

SEC Finally Publishes Proposed Amendments to Part 2 of Form ADV

March 7, 2008

On March 3, 2008, the Securities and Exchange Commission (SEC) published proposed amendments to Part 2 of Form ADV, the investment adviser registration form. The proposed amendments would replace the current “check-the-box” format and related disclosure schedules with a plain English, narrative brochure. The brochure would contain enhanced disclosure of potential conflicts of interest and would incorporate the disclosure of legal and disciplinary events involving the firm and its management personnel currently required by Rule 206(4)-4, which the SEC is proposing to withdraw. This week’s proposal incorporates public comments the SEC received on the amendments to Part 2 originally proposed on April 5, 2000.

As proposed, Part 2 would consist of three different elements:

- *Part 2A* – Part 2A, known as the “brochure,” would require advisers to describe the firm’s investment advisory services, fees, disciplinary history, and conflicts of interest. An adviser would only be required to address the items that apply to its business.
- *Appendix 1 to Part 2A* – Appendix 1 would contain disclosure applicable to wrap-fee programs. Appendix 1 replaces the current Schedule H of Form ADV.
- *Part 2B* – Part 2B, known as the “brochure supplement,” would require an adviser to provide specific information regarding supervised persons who provide investment advice to clients, including their educational background, business experience, compensation, other business activities, and disciplinary history.

Part 2A – The Firm Brochure

Part 2A consists of 19 separate disclosure items that relate to the firm’s advisory business. In general, Part 2A reflects the view that advisers should not simply identify conflicts or describe policies and procedures, but should explain *how* they propose to address conflicts of interest. This concept has been incorporated into many of the disclosure requirements. Following is a summary of items that have been added or enhanced:

- **Item 5 – Fees and Compensation.** An adviser will be required to describe how it is compensated for its services and describe other costs (e.g., brokerage and custody fees and fund expenses) clients may pay in connection with the advisory services they receive. In addition, an adviser must describe any compensation (e.g., brokerage commissions) it receives from the sale of a security or other investment product to an advisory client, the associated conflicts of interest and how they are managed, and the fact that clients may purchase the same securities or investment products from brokers that are not affiliated with the adviser, if true.
- **Item 6 – Performance Fees and Side-by-Side Management.** Any adviser that charges performance fees must disclose this fact. If the adviser manages other accounts that do not pay a performance-based fee, it must disclose any conflicts of interest (e.g., allocation of investment opportunities, trade sequencing) presented by the simultaneous management of both types of accounts and how the adviser addresses them.

- Item 8 – Methods of Analysis, Investment Strategies, and Risk of Loss. This item, currently addressed through a check-the-box response, would now require advisers to disclose the risks associated with the adviser’s advice, including the impact of frequent trading and cash management strategies. Advisers that use particular methods of analysis, strategies, or types of securities would be required to explain any associated material risks, including significant or unusual risks.
- Item 9 – Disciplinary Information. An adviser must disclose any legal or disciplinary event that is material to a client’s evaluation of the integrity of the adviser or its management. This item essentially incorporates the provisions of Rule 206(4)-4 into Part 2A of Form ADV and, as a result, the SEC is proposing to withdraw the rule. Item 9 identifies a list of disciplinary events that are presumed to be material. An adviser may rebut the presumption so long as it documents its determination that a particular disciplinary event is not material.

Consistent with the terms of Rule 206(4)-4, Item 9 generally requires disclosure of any legal or disciplinary event in which the firm or its “management persons” have been “involved” within the last 10 years. The list of legal and disciplinary events included in Item 9 is not intended to be exclusive. In addition, while the disclosure obligation generally extends to events within the last 10 years, advisers would continue to have to disclose events that are so serious as to remain “currently material” to a client’s evaluation of the adviser’s services, even after 10 years.

- Item 12 – Brokerage Practices. An adviser would be required to disclose its soft-dollar practices and the types of products and services acquired with client brokerage commissions with enough specificity to allow a client to evaluate possible conflicts of interest. Notably, the description must be more detailed for products and services that do not qualify for the safe harbor provided by Section 28(e). Item 12 would also require disclosure regarding the receipt of client referrals from broker-dealers, directed brokerage arrangements, and whether the adviser aggregates (or bunches) trades.
- Item 17 – Voting Client Securities. Item 17 would require advisers to disclose their proxy voting procedures and how they address any associated conflicts of interest, as currently required by Advisers Act Rule 206(4)-6. In addition, this item would require advisers to identify by name any third-party proxy voting services the adviser uses to make proxy voting decisions, describe how the adviser selects the proxy voting service, whether the client can direct the adviser to use a particular service, and whether the cost of the service is paid for with soft dollars or passed on to clients.

Appendix 1 to Part 2A – The Wrap Fee Program Brochure

Proposed Appendix 1 is substantially the same as the current Schedule H, except that there is additional focus on the conflicts of interest associated with the use of affiliated portfolio managers. Specifically, advisers are required to identify whether any of their related persons serves as portfolio manager for the program and whether the related persons are subject to the same selection and review criteria as unaffiliated managers.

Part 2B – The Brochure Supplement

The SEC has retained the requirement—originally proposed in 2000—that an adviser send each of its clients (with certain exceptions noted below) a brochure supplement that includes information about investment personnel who service that particular client. The disclosure is required for each supervised person who:

- formulates investment advice for a particular client and has direct contact with that client; or
- makes discretionary investment decisions for a particular client’s assets (unless as a member of a team), even if such person does not have direct contact with that client.

Brochure supplements are not required to be sent to: (i) clients to whom the adviser does not have to deliver a firm brochure (e.g., investment companies and business development companies); (ii) clients who receive only impersonal investment advice; (iii) clients who are “qualified purchasers”; and (iv) certain “qualified clients” who are also officers, directors or employees, and other persons related to the adviser.

Part 2B consists of six disclosure items relating to the investment personnel who service a particular client, including disciplinary information, other business activities, and additional compensation. As proposed, advisers would have to disclose any disciplinary event that is “material to a client’s evaluation of the supervised person’s integrity.” The disclosure items generally track those in Part 2A relating to the firm’s disciplinary history. Thus, unlike broker-dealers that are only required to make the disciplinary history of their registered representatives available to investors through the FINRA website, advisers would have to deliver the disclosure about their supervised persons directly to clients.

The supplemental brochure also requires disclosure of other business activities that are investment related, including any resulting material conflicts of interest with clients and any cash or noncash compensation based on the sale of securities or other investment products. Other business activities that are not investment related, but which provide a substantial source of income, would also need to be disclosed. Finally, firms would be required to disclose any economic benefit provided to the supervised person by a nonclient, including sales awards and other prizes and bonuses that are based, at least in part, on the number or amount of sales, client referrals, or new accounts.

Delivery Requirements

- **Initial Delivery.** An adviser would be required to deliver Part 2A before or at the time it enters into an investment advisory agreement with a client. Similarly, Part 2B, the brochure supplement, would have to be delivered before or at the time a supervised person begins to provide advisory services to a client.
- **Annual Delivery.** An adviser would be required to deliver Part 2A of its Form ADV and/or Appendix 1 (the wrap fee brochure) to existing clients annually within 120 days of the adviser’s fiscal year. In addition, an adviser would be required to summarize any material changes to its brochure made since the last annual update. The summary may appear on the cover page or immediately behind it, or in a separate communication (such as a cover letter) accompanied by the updated brochure. Because the summary is intended to help existing clients identify any changes, it would not need to be sent to new or prospective clients who have not previously received a copy of the adviser’s brochure.

Part 2B (the brochure supplement) would not be required to be delivered annually. An adviser would be required to deliver its Part 2A and Part 2B on an interim basis only if there are changes to the disclosure of legal or disciplinary events.

- **SEC Filing.** An adviser would file Part 2A of Form ADV electronically, and each adviser’s brochure would be publicly available through the Investment Adviser Registration Depository website. Notably, neither Part 2B, nor any annual summary of material changes distributed as a document separate from Part 2A, would need to be filed with the SEC.

Proposed Implementation

Advisers currently registered with the SEC would have to comply with the new requirements by the date of the first annual update to their Form ADV after the new Part 2 becomes effective, but not earlier than six months after the effective date. New SEC-registered advisers would not have to include the new Part 2 in their initial application until six months after the new Part 2 becomes effective.

Comments on the proposed amendments to Part 2 of Form ADV must be received by May 16, 2008.

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