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**SEC Adopts Final Amendments to Form ADV, Part 2**

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The Securities and Exchange Commission (the “Commission”) voted unanimously to adopt changes to Form ADV, Part 2 – commonly referred to as the “brochure” - that SEC-registered investment advisers must provide to their clients and prospective clients.<sup>1</sup> Such changes not only expand the content of Form ADV, Part 2 but also impose new obligations on registered investment advisers with regards to the delivery and availability of Form ADV, Part 2. The adopted changes to Form ADV, Part 2 also affect state-registered investment advisers because the Commission staff is working with the states to publish a uniform SEC-state form.

According to the Commission, Form ADV, Part 2’s current format of multiple choice and “check-the-box/fill-in-the-blank questions” “frequently does not correspond well to an adviser’s business” and “may not describe the adviser’s business or conflicts in a user-friendly manner.” The current amendments change this “check-the-box” format and, instead, require registered investment advisers to provide new and prospective clients with narrative brochures that are organized in a consistent, uniform manner and that include plain English disclosures of the adviser’s business practices, fees, conflicts of interest and disciplinary information.

Regarding delivery of Form ADV, Part 2, the amendments require the electronic filing of Part 2 in the same manner as Part 1. Currently, Part 2 is delivered to new and prospective clients only, but will from now on be publicly available on the Commission’s website.

The amended rules and forms are expected to be published in the next several days. We have highlighted the changes and new obligations below and will circulate a more comprehensive client alert after the amended rules and forms are published.

**Delivery and Electronic Filing of Form ADV, Part 2, Annual Summary of Material Changes and “Brochure Supplements”**

Currently, registered investment advisers must deliver Form ADV, Part 2 to a client at least 48 hours prior to entering into an advisory contract, or at the time of entering into the contract if the client has the right to terminate the contract without penalty within five business days thereafter.<sup>2</sup> Under the amended rules, the Commission simply requires that

<sup>1</sup> *SEC Approves Disclosure Form Changes to Provide Investors Greater Information About Their Investment Advisers*, SEC Press Release (July 21, 2010). See also *Amendments to Form ADV*, SEC Release No. 2711 (Mar. 3, 2008) (“Release No. IA-2711”) and *Electronic Filing by Investment Advisers; Proposed Amendments to Form ADV*, SEC Release No. 1862 (Apr. 5, 2000).

<sup>2</sup> Rule 204-3 under the Investment Advisers Act of 1940, as amended.

advisers deliver the brochure before or at the time of entering into the advisory agreement.<sup>3</sup> Moreover, under the new rules, such advisers will also be required to file electronically Part 2 which will be publicly available on the Commission's website. The Commission anticipates that this will enable investors to compare brochures of several advisers and to make the best possible informed choice.

In addition, investment advisers will be required to provide each client with two new documents. First, they must provide an annual summary of material changes to Form ADV, Part 2 and must either deliver a complete updated Part 2 or offer to provide the client with the updated brochure.<sup>4</sup> Investment advisers must also deliver interim updates of Part 2 to their clients when a material change occurs with respect to disciplinary information.

Second, advisers must provide new and prospective client with "brochure supplements" which will furnish information about the specific individuals who will provide services to the clients. Currently, investors receive only information about the advisory firm and the education and business background of individuals who determine general investment advice and the firm's principal executive officers;<sup>5</sup> under the amended rules, investors will now receive information about the specific individuals they will be directly dealing with. This new obligation will be particularly significant for clients of large advisory firms who employ many employees that perform advisory services. The supplements will contain brief résumé-like disclosure about the educational background, business experience, other business activities, and disciplinary history of the individuals, so that the client can assess their background and qualifications. Such supplements will also include contact information for the individual's supervisor in case the client has a concern about the person. The "brochure supplement" will be delivered to new and prospective clients before the individuals in question start delivering investment services. Such supplements will not be filed electronically (although Commissioner Elisse B. Walter has proposed the electronic filing of these supplements as well and the Commission may reconsider its position at a later date).

## **Expanded Content**

Amended Form ADV, Part 2 will require registered investment advisers to include the following disclosures about themselves:

- **Advisory business** - An investment adviser must describe its advisory business, including the types of advisory services offered, state whether it holds itself out as specializing in a particular type of advisory service, and disclose the amount of client assets that it manages.
- **Fees and compensation** - An investment adviser must describe how it is compensated for its advisory services, provide a fee schedule, and disclose whether fees are negotiable. The investment adviser must also describe the types of other fees or expenses, such as brokerage fees, custody fees, and fund expenses that clients may pay in connection with the services provided.
- **Performance-based fees and side-by-side management** - An investment adviser that accepts performance-based fees, or that supervises an individual who accepts such fees, is required to disclose this fact. If the investment adviser also manages accounts that are not charged a performance fee, the adviser must explain the conflicts of interest that arise from the simultaneous management of these accounts and must describe how it addresses those conflicts.
- **Methods of analysis, investment strategies and risk of loss** - An investment adviser must describe its methods of analysis and investment strategies and explain that investing in securities involves risk of loss which clients should be prepared to bear. Investment advisers who use a particular method of analysis or strategy or who

<sup>3</sup> See Release No. IA-2711, note 135. We expect the Commission to clarify this requirement in the final release.

<sup>4</sup> Under current rules, Rule 204-1 requires an adviser registered with the Commission to annually revise its Form ADV, including its brochure, within 90 days of its fiscal year end.

<sup>5</sup> See Form ADV, Part 2, item 6.

recommend a particular type of security are required to explain the material risks involved and discuss the risks in detail if those risks are unusual.

- **Disciplinary information** - An investment adviser is required to disclose in its brochure material facts about any legal or disciplinary event that is material to a client's evaluation of the advisory business or to the integrity of its management personnel. An investment adviser must deliver promptly to clients updated information when there is new disclosure of a disciplinary event or a material change to an existing disciplinary event.
- **Code of ethics, participation or interest in client transactions and personal trading** - An investment adviser is required to describe briefly its code of ethics and state that a copy is available upon request. The adviser must also disclose whether it or an affiliate recommends to clients, or buys or sells for client accounts, securities in which the adviser or an affiliate has a material financial interest and, if so, the conflicts of interest associated with that practice. The adviser also must disclose whether it or an affiliate invests (or is allowed to invest) in the same securities that it recommends to clients or in related securities, such as options or other derivatives, and must explain the conflicts involved and how it addresses those conflicts. In addition, an investment adviser that trades in the recommended securities at or around the same time as the client has to explain the specific conflicts inherent in that practice and how it addresses them.
- **Brokerage practices** - An investment adviser is required to describe the factors considered in selecting or recommending broker-dealers for client transactions and determining the reasonableness of brokers' compensation. Investment advisers also must disclose soft dollar practices (research or other products or services, other than execution, provided by brokers or a third party to the investment adviser in connection with client transactions); client referrals (using client brokerage to compensate brokers for client referrals); directed brokerage (asking or permitting clients to send trades to a specific broker for execution); and trade aggregation (bundling trades to obtain volume discounts on execution costs). Investment advisers must explain how they address the various conflicts of interest associated with these practices.

### **Impact on State-Registered Investment Advisers**

The Commission staff is working with the states to accommodate technical, state-specific changes to the items and instructions of the form. When published in its final format, amended Form ADV, Part 2 will be a uniform SEC-state form.

### **Effective Date**

The amended rules and forms will be effective 60 days after publication in the Federal Register. The Commission expects most investment advisers to begin distributing and publicly posting Form ADV, Part 2 in its amended format in the first quarter of 2011.<sup>6</sup>

### **Impact on Hedge Fund Managers**

In light of the emphasis on fees and compensation, conflicts of interest, risk disclosures and brokerage practices, registered hedge fund managers should review their operations and practices to determine the adequacy of their current disclosures and narratives in Form ADV, Part 2 under the amended rules.<sup>7</sup> Private fund advisers that are currently unregistered but find themselves having to register under the newly adopted Dodd-Frank Wall Street Reform and

<sup>6</sup> Advisers that register with the Commission during the fourth quarter of 2010 will likely be required to use and deliver the amended format of Form ADV, Part 2.

<sup>7</sup> See Release No. IA-2711, note 53.

Consumer Protection Act should also review their operations and practices as a first step towards drafting disclosures about their business and practices.<sup>8</sup>

If you have any questions regarding this client alert, or require assistance with any other issue relating to private funds and investment advisory issues, please contact the authors Roderick J. Cruz (rc@garritygraham.com; (973) 576-9615) and Linda Smith (ls@garritygraham.com; (973) 576-9614), or any of the members of the Investment Management practice group:

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<sup>8</sup> See Title IV (the “Private Fund Investment Adviser Registration Act of 2010”) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”). An investment adviser that acts solely as an adviser to private funds (i.e., an issuer that would be an investment company as defined in section 3 of the Investment Company Act of 1940, as amended, but for section 3(c)(1) of 3(c)(7) of that Act) and has assets under management in the United States of less than \$150 million is exempt from federal registration as an investment adviser. See Section 408 of the Dodd-Frank Act. Note that a “foreign private adviser” that (i) has no place of business in the United States; (ii) has, in total, fewer than 15 clients and investors in the United States in private funds advised by such adviser; and (iii) has aggregate assets under management attributable to clients in the United States and investors in the United States in private funds advised by such adviser of less than \$25 million, is exempt from federal registration as an investment adviser. See Section 402(a) of the Dodd-Frank Act.



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