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Investment Adviser Update

On July 28, 2010, the Securities and Exchange Commission (the "SEC") adopted amendments to Form ADV, and related rules under the Investment Advisers Act of 1940, as amended (the "Advisers Act"), which require advisers to deliver to clients and prospective clients a narrative brochure in plain English describing the adviser's business practices, conflicts of interest, risks and disciplinary history. A new adviser must comply with the new form beginning January 1, 2011. An existing adviser must comply with the new form as of the date of its first annual update after January 1, 2011. For most advisers, this will be March 31, 2011. The amendments and related rule changes impact the format and content of the Firm Brochure, as well as updating and delivery requirements. In addition, the amendments create a new Brochure Supplement containing information about certain advisory personnel.

I. The Firm Brochure (Part 2A)

A. Content

The amendments include substantial revisions to the format and content of the Firm Brochure. The new form uses a narrative format rather than a check-the-box format and is intended to provide more detailed disclosure on the adviser's business practices with an emphasis on conflicts of interest and risks. Although the new form contains many items that appeared in former Part II, many items are entirely new and many items include changes, often subtle, to items that appeared previously. The new form calls for much of the same information previously requested, but presents it in a different way and often in more detail.

In addition, the new Firm Brochure must be written in "plain English." All items must be presented in the order shown.

Practice Tip:

We recommend that advisers take a fresh look at their disclosure and start by compiling an inventory of business practices, risks and potential conflicts. Particular emphasis should be given to identifying potential conflicts of interest. We also caution against merely cutting and pasting from last year's document, as such an approach may result in missing, incomplete or out-of-order responses.

Item 1. Cover Page

Item 1, which is entirely new to Form ADV Part 2, requires that an adviser disclose the following on the cover page of its brochure: the name of the firm, its business address, contact information and website (if applicable), and the brochure's date.[1] If an adviser refers to itself as a "registered investment adviser," it must include a disclaimer that registration does not imply any particular level of skill or training. In addition, the cover page must include a standard legend for all advisers.

Item 2. Material Changes

Item 2, which is entirely new to Form ADV Part 2, requires an adviser that is amending its brochure to identify and discuss any material changes since the last annual update on the cover page of the brochure or on the page immediately following the cover page. Item 2 is designed to make clients aware of information that has changed since the prior year's brochure that may be important to them.[2] Advisers may include the summary in their brochure or as a separate document that must be filed with the SEC as an exhibit to Part 2.[3] If the adviser prepares a summary as a separate document, such document may also be used to satisfy an adviser's annual client delivery obligation.[4] If an adviser includes the summary of material changes in its brochure

[1] Form ADV, Part 1A, Item 1.A; *see also* Adopting Release at pp. 10-11.

[2] Adopting Release at p. 11.

[3] Part 2A, Item 2; Note to paragraphs (a) and (b) of Rule 204-1; Instruction 6 for Part 2A of Form ADV.

[4] *See* Rule 204-3(b)(2) under the Advisers Act; Adopting Release at p. 11, n. 31.

and amends its brochure on an interim basis between annual updating amendments, the adviser should consider whether it should update its summary of material changes to avoid confusing or misleading clients.[5] The summary should contain only as much information as is necessary to inform clients of the substance of the changes to the adviser's policies, practices or conflicts of interest so that they can determine whether to review the brochure in its entirety or to contact the adviser with questions about the changes.[6]

Practice Tip:

Advisers should develop a consistent framework for assessing materiality. Describing all changes is not necessarily the right approach.

Item 3. Table of Contents

Item 3 of the brochure requires a table of contents with enough detail to permit clients to easily locate the covered topics. As discussed above, the information required by revised Part 2 must appear in the order of the form, and contain the same headings as the items listed in Part 2A to facilitate comparisons across multiple advisers.[7]

Item 4. Advisory Business

Item 4 requires an adviser to provide a general description of its advisory business. An adviser must discuss how long it has been in business, the types of advisory services it offers and whether it holds itself out as specializing in a particular type of service and must identify its principal owners.[8] In addition, an adviser must disclose the amount of client assets it manages on both a discretionary and nondiscretionary basis and the date as of which these amounts were calculated.[9] In order to provide clients with a better understanding of the scope of its business, an adviser may compute its assets under management using a method that differs from Item 5.F in Part 1A of Form ADV.[10] Advisers that elect to use a methodology different from that contained in Part 1A must maintain documentation describing such method.[11] Advisers must update the amount of client assets under management at least annually, but they must also make interim amendments for any material change to the amount when filing an amendment required by any other portion of the form.[12]

Practice Tip:

Throughout the form, make sure you understand whether the question relates only to the firm, its management persons or its related persons. Item 4 relates to the firm. In addition, the methodology for calculating assets under management in Part 1 may differ from the methods you have historically used. Make sure you fully understand the new methodology.

Item 5. Fees and Compensation

Item 5 requires an adviser to describe how it is compensated for its advisory services, provide a fee schedule and disclose whether fees are negotiable.[13] In connection with this Item,

[5] *See* Note to Instruction 6 for Part 2A of Form ADV.

[6] Adopting Release at p. 12.

[7] Instruction 1 of General Instructions for Part 2 of Form ADV.

[8] For purposes of this Item, principal owners include the persons listed as owning 25% or more of the adviser's firm on Schedule A of Part 1A of Form ADV. Publicly held companies without a 25% shareholder must simply disclose that they are publicly held. If an individual or company owns 25% or more of the adviser's firm through subsidiaries, the adviser must identify the individual or parent company and intermediate subsidiaries. SEC-registered advisers must identify intermediate subsidiaries that are publicly held, but not other intermediate subsidiaries. State-registered advisers must identify all intermediate subsidiaries. *Id.* at Item 4.A, Notes.

[9] The "as of" date must not be more than 90 days before the date the adviser last updated its response to this Item of the brochure. Item 4.E, Form ADV Part 2A.

[10] The Adopting Release explains that calculation of assets under management under Part 1A is designed to determine whether an adviser should register with the SEC or the states. In contrast, the disclosure under Item 4 of Part 2A is intended to provide clients with meaningful information about the scope of an adviser's business.

[11] *See* Rule 204-2(a)(14)(ii) and Note to Item 4.E, Part 2A.

[12] The SEC noted in the Adopting Release that an adviser, as a fiduciary, has an ongoing obligation to inform its clients of any material information that could affect the advisory relationship, which could include a change to assets under management. Adopting Release at p. 15. There is no guidance regarding what level of change is deemed material.

[13] *See* Item 5.A of Part 2A. Former Part 2 of Form ADV required an adviser to disclose the types of fees charged, its basic fee schedule, how fees are charged and whether fees are negotiable, when compensation is payable and whether payable in advance, and how a client may get a refund or terminate the advisory contract before its expiration date. Noticeably absent in former Part 2 is a requirement to discuss conflicts of interest related to advisory fees, but many advisers have included this information in order to fulfill their fiduciary duty to their clients.

an adviser must disclose whether it deducts fees from clients' assets or bills clients for fees incurred and the frequency of such bills or deductions. An adviser must also describe any other types of fees or expenses that clients may pay in connection with its services (e.g., custodian fees or mutual fund expenses), disclose that clients will incur brokerage and other transaction costs, and direct clients to the section(s) of the brochure that discuss brokerage. If an adviser charges fees in advance, it must explain how it calculates such fees and refunds prepaid fees when a client terminates its contract before the end of a billing period. Item 5 also requires that an adviser disclose whether it, or its personnel, receives compensation attributable to the sale of a security or other investment product (e.g., brokerage commissions or asset-based sales charges or service fees from the sale of mutual funds), the conflict of interest such compensation creates and how the adviser addresses this conflict.[14]

Item 6. Performance-Based Fees and Side-by-Side Management

Advisers that charge performance-based fees or that have supervised persons who manage accounts that pay performance-based fees must disclose this fact under Item 6.[15] If an adviser also manages accounts that are not charged performance fees, Item 6 requires the adviser to discuss the conflicts of interest that arise from simultaneous management of such accounts and describe how the adviser addresses related conflicts (e.g., through trading or other policies that are fee neutral).[16] Brochures that are delivered only to "qualified purchasers" (as defined under the Investment Company Act of 1940) are not required to include a description of how the adviser is compensated for its services.[17]

Item 7. Types of Clients

Item 7 requires the adviser to describe the types of advisory clients the firm generally has (e.g., individuals, trusts, investment companies or pension plans). Item 7 must also include the adviser's requirements for opening or maintaining an account (i.e., minimum account size).

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

Item 8 requires an adviser to describe its methods of analysis and investment strategies and to explain that investing in securities involves a risk of loss that clients should be prepared to bear.[18] Under this Item, advisers must describe the material risks involved for each significant investment strategy or method of analysis they use and each particular type of security they recommend, with increased detail for those risks that are unusual.[19] In the Adopting Release, the SEC noted that a method of analysis or strategy would be considered "significant" if more than a

Practice Tip:

Risk disclosure appearing in Form ADV should be consistent with disclosure used in other channels, including offering memoranda, websites and marketing materials. Such disclosure may, however, provide greater or lesser detail than other channels. Each adviser should carefully review its own circumstances.

[14] *See* Item 5.E, Part 2A. The adviser must explain that this practice provides an incentive to recommend investment products based on the compensation received, rather than on a client's needs. This disclosure must also include a statement that the client may purchase investment products that it recommends through unaffiliated brokers or agents. An adviser that receives more than half of its revenue from commissions and other sales-based compensation must explain that commissions are the firm's primary (or, if applicable, exclusive) form of compensation. An adviser that charges advisory fees in addition to commissions or markups to an individual client must disclose whether it reduces its fees to offset the commissions or markups.

[15] As fiduciaries, advisers must disclose all material information regarding any proposed performance fee arrangements as well as any material conflicts of interest posed by the arrangements. *See Exemption to Allow Investment Advisers to Charge Fees Based upon a Share of Capital Gains or Capital Appreciation of a Client's Account*, Investment Advisers Act Release No. 1731, at nn. 13-14 and accompanying text (July 15, 1998), 63 Federal Register 39022 (July 21, 1998).

[16] The Adopting Release notes that an adviser that charges a performance fee to some accounts faces a variety of conflicts because the adviser can potentially receive greater fees from its accounts that have a performance-based fee structure as opposed to those accounts that have fees unrelated to performance (e.g., asset-based fees). As a result, such adviser may have an incentive to direct the best investment ideas to, or allocate or sequence trades in favor of, the account that pays a performance fee. Adopting Release at p. 19, n. 67.

[17] Because this exception applies to SEC-registered advisers only, state-only registered advisers will need to consult with the relevant state regulatory authority to determine whether they may rely on this exception. *See* Item 5.D, Part 2A.

[18] This disclosure was also required under former Part 2, Form ADV.

[19] Adopting Release at p. 20.

small portion of client assets are advised using the method or strategy.[20] Finally, for those advisers that employ strategies involving frequent trading, Item 8 requires a description of how such trading can affect investment performance, including the higher transaction costs associated with the strategy.[21]

Item 9. Disciplinary Information

Item 9 requires disclosure of any legal or disciplinary event that would be material to a client's (or prospective client's) evaluation of the integrity of the adviser or its management personnel.[22] This Item incorporates into the brochure the disciplinary disclosure required under Rule 206(4)-4 under the Advisers Act.[23] Items 9.A, B and C provide a list of disciplinary events that are presumptively material if they have occurred in the previous ten years.[24] If an adviser (or any of its management persons) has been "involved" in one of the events listed in Item 9, such involvement must be disclosed.[25] Item 10 does not require disclosure of arbitration awards and claims, as contemplated in the Proposing Release. However, the Adopting Release notes that advisers should carefully consider whether a particular arbitration award or settlement involves or implicates wrongdoing and/or reflects on an adviser's integrity.[26] As was required by Rule 206(4)-4, disciplinary events that are more than ten years old must be disclosed if the event was so serious that it would be material to a client's (or prospective client's) evaluation of the adviser or the integrity of its management personnel.[27] The Adopting Release notes that an adviser's fiduciary duty of full and fair disclosure requires it to continue to disclose to all clients (including those clients to whom the adviser is not required to deliver a brochure) its material disciplinary and legal events or its inability to meet contractual commitments.[28]

Item 10. Other Financial Industry Affiliations and Activities

Item 10 requires an adviser to describe any material relationships or arrangements it (or any of its management persons) has with related financial industry participants, any material conflicts of interest that these relationships or arrangements create, and how the adviser addresses such conflicts.[29] Financial industry participants include, but are not limited to, broker-dealers, futures commission merchants, commodity pool operators and commodity trading advisors, investment companies or other pooled investment vehicles (including private investment companies), sponsors or syndicators of limited partnerships and real estate brokers or dealers.

Practice Tip:

Item 10 extends to the firm and its management persons. Other affiliations are a critical source of potential conflicts, and should be carefully reviewed.

[20] Adopting Release at p. 24, n. 74. The Adopting Release explains that the brochure may not always be the best place for a multi-strategy adviser to disclose the risks associated with all of its methods of analysis or strategies, due to concerns that such disclosure would lengthen the brochure unnecessarily given the fact that different clients will be pursuing different strategies.

[21] Adopting Release at p. 21.

[22] For purposes of this Item, the new Form ADV Glossary defines "management persons" to include anyone with the power to exercise, directly or indirectly, a controlling influence over the adviser's management or policies, or to determine the general investment advice given to the adviser's clients. New Form ADV, Glossary.

[23] In conjunction with adopting the amendments to Form ADV Part 2, the SEC also rescinded Rule 206(4)-4 due to the fact that the information required by the rule is now incorporated directly into the Form. Other disclosures required by Rule 206(4)-4 (i.e., certain financial information and changes in financial condition) have also been incorporated into the revised brochure. *See* Item 18.B of Part 2A. The rescission of Rule 206(4)-4 will be effective for a particular investment adviser on the date on which that adviser must deliver its narrative brochure to existing clients and/or to prospective clients as required by the amendments.

[24] The SEC noted in the Adopting Release that the events listed in Item 9 are those that are presumed to be material and do not constitute an exhaustive list of material disciplinary events. Generally, these events include convictions for theft, fraud, bribery, perjury, forgery, counterfeiting, extortion and violations of securities laws by the adviser or any of its executives.

[25] The SEC defines "involved" for purposes of Form ADV as "[e]ngaging in any act or omission, aiding and abetting, counseling, commanding, inducing, conspiring with or failing to reasonably supervise another in doing an act."

[26] To the extent that such an award or settlement constitutes material information, an adviser's failure to inform clients would be a violation of Section 206 of the Advisers Act.

[27] The Adopting Release notes that an adviser's fiduciary duty of full and fair disclosure requires it to continue to disclose to all clients material disciplinary and legal events or its inability to meet contractual commitments, including those clients to whom the adviser is not required to deliver a brochure.

[28] Adopting Release at p. 24. The SEC noted that the failure by an adviser to provide such disclosure may constitute a violation of Section 206 of the Advisers Act.

[29] The requirements under Item 10 retain the disclosure items required under Item 8 of previous Part 2 of Form ADV.

If an adviser selects or recommends other advisers for clients, Item 10.D requires disclosure of any compensation arrangements or other business relationships between the advisory firms, the conflicts of interest created by any such arrangements, and a discussion of how these conflicts are addressed.[30] This disclosure in Item 10 is intended to highlight for clients an adviser's other financial industry activities and affiliations that can create conflicts of interest and impair the objectivity of the adviser's investment advice.

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

Code of Ethics. Item 11, which is substantially identical to the previous disclosure requirements of Item 9 of previous Part 2, requires an adviser to briefly describe its code of ethics and state that a copy of its code is available upon request.

Participation or Interest in Client Transactions. If an adviser or a related person recommends to clients, or buys and 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.[31] Any practices giving rise to these conflicts must be disclosed, as well as the nature of the conflicts presented and how the adviser addresses such conflicts.

Personal Trading. Items 11.C and 11.D govern disclosure of personal trading by the adviser and its personnel. 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). If such personal trading is permitted, the brochure must discuss the conflicts presented and describe how the firm addresses these conflicts.[32] Item 11.D, although similar, requires a discussion of the specific conflicts that an adviser has when it or a related person trades in the same securities at or about the same time as a client.[33] An adviser should respond to this Item by explaining how its internal controls, including its code of ethics, prevent the firm and its staff from buying or selling securities contemporaneously with client transactions.[34]

Item 12. Brokerage Practices

General. Item 12 requires an adviser to disclose the manner in which it selects brokers for client transactions and determines the reasonableness of broker compensation. In addition, this Item requires advisers to disclose 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).[35]

Soft Dollar Practices. Item 12 requires an adviser that receives soft dollar benefits in connection with client securities transactions to disclose its practices in a specific enough manner for clients and prospective clients to understand the types of products or services the adviser is receiving and permit the client to evaluate the potential conflicts of interest associated therewith.[36] Item 12 also requires that an adviser discuss the types of conflicts it has when it accepts soft dollar benefits and how those conflicts are addressed, including an explanation that (a) the adviser benefits because it does not have to produce or pay for research or other products or services acquired from soft dollars, and (b) the adviser therefore has an incentive to select or recommend brokers based on the adviser's interest in receiving these benefits, rather than on the client's interest in getting the most favorable execution. Advisers must also explain whether they use soft dollars to benefit all client accounts or only those accounts whose brokerage "pays" for these benefits, and whether soft dollar benefits are allocated proportionately to the soft dollar credits different accounts generate.[37]

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[30] Adopting Release at p. 29.

[31] In the Adopting Release, the SEC offered as an example an adviser who recommends that clients invest in a pooled investment vehicle that the firm advises or for which it serves as general partner, or when an adviser with a material financial interest in a company recommends that a client buy shares of that company. This Item requires an adviser to disclose any practices giving rise to these conflicts, the nature of the conflicts presented and how the adviser addresses these conflicts. Adopting Release at p. 30.

[32] *See* Item 11.C, Part 2A.

[33] *See* Item 11.C, Part 2A.

[34] The note to Item 11 clarifies that Items 11.B, 11.C and 11.D do not require disclosure with respect to securities that are not "reportable securities" under Advisers Act Rule 204A-1(e)(10) (e.g., shares in unaffiliated mutual funds). Such securities are not reportable under the Advisers Act because they present little opportunity for front-running.

[35] Item 12 of Form ADV Part 2 largely tracks Item 12.B of the previous Part 2.

[36] Disclosure must be more detailed for products or services that do not qualify for the safe-harbor provision in Section 28(e) of the Exchange Act, such as services that do not aid in the adviser's investment decision-making process.

[37] Under Item 12, advisers must also explain whether they "pay up" for soft dollar benefits. "Paying up" refers to the practice in which an adviser causes a client account to pay more than the lowest available commission rate in exchange for soft dollar products or services. Adopting Release at p. 34, n. 133.

Client Referrals. Advisers that use client brokerage to compensate or otherwise reward brokers for client referrals must disclose this practice, the conflict of interest it creates, and any procedures the adviser used to direct client brokerage to referring brokers during the last fiscal year (i.e., the system of controls used by the adviser when allocating brokerage).[38]

Directed Brokerage. Item 12 requires an adviser that permits clients to direct brokerage to describe its practices in this area, explain that it may be unable to obtain the most favorable execution of client transactions if the client directs brokerage, and explain that directed brokerage may be more costly for clients. Advisers that routinely recommend, request or require clients to direct brokerage are required to describe this practice in the brochure, disclose that not all advisers require clients to direct brokerage, and describe any relationship with a broker-dealer to which the brokerage may be directed that creates a material conflict of interest.[39]

Trade Aggregation. Item 12 requires an adviser to describe whether and under what conditions it aggregates trades. Advisers that do not aggregate trades must explain that as a result, clients may pay higher brokerage costs.[40]

Item 13. Review of Accounts

Item 13 requires an adviser to disclose whether, and how often, client accounts or financial plans are reviewed and to identify who conducts the review. Advisers should explain what circumstances trigger a review for reviews other than scheduled reviews.

Item 14. Client Referrals and Other Compensation

Item 14 requires an adviser to describe in its brochure any arrangement under which it or a related person compensates others for client referrals and to describe the compensation. This disclosure must also include 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 clients.[41] Advisers that accept benefits from non-clients for providing advisory services to clients must describe the arrangement, any conflicts of interest that may arise or have arisen from the arrangement and how the adviser addresses these conflicts.

Item 15. Custody

Item 15 requires an adviser with custody of client funds or securities to explain that clients will receive account statements directly from the qualified custodian, such as a bank or broker-dealer that maintains those assets. Advisers must also explain to clients that they should carefully review the account statements they receive from the qualified custodian. If an adviser also sends account statements directly to clients, 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.[42]

Item 16. Investment Discretion

Item 16 requires an adviser with discretionary authority over client accounts to disclose this fact in its brochure, along with any limitations that clients may (or customarily do) place on this authority (e.g., that a client may ask the adviser not to invest in securities of particular issuers).[43]

Item 17. Voting Client Securities

Item 17 requires an adviser to disclose its proxy voting practices. While this information parallels Rule 206(4)-6 under the Advisers Act, Item 17 also requires advisers to disclose whether they have or will accept authority to vote client securities and, if so, to describe briefly the voting policies they have adopted under the rule.[44] Advisers must include in this description whether (and how) clients can direct voting in particular solicitations, how the adviser addresses conflicts of interest when it votes securities, and

[38] Previous Form ADV Part II required advisers to disclose these arrangements, but it did not specifically require that the descriptions discuss the conflicts of interest created.

[39] An adviser may omit the disclosure regarding its inability to obtain best execution if directed brokerage arrangements are conducted only subject to the adviser's ability to obtain best execution.

[40] The disclosure required under this Item was modified from the Proposing Release by removing the words "in quantities sufficient to obtain reduced transaction costs" from the first sentence of Item 12.B. The limiting phrase was removed in recognition of the fact that there may be other circumstances in which advisers may aggregate trades that should be disclosed to clients.

[41] Similar disclosure was required under Item 13 of previous Part 2.

[42] This disclosure is similar to that required under the amended custody rule. *See Custody of Funds or Securities of Clients by Investment Advisers*, Investment Advisers Act Release No. 2968 (Dec. 30, 2009), 75 Federal Register 1456 (Jan. 11, 2010) ("Custody Rule Adopting Release") at section II.A.

[43] If this information is provided in response to Item 4, the adviser may cross-reference the information. See Adopting Release at p. 41.

[44] Rule 206(4)-6 requires advisers to adopt and implement written voting policies and procedures. Advisers are required to keep certain records relating to their voting, and advisers that exercise voting authority over client securities must describe their voting policies and procedures to clients and furnish clients with a complete copy of such policies and procedures upon request.

how clients can obtain information from the adviser on how the adviser has voted their securities. Finally, advisers must also explain that clients may obtain a copy of the adviser's proxy voting policies and procedures upon request. 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 disclosure of certain financial information about an adviser, when such information is material to clients. Advisers that require prepayment of fees must give clients an audited balance sheet showing the adviser's assets and liabilities at the end of its most recent fiscal quarter.[45] As part of this Item, advisers must also disclose any financial condition that is reasonably likely to impair the adviser's ability to meet contractual commitments to clients if the adviser (1) has discretionary authority over client assets, (2) has custody of client funds or securities or (3) requires or solicits prepayment of more than $1,200 in fees per client six months or more in advance.[46] Item 18 also requires an adviser that has been the subject of a bankruptcy petition during the past 10 years to disclose that fact to clients.[47]

II. The Wrap Fee Program Brochure (Part 2A, Appendix 1)

Advisers that sponsor wrap fee programs are required to prepare a separate, specialized firm brochure (a "wrap fee program brochure" or "wrap brochure") for clients of the wrap fee program in lieu of the sponsor's standard brochure. The items in Appendix 1 of Part 2A contain the requirements for a wrap fee program brochure and are substantially similar to those previously contained in Schedule H.[48] The amendments contain additional disclosure items in the wrap fee brochure requiring 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 of interest.[49] This Item will require advisers 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.[50]

A. Delivery of Firm Brochure

Initial Delivery. Rule 204-3, as amended, requires an adviser to deliver a current brochure before or at the time it enters into an advisory contract with the client.[51] The rule does not require advisers to deliver brochures to certain advisory clients receiving only impersonal investment advice or to clients that are investment companies registered under the Investment Company Act of 1940 (the "1940 Act"). The exception for registered investment companies has been expanded to cover advisers to business development companies.

Annual Delivery. Advisers must annually provide to each client to whom they must deliver a brochure either: (1) a copy of the current (updated) brochure that includes, or is accompanied by, a summary of material changes; or (2) a summary of material changes that includes an offer to

[45] The threshold for prepayment of fees triggering compliance with this requirement has been increased from $500 to $1,200. Additionally, an audited balance sheet must be provided by advisers that solicit clients to prepay fees over $1,200. Adopting Release at p. 43.

[46] The Adopting Release notes that disclosure may be required where a judgment or arbitration award was sufficiently large that payment of it would create such a financial condition. The Adopting Release states that under these circumstances, clients are exposed to the risk that their assets may not be properly managed – and prepaid fees may not be returned – if, for example, the adviser becomes insolvent and ceases to do business.

[47] The Adopting Release cautioned that although the SEC has rescinded Rule 206(4)-4, an adviser's fiduciary duty of full and fair disclosure may require it to continue to disclose any precarious financial condition promptly to all clients, even those clients to whom the adviser may not be required to deliver a brochure or amended brochure.

[48] The requirements of Schedule H have been revised to incorporate many of the amendments to the Part 2A firm brochure.

[49] For example, an adviser may have an incentive to select a related person to participate as a portfolio manager based on the person's affiliation with the adviser, rather than based on expertise or performance.

[50] An adviser may delegate its brochure delivery requirement to the sponsor of the wrap fee program and satisfy its record-keeping obligations that evidence delivery of the brochure through records retained in the offices of the sponsor and not those of the adviser, as long as the adviser is able to provide the records to the SEC staff upon request. However, this delegation does not relieve the adviser of its legal delivery obligation, and the adviser should take steps to assure that the sponsor is performing the tasks the adviser has delegated.

[51] Adopting Release at p. 47, n. 188. Rule 204-3 requires a registered adviser to furnish each client and prospective client with a written disclosure statement, which may be either a copy of the adviser's completed Part 2A or a written document containing the information required by Part 2A. Previously, such delivery had to occur at least 48 hours before entering into the advisory agreement, or at the time of entering into the agreement if the client has the right to terminate the agreement without penalty within five business days thereafter.

provide a copy of the current brochure.[52] Advisers are required to deliver the brochure no later than 120 days after the end of their fiscal year, and they may deliver either of the foregoing to clients electronically in accordance with the SEC's guidelines regarding electronic delivery of information.[53] If an adviser does not include, and therefore file, its summary of material changes as part of its brochure (on the cover page or on the page immediately following the cover), the adviser must file its summary as an exhibit to its brochure when it files its annual updating amendment with the SEC.[54]

Interim Delivery. Rule 204-3 of the Advisers Act, as amended, requires advisers to deliver an updated brochure (or a document describing the material facts relating to the amended disciplinary event) promptly whenever the adviser amends its brochure to add a disciplinary event or to change material information already disclosed in response to Item 9 of Part 2A. Advisers may also fulfill their obligations under amended Rule 204-3 by delivering a separate document describing the material facts relating to the disciplinary event triggering the required amendment.

B. Updating Part 2A of Form ADV

The amendments to Part 2A require advisers to keep current the brochures they file with the SEC by updating them at least annually and by updating the brochure promptly when any information contained therein becomes materially inaccurate. Advisers making changes for both the annual and interim updates will make changes to their brochures using their own computer systems and then file the revised brochure through the Investment Adviser Registration Depository (IARD). If an adviser filing its annual update does not have any material changes to make to its brochure, the adviser would not be required to prepare or deliver a summary of material changes or prepare and file an updated firm brochure as part of its annual updating amendment. If there is an interim amendment to the brochure or the brochure contains a material inaccuracy, the adviser must file a summary of material changes describing any interim amendment(s) along with an updated firm brochure as part of its annual amendment filing.[55]

Practice Tip:

Advisers should review and update compliance materials to reflect these changes in delivery and updating processes, and should train employees responsible for fulfillment functions.

III. The Brochure Supplement (Part 2B)

Under Rule 204-3, each firm brochure must be accompanied by brochure supplements providing information about the advisory personnel on whom the particular client receiving the brochure relies for investment advice. The supplements contain information about the educational background, business experience and disciplinary history (if any) of the supervised person(s) providing advisory services to the client.[56] Part 2B represents the most significant change to Part 2 of Form ADV in that it requires specific information about advisory personnel that was not previously required to be provided.

A. Content

General. Brochure supplements must be written in plain English, and the amendments provide some flexibility on the format in which the adviser may present the required information. The Adopting Release notes that some

[52] *See* Item 2 to Part 2A of Form ADV. The offer must also include the website address, telephone number and e-mail address for obtaining the complete brochure pursuant to the Instructions for Part 2, as well as the website address for obtaining information about the adviser. The Adopting Release also includes amendments to the record-keeping rule that will require an adviser choosing this approach to preserve a copy of the summary of material changes. An adviser that includes the summary of material changes in its brochure and amends its brochure pursuant to the Instructions for Part 2 should consider whether it should update its summary of material changes to avoid confusing or misleading clients reading the updated brochure.

[53] *See Use of Electronic Media by Broker-Dealers, Transfer Agents, and Investment Advisers for Delivery of Information*, Investment Advisers Act Release No. 1562 (May 9, 1996), 61 Federal Register 24644 (May 15, 1996) ("Electronic Media Release").

[54] *See* Electronic Media Release. The Adopting Release notes that an adviser's fiduciary duties may require it to obtain client consent to many of the disclosures required by Part 2 and that electronic access, without evidence that the adviser's delivery obligation has been met (such as by obtaining the client's consent to electronic delivery along with appropriate notice and access), would not, in the SEC's judgment, serve to adequately protect client interests.

[55] Adopting Release at p. 52. Although previously filed versions of an adviser's brochure will remain in the IARD system, only the most recent version of an adviser's brochure will be available to the public through the SEC's website.

[56] Adopting Release at p. 58. Advisers that are also registered as broker-dealers will be permitted to make use of FINRA's BrokerCheck as well as the

advisers may elect to include the supplement information in the firm's brochure, while others may choose to prepare a supplement for each supervised person, or different groups of supervised persons (e.g., all supervised persons in a particular office or work group). Brochure supplements, whether provided in a brochure or separately, are required to be organized in the same order and under the same headings as the Items appear in the form to promote comparability.[57]

Required Items. The brochure supplement consists of the following six Items:

Item 1. Cover Page

The cover page must include information identifying the supervised person(s) covered by the supplement as well as the advisory firm. This information may appear on a separate cover page or on the top of the first page of the brochure supplement.

Item 2. Educational Background and Business Experience

Item 2 of the supplement requires a description of the supervised person's formal education and his or her business background for the past five years.[58] If an adviser discloses a professional designation under Item 2 of the supplement, the supplement must also provide a sufficient explanation of the minimum qualifications the designation requires to allow clients and potential clients to understand its value.

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 and includes disciplinary events that the SEC presumes to be material if they occurred during the last ten years.[59] As discussed above, advisers that send supplements electronically are permitted to include hyperlinks to disciplinary information available through the FINRA BrokerCheck website as well as the IAPD website.[60]

Item 4. Other Business Activities

Item 4 requires an adviser to describe other business activities of its supervised persons, including other capacities in which the supervised person participates in any investment-related business and any material conflicts of interest such participation may create. The item must disclose information about any compensation, including bonuses and noncash 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 4.B of Part 2B requires disclosure of any other business activities or occupations in which the supervised person engages if they involve a substantial amount of time and pay.[61]

Investment Adviser Public Disclosure (IAPD) website to disclose disciplinary information available on those websites when a client has received a brochure supplement electronically. The instructions for Part 2B of Form ADV provide that the adviser must disclose in a supplement delivered electronically that the supervised person has a disciplinary event and provide a hyperlink to either BrokerCheck or the IAPD system. To take advantage of this provision, the brochure supplement must be delivered electronically and must include: (i) a statement that the supervised person has a disciplinary history, the details of which can be found on BrokerCheck or the IAPD website (as the case may be); and (ii) a hyperlink to the relevant system with a brief explanation of how the client may access the adviser's disciplinary history.

[57] Supplements provided in a brochure must be included at the end of the brochure and be sequenced for each supervised person. Adopting Release at p. 55, n. 223.

[58] If the supervised person has no high school education, no formal education after high school, or no business background, the adviser must disclose this in the supplement. The business background section must identify the supervised person's positions at prior employers, rather than just listing the names of prior employers.

[59] The brochure supplement also requires disclosure by the adviser of any event for which the supervised person has ever resigned or otherwise relinquished a professional attainment, designation or license in anticipation of it being suspended or revoked (other than suspensions or revocations for failure to pay membership dues), when the adviser knew or should have known that the supervised person relinquished his or her designation or license.

[60] Adopting Release at p. 59. Because a number of supervised persons of investment advisers are also registered representatives of broker-dealer firms or are subject to state investment adviser reporting requirements, disciplinary disclosure may be available through BrokerCheck or IAPD. Permitting advisers to hyperlink to these systems could serve to minimize the costs of brochure supplements by leveraging existing infrastructure established by broker-dealer and adviser regulation. To utilize this provision, the brochure supplement must be delivered electronically and must include: (i) a statement that the supervised person has a disciplinary history, the details of which can be found on BrokerCheck or the IAPD (as the case may be); and (ii) a hyperlink to the relevant system with a brief explanation of how the client can access the adviser's disciplinary history.

[61] *See* Item 4B, Part 2B. In defining what constitutes a "substantial" amount of time and pay, the Adopting Release states that if other business activities represent less than ten percent of the supervised person's time and income, they are not substantial. This information is intended to help clients evaluate the conflicts that a supervised person's other business activities may present. The Adopting Release further explains that clients may have different expectations of an individual whose sole business is providing investment advice than of an individual who is engaged in other substantial business activities.

Item 5. Additional Compensation

Item 5 requires a description of any arrangement in which someone other than a client gives the supervised person an economic benefit (such as sales awards or other prizes) for providing advisory services.[62] Examples that trigger required disclosure include bonuses based (in whole or in part) on sales, client referrals or new accounts.

Item 6. Supervision

Item 6 requires an adviser to explain how the firm monitors the advice provided by the supervised person addressed in the brochure supplement and the name, title and telephone number of the person responsible for supervising the advisory activities of the supervised person.

B. Delivery

Part 2B requires that a client be given a brochure supplement for each supervised person who (i) formulates investment advice for that client and has direct client contact, or (ii) makes discretionary investment decisions for that client's assets, even if the supervised person has no direct client contact.[63] Although an adviser is generally required to provide its clients with a brochure supplement for each supervised person who is covered by the amendments, delivery of a supplement is not required for (i) clients to whom an adviser is not required to deliver a firm brochure (e.g., registered investment companies and business development companies), (ii) clients who receive only impersonal investment advice, and (iii) certain "qualified clients" who also are officers, directors, employees and other persons related to the adviser.[64] The supervised person's supplement initially must be provided to each client at or before the time when that specific supervised person begins to provide advisory services to that specific client.[65]

C. Updating

Advisers must deliver an updated supplement to clients only when there is new disclosure of a disciplinary event, or a material change to disciplinary information already disclosed, in response to Item 3 of Part 2B.[66] As is required for the brochure, advisers must amend a brochure supplement if information in it becomes materially inaccurate, and any new clients to whom the adviser is obligated to deliver a supplement under the amended rule must be given an amended supplement (or the "old" supplement and a sticker). Supplements (like brochures) may be delivered on paper or electronically.

D. Filing Requirements, Public Availability

Advisers are not required to file brochure supplements or to supplement amendments with the SEC, and these items will not be available on the SEC's public website. Advisers are, however, required to maintain copies of all supplements and any amendments in their files. Brochure filings on the IARD website will be submitted in text-searchable Adobe Portable Document Format ("PDF"). Advisers must create their brochure on their own computers, convert the file to a PDF, and then attach the completed document to their filing on the IARD, in the same way that a document is attached to an e-mail. When updating brochures, advisers must make the necessary changes to the source file on their own computer and then attach the revised version to their IARD filing. The IARD will not accept an annual updating amendment without an updated brochure. The annual updating amendment must also include a representation by the adviser that the brochure does not contain any materially inaccurate information or a representation that the adviser does not have to prepare a brochure because it does not

[62] Adopting Release at p. 61. Bonuses based in part or in whole on sales, client referrals or new accounts would trigger disclosure, whereas other bonuses do not. Regular salaries need not be disclosed.

[63] The requirement under this Item has been modified to track the approach to disclosure for mutual fund portfolios. If investment advice is provided by a team of more than five supervised persons, a brochure supplement is required only for the five supervised persons with the most significant responsibility for the day-to-day advice provided to the client. *See* Adopting Release at p. 64.

[64] Advisers that do not have any clients to whom a supplement would have to be delivered and advisers with supervised persons who do not have clients to whom a supplement must be delivered will not be required to prepare supplements.

[65] The Adopting Release states that the timing of the delivery requirement is intended to assist investors in determining whether to retain the services of a particular adviser and in evaluating the individual investment advice they are receiving.

[66] The Adopting Release notes that because the final rule allows advisers to reference BrokerCheck or IAPD for disclosure of a supervised person's disciplinary information when the supplement is delivered electronically, if the supplement refers to BrokerCheck or IAPD websites a change in disclosure required by Part 2B would require the adviser to electronically deliver an updated supplement (or sticker) to clients when either database has been updated with new disclosure of a disciplinary event, or a material change to disciplinary information has already been disclosed, with the update supplement (or sticker) indicating that the disciplinary information for the supervised person has changed and providing a hyperlink to BrokerCheck or IAPD.

have to deliver a brochure to any clients (e.g., the adviser's clients are limited to registered investment companies).[67]

Practice Tip:

Advisers should designate a point person or group for organizing information needed for the brochure supplement and drafting the brochure supplement. Advisers will need to develop procedures for amending, updating and delivering the brochure supplement and will need to update compliance manuals to reflect these changes.

IV. Recordkeeping

The Adopting Release also includes amendments to Rule 204-2 under the Advisers Act, which now requires registered advisers to retain copies of each brochure, each brochure supplement and each amendment to the brochure and supplements.[68] As discussed above, registered advisers must prepare and preserve documentation of the method they use to calculate managed assets for purposes of Item 4.E in Part 2A of Form ADV, if that method differs from the method used to calculate "assets under management" in Part 1A of Form ADV. The amendments also require advisers to prepare and preserve a memorandum describing any legal or disciplinary event listed in Item 9 of Part 2A and Item 3 of Part 2B for the period the event is presumed to be material, if the event is not disclosed in the adviser's brochure or relevant brochure supplement. These records will be required to be maintained in the same manner, and for the same period of time, as other books and records required to be maintained under Rule 204-2(a).

[67] The IARD will not accept an annual updating amendment without a representation that the summary of material changes is attached as an exhibit to or included in the updated brochure or a representation that no summary of material changes is required because there have been no material changes to the adviser's brochure since its last annual updating amendment. If the adviser's summary of material changes is a separate document, the adviser must attach the summary as an exhibit to its brochure and upload the brochure and summary in one single, text-searchable, PDF file on IARD.

[68] Advisers must also maintain a copy of the summary of material changes and a record of the dates when each brochure, amendment and summary of material changes was given to any client.

V. Effective and Compliance Dates

A. Firm Brochure

New Advisers. Any adviser applying for registration with the SEC after January 1, 2011 must prepare and file a brochure or brochures that meet the new requirements of Part 2A of Form ADV.

Existing Advisers. An adviser that is currently registered with the SEC with a fiscal year that ends on or after December 31, 2010 must include the information required by revised Part 2 in its next annual updating amendment to its Form ADV. An adviser with a fiscal year end of December 31, 2010 must file an annual updating amendment under the new form no later than March 31, 2011 and deliver the brochure to its existing clients within 60 days of filing such amendment. Following the initial filing, the adviser must deliver to new clients and prospective clients a new brochure to satisfy its obligations under the brochure rule.

B. Brochure Supplement

New Advisers. Advisers applying for registration 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 brochure supplements to existing clients.

Existing Advisers. Existing registered advisers having a fiscal year ending on December 31, 2010 through April 30, 2011 have until July 31, 2011 to begin delivering brochure supplements to new and prospective clients and until September 30, 2011 to deliver brochure supplements to existing clients.

* * * *

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