

SEC Adopts Amendments to Form ADV Part 2

The Securities and Exchange Commission (“SEC”) has adopted amendments to Part 2 (previously designated Part II) of Form ADV and certain related rules under the Investment Advisers Act of 1940. Designed to promote enhanced disclosure, the amendments require registered investment advisers to prepare and deliver to clients and prospective clients narrative brochures written in “plain English” and supplemental brochures with tailored portfolio manager information. In addition, the amendments require registered investment advisers to file the narrative brochures electronically with the SEC which, in turn, will make the brochures available to the general public through its Investment Adviser Public Disclosure (“IAPD”) website. The amendments are described in more detail below.

New Form ADV Part 2

The amended Form ADV Part 2 contains two parts: Part A and Part B. Part A contains eighteen separate disclosure items, each of which must be addressed (even if not applicable) by the adviser in the order presented. Part B requires disclosure about the qualifications and disciplinary history of specific advisory employees who give advice to the particular client to whom the Form ADV Part 2 is delivered.

The Narrative Brochure (Part 2A)

The amended Form ADV Part 2A requires an adviser to disclose, in “plain English,” the adviser’s services, fees, business practices, disciplinary information, and conflicts of interest. The SEC has described “plain English” as using short sentences; using definitive, concrete and everyday words; using active voice; using tables or bullet lists for complex material, whenever possible; generally avoiding legal or business jargon; and avoiding multiple negatives. Key aspects of Form ADV Part 2A’s specific disclosure items are summarized below.

Item 2: Material Changes

- An adviser must summarize any material changes to its narrative brochure since its last annual update, either in the brochure itself or in a separate document. The summary of material changes is meant to contain only the information necessary to inform clients of the substance of changes to the adviser’s policies, practices, or conflicts of interests, so that they can determine whether to review the brochure in its entirety or to contact the adviser with questions about the changes.

Item 4: Advisory Business

- An adviser must describe its business, including the specific types of advisory services offered, whether the adviser holds itself out as specializing in a particular type of advisory service, and total client assets under management.
- Assets under management need not be calculated in the same manner required by Form ADV Part 1, but documentation must be kept regarding any other method used.

Item 5: Fees and Compensation

- An adviser must describe its compensation, provide a fee schedule, and disclose whether its fees are negotiable, except in brochures provided only to clients who are qualified purchasers.
- If applicable, an adviser must disclose that it (or its personnel) receives compensation for selling securities or other investment products, the conflicts of interest that practice creates and how the adviser addresses those conflicts.

Item 6: Performance-Based Fees and Side-By-Side Management

- If applicable, an adviser must disclose that it charges performance-based fees, or that it has a supervised person who manages an account that pays such fees.
- If the adviser also manages accounts that are not charged performance-based fees, the adviser must disclose the conflicts of interest that practice creates and how it addresses those conflicts.

Item 7: Types of Client

- An adviser must describe the types of clients to which it generally provides advice and any requirements for opening or maintaining an account with the adviser.

Item 8: Methods of Analysis, Investment Strategies and Risk of Loss

- An adviser must disclose its methods of analysis and investment strategies and the material risks associated with each significant investment strategy or method of analysis used and particular type of security recommended, with more detail for unusual risks.

Item 9: Disciplinary Information

- An adviser must disclose material facts about legal or disciplinary events that are material to a client's evaluation of the integrity of the adviser or its management personnel. Unlike Form ADV Part 1A, this item does not address all of an adviser's advisory affiliates. This item of the amended Form ADV Part 2 effectively replaces Rule 206(4)-4, which has been rescinded.
- Item 9 provides a list of disciplinary events presumed to be material, subject to rebuttal, which must be documented in a memorandum and retained as a record.

Item 10: Other Financial Industry Activities and Affiliations

- An adviser must disclose any material relationships or arrangements that it (or its management personnel) has with related financial industry participants, any material conflicts of interest those relationships or arrangements create, and how it addresses those conflicts.

Item 11: Code of Ethics, Participation or Interest in Client Transactions and Personal Trading

- An adviser must describe briefly its code of ethics and state that a copy is available on request.
- If an adviser or a related person recommends to its clients, or buys or sells for client accounts, securities in which the adviser or a related person has a material financial interest, the adviser must discuss the related conflicts of interest and how it addresses those conflicts.
- An adviser must disclose whether a related person invests or may invest in the securities it recommends to clients or in related securities, the related conflicts of interest (including specific conflicts relating to trades at or about the same time as client trades), and how it addresses those conflicts.

Item 12: Brokerage Practices

- An adviser must disclose how it selects brokers for client transactions and how it determines the reasonableness of brokers' compensation.
- An adviser that receives soft dollar benefits must disclose its soft dollar practices, the conflicts of interest arising from the receipt of soft dollar benefits, and how it addresses such conflicts.
- If an adviser uses client brokerage to compensate or reward brokers for client referrals, it must disclose that practice, the conflicts of interest it creates, and any procedures used by it to direct client brokerage to referring brokers during the last fiscal year.
- An adviser must disclose its directed brokerage practices, its potential inability to obtain best execution when clients direct brokerage and, if it routinely recommends, requests, or requires clients to direct brokerage, that practice, the fact that not all advisers require directed brokerage, and any relationship with a broker-dealer that creates a material conflict of interest.
- An adviser must disclose whether and under what conditions it aggregates client trades.

Item 13: Review of Accounts

- An adviser must disclose whether and how often it reviews clients' accounts or financial plans and who conducts the review.

Item 14: Client Referrals and Other Compensation

- An adviser must describe any arrangement pursuant to which it or a related person compensates another person who is not a supervised person of the adviser for client referrals, as well as any arrangement pursuant to which it receives benefits from non-clients for providing advisory services to clients, any conflicts of interest that arise from such an arrangement, and how it addresses those conflicts.

Item 15: Custody

- An adviser that has custody of client funds or securities must explain that clients will receive account statements from custodians and that such statements should be reviewed carefully by the client and compared to any statements sent by the adviser.

Item 16: Investment Discretion

- An adviser with discretionary authority over client accounts must disclose that fact and any limitations clients may (or customarily do) place on that authority.

Item 17: Voting Client Securities

- An adviser must disclose whether it has or will accept authority to vote client securities and if so, whether and how clients can direct it to vote, how it addresses conflicts of interest when voting, how clients can obtain information on voting, and that its voting policies may be obtained by clients upon request.
- An adviser who does not accept authority to vote client securities must disclose how clients receive proxies and other solicitations.

Item 18: Financial Information

- An adviser that requires or solicits prepayment of more than \$1,200 in fees per client six months or more in advance must provide a balance sheet.
- An adviser that has discretionary authority or custody of client funds or securities, or that requires or solicits prepayment of more than \$1,200 in fees per client six months or more in advance, must disclose any financial condition that is reasonably likely to impair its ability to meet contractual commitments to its clients.
- An adviser that has been the subject of a bankruptcy petition at any time during the past ten years must disclose that fact and certain related information.

Wrap Fee Programs

Advisers who sponsor wrap fee programs must prepare a separate, specialized brochure for wrap fee program clients. The required disclosures for the wrap fee brochures are substantially similar to the disclosures previously required by the old Part II, but have been revised to incorporate many of the amendments to the standard firm brochure. Wrap fee program sponsors also must disclose whether any related person is a portfolio manager in the wrap fee program and, if so, the related conflicts of interest. A wrap fee program sponsor means an investment adviser that is compensated under a wrap fee program for sponsoring, organizing, or administering the program, or for selecting, or providing advice to clients regarding the selection of, other investment advisers in the program.

Delivery and Updating of Brochures

Initial Delivery. An adviser must deliver a current brochure at or before the time it enters into an advisory contract with a client. An adviser need not deliver a brochure to clients receiving only impersonal investment advice or to clients registered as investment companies under the Investment Company Act of 1940, including business development companies that are subject to Section 15(c) thereof. In the adopting release for amended Form ADV Part 2, the SEC noted, with respect to advisers to hedge funds, that Rule 204-3 requires only that brochures be delivered to “clients,” and that the D.C. Circuit Court of Appeals stated in *Goldstein v. SEC* that the “client” of an adviser managing a hedge fund is the fund itself, and not its investors. Although the SEC’s observations in this area referred specifically to “hedge funds,” the same analysis should apply with respect to the delivery of Form ADV Part 2 to any private fund, including private equity funds and privately offered funds-of-funds.

Annual Delivery. An adviser must annually deliver either a current updated brochure including or accompanied by a summary of material changes or a summary of material changes including an offer to provide the current brochure, in either case no later than 120 days after the adviser’s fiscal year end.

Interim Updates. An adviser must update its brochure promptly whenever information (other than the summary of material changes or the amount of assets under management) becomes materially inaccurate.

Updates Requiring Interim Delivery. If an adviser amends its brochure to add a disciplinary event or to change other material information previously disclosed in response to Item 9 of Part 2A (Disciplinary Information), the adviser must update the brochure to reflect the new information and deliver the updated brochure to its existing clients. Other interim updates described above do not require delivery of an updated brochure to existing clients.

Part B: The Brochure Supplement

The amendments require that the brochure be accompanied by brochure supplements disclosing information about the advisory personnel on whom the client receiving the brochure relies for investment advice. The required disclosure includes information about such personnel's educational background, business experience, disciplinary history, other business activities, additional compensation, and supervision. Advisers are required to update brochure supplements when information contained therein becomes materially inaccurate. New clients must receive an updated brochure supplement or the old supplement and a sticker, provided electronically or in paper form.

Compliance Dates

Each adviser applying for registration with the SEC after January 1, 2011 must file a brochure that meets the requirements of the new Part 2A and, upon registering, must begin delivering supplements that meet the requirements of the new Part 2B to its clients and prospective clients. Each adviser currently 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 (due 90 days after the end of its fiscal year) a brochure that meets the requirements of the amended form, and must deliver a brochure and supplement that meet the requirements of the amended form to its existing clients no later than 60 days after filing such amendment.

Contact Information

If you have any questions, please contact your regular Ropes & Gray attorney.