

SEC Adopts Changes to Form ADV

The Securities and Exchange Commission (the “SEC”) has adopted amendments to Part 2 of Form ADV and related rules under the Investment Advisers Act of 1940, as amended (the “Act”), to require investment advisers registered with the SEC (“RIAs”) to provide new and prospective clients (“Advisory Clients”) with a narrative brochure and brochure supplements written in plain English. The amendments expand and broaden the disclosure requirements and are intended to provide Advisory Clients with improved, clearer disclosure of the RIAs’ business practices, conflicts of interest and background, and that of its advisory personnel.¹ The SEC is requiring RIAs to file their brochures electronically and will make them available to the public through the SEC Web site. The SEC also is withdrawing Rule 206(4)-4 under the Act, which requires RIAs to disclose certain disciplinary and financial information.

Effective Dates – The amendments will be effective 60 days after publication in the Federal Register. The SEC expects that most investment advisers will begin distributing and publicly posting new brochures in the first quarter of 2011. New investment advisers applying for SEC registration after January 1, 2011 must file a brochure that meets the requirements of the amended Part 2A as part of the application for registration on Form ADV. An existing RIA with a fiscal year end of December 31, 2010 or later, must include in its next annual updating amendment to its Form ADV a brochure that meets the requirements of the amended form. Therefore, RIAs with a fiscal year end of December 31, 2010 must file an annual updating amendment with the new brochures no later than March 31, 2011.

Costs – The SEC acknowledges that the new narrative brochure will entail additional expenses, particularly in connection with its initial drafting. The SEC, however, does not expect advisers to face substantial costs in gathering the required disclosure information. Many commenters disagree, however. Commenters on the proposed rules had estimated that preparing the initial Form ADV Part 2 would require between 15 and 60 hours on average for small firms. Based on such comments, the SEC now estimates that the average initial burden associated with preparing the new Form ADV Part 2 is 15 hours for small advisers, 97.5 hours for medium-sized advisers, and 1,989 hours for each large adviser. This does not include the time required for an investment adviser to collect the information required by the Form ADV. Suffice it to say that many commenters believe that the SEC’s estimates are still too low and that the costs associated with preparing the new brochure may be substantial.

Summary of Changes

Form ADV is the basic disclosure document for advisers to use to satisfy their disclosure obligations under the Act and under state securities laws. The form has two parts. Part 1 (A and B) of Form ADV provides the SEC and state regulators with information to register advisers and manage their regulatory and examination programs. Part II (to be changed to “Part 2”) of Form ADV, which is known as the brochure, contains certain disclosure that advisers must provide to prospective clients initially and to existing clients annually. The main changes to the form are as follows:

¹ While the SEC release only concerns advisers registered with the SEC, the form also is used by state regulators with respect to the state regulation of investment advisers.

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Change in Format – The format of Part II of the Form ADV was a series of multiple choice and fill-in-the blank questions organized in a “check the box” format, that was supplemented in some cases with narrative responses in the schedules to the form. As it has been revised, Form ADV is a narrative brochure that is to be written in plain English.

Disclosure Topics – The revised form includes additional disclosure requirements, the most noteworthy of which are described below:

- **Item 2 – Material Changes:** An adviser amending the brochure will now be required to identify and discuss material changes since the last annual update.
- **Item 3 – Table of Contents:** The form must include a table of contents in a specified and uniform format.
- **Item 4 – Advisory Business:** This item requires each adviser to describe its advisory business, including the types of advisory services offered, whether it holds itself out as specializing in a particular type of advisory service, and the amount of client assets that it manages.² As it has been revised, the form broadens and expands on the disclosure previously required by Item 1A of the old form by eliciting disclosure of whether advisory services are tailored to the individual needs of clients, and whether clients may impose restrictions on investing in certain securities or types of securities. In computing the amount of client assets that it manages, an adviser may use a method that differs from the method used in Part 1A of Form ADV to report “assets under management.” An adviser opting to use a different method must keep documentation describing the method used. This item also asks advisers that participate in wrap fee programs to disclose that they receive a portion of the wrap fee and to describe the differences between how they manage wrap accounts versus how they manage other accounts.
- **Item 5 – Fees and Compensation:** Item 5 of the new form requires that an adviser describe in its brochure how it is compensated for its advisory services, provide a fee schedule, and disclose whether fees are negotiable. As it has been revised, this item of the form also broadens and expands on the disclosure previously required

by Item 1A of the old form by eliciting more detailed and specific disclosure than was required under the old form. An adviser must disclose whether it bills clients or deducts fees directly from clients’ accounts, and how often it assesses fees (or bills clients). The item also requires each adviser to 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. An adviser charging fees in advance must explain how it calculates and refunds prepaid fees when a client contract terminates. Item 5 also requires an adviser that receives compensation attributable to the sale of a security or other investment product (e.g., brokerage commissions), or whose personnel receive such compensation, to disclose this practice and the conflict of interest it creates, and to describe how the adviser addresses this conflict. Such an adviser also must disclose that the client may purchase the same security or investment product from a broker that is not affiliated with the adviser. An adviser may omit disclosure of its fee schedule and the other information in Item 5.A in any brochure provided only to clients who are “qualified purchasers.”

- **Item 6 – Performance-Based Fees and Side-by-Side Management:** Item 6 also expands on the disclosure in Form ADV by requiring an adviser that charges performance-based fees or that has a supervised person who manages an account that pays such fees to disclose this fact. If such an adviser also manages accounts that are not charged a performance fee, the item also requires the adviser to discuss the conflicts of interest that arise from its (or its supervised person’s) simultaneous management of these accounts, and to describe generally how the adviser addresses those conflicts.
- **Item 8 – Methods of Analysis, Investment Strategies, and Risk of Loss:** As with Item 4 of the old form, Item 8 requires that advisers describe their methods of analysis and investment strategies. Item 8 now also requires that advisers disclose that investing in securities involves risk of loss which clients should be prepared to bear and requires specific disclosure of how strategies involving frequent trading can affect investment performance.³

² Advisers must update the amount of their assets under management annually (as part of their annual updating amendment) and make interim amendments only for material changes in assets under management when they are filing an “other than annual amendment” for a separate reason.

³ The form does not define what is considered frequent trading. In the adopting release the SEC says that “we would expect advisers to respond to this item only if their intended investment strategies involve frequent trading of securities that a reasonable client would otherwise not expect in light of the other disclosures contained in the brochure.” SEC Release No. IA-3060.

Item 8 further requires that advisers explain the material risks involved for each significant investment strategy or method of analysis they use and particular type of security they recommend, with more detail if those risks are unusual.

- **Item 9 – Disciplinary Information:** Item 9 requires that an adviser disclose in its brochure material facts about any legal or disciplinary event that is material to a client’s (or prospective client’s) evaluation of the integrity of the adviser or its management personnel. Unlike the disciplinary disclosure in Part 1 of Form ADV, this item does not elicit disclosure on disciplinary events involving advisory affiliates. The Item 9 disclosure incorporates into the brochure the client disclosure regarding disciplinary information required by Rule 206(4)-4 under the Advisers Act, which is being withdrawn.
- **Item 10 – Other Financial Industry Activities and Affiliations:** Item 10 expands upon the disclosure required in Item 8 of the old form. As revised, Item 10 requires each adviser to describe in its brochure material relationships or arrangements the adviser (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 the conflicts. In addition, if an adviser selects or recommends other advisers for clients, Item 10 requires that it disclose any compensation arrangements or other business relationships between the advisory firms, along with the conflicts created, and explain how it addresses these conflicts. The disclosure that Item 10 requires is intended to highlight the adviser’s other financial industry activities and affiliations that can create conflicts of interest and that may impair the objectivity of the adviser’s investment advice.
- **Item 11 – Code of Ethics, Participation or Interest in Client Transactions, and Personal Trading:** Item 11 expands upon the disclosure required in Item 9 of the old form by requiring more detailed disclosure including requiring an adviser to disclose whether it or its 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 so, the brochure must discuss the conflicts presented and describe how the firm addresses the conflicts.
- **Item 12 – Brokerage Practices:** Item 12 specifies the content of disclosure that the adviser is to provide with respect to certain brokerage practices, such as soft dollars, client referrals, directed brokerage, and trade aggregation. Whereas the SEC expected advisers to provide similar disclosure under the old form, Form ADV now requires specific information.
- **Item 14 – Client Referrals and Other Compensation:** Item 14 modifies the disclosure required in Item 14 of the old Form to require an adviser to describe in its brochure any arrangement under which it or its related persons compensate another person for client referrals and describe the compensation. The brochure also must disclose 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.
- **Item 15 – Custody:** Item 15, which elicits disclosure on custody that reflects the SEC’s recent amendments to Rule 206(4)-2, is new to the brochure. It requires an adviser with custody of client funds or securities to explain in its brochure that clients will receive account statements directly from the qualified custodian, such as a bank or broker-dealer that maintains those assets, and that advisers must explain to clients that they should carefully review the account statements they receive from the qualified custodian. In addition, if an adviser also sends clients account statements, the adviser’s explanation must include a statement urging clients to compare the account statements they receive from the qualified custodian with those they receive from the adviser.
- **Item 17 – Voting Client Securities:** Item 17, which requires advisers to disclose their proxy voting practices, also is new to the brochure. This item parallels rule 206(4)-6 under the Advisers Act, which, among other things, requires advisers registered with the SEC to disclose certain information about their proxy voting practices. Item 17 also requires advisers to disclose whether they have or will accept authority to vote client securities and, if so, to describe briefly their voting policies.
- **Item 18 – Financial Information:** Item 18 significantly expands upon the amount of disclosure of financial information that advisers must provide. It requires disclosure of certain financial information about an adviser when material to clients. Specifically, an adviser that requires 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 year. Item 18 also requires an adviser to disclose any financial condition reasonably likely to impair the adviser's ability to meet contractual commitments to clients if the adviser has discretionary authority over client assets, has custody of client funds or securities, or requires or solicits prepayment of more than \$1,200 in fees per client and six months or more in advance. Finally, Item 18 requires an adviser that has been the subject of a bankruptcy petition during the past 10 years to disclose that fact to clients.

- **Item 19 – Requirements for State-Registered Advisers:** Item 19 also is new to the brochure, and is only applicable to advisers that are using Form ADV to register with state securities authorities.
- **Part 2A – Appendix 1:** The Wrap Fee Program Brochure: The items in Appendix 1 to Part 2A contain the requirements for a wrap fee program brochure, and are substantially similar to those associated with Schedule H, the separate wrap fee program brochure in the previous Part 2. However, the amendments revise

the requirements of Schedule H to incorporate many of the amendments to the Part 2A firm brochure described above. The SEC also is adopting an additional disclosure requirement to the wrap fee program brochure that requires an adviser to identify whether any of its related persons is a portfolio manager in the wrap fee program and, if so, to describe the associated conflicts. This item requires 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.

If you have any questions concerning the application of the changes described in this briefing to your business or Form ADV, or may require assistance with preparing your new Form ADV, we encourage you to contact us at your earliest opportunity.

The Financial Services Practice Group of Winston & Strawn represents a broad range of financial institutions on all aspects of their businesses, including regulatory matters, legislative developments, and proposals affecting the financial industry. If you have questions regarding the new rules, if you need advice with respect to how those rules may affect you, or if you need advice or assistance in preparing policies and procedures to address the new rules, please contact any of the Winston & Strawn attorneys listed below or your usual Winston & Strawn contact:

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