasonableness of brokerage fees and address the conflicts arising from the use of "soft dollars." Advisers are required to explain whether they use soft dollars to benefit all accounts proportionately and whether they "pay up" for soft dollar benefits. The SEC expects more detailed disclosure for products or services that fall outside of the safe harbor provided in Section 28(e) of the Securities Exchange Act of 1934. Advisers who direct trades to brokers in exchange for client referrals must disclose this practice, the related conflicts of interest and the way in which they are addressed. Additional disclosures are required regarding directed brokerage arrangements, including whether advisers routinely recommend or require clients to direct brokerage. Finally, advisers are required to describe the circumstances under which they aggregate trades and the fact that clients may end up incurring higher brokerage costs if they choose not to aggregate trades when they have an opportunity to do so.

Item 13: **Review of Accounts.** Similar to a requirement in the current form, Item 13 requires advisers to disclose their account review practices, including who conducts the reviews and how frequently they occur.

Item 14: **Client Referrals and Other Compensation.** Item 14 requires advisers to disclose client referral arrangements, including arrangements covered by the cash solicitation rule (with additional disclosure for any noncash items) and any arrangement whereby the adviser accepts benefits from a non-client (such as sales awards or prizes from a broker-dealer) for providing advisory services to a client.

Item 15: **Custody.** Item 15 requires advisers with custody to make certain required disclosures, as set forth in the recently amended custody rule, [12] if a qualified custodian sends account statements, including: (1) that clients will receive account statements directly from the qualified custodian, (2) that clients should carefully review the account statements received from the custodian and (3) if an adviser also sends account statements, that clients should compare the statements they receive from the custodian with the statements received from the adviser. Advisers to pooled investment vehicles may omit these disclosures from the Brochure if they rely upon the terms and conditions of the available exemption from the reporting requirements set forth in the amended custody rule.[13]

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[11] The disciplinary disclosures required by the form incorporate the information required by rule 206(4)-4 under the Advisers Act, which will be phased out with the compliance date for the new form.

[12] 17 CFR 275.206(4)-2.

[13] Advisers need not comply with the reporting requirements of the rule with respect to pooled investment vehicles, such as limited partnerships or limited liability companies, if the pooled investment vehicle (1) is audited at least annually and (2) distributes its audited financial statements prepared in accordance with generally accepted accounting principles to all limited partners (or members or other beneficial owners) within 120 days of the end of its fiscal year.

Item 16: **Investment Discretion.** An adviser that has discretionary authority over client accounts is required to disclose this arrangement and any limitations placed on the adviser's authority by its clients.

Item 17: **Voting Client Securities.** This item requires advisers to disclose their proxy voting procedures and tracks the disclosure requirements of rule 206(4)-6 under the Advisers Act. In response to concerns raised by commenters, the SEC did not require advisers to detail the use of third-party proxy voting services and how such services are paid, citing the SEC's recent concept release on the subject.[14]

Item 18: **Financial Information.** Item 18 requires an adviser to make disclosures to its clients if its financial condition becomes impaired.

[14] Concept Release On the U.S. Proxy System, Exchange Act Release No. 62495, 75 FR 42982 (July 14, 2010).