

SEC Amendments to Form ADV and Related Rules under the Investment Advisers Act of 1940

The Securities and Exchange Commission (the “SEC”) has approved significant amendments to Form ADV and related rules under the Investment Advisers Act of 1940, as amended (the “Advisers Act”).¹ Form ADV is the form that investment advisers use to register with the SEC or state securities commissions. The rule changes (hereinafter, the “Final Rule”) expand the disclosures that registered investment advisers must make to existing and prospective clients and require that disclosures be made in a specified format. Investment advisers currently registered with the SEC are not required immediately to conform their client disclosures to the Final Rule but must do so not later than the date on which they file an annual updating amendment to Form ADV for a fiscal year ended on or after December 31, 2010. This Financial Markets Alert summarizes the principal disclosure requirements imposed by the Final Rule.

BACKGROUND

Form ADV is the document that advisers use to comply with their registration and certain disclosure obligations under the Advisers Act. Part 1A of Form ADV is used to apply for registration with the SEC and Part 1B with state securities authorities. As revised by the Final Rule, Part 2A contains eighteen (18) items required to be disclosed in an adviser’s “brochure,” which advisers must provide to prospective clients initially and to existing clients annually. Part 2B is called the “brochure supplement,” which contains information about the advisory personnel who provide clients with investment advice. The Final Rule affects only Part 2, which was formerly designated as “Part II”.

The Final Rule will be effective on October 12, 2010 subject to the implementation schedule approved by the SEC. Specifically, each adviser applying for registration with the SEC after January 1, 2011 must file a brochure or brochures that meet the requirements of amended Part 2A as part of the application for registration on Form ADV. Each adviser registered with the SEC whose fiscal year ends on or after December 31, 2010 must include in its next annual updating amendment to its Form ADV new brochures that meet the requirements of the amended form.² Within 60 days of filing such amendment, the adviser must deliver to its existing clients a brochure and brochure supplement that meet the requirements of amended Form ADV. Each adviser must, after the initial filing of the brochures, begin to deliver to new clients and prospective clients a new brochure and brochure supplements in order to satisfy its obligations under the brochure rule.

We encourage you to contact us if you have any questions regarding the Final Rule. Please contact:

Jim Croke
Partner
Financial Markets
jcroke@orrick.com
+1 212 506 5085

Peter Manbeck
Senior Counsel
Financial Markets
pmanbeck@orrick.com
+1 212 506 5095

Useful Resources

 [Dodd-Frank Analysis](#)

¹ Release No. IA-3060 (July 28, 2010).

² Advisers Act Rule 204-1(a)(1) requires each adviser registered with the SEC to file an annual updating amendment to Form ADV not later than 90 days after the end of the adviser’s fiscal year. Accordingly, each adviser with a fiscal year end of December 31, 2010 must file an annual updating amendment with the new brochures no later than March 31, 2011.

PART 2A: BROCHURE FORMAT AND CONTENT

1. Brochure Format

Registered advisers must provide prospective and existing clients with a narrative brochure written in plain English, rather than in a series of multiple-choice and fill-in-the-blank questions organized in a “check-the-box” format as was done in the past, and communicate clearly to their clients and prospective clients in the brochure following a specified format using short sentences, definite, concrete, everyday words and the active voice.

Advisers will be required to file their new brochures electronically with the SEC and once filed the brochures will be publicly available. Advisers will not be required to file their brochure supplements (discussed below) with the SEC.

2. Brochure Items

Item 1. Cover Page. The cover page of an adviser’s brochure must include the name of the firm, its business address, a general telephone number and/or e-mail address, website (if any), the date of the brochure and a statement that the brochure has not been approved by the SEC or any state securities authority and, if the adviser refers to itself as a “registered investment adviser”, a disclaimer that registration does not imply a certain level of skill or training.

Item 2. Material Changes. An adviser amending its brochure must identify and discuss a summary of the material changes since the last annual update to the adviser’s policies, practices or conflicts of interests.

Item 3. Table of Contents. An adviser must include in its brochure a table of contents detailed enough to permit clients and prospective clients to locate topics easily.

Item 4. Advisory Business. Item 4 broadens the disclosure requirements under Item 1A of the old Form and requires an adviser to describe its advisory business, such as the types of advisory services offered, whether it holds itself out as specializing in a particular type of advisory service and the amount of client assets that it manages. Advisers must update the amount of their assets under management annually (as part of their annual updating amendment) and make interim amendments only for material changes in assets under management when they are filing an “other than annual amendment” for a separate reason as part of the adviser’s ongoing fiduciary obligation to inform its clients of any material information that could affect the advisory relationship, which could include a material change to assets under management.

Item 5. Fees and Compensation. An adviser must describe in its brochure how it is compensated for its advisory services, provide a fee schedule (except for institutional and large, sophisticated clients), disclose whether fees are negotiable, whether it bills clients or deducts fees directly from clients’ accounts, and how often it assesses fees (or bills clients) and describe the types of other costs, such as brokerage, custody fees and fund expenses that clients may pay in connection with the advisory services. An adviser charging fees in advance must explain how it calculates and refunds prepaid fees when a client contract terminates. An adviser is required to disclose any transaction-based compensation it receives attributable to the sale of a security or other investment product (e.g., brokerage commissions) or any practices under which its personnel receive such compensation and the conflict of interest that such compensation creates, and to describe how the adviser addresses this conflict. Such an adviser must also disclose that the client may purchase the same security or investment product from a broker that is not affiliated with the adviser.

Item 6. Performance-Based Fees and Side-By-Side Management. An adviser that charges performance-based fees or has any supervised person who manages an account that pays such fees must disclose this fact. If such an adviser also manages accounts that are not charged a performance fee, the item also requires the adviser to discuss the conflicts of interest that arise from its (or its supervised person’s) simultaneous management of these accounts, and to describe generally how the adviser addresses those conflicts.

Item 7. Types of Clients. An adviser must describe in its brochure the types of advisory clients the firm generally has, as well as the firm’s requirements for opening or maintaining an account, such as minimum account size.

Item 8. Methods of Analysis, Investment Strategies and Risk of Loss. An adviser must disclose its methods of analysis and investment strategies as was required in Item 4 of the old Form and must now also disclose that investing in securities involves risk of loss that clients should be prepared to bear and how strategies involving frequent trading can affect investment performance. The adviser further must explain the material risks involved for each significant investment strategy or method of analysis it uses and particular type of security it recommends, with more detail if those risks are unusual.

Item 9. Disciplinary Information. An adviser must disclose material facts about any legal or disciplinary event that is material to a client's (or prospective client's) evaluation of the integrity of the adviser or its management personnel (and not advisory affiliates). These requirements incorporate into the brochure the client disclosure regarding disciplinary information previously required by Rule 206(4)-4 under the Advisers Act, which is being withdrawn.

Item 10. Other Financial Industry Activities and Affiliations. An adviser must disclose material relationships or arrangements the adviser (or any of its management persons) has with related financial industry participants (such as referral arrangements), any material conflicts of interest that these relationships or arrangements create and how the adviser addresses the conflicts. In addition, if an adviser selects or recommends other advisers for clients, it must disclose any compensation arrangements or other business relationships between the advisory firms, along with the conflicts created, and how it addresses these conflicts.

Item 11. Code of Ethics, Participation or Interest in Client Transactions and Personal Trading. Each adviser must provide a brief, concise summary of its code of ethics and state that a copy is available upon request. If the adviser or a related person recommends to clients, or buys or sells for client accounts, securities in which the adviser or a related person has a material financial interest, Item 11.B requires the brochure to discuss this practice and the conflicts of interest presented, the nature of the conflicts presented and how the adviser addresses the conflicts. Item 11.C requires an adviser to disclose whether it or a related person (e.g., advisory personnel) invests (or is permitted to invest) in the same securities that it recommends to clients, or in related securities (such as options or other derivatives), the conflicts presented and how the firm addresses the conflicts. Item 11.D focuses on the specific conflicts an adviser has when it or a related person trades in the same securities at or about the same time as a client and an adviser should explain how its internal controls, including its code of ethics, prevent the firm and its staff from buying or selling securities contemporaneously with client transactions. Items 11.B, 11.C, and 11.D would not require disclosure with respect to securities that are not "reportable securities" under Advisers Act Rule 204A-1(e)(10), such as shares in unaffiliated mutual funds.

Item 12. Brokerage Practices. Item 12 now specifies certain information that advisers must disclose with respect to brokerage practices, such as soft dollar practices, client referrals, directed brokerage and trade aggregation. Among other information, advisers must disclose how they select brokers for client transactions and determine the reasonableness of brokers' compensation and how they address conflicts of interest arising from their receipt of soft dollar benefits (i.e., research or other products or services they receive in connection with client brokerage).

Item 13. Review of Accounts. Item 13 requires that an adviser disclose whether, and how often, it reviews clients' accounts or financial plans, and identify who conducts the review.

Item 14. Client Referrals and Other Compensation. An adviser must disclose any arrangement under which it or its related person compensates another for client referrals and describe the compensation and any arrangement under which the adviser receives any economic benefit, including sales awards or prizes, from a person who is not a client for providing advisory services to client, any conflicts of interests that arise from the arrangement, and how the adviser addresses those conflicts.

Item 15. Custody. Item 15 is added to require an adviser with custody of client funds or securities to explain in its brochure that clients will receive account statements directly from the qualified custodian, such as a bank or broker-dealer, that maintains those assets and to explain to clients that they should carefully review the account statements they receive from the qualified custodian. In addition, if an adviser also sends clients account statements, the adviser's explanation must include a statement urging clients to compare the account statements they receive from the qualified custodian with those they receive from the adviser.

Item 16. Investment Discretion. Item 16 requires an adviser with discretionary authority over client accounts to disclose this fact in its brochure, and any limitations clients may (or customarily do) place on this authority. If the information is provided in response to Item 4, the adviser may cross-reference the information.

Item 17. Voting Client Securities. Item 17 is new and requires advisers to disclose their proxy voting practices. This item parallels Rule 206(4)-6 under the Advisers Act. Advisers must also disclose whether they have or will accept authority to vote client securities and, if so, to describe briefly the voting policies they adopted under rule 206(4)-6. Advisers that do not accept authority to vote securities must disclose how clients receive their proxies and other solicitations.

Item 18. Financial Information. Item 18 requires an adviser that requires prepayment of fees to provide clients with an audited balance sheet showing the adviser's assets and liabilities at the end of its most recent fiscal year. The item also requires an adviser to disclose any financial condition reasonably likely to impair the adviser's 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 or solicits prepayment of more than \$1,200 in fees per client and six months or more in advance (e.g., the adviser could be required to disclose a large judgment or

arbitration award against it). Finally, Item 18 requires an adviser that has been the subject of a bankruptcy petition during the past ten years to disclose that fact to clients.

Part 2A Appendix 1: The Wrap Fee Program Brochure. Advisers that sponsor wrap fee programs continue to be required to prepare a separate, specialized firm brochure (a “wrap fee program brochure”) for clients of the wrap fee program in lieu of the sponsor’s standard brochure as provided in Appendix 1 to Part 2A. The Final Rule requires an adviser to identify whether any of its related persons is a portfolio manager in the wrap fee program and, if so, to describe the associated conflicts and to disclose whether related person portfolio managers are subject to the same selection and review criteria as the other portfolio managers who participate in the wrap fee program and, if they are not, how they are selected and reviewed.

PART 2B: THE BROCHURE SUPPLEMENT

Rule 204-3 requires that each firm brochure be accompanied by brochure supplements providing information about the advisory personnel on whom the particular client receiving the brochure relies for investment advice and who actually provide the investment advice and interact with the client.

1. Supplement Format

The Final Rule requires advisers to write their supplements in plain English, but offer an adviser flexibility in presenting information in a format that is best suited to the advisory firm in order to reduce the cost of preparing and delivering supplements. However, a brochure supplement must be organized in the same order, and contain the same headings, as the items appear in the form, whether provided in a brochure or separately.

2. Supplement Items

Item 1. Cover Page. Each supplement’s cover page must include information identifying the supervised person (or persons) covered by the supplement as well as the advisory firm.

Item 2. Educational Background and Business Experience. Item 2 requires the supplement to describe the supervised person’s formal education and his or her business background for the past five years, identify the supervised person’s positions at prior employers and not merely list the names of prior employers and provide a sufficient explanation of the minimum qualifications required for any professional designations disclosed in the supplement to allow clients and potential clients to understand the value of the designation.

Item 3. Disciplinary Information. Item 3 requires disclosure of any legal or disciplinary event that is material to a client’s evaluation of the supervised person’s integrity, including certain disciplinary events that the SEC presumes are material to such an evaluation if they occurred during the last 10 years.

Item 4. Other Business Activities. Item 4 requires an adviser to describe other capacities in which the supervised person participates in any investment-related business, other business activities or occupations that the supervised person engages in if they involve a substantial amount of time or pay and any material conflicts of interest such participation may create and any compensation, including bonuses and non-cash compensation, the supervised person receives based on the sales of securities or other investment products, as well as an explanation of the incentives this type of compensation creates.

Item 5. Additional Compensation. This item requires that the supplement describe arrangements in which someone other than a client gives the supervised person an economic benefit (such as a sales award or other prize) for providing advisory services.

Item 6. Supervision. This item requires an adviser to explain how the firm monitors the advice provided by the supervised person addressed in the brochure supplement. It also requires a firm to provide the client with the name, title, and telephone number of the person responsible for supervising the advisory activities of the supervised person.