

## SEC Proposes Amendments to Part II of Form ADV

The Securities and Exchange Commission ("SEC") recently proposed amendments to Part II of Form ADV and changes to related rules under the Investment Advisers Act of 1940, as amended ("Advisers Act").<sup>1</sup> There are two primary purposes of the proposed amendments: to force investment advisers to provide current and prospective advisory clients with plain English narrative disclosure regarding an adviser's business practices, especially those business practices that may cause conflicts of interest, and to provide more information regarding advisory personnel.

The proposed amendments include substantial revisions to the brochure requirements in Part II of Form ADV and introduce a new brochure supplement requirement for the disclosure of information regarding investment advisory personnel. The Release also mandates the electronic filing of Part II. The comment period ends on 16 May 2008.

### The Brochure

The proposed amendments would require investment advisers to provide detailed disclosure of the conflicts of interests that may arise from various professional relationships, investment strategies, fee structures, compensation arrangements for personnel, etc., used by the investment adviser. The proposed Part II would rely on narrative disclosure, as opposed to the "check the box" disclosure required by the current Part II. The Release states that the narrative disclosure is meant to

increase the ability of investment advisers to present clear and meaningful disclosure. This change would likely increase the amount of time required to draft a brochure. The Release also warns that, although the proposed Part II disclosure requirements are meant to provide guidance to investment advisers with respect to complying with statutory disclosure requirements, investment advisers may need to provide disclosures beyond those required by the proposed revised Part II in order to fully satisfy their statutory disclosure obligations.

Some of the proposed changes are described below:

- The cover page of the brochure must contain the name, business address and telephone number of the investment adviser. It must also contain a statement that the brochure has not been approved by the SEC or any state securities authority. Investment advisers that hold themselves out as being "registered" must also explain on the cover page that registration with the SEC does not imply that the investment adviser possesses a certain level of skill or training. Investment advisers that maintain a website will also be required to disclose their website address on the cover page of the brochure.<sup>2</sup>
- Material changes made since the last annual update of the brochure must be identified on the brochure cover, on the page immediately following the cover page or in a separate communication accompanying the brochure. If the summary is provided as a separate

<sup>1</sup> *Amendments to Form ADV*, Rel. No. IA-2711 (Mar. 3, 2008) (the "Release"). The Release includes the re-proposal of amendments to the Form ADV Part II which were originally proposed on 5 April 2000 (see Rel. No. IA-1862) (the "Original Proposing Release") and commentary on changes made to the proposals in the Release based on comments received in respect of the proposals in the Original Proposing Release.

<sup>2</sup> The public posting of an investment adviser's website address could bring increased scrutiny of the substance of the website. Hedge fund managers conducting private placements in the United States in reliance on Regulation D should ensure that any websites comply with the prohibition against general solicitation and advertising.

- communication, it need not be filed with the SEC, but the investment adviser must preserve a copy of any such communication in accordance with applicable recordkeeping rules.
- The brochure must disclose the types of services provided, including any specialized services, and methods of analysis and investment strategies, including risks involved in any particular method. While providers of a wide range of services could provide a more general “risk of investing” type disclosure, advisers utilizing a particular method of analysis, strategy or type of security would be required to provide the specific material risks of such an approach. Investment advisers must also provide disclosure on how strategies involving frequent trading present a risk to investors, if applicable. An investment adviser may prepare separate brochures for different types of clients or with respect to different types of services, provided each client receives all information about the services and fees applicable to that client.
  - Investment advisers will be required to disclose the amount of client assets that they manage. The figure may be calculated in a manner that differs from the calculation method required by Form ADV Part I, provided the investment adviser keeps records describing the calculation method used.
  - Investment advisers will be required to disclose situations where compensation is received for the sale of securities (brokerage commissions). This disclosure must identify any conflicts of interest created by such compensation and discuss how the investment adviser addresses those conflicts.
  - Investment advisers will be required to disclose whether they charge performance fees. If an investment adviser manages both performance fee and non-performance fee accounts, the investment adviser must also describe the resulting conflicts of interest and what it does to address those conflicts.
  - The brochure must include descriptions of material relationships of the investment adviser and/or its management personnel with other financial industry participants (including compensation arrangements between firms, referrals, etc.) and possible conflicts of interest the relationships may create with a client.
  - Investment advisers will be required to disclose how they select brokers and how the reasonableness of broker fees is determined. As part of the disclosure, investment advisers will also be required to (i) address the conflicts inherent in receiving soft-dollar benefits as a result of client securities transactions; (ii) disclose whether the benefits inure to all clients or only those whose transactions “paid” for the research; and (iii) discuss all soft-dollar benefits received, including both proprietary research and third-party research. Investment advisers will also be required to disclose the effect broker client referrals may have on brokerage choices and the extent to which the investment adviser engages in trade aggregation or directed brokerage.
  - Investment advisers will be required to provide disclosure regarding any compensation received by the adviser or related person for client referrals, or compensation received from non-clients for providing advisory services to clients.
  - The brochure will be required to be updated at least annually and otherwise updated promptly when any information in the brochure becomes materially inaccurate.
  - Annually updated brochures must be delivered to existing clients (and not just offered as is currently required) every year within 120 days of the investment adviser’s fiscal year end. Interim updates to the brochure would only be required to be delivered to existing clients if the investment adviser amends its brochure to add a disciplinary event or materially change information already disclosed in the brochure regarding disciplinary events, or as otherwise required to disclose any material information to its clients.
  - The proposed Part II would be required to be filed electronically through the IARD system. In this respect, the Release has lessened the burden on advisers, as the electronic filing will not be done through special software but simply through the submission of a PDF document. This choice of delivery system will allow advisers to draft the brochure on their own systems and submit the final document in PDF format attached to their IARD filing of Part I.

## The Brochure Supplement

As the information requested in the current and revised Part II is primarily focused on advisory firms (and their senior personnel) and not the employees with whom clients regularly interact and who may have discretion over client funds, the SEC has proposed a brochure supplement to provide information about the day-to-day advisory personnel (a “Brochure Supplement”). The Brochure Supplement is intended to be less than a page long per person and would contain information regarding education, experience and disciplinary history.

Supplements would have to be prepared for any “supervised person” who (i) formulates investment advice for a client and has direct client contact; or (ii) has discretionary authority over a client’s assets, even if the supervised person has no direct client contact.<sup>3</sup> A “supervised person” is any officer, partner or director (or other persons occupying a similar status or performing similar functions) or employee or other person who provides investment advice on the investment adviser’s behalf and who is subject to the supervision or control of the investment adviser.<sup>4</sup>

The disclosures that would be required to be made with respect to each supervised person disclosed include:

- educational background and business experience for the past five years;
- any legal or disciplinary event material to a client’s evaluation of the person’s integrity;<sup>5</sup>
- other paid business activities and the form of compensation received (non-investment related business activities need only be

included where they constitute a substantial portion of their income or time);

- any information regarding compensation received based on the sales of securities; and
- an explanation of how the person is supervised at the firm and the name, title and phone number of the supervising individual.

The applicable Brochure Supplement would have to be delivered to a client at or before the time that the supervised person begins to provide advisory services to that client. However, delivery would not be required for certain categories of clients, including:

- clients to whom an adviser is not required to deliver a brochure (e.g., registered investment companies);
- clients who receive only impersonal investment advice;
- clients who are “qualified purchasers” as defined under the U.S. Investment Company Act of 1940, as amended; and
- certain “qualified clients” who are also officers, directors, employees and other persons related to the investment adviser.

Where an investment adviser does not have any clients requiring delivery of a Brochure Supplement, preparation of a Brochure Supplement is not required. Brochure Supplements need only be revised and delivered when they become materially inaccurate; annual updating is not required. Each new client must receive the most up-to-date version of the Brochure Supplement available at the time it is required to be delivered, but an investment adviser is not required to deliver a revised Brochure Supplement to existing clients unless the information regarding the supervised person’s disciplinary history has been changed to add a new disciplinary event or make a material amendment to information already disclosed.

Investment advisers would not be required to file their Brochure Supplements with the SEC but copies of each Brochure Supplement and any amendments thereto must be preserved in accordance with applicable recordkeeping requirements.

### Compliance Date

If the amendments to Form ADV Part II are adopted, investment advisers already registered with the SEC

<sup>3</sup> A Brochure Supplement is not required if the supervised person only has discretion as part of a team, provided there is no client contact.

<sup>4</sup> Employees of non-U.S. non-SEC registered investment managers who provide services to U.S. clients of SEC-registered affiliates under a “participating affiliate” arrangement will also be considered supervised persons for this purpose.

<sup>5</sup> Including, but not limited to, criminal or civil convictions concerning investments, investment related services, fraud, bribery, perjury, forgery, counterfeiting, extortion, etc.; administrative or self-regulatory organization proceedings concerning investment related activities; revocation or suspension of professional credentials or licenses.

would be required to comply with the new Part II requirements by the due date of their next annual updating amendment to Form ADV (i.e., 90 days after the end of the investment adviser's fiscal year) following the effective date of the revisions to Part II, provided the revisions to Part II have been in effect for at least six months prior to that due date. This would mean that if the SEC were to adopt the revisions to Form ADV Part II prior to late September 2008, all registered investment advisers

with a fiscal year ending 31 December 2008 will be required to comply with any revised requirements for their annual update due at the end of March 2009.



This update was written by Jennifer O. Epstein and Patrick W. Dennis.

## Practice group contacts

For more information, please contact one of the lawyers listed, or the Dechert lawyer with whom you regularly work. Visit us at [www.dechert.com/financialservices](http://www.dechert.com/financialservices).

**Karen L. Anderberg**  
London  
+44 20 7184 7313  
karen.anderberg@dechert.com

**Jennifer O. Epstein**  
London  
+44 20 7184 7403  
jennifer.epstein@dechert.com

**Patrick W. Dennis**  
London  
+44 20 7184 7571  
patrick.dennis@dechert.com

**Keith T. Robinson**  
Hong Kong  
+852 3518 4705  
keith.robinson@dechert.com



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