

March 13, 2008

## Form ADV Part 2 Proposal

On February 13, 2008, the Securities and Exchange Commission (the "Commission") proposed amendments to Form ADV Part II and certain rules under the Investment Advisers Act of 1940, as amended (the "Advisers Act"), which would significantly alter the manner and form in which investment advisers registered with the Commission disclose information about their operations to clients and prospective clients. The Commission published the proposed Form ADV Part II and rule amendments in a release on March 3, 2008.<sup>1</sup> The Commission's proposed amendments are a significant departure from the amendments to Form ADV Part II that were proposed in 2000 but were never approved.<sup>2</sup> Comments on the proposed amendments are due by May 16, 2008.

### Overview

Two new disclosure documents would be created: a brochure ("Brochure") and a brochure supplement (the "Supplement"). The Brochure would replace the cumbersome check-the-box Part II and Schedule F disclosure forms with a brochure that, in narrative form, describes an adviser's services, fees, business practices and conflicts of interest with clients. The Supplement would provide specific information about the advisory personnel on whom clients rely for investment advice. Both documents would have to be written in plain English. Additionally, the proposed amendments would continue to require advisers that sponsor wrap programs to prepare and deliver a specialized firm brochure ("Wrap Program Brochure") to clients of the wrap program in lieu of the standard Brochure. The Brochure, Wrap Program Brochure, and Supplement would contain the information required by new Form ADV Part 2A, new Form ADV Part 2A Appendix 1, and new form ADV Part 2B, respectively.

### Filing Mechanics

The proposed amendments would change how advisers file their Form ADV. Brochures would be filed electronically with the Commission through the Investment Adviser Registration Depository ("IARD"). Once filed, the Brochure would then be available to the public through the Commission's Investment Adviser Public Disclosure ("IAPD") website, as is currently the case with Form ADV Part I. Importantly, the proposed amendments would not require advisers to file their Supplements electronically through the IARD.

### Delivery Requirements

Under the proposed amendments an investment adviser would be required to deliver a current Brochure before or at the time of entering into an advisory contract with a client.<sup>3</sup> Consistent with current

---

<sup>1</sup> See Inv. Advisers Act Rel. No. 2711 (March 4, 2008) (the "Release").

<sup>2</sup> See Inv. Advisers Act Rel. 1862 (Apr. 5, 2000).

<sup>3</sup> Currently, Brochure delivery must occur 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. See current Rule 204-2 under the Advisers Act.

requirements, advisers would not be required to deliver brochures to (1) certain advisory clients receiving only impersonal investment advice,<sup>4</sup> or (2) clients that are mutual funds or other registered investment companies. The proposed amendments would extend the latter exception to business development companies. In addition, if an adviser does not have any clients to whom a Brochure is required to be delivered, the adviser would not have to prepare a Brochure.

## Brochure Updates

In a notable change from the current delivery obligation in Rule 204-3 under the Advisers Act, the proposed amendments would require advisers to deliver to existing clients a current Brochure at least once each year within 120 days after the end of their fiscal year, as well as a summary of any material changes to their Brochure since the last annual update. The summary may appear on the cover page of the Brochure (or immediately thereafter), or in a separate letter that accompanies the Brochure. As with the initial Brochure, the proposed amendments would require that advisers file their annual update Brochures electronically through the IARD. However, the annual summary would neither be required to be filed with the Commission nor required to be provided to new clients who have not received a previous version of an adviser's Brochure.

In addition to the annual updates, advisers would be required to deliver an interim update (*i.e.*, an update between annual update amendments) to clients if their Brochures are amended to add or materially change information relating to a disciplinary event. Consistent with current requirements, the proposed amendments would also require that an adviser update its Brochure promptly when any information in its brochure becomes materially inaccurate. In addition, the Commission also notes in the Release that advisers, as fiduciaries, have an ongoing obligation to inform their clients of any material information that could affect the advisory relationship. Therefore, advisers may be required to disclose material changes to clients between annual updating amendments even if those changes do not trigger delivery of a required interim update to their Brochures.

## The Brochure Supplement

One of the most significant changes from the current disclosure rules is the new requirement that Supplements accompany the adviser's Brochure. The Supplement would provide information about the advisory personnel on whom clients rely for investment advice. The Commission envisions that the Supplement would ordinarily be less than a page long.<sup>5</sup>

An adviser would have to prepare and deliver a Supplement for each supervised person who: (1) formulates investment advice for that client and has direct client contact; or (2) makes discretionary investment decisions for that client's assets, even if the supervised person has no direct client contact.<sup>6</sup>

---

<sup>4</sup> Advisers would not be required to deliver Brochures to advisory clients receiving only impersonal investment advice for which the adviser charges less than \$500 per year. The current dollar amount is \$200.

<sup>5</sup> The Commission suggested that advisers could prepare a Supplement for each supervised person or prepare separate Supplements for different groups of supervised persons, such as all supervised persons in a particular office or group.

<sup>6</sup> Where a supervised person provides discretionary advice only as part of a team and has no direct client contact, an adviser would not have to provide a supplement for the supervised person.

However, advisers are exempt from the Supplement delivery requirement with respect to the following four types of clients:

- Clients to whom an adviser is not required to deliver a Brochure (e.g., registered investment companies);
- Clients who receive only impersonal investment advice;<sup>7</sup>
- Clients who are “qualified purchasers;”<sup>8</sup> and
- Certain “qualified clients” who also are officers, directors, employees, and other persons related to the adviser.<sup>9</sup>

If an adviser does not have any clients to whom a Supplement would have to be delivered, it need not prepare any Supplements. Likewise, an adviser need not prepare a Supplement for any supervised person who does not have clients to whom the adviser must deliver a Supplement.

Where applicable, the adviser would have to provide a supervised person’s Supplement to the client at or before the time that supervised person begins to provide advisory services to that client. However, unlike the proposed filing requirement for the Brochure, the proposed amendments would not require advisers to file Supplements or Supplement amendments with the Commission, and therefore Supplements would not be available publicly on the IAPD.<sup>10</sup> In addition, unlike the proposed delivery requirement for Brochures, advisers would not have to annually deliver updated Supplements to clients. However, the proposed amendments would require advisers to update their Supplements if the information contained therein becomes materially inaccurate. In such instances, new clients that are required to receive a Supplement would have to be given the amended version (or the “old” Supplement and a sticker) of the Supplement. Finally, where advisers have delivered a Supplement to existing clients, the proposed amendments would require such advisers to deliver an updated Supplement to their existing clients only to disclose a new disciplinary event or a material change to disciplinary information already disclosed.<sup>11</sup>

## Wrap Fee Program Brochure

The proposed disclosure item requirements for a Wrap Program Brochure would be located in the proposed Appendix 1 to Part 2A. These items would be substantially similar to those currently in Schedule H of Form ADV Part II. However, the Release proposes that the Wrap Program Brochure also disclose: (i) whether any of the adviser’s related persons are portfolio managers in the program, and a description of the conflicts that may be present; and (ii) whether related person portfolio managers are subject to the same selection and review as the other portfolio managers who participate in the wrap program and, if they are not, how they are selected and reviewed.

---

<sup>7</sup> This exception, unlike its analog for Brochure delivery, does not depend on the cost of the impersonal advisory services involved.

<sup>8</sup> “Qualified purchasers” is defined in section 2(a)(51)(A) of the Investment Company Act of 1940, as amended.

<sup>9</sup> “Qualified clients” is defined in Rule 205-3(d)(iii) under the Advisers Act.

<sup>10</sup> An adviser would be required, however, to maintain copies of all Supplements and applicable amendments in its files.

<sup>11</sup> As fiduciaries, advisers have an ongoing obligation to inform their clients of any material information that could affect the advisory relationship. As a result, advisers may be required to disclose material changes to clients even if those changes do not trigger a disclosure obligation under the Form ADV.

## Highlights of Proposed Brochure and Supplement Requirements

Part 2A sets forth 20 topics or items that an investment adviser must discuss in its Brochure. An investment adviser may omit responses to items that do not apply to its business. The investment adviser may order the responses in its Brochure in any way it chooses.

The following table contains a summary of the key items in proposed Part 2A.

Form ADV Part 2A Item	Material Requirements – Brochure
Item 2 - Material Changes	<ul style="list-style-type: none"> <li>▪ Provide clients with annual summary of any material changes to their Brochures since the last annual update.</li> <li>▪ Summary would appear on the cover page of the brochure (or immediately thereafter), or could be included in a separate letter that accompanied the Brochure.</li> <li>▪ Annual summary would <u>not</u> be required to be filed with the Commission nor required to be provided to new clients.</li> </ul>
Item 4 - Advisory Business	<ul style="list-style-type: none"> <li>▪ Describe advisory business, including 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 it manages.</li> <li>▪ Method to compute managed client assets may differ from the method used in Form ADV Part IA to report “assets under management.”</li> <li>▪ Do not have to list all wrap fee programs in which adviser participates and do not have to list and describe all periodicals or periodic reports that an adviser issues about securities.</li> </ul>
Item 5 - Fees and Compensation	<ul style="list-style-type: none"> <li>▪ Describe how adviser is compensated for providing advisory services 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 provided to them by the adviser.</li> <li>▪ Disclose fee schedule, whether fees are negotiable and billing practices.</li> <li>▪ For advisers that receive compensation attributable to the sale of a security or other investment product (e.g., brokerage commissions), or whose personnel receive such compensation:               <ul style="list-style-type: none"> <li>○ Disclose this practice, the conflict of interest it creates and describe how the adviser addresses the conflict; and</li> <li>○ Disclose that the client may purchase the same security or investment products from brokers that are not affiliated with that adviser.</li> </ul> </li> <li>▪ If more than half of an adviser’s revenue is from commissions and other sales-based compensation, explain that commissions are the firm’s primary (or, if applicable, exclusive) form of compensation.</li> <li>▪ An adviser that charges both advisory fees and commissions must disclose whether it reduces its fees to offset the commissions.</li> </ul>
Item 6 - Performance Fees and Side-by-Side Management	<ul style="list-style-type: none"> <li>▪ For advisers that charge performance fees (or who have a supervised person who manages an account that charges such fees), disclose this fact.</li> <li>▪ For such advisers that also manage accounts that are <i>not</i> charged a performance fee, discuss the conflict that arise from its (or its supervised persons) simultaneous management of these accounts, and describe generally</li> </ul>

Form ADV Part 2A Item	Material Requirements – Brochure
	how the adviser addresses these conflicts.
Item 8 - Methods of Analysis, Investment Strategies and Risk of Loss	<ul style="list-style-type: none"> <li>▪ Describe methods of analysis and investment strategies.</li> <li>▪ Discuss the risks clients face in following adviser’s advice or permitting the adviser to manage assets.</li> <li>▪ Where an adviser uses primarily a particular method of analysis, strategy, or type of security, explain the specific material risks involved, with more detail if those risks are significant or unusual.</li> <li>▪ Disclose how strategies involving frequent trading can affect investment performance.<sup>12</sup></li> <li>▪ Discuss practices regarding cash balances in client accounts:               <ul style="list-style-type: none"> <li>○ Concise, general explanation of adviser’s practice with respect to situations in which a particular client has not provided the adviser specific directions for handling cash balances.</li> </ul> </li> </ul>
Item 9 - Disciplinary Information	<ul style="list-style-type: none"> <li>▪ Disclose material facts about any legal or disciplinary event that is material to a client’s evaluation of the integrity of the adviser or its management:               <ul style="list-style-type: none"> <li>○ Part 2A would contain a list of disciplinary events that are presumptively material if they occurred in the previous 10 years.<sup>13</sup></li> <li>○ Advisers would be permitted to rebut the presumption, in which case no disclosure would be required. However, an adviser rebutting a presumption of materiality must document the determination in a memorandum and retain that record in order to permit SEC staff to monitor compliance with this disclosure requirement.<sup>14</sup></li> </ul> </li> </ul>
Item 10 - Other Financial Industry Activities and Affiliations	<ul style="list-style-type: none"> <li>▪ Describe material relationships or arrangements the adviser (or any of its management persons) has with related financial industry participants, any material conflict of interest that the relationships or arrangements create, and how the adviser addresses the conflict.</li> <li>▪ If an adviser selects or recommends other advisers for clients, disclose any compensation arrangements or other business relationships between the two advisory firms, as well as the conflicts created.</li> </ul>

<sup>12</sup> The Commission did not propose a definition of “frequent trading of securities,” but instead proposed to permit advisers some flexibility in determining whether the strategies they employ involve frequent trading.

<sup>13</sup> The list would include most of the events currently presumed material under existing Rule 206(4)-(4) under the Advisers Act. Proposed Item 9 would state that the listed items are presumed to be material, but do not constitute an exhaustive list of material disciplinary events.

<sup>14</sup> Item 9 would note the following four factors an adviser should consider when assessing whether the presumption can be rebutted: (1) the proximity of the person involved in the disciplinary event to the advisory function; (2) the nature of the infraction that led to the disciplinary event; (3) the severity of the disciplinary sanction; and (4) the time elapsed since the date of the disciplinary event. These are the same factors in use under current Rule 206(4)-4 under the Advisers Act. In connection with the ADV Part 2 proposal, the Commission proposed in the Release to withdraw current Rule 206(4)-4, the rule requiring advisers to disclose certain disciplinary and financial information, because the proposed amendments would require advisers to disclose the information required by the rule in their Brochures, Wrap Program Brochures and Supplements, thus making the rule unnecessary.

Form ADV Part 2A Item	Material Requirements – Brochure
Item 11 - Code of Ethics, Participation or Interest in Client Transactions and Personal Trading	<ul style="list-style-type: none"> <li>▪ <i>Code of Ethics.</i> Describe briefly the adviser’s code of ethics and state that a copy is available upon request.</li> <li>▪ <i>Participation or Interest in Client Transactions.</i> Where adviser or a related person recommends to clients or buys or sells for clients securities in which the adviser or a related person has a material financial interest, adviser must discuss this practice and the conflicts presented.</li> <li>▪ Disclose any practices giving rise to these conflicts, the nature of the conflicts presented, and how the adviser addresses the conflicts.</li> <li>▪ <i>Personal Trading.</i> Disclosure regarding personal trading by the adviser and its personnel.</li> <li>▪ Disclose whether the adviser 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).               <ul style="list-style-type: none"> <li>○ Discuss the conflicts presented and describe how the firm addresses the conflicts.</li> <li>○ Similar disclosure is required when adviser or a related person trades in the</li> </ul> </li> </ul>

Form ADV Part 2A Item	Material Requirements – Brochure
	same securities at or about the same time as a client.
Item 12 - Brokerage Practices	<ul style="list-style-type: none"> <li>▪ Describe how adviser selects brokers for client transactions and determines the reasonableness of brokers-dealers' compensation.</li> <li>▪ <i>Soft Dollars</i>. Disclose soft dollar practices:<sup>15</sup> <ul style="list-style-type: none"> <li>○ Describe the types of products or services the adviser acquires.</li> <li>○ Describe the types of conflicts the adviser has when it accepts soft dollar benefits and how it addresses those conflicts.</li> <li>○ Explain whether adviser uses soft dollars to benefit all client accounts or only those accounts whose brokerage "pays" for the benefits, and whether the adviser seeks to allocate the benefits to client accounts proportionally to the soft dollar credits those accounts generate.</li> <li>○ Explain whether adviser "pay up" for soft dollar benefits.</li> </ul> </li> <li>▪ <i>Client Referrals</i>. Where adviser uses client brokerage to reward broker-dealers for client referrals, disclose this practice, the conflict it creates, and any procedures the adviser used to direct client brokerage to referring brokers during the last fiscal year.</li> <li>▪ <i>Trade Aggregation</i>. Describe whether and under what conditions adviser negotiates lower commissions or "bunches" trades to obtain volume discounts on execution costs.           <ul style="list-style-type: none"> <li>○ Where adviser does not bunch trades when it has the opportunity to obtain discounts, explain that clients may pay higher brokerage costs.</li> </ul> </li> <li>▪ <i>Directed Brokerage</i>. Where clients direct or agree to direct brokerage, explain that client's account will pay higher commissions and receive less favorable execution.           <ul style="list-style-type: none"> <li>○ Adviser may be unable to obtain best execution, and that directing brokerage may cost clients more money.</li> <li>○ Where adviser routinely recommends, requests or requires clients to direct brokerage, describe the practice, disclose that not all advisers require directed brokerage, and discuss any broker-dealer relationship that creates a material conflict of interest.</li> </ul> </li> </ul>
Item 13 - Review of Accounts	<ul style="list-style-type: none"> <li>▪ Disclose whether, and how often, adviser reviews clients' accounts or financial plans, and identify who conducts the review.</li> </ul>
Item 14 - Payment for Client Referrals	<ul style="list-style-type: none"> <li>▪ Describe any cash or other payment that adviser or a related person makes for client referrals.</li> <li>▪ Disclose whether adviser receives any benefit, including sales awards or prizes, from a non-client for providing advisory services to clients.</li> </ul>
Item 15 – Custody	<ul style="list-style-type: none"> <li>▪ Where adviser utilizes a qualified custodian that directly sends account statements to clients, explain that clients will receive these statements from their custodian and should review the statement carefully.</li> <li>▪ Where clients do not receive, from a qualified custodian, account statements</li> </ul>

<sup>15</sup> Disclosure must be more detailed for products or services that do not qualify for the safe harbor in Section 28(e) of the 1934 Securities Exchange Act of 1934, as amended.

Form ADV Part 2A Item	Material Requirements – Brochure
	covering all of securities and funds over which the adviser has custody, disclose that it has custody and explain the risks that clients will face as a result.
Item 16 - Investment Discretion	<ul style="list-style-type: none"> <li>▪ Where an adviser has discretionary authority over client accounts, disclose such arrangements and any limitations clients may (or customarily do) place on this authority.</li> </ul>
Item 17 - Voting Client Securities	<ul style="list-style-type: none"> <li>▪ Disclose adviser's proxy voting practices.</li> <li>▪ Disclose whether adviser will accept authority to vote client securities and, if so, briefly describe the voting policies they adopted.</li> <li>▪ Describe whether (and how) clients can direct the adviser to vote in a particular solicitation, how the adviser addresses conflicts of interest when it votes securities, and how clients can obtain information from the adviser on how the adviser voted their securities.</li> <li>▪ Explain that clients may obtain a copy of the adviser's proxy voting policies and procedures, upon request.</li> <li>▪ Where an adviser routinely relies on one or more third-party proxy voting services to advise them in connecting with voting client securities, list the proxy voting services that the adviser uses and describe how the adviser selects the proxy voting services.</li> <li>▪ Disclose whether the adviser permits clients to direct the use of a particular proxy voting service.</li> <li>▪ Disclose how adviser pays for proxy voting services.</li> </ul>
Item 18 - Financial Information	<ul style="list-style-type: none"> <li>▪ Where adviser requires or solicits prepayment of more than \$1,200 in fees, 6 months or more in advance, adviser must provide clients an audited balance sheet showing the adviser's assets and liabilities at the end of its most recent fiscal year.</li> <li>▪ Where 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 six months or more in advance, disclose any financial condition reasonably likely to impair adviser's ability to meet contractual commitments to clients.</li> <li>▪ Where adviser has been the subject of a bankruptcy petition during the past ten years, disclose this fact.</li> </ul>

The other items of proposed Part 2A are: Item 1 – Cover Page; Item 3 – Table of Contents; Item 7 – Types of Clients; Item 19 – Index; and Item 20 – Requirements for State-Registered Advisers.

Part 2B sets forth 11 topics or items that an investment adviser must discuss in its Brochure Supplements. Like the Brochure, an investment adviser could omit items from its Brochure Supplements that do not apply, and order its responses in any way it chooses.

The following table contains a summary of the items in proposed Part 2B.

Form ADV Part 2B Item	Material Requirements - Supplement
Item 2 - Educational Background and Business Experience	<ul style="list-style-type: none"> <li>▪ Describe the supervised person's formal education and his/her business background for the past five years. Where supervised person has no formal education after high school or has no business background, disclose this fact.<sup>16</sup></li> <li>▪ No requirement to describe professional designations or attainments.<sup>16</sup></li> </ul>
Item 3 - Disciplinary Information	<ul style="list-style-type: none"> <li>▪ Disclose any legal or disciplinary event that is material to a client's evaluation of the supervised person's integrity.<sup>17</sup></li> <li>▪ Need to disclose a proceeding that revoked or suspended supervised person's professional attainment, designation, or license only if the action was a result of a violation of rules relating to professional conduct.</li> <li>▪ Describe any event over which supervised person has ever resigned or otherwise relinquished a professional attainment, designation or license in anticipation of it being suspended or revoked.</li> </ul>
Item 4 - Other Business Activities	<ul style="list-style-type: none"> <li>▪ Disclose other capacities in which a supervised person participates in any investment-related business and any related conflicts of interest.</li> <li>▪ Disclose information about any compensation, including bonuses and non-cash compensation, the supervised person receives based on the sales of securities, as well as an explanation of the incentives this type of compensation creates.</li> <li>▪ Disclose <i>other</i> business activities or occupations that the supervised person engages in for pay.               <ul style="list-style-type: none"> <li>○ Disclosure of other investment-related activities is <u>not</u> limited to those characterized as "substantial."</li> <li>○ Disclosure of other <i>non</i>-investment-related business activities is limited to activities or occupations that: (i) provide a substantial source of the supervised person's income, or (ii) involve a substantial amount of the supervised person's time.<sup>18</sup></li> </ul> </li> </ul>
Item 5 - Additional Compensation	<ul style="list-style-type: none"> <li>▪ Describe arrangements in which someone other than the client gives the supervised person an economic benefit (such as a sales award or other prize) for providing advisory services.</li> </ul>
Item 6 - Supervision	<ul style="list-style-type: none"> <li>▪ Explain how adviser monitors advice provided by its supervised persons.</li> <li>▪ Provide name, title, and telephone number of person responsible for supervising the advisory activities of supervised person.</li> </ul>

<sup>16</sup> Advisers would be permitted to include information about professional designations and attainments in the Supplement if they so choose.

<sup>17</sup> This disciplinary information disclosure requirement for the Supplement is substantially the same as that proposed to be disclosed in an adviser's Brochure.

<sup>18</sup> The SEC staff states in the Release that "substantial" for purposes of this item is not defined in order to allow "some flexibility for advisers to determine whether their supervised persons' non-investment related business provides a substantial source of income or involves a substantial amount of time."

The other items of proposed Part 2B are: Item 1 – Cover Page; Item 7 – Client Information Provided to Portfolio Managers; Item 8 – Client Contact with Portfolio Manager; Item 9 – Additional Information; Item 10 – Index; and Item 11 – Requirements for State-Registered Advisers.

## Transition Period

If the proposed amendments are adopted as proposed, existing investment advisers registered with the Commission would be required to comply with the new Part 2 requirements by the date they must make their next annual updating amendment to Form ADV following the date the revised form becomes effective. However, advisers would not be required to comply with the new form requirements earlier than six (6) months after the proposed amendments become effective.

If the proposed amendments are adopted as proposed, new adviser applicants would not be required to include their Brochures as part of their initial application for registration until the date six months after the effective date of the amendments. After that time, the Commission would require that all initial adviser registration applications include a Brochure that satisfies the requirements of Form ADV Part 2A.



*If you are interested in more information about this development, or any of the services we provide, please contact any of the following attorneys:*

Eric A. Arnold	202.383.0741	<a href="mailto:eric.arnold@sutherland.com">eric.arnold@sutherland.com</a>
Eric C. Freed	212.389.5055	<a href="mailto:eric.freed@sutherland.com">eric.freed@sutherland.com</a>
Jon K. Hadfield	202.383.0878	<a href="mailto:jon.hadfield@sutherland.com">jon.hadfield@sutherland.com</a>
Clifford E. Kirsch	212.389.5052	<a href="mailto:clifford.kirsch@sutherland.com">clifford.kirsch@sutherland.com</a>
Michael B. Koffler	202.383.0106	<a href="mailto:michael.koffler@sutherland.com">michael.koffler@sutherland.com</a>
Susan S. Krawczyk	202.383.0197	<a href="mailto:susan.krawczyk@sutherland.com">susan.krawczyk@sutherland.com</a>
Bibb L. Strench	202.383.0509	<a href="mailto:bibb.strench@sutherland.com">bibb.strench@sutherland.com</a>