

FS Regulatory Brief

Amendments to Form ADV Part 2

On July 21, 2010 the US Securities and Exchange Commission (“SEC”) unanimously voted to adopt amendments to Form ADV Part 2 and related rules under the Investment Advisers Act of 1940 (the “Advisers Act”). The purpose of the amendment is to improve the clarity and enhance the quality of information that registered advisers disclose to clients.¹ The SEC adopted amendments to rules 203-1, 204-1, 204-2, and 204-3 and to Form ADV under the Advisers Act while withdrawing rule 206(4)-4. The new rules require advisers to include certain key information about the advisory firm in a narrative brochure filed with Form ADV as well as to provide clients with information about key advisory personnel in a brochure supplement.

Application: The amendments adopted by the SEC became effective on October 12, 2010 and apply to the more than 11,000 advisers registered with the SEC, as well as any future registrants. Each adviser filing for registration after January 1, 2011 must file a brochure that meets the requirements of the amendments and begin to provide this brochure to clients upon registering. Each currently registered adviser whose fiscal year ends on December 31, 2010 or later must file a compliant brochure, along with its annual updating amendment, within 90 days of its fiscal year end and provide the brochure to its existing clients within 60 days of this filing.

¹“Client” as used in this brief refers to current and prospective clients to whom an adviser must provide a brochure and brochure supplement under the amendments to Form ADV Part 2.

An adviser does not have to prepare or file a brochure if it does not have any clients to whom a brochure must be delivered.² In December 2010, the SEC extended the compliance date for delivery of brochure supplements, Part 2B of Form ADV, for up to four months in order to provide investment advisers additional time to produce and deliver brochure supplements to clients.

Stated Purpose: As stated in the release, the amendments to Form ADV Part 2 are designed to provide new and prospective advisory clients with clearly written, meaningful and current disclosures of the business practices, conflicts of interest and background of the investment adviser and its advisory personnel. The new disclosure documents are intended to allow clients and prospective clients to make an informed decision about whether to engage an adviser and to manage the relationship with the adviser.

Part 2A “The Brochure”

Summary: Since 1979, the SEC has required registered investment advisers to provide a written disclosure statement or “brochure” to clients in accordance with Adviser’s Act rule 204-3. The newly adopted amendments require investment advisers to complete a narrative brochure written in “plain English” that addresses 18 key disclosure items about the advisory firm.³ The adviser’s brochure must be presented in a standardized order and format and address all of the items required by Form ADV Part 2, even those that are

²The amended rule does not require advisers to deliver brochures to certain advisory clients receiving only impersonal investment advice and paying less than \$500 per year or to clients that are investment companies or business development companies registered under the Investment Company Act of 1940 whose advisory contracts adhere to the requirements of Section 15(c) of that act.

³ One additional disclosure item, Item 19, is included in Form ADV Part 2A for advisers registered with one or more state securities authorities.

not applicable to its business.⁴ An adviser must file its brochures through the SEC's IARD system and the information will be made public via the SEC's website.

The SEC believes that requiring advisers to complete a narrative brochure with a standardized format and making it publicly available will increase clients' ability to evaluate and compare firms offering advisory services.

Key disclosure items:

Item 1. Cover Page: The cover page of the brochure must be dated and include the name of the firm, its business address, phone number and website (if applicable). Additional disclaimers are necessary to indicate that neither the SEC nor any state securities authority has approved a brochure and, if a firm refers to itself as a "registered investment adviser," that registration does not imply a certain level of skill or training.⁵

Item 2. Material Changes: An adviser must discuss any material changes since the last annual update of their brochure either on the cover page or as a separate document filed as an exhibit to Part 2. The summary must contain enough information to inform clients of the substance of changes to the adviser's policies, practices or conflicts of interest.

Item 3. Table of Contents: The brochure must contain a detailed table of contents, in the format prescribed within the General Instructions for Part 2, which will allow clients to easily locate topics addressed within the brochure.

Item 4. Advisory Business: An adviser must disclose its principal owners,⁶ describe the types of advisory services it offers and disclose if the firm holds itself out as specializing in a particular type of advisory service. The adviser must also disclose the amount of client assets that it manages and maintain documentation describing the method

used for this calculation if it is different than the methodology by which it calculates "assets under management" in Form ADV Part 1A.

Item 5. Fees and Compensation: Advisers must disclose how they are compensated for advisory services, provide a fee schedule and disclose whether fees are negotiable. They must also describe other costs that clients may pay including brokerage costs, custody fees or expenses of the adviser. An adviser must disclose if the firm or its personnel receive commissions attributable to the sale of an investment product and the process for managing resulting conflicts of interest. If commissions comprise over 50% of firm revenue, the adviser must disclose that commissions are the firm's primary source of revenue. An adviser does not need to disclose how it is compensated for advisory services, whether fees are negotiable or to provide a fee schedule if a brochure is delivered only to qualified purchasers.⁷

Item 6. Performance-Based Fees and Side-By-Side Management: An adviser must disclose if it charges performance-based fees or if any supervised person manages an account that pays such fees. An adviser must disclose conflicts of interest that may arise and the process for addressing these conflicts if the adviser manages both accounts that have performance-based fees and accounts that do not charge such fees.

Item 7. Types of Clients: An adviser must describe the type of advisory client that the firm typically has as well as its requirements for opening or maintaining an account, including minimum account size.

Item 8. Methods of Analysis, Investment Strategies and Risk of Loss: The brochure must describe the adviser's investment strategies, methods of analysis and a statement that investing in these strategies involves the risk of losses that will be borne by the client.

Advisers must disclose how strategies involving frequent trading can affect investment performance and should describe the material,

⁴ If items are not applicable an explanation as to why they are not applicable should be included.

⁵ Required under Section 208(a) of the Investment Adviser's Act of 1940 [15 U.S.C. 80b-8(a)]

⁶ Principal owner refers to persons listed as owning 25% or more of the adviser on Schedule A of Form ADV Part 1A and any individual or parent company that owns 25% or more of the adviser through subsidiaries.

⁷ Qualified purchasers include 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.

significant or unusual⁸ risks to each investment strategy. Absent other requirements, an adviser does not need to disclose its policies relating to the management of cash balances.

Item 9. Disciplinary Information: An adviser must disclose material facts about any legal or disciplinary event that is material to the client or to the client's evaluation of the integrity of the adviser or its personnel. Advisers should presume that disciplinary events including, but not limited to, convictions for fraud, theft, bribery or perjury are material. Any such violations in the last 10 years must be disclosed and any violations which, in the adviser's opinion, comprise serious violations should be reported beyond 10 years. The requirement to disclose serious violations beyond 10 years has rendered rule 206(4)-4 duplicative and resulted in the SEC rescinding it.

Item 10. Other Financial Industry Activities and Information: An adviser must describe its material relationships with financial industry participants, including any compensation arrangements, the conflicts created by these relationships and how the adviser manages these conflicts.

Item 11. Code of Ethics, Participation or Interest in Client Transactions and Personal Trading: The brochure must include a brief description of the Adviser's Code of Ethics and state that a copy is available upon request. Additionally, advisers must disclose if they invest in securities they recommend to clients, the conflicts inherent in this practice and the process for managing these conflicts.

Item 12. Brokerage Practices: Advisers must describe how they select brokers for client transactions and how they determine the reasonableness of broker compensation. The adviser must describe its involvement in any soft dollar relationships and disclose if clients may pay higher commissions in return for soft dollar benefits and whether soft dollars only benefit the client accounts that generated the commissions. Additionally, the adviser must disclose the conditions under which it will engage in trade aggregation, its client referral and directed brokerage practices and that directed brokerage

may result in the client not obtaining the lowest commissions.

Item 13. Review of Accounts: An adviser must disclose whether and how often it reviews client accounts and financial plans, the nature of the review and the titles of the supervised persons who conduct the review.

Item 14. Client Referrals and Other Compensation: An adviser must disclose any arrangement under which it compensates another for client referrals and describe the compensation. Advisers must disclose any arrangement under which they receive economic benefits, including sales awards or prizes, from a person who is not a client for services provided to clients and explain their process for addressing related conflicts.

Item 15. Custody: An adviser that has custody of client funds or securities must explain that clients will receive account statements directly from the qualified custodian. This item also requires advisers to disclose that clients should carefully review statements from the custodian and any account statements provided by the adviser.⁹

Item 16. Investment Discretion: An adviser must disclose if it has the authorization to make purchase and sale decisions for client accounts or to select other advisers for the account as well as any limitation that clients can place upon this authority.¹⁰

Item 17. Voting Class Securities: An adviser must disclose its proxy voting practices, including whether it has or will accept authority to vote client securities, and make this information available to clients upon request. The adviser must also inform clients how they can direct it to vote in a solicitation, how the client can obtain information about how the adviser has voted and how the adviser addresses conflicts relating to proxy voting. If the adviser does not accept the authority to vote proxies, it must inform clients how they can receive proxies and solicitations.

⁸ Significant or unusual risks are defined as risks that otherwise would not be apparent to the client from reading the adviser's brochure.

⁹ This disclosure is similar to the statement required under the amended custody rule contained within Investment Advisers Act Release No. 2968 *Custody of Funds or Securities of Clients by Investment Advisers*.

¹⁰ Advisers can include cross references between Item 16 and Item 4.

Item 18. Financial Information: An adviser that requires prepayment of fees must provide clients with an audited balance sheet. If an adviser has discretionary authority over accounts, custody of client funds or securities or solicits certain prepayments from clients, it must disclose any financial conditions, such as insolvency or bankruptcy, which may impair its ability to meet contractual commitments to clients. An adviser must also disclose if it has been the subject of a bankruptcy petition in the last ten years.

**Item 19. Requirements for State-Registered Advisers:* If they have not addressed these requirements in other sections of Form ADV, state registered advisers must identify each of their principal executive officers and management persons and describe their formal education and business background. In addition, these advisers must describe any business in which they are actively engaged and the approximate amount of time that they spend on that business. The advisers must also disclose their relationships with any issuers of securities, the method by which they calculate performance-based fees and instances in which a management person has been found liable for fraud, theft, bribery, unethical practices or certain other instances of wrongdoing.

Part 2A Appendix 1 “The Wrap Fee Program Brochure”

Summary: An adviser must provide a separate brochure to any client that pays fees for advisory services not based directly on transactions in the client’s account, such as portfolio management or the selection of other advisers. The Wrap Fee Program Brochure includes 9 key disclosure items and one additional item for state registered advisers. Many of these requirements overlap with responses for Form ADV Part 2A. An adviser that sponsors a wrap fee program must identify whether any of its related persons is a portfolio manager in the wrap fee program and describe any associated conflicts. The adviser must also disclose whether related person portfolio managers are subject to the same due diligence and selection criteria as other portfolio managers who participate in the wrap fee program.

Delivery of brochures

As part of the updates to Form ADV Part 2, the SEC also amended rule 204-3 by requiring that an adviser must deliver a current brochure, either in paper or electronic format, to a client before or at the time it enters into an advisory relationship with the client.¹¹ However, the SEC expanded its exemption of the delivery requirements to advisers of business development companies whose advisory contracts adhere to the requirements of Section 15(c) of the Investment Company Act. In addition, the SEC noted that rule 204-3 requires only that an adviser delivers its brochure to clients and cited a court ruling stating that the client of an adviser to a hedge fund is the fund itself, not the investors in the fund.¹²

An adviser must provide an updated brochure to clients within 120 days of its fiscal year end or when disciplinary events or material changes require an update of the brochure.¹³ The update must either include a copy of the current brochure and a summary of material changes or a summary of material changes with an offer to provide a copy of the current brochure upon request. If an adviser has not made any interim amendments to its brochure and the brochure continues to be accurate in all material respects, the adviser does not need to prepare or deliver a summary of material changes to clients or to file an updated brochure as part of its annual updating amendment.

Advisers are allowed to create separate brochures for the different type of advisory relationships that they have with clients. However, in all cases, clients must receive clear and complete information about the services, fees and conflicts that affect them.

¹¹ Rule 204-3 previously required disclosure to clients 48 hours in advance of entering into an advisory relationship with the client.

¹² Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006)

¹³ In the year in which it initially files a brochure with the SEC, an existing registered adviser must provide the brochure to existing clients within 60 days of the filing. An existing registered adviser with a December 31, 2010 fiscal year end must file the brochure with the SEC by March 31, 2011 and deliver it to existing clients by May 31, 2011.

Part 2B “The Brochure Supplement”

Summary: For the first time, advisers must provide to clients a brochure supplement which includes information about key personnel of the adviser upon whom clients rely for investment advice. This amendment extends the existing requirement within Form ADV Part 2 to disclose certain information about an adviser’s principal executive officers. The brochure supplement will contain the educational background, business experience and disciplinary history of advisory personnel who make discretionary investment decisions for a particular client’s assets or who formulate investment advice for the client and have direct client contact¹⁴. Exemptions exist which do not require an adviser to provide a brochure supplement to clients who receive only impersonal investment advice¹⁵ and clients who are officers, directors or certain other employees of the adviser. However, the amendment does not extend this exemption to advisers to financially sophisticated investors. The supplement must be given to each non-exempt client at or before the time when that specific supervised person begins to provide advisory services to that client.

Key disclosure items:

Item 1. Cover Page: On either a separate cover page or at the top of the first page of the brochure supplement, an adviser must include the name of the advisory firm and identify the supervised person or persons covered by the supplement.

Item 2. Educational Background and Business Experience: An adviser must describe the supervised person’s formal education and business background including employers and positions held over the past five years. If the adviser discloses a supervised person’s professional designation, the supplement must provide an explanation of the minimum qualifications required for the designation.

¹⁴ If a team comprised of more than five supervised persons provides investment advice to a client, the adviser only needs to prepare brochure supplements for the five supervised persons most responsible for the day-to-day advice provided to the client.

¹⁵ Impersonal Investment Advice refers to investment advisory services that do not purport to meet the objectives or needs of specific individuals or accounts.

Item 3. Disciplinary Information: An adviser must disclose any legal or disciplinary event that has occurred in the last 10 years that is material to the client’s evaluation of the supervised person’s integrity. If the adviser provides an electronic brochure supplement to clients, it can include an electronic link to BrokerCheck or the Investment Adviser Public Disclosure website rather than separately disclose disciplinary history in the brochure supplement.

Item 4. Other Business Activities: An adviser must disclose any other capacity in which the supervised person participates in any investment related business, information about any compensation they receive for the sale of investment products and the conflicts of interest and incentives these respective activities create. Further, an adviser must disclose all other business activities that the supervised person engages in if they involve a substantial amount of time or pay.¹⁶

Item 5. Additional Compensation: The brochure supplement must describe any arrangement in which someone other than the client gives the supervised person an economic benefit for providing advisory services. An economic benefit would include a bonus based, at least in part, on sales, client referrals or new accounts.¹⁷

Item 6. Supervision: An adviser must explain how it monitors the advice provided by the supervised person and provide the name, title and telephone number of the supervisor who oversees the supervised person’s advisory activities.

***Item 7. Requirements for State-Registered Advisers:** State registered advisers must disclose if a supervised person has been found liable for fraud, theft, bribery, unethical practices or certain other instances of wrongdoing in an arbitration claim or a civil, administrative or self-regulatory organization proceeding. The state registered adviser must also disclose any instance in which the supervised person has been the subject of a bankruptcy petition, the date the petition was first brought and the petition’s current status.

¹⁶ Advisers can make a presumption that outside business activities that represent less than 10% of a supervised person’s time and income are not substantial.

¹⁷ No disclosure is required for other bonuses or for employee salaries.

Delivery of brochure supplements

An adviser can prepare the brochure supplement for each individual supervised person or prepare separate supplements for different groups of supervised persons. Advisers should update the brochure supplement in order to provide it to new clients but only need to deliver updates to existing clients when there is new disclosure of a disciplinary event or a material change to a previously disclosed event. Advisers are not required to file brochure supplements or supplement amendments with the SEC.

In December 2010, the SEC extended the compliance date for delivery of brochure supplements to clients. Existing registered advisers with fiscal year ends from December 31, 2010 through April 30, 2011 have until July 31, 2011 to deliver brochure supplements to new and prospective clients and until September 30, 2011 to deliver supplements to existing clients. A registered adviser with a fiscal year end after April 30, 2011 must provide brochure supplements to new and prospective clients once it files its annual updating amendment, within 90 days of its fiscal year end, and to existing clients within 60 days of this filing. All advisers registering with the SEC from January 1, 2011 through April 30, 2011 have until May 1, 2011 to begin delivering brochure supplements to new and prospective clients and until July 1, 2011 to deliver supplements to existing clients. Advisers registering after April 30, 2011 must provide brochure supplements to clients and prospective clients upon registration.

Important points to consider

It will be important for advisers to ensure that they fully understand and have evaluated the required disclosures, particularly concerning conflicts of interest. While advisers have long been required to disclose conflicts of interest, the new form provides greater specificity and guidance concerning the types of conflicts that will require disclosure. Advisers should consider conducting a review of their conflicts of interest with the new guidance in mind prior to preparing the new disclosure. In addition, the SEC specifically indicated that it expects advisers to provide “clearly written, meaningful and current” disclosures that advisory clients are likely to read

and understand. Thus, care should be taken to draft the disclosures so that they are clear and in non-legalistic.

Advisers must also recognize that the SEC will review the disclosures that advisers make in the brochure and brochure supplements and use this information when conducting exams. Thus, the information must accurately reflect the practices in place within the organization or the adviser will be vulnerable to easily identified deficiencies and resulting fines by the SEC. By developing a comprehensive approach to maintaining the information required to complete the brochure and brochure supplement disclosures, advisers will have the opportunity to establish formal mechanisms for evaluating the quality of disclosures and identifying and managing conflicts of interest which the advisers can use to demonstrate their control practices to clients and the SEC.

Additional considerations

Advisers will need to identify certain information and make certain decisions when planning for and preparing an amended Form ADV Part 2. In response to the new requirements, the adviser should develop a strategy for compliance that considers:

1. Whether the adviser must prepare and to whom it must deliver a brochure and brochure supplements. An adviser does not need to prepare or deliver a brochure or brochure supplements if the adviser deals exclusively with investment companies and business development companies registered under the Investment Company Act of 1940 or advisory clients receiving only impersonal investment advice and paying less than \$500 per year.
2. The time that it will take for the adviser to prepare, file and distribute the brochure and brochure supplements. The SEC estimates that the average initial annual burden for advisers to achieve compliance with the amended requirements of Form ADV for small, medium and large advisers will be 15, 97.5 and 1,989 hours, respectively. The actual time that it takes the largest advisers to prepare the necessary brochures and supplements may exceed these estimates as these advisers may have extensive conflicts to disclose and numerous supervised persons for

whom brochure supplements will be prepared. For large advisers, the SEC estimates that it will take 100 hours to prepare Form ADV Parts 1 and 2A and that it will take 30 minutes to prepare each brochure supplement.

3. The timeline by which the adviser must file their brochures whether as part of a new registration or in an annual updating amendment. As mentioned previously, all advisers registering after January 1, 2011 and all currently registered advisers with fiscal year ends of December 31, 2010 or later must file a brochure that adheres to the requirements of the amended Form ADV Part 2 as part of their registration or next annual updating amendment, respectively.
4. The timeline by which the adviser must provide brochures and brochure supplements to clients. Advisers must generally provide a brochure to prospective clients before entering into an advisory relationship with the client and must provide a brochure supplement with information about the supervised persons who will provide services to the client before the supervised persons begin to provide such services. Newly registered advisers must begin providing brochures to clients once they register with the SEC. Existing registered advisers must begin to provide brochures to new and prospective clients upon initially filing the brochure with the SEC and to existing clients within 60 days of the filing.
5. Whether separate brochures will be prepared for different advisory services or whether a single brochure will address all services of the adviser. As part of this effort, an adviser should consider how it will identify the key risks and conflicts of interest involved in its businesses. The SEC expects advisers to implement the rules “in the spirit in which they were adopted” and to produce brochures and supplements which are clear, avoid confusion and effectively communicate the advisers’ businesses to clients.
6. Whether the adviser participates in any wrap fee programs which will require the completion of a separate brochure.
7. Whether the adviser will prepare brochure supplements by group or by individual. As part of this effort, the adviser will need to identify, for each of its clients, all advisory personnel who make discretionary investment decisions, formulate investment advice or have direct client contact and compile educational, professional and disciplinary information about these personnel.
8. How the adviser will handle the new recordkeeping requirements imposed by the amendments to Form ADV Part 2. The amendments to Form ADV Part 2 will require the adviser to maintain brochures, brochure supplements, summaries of any material changes in its brochure and the methodology for calculating managed assets if the amount differs from “assets under management” in Form ADV Part 1A. In addition, advisers will need to maintain records of disciplinary events, even if they determine that they do not need to disclose the event in their brochure or brochure supplements.

Additional information

If you would like additional information about the topic discussed in this FS Regulatory Brief, please call:

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