

## Financial Services and Products ADVISORY

August 5, 2010

### SEC Adopts Amendments to Form ADV Part 2

On July 21, 2010, the Securities and Exchange Commission (SEC) adopted amendments (the “Amendments”) to Form ADV and the rules relating to it under the Investment Advisers Act of 1940, as amended (the “Advisers Act”). Part 2 of Form ADV (“Part 2”), commonly known as the “brochure,” is the primary disclosure document used by registered investment advisers to provide prospective and existing clients with material information relating to the adviser, its business practices and its investment strategies. Part 2 has always been arranged in a “check-the-box” format, requiring advisers to answer multiple-choice and fill-in-the-blank questions. While the “check-the-box” format conveyed the information it was intended to convey, there was concern that it did not always describe the adviser’s business or conflicts in a way that was accessible to clients, as the questions asked did not always correspond well to an adviser’s business. The Amendments change Part 2 to now require advisers to provide information in a narrative form, written in plain English, in an effort to ensure that clients receive clear, easy-to-read disclosure statements that will allow them to evaluate the risks associated with a particular investment adviser.

#### I. AMENDMENTS TO FORM ADV, PART 2

##### A. *Part 2A of Form ADV – the Brochure*

###### Format

The Amendments require registered investment advisers to provide prospective and existing clients with a brochure that sets forth all required information in a narrative format, written in plain English (i.e., using short sentences; definite, concrete, everyday words; and the active voice). The narrative must contain information responding to each of the 18 items required by Part 2A and must present such information in the order in which the items are listed in Part 2A, using the headings provided on the form. In the event that a required item does not apply to an adviser, the adviser must nonetheless include the heading in its narrative, along with an explanation of why such heading does not apply. If the information provided in one item also relates to another item, an adviser may cross-reference the information contained in the other item.

The narrative should only convey information related to conflicts that an adviser has or is reasonably likely to have and practices in which it currently engages or is reasonably likely to engage. If the adviser subsequently experiences additional conflicts or engages in additional practices, it must then provide supplemental disclosure to clients describing those conflicts or practices.

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## Content

Part 2A contains 18 items, each of which must be addressed in the narrative brochure. The items include:

- (1) **Cover Page:** a cover page containing contact information for the adviser and a statement informing clients that the brochure has not been approved by the SEC or any state securities authority, as well as a disclaimer that the registration of the adviser with the SEC does not imply any level of skill or training
- (2) **Material Changes:** identification and a brief explanation of material changes that have taken place since the last annual update of the brochure
- (3) **Table of Contents**
- (4) **Advisory Business:** a description of the adviser's advisory business, including the types of advisory services offered, whether the adviser holds itself out as a specialist in any particular type of advisory service and the amount of client assets it manages
- (5) **Fees and Compensation:** a description of how the adviser is compensated for its advisory services, a fee schedule, disclosure of whether or not its fees are negotiable and details of how fees and other charges are assessed to clients
- (6) **Performance Based Fees and Side-by-Side Management:** disclosure of any performance-based fees received by the adviser
- (7) **Types of Clients:** a description of the types of advisory clients an adviser generally has, as well as its requirements for opening or maintaining an account
- (8) **Methods of Analysis, Investment Strategies and Risk of Loss:** a description of an adviser's method of analysis and investment strategies and disclosure informing clients that investing in securities involves risk of loss that clients should be prepared to bear
- (9) **Disciplinary Information:** disclosure of any material facts relating to any legal or disciplinary event that is material to a client's evaluation of the adviser's integrity
- (10) **Other Financial Industry Activities and Affiliations:** a description of material relationships or arrangements the adviser has with related financial industry participants, any material conflicts of interests arising therefrom and how such conflicts are addressed
- (11) **Code of Ethics, Participation or Interest in Client Transactions and Personal Trading:** a brief description of the adviser's code of ethics, a discussion of any participation or interest the adviser may have in client transactions and disclosure of personal trading by the adviser and its employees
- (12) **Brokerage Practices:** a description of how the adviser selects brokers for client transactions and determines broker compensation, as well as disclosure of how the adviser addresses conflicts of interest arising from its receipt of soft dollars and its use of client referrals, directed brokerage and trade aggregation
- (13) **Review of Accounts:** disclosure of whether the adviser reviews client accounts and financial plans, how often such reviews are conducted (if ever) and who conducts the reviews

- (14) **Client Referrals and Other Compensation:** a description of any arrangement under which the adviser compensates another adviser for client referrals or receives economic benefit from a person who is not a client for providing advisory services to clients
- (15) **Custody:** an explanation that clients will receive account statements directly from the qualified custodian maintaining those assets
- (16) **Investment Discretion:** disclosure of any discretionary authority an adviser has over client accounts and any limitations clients may place on this authority
- (17) **Voting Client Securities:** disclosure of an adviser's proxy voting practices
- (18) **Financial Information:** disclosure of certain financial information about an adviser that is material to clients

**Wrap Fee Program Brochure:** Appendix 1 to Part 2A contains requirements for advisers that sponsor wrap fee programs. As previously required, such advisers must prepare a separate brochure, known as a "wrap fee program brochure," that must be provided to clients of the wrap fee program instead of the adviser's standard brochure. The Amendments expand the requirements for wrap fee program brochures to include many of the amendments to the Part 2A brochure. The Amendments also add a new requirement that advisers identify whether any of their related persons are portfolio managers in the wrap fee program and, if so, what conflicts might arise from that fact.

## Delivery

**Initial Delivery:** An adviser must deliver a current brochure before or at the time it enters into an advisory contract with a client. Delivery is not required to clients receiving only impersonal investment advice or clients that are registered investment companies or business development companies. If an adviser has no clients to whom a brochure is required to be delivered, the adviser does not have to prepare a brochure or file one with the SEC.

**Annual Delivery:** An adviser must provide to each client to whom it is required to deliver a brochure, on an annual basis, either (1) a copy of its current brochure, including or accompanied by a summary of material changes, or (2) a summary of material changes that includes an offer to provide a copy of the current brochure. The brochure and/or summary of material changes must be delivered no later than 120 days after the end of the adviser's fiscal year and may be delivered electronically, provided such delivery is in accordance with SEC guidelines regarding electronic delivery of information.

**Interim Delivery:** In the event that an adviser amends its brochure to include a disciplinary event or to change any material information provided in response to Item 9 of Part 2A, the adviser must deliver an updated brochure, or a document describing the material facts related to the disciplinary event, to clients.

## Requirements to Update

Advisers must update any brochures they file with the SEC at least annually, but sooner if any of the information contained in the brochures becomes materially inaccurate (except for the summary of material changes or the amount of assets under management). Updates to brochures must be made by advisers using their own computer systems. The updated brochures must then be filed through the Investment Adviser Registration Depository (IARD). If no interim amendments have been made to an adviser's brochure and the brochure remains accurate in all material respects, the adviser is not required to prepare and deliver a summary of material changes to clients, nor does the adviser have to prepare and file an updated firm brochure as part of its annual updating amendment. If interim amendments were made, or the brochure has become inaccurate in a material respect, the adviser must file a summary of material changes describing the interim amendments, along with an updated brochure, as part of its annual amendment filing. Only the most recent version of an adviser's brochure will be publicly available on the SEC's website.

### ***B. Part 2B of Form ADV – the Brochure Supplement***

In addition to the brochure, an adviser must also prepare brochure supplements containing information about the particular employees of the adviser from whom the client receiving the brochure supplement receives investment advice.

## Format

As with the brochure, the brochure supplement must be written in plain English and must be organized in the same order as the required items appear in the form, using the headings provided in the form. Beyond these requirements, advisers have flexibility in choosing the format in which they prepare their brochure supplements. They may include the required information in their brochure, prepare a brochure supplement for each supervised person or prepare separate brochure supplements for specific groups of employees.

## Content

Part 2B contains 6 items, each of which must be addressed in the brochure supplement. The items include:

- (1) **Cover Page:** a cover page identifying the supervised person or persons covered by the brochure supplement
- (2) **Educational Background and Business Experience:** information pertaining to the supervised person's educational background and business experience over the last five years
- (3) **Disciplinary Information:** disclosure of any legal or disciplinary information about the supervised person that is material to the client's evaluation of the supervised person
- (4) **Other Business Activities:** disclosure of other investment-related business activities of the supervised person and any material conflicts of interest that may arise therefrom
- (5) **Additional Compensation:** a description of any arrangements in which someone other than a client gives the supervised person an economic benefit for providing advisory services to clients
- (6) **Supervision:** an explanation of how the adviser monitors the advice provided by the supervised person and contact information for the person responsible for overseeing the supervised person

## Delivery

An adviser must provide clients with a brochure supplement for each supervised person of the adviser 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. If investment advice is provided by a team of more than five individuals, the brochure supplements need only cover the five individuals who have the most significant responsibility for the day-to-day advice provided to the client receiving the brochure. An adviser does not have to deliver a brochure supplement to (1) clients to whom the adviser is not required to deliver a brochure; (2) clients who receive only impersonal investment advice and (3) certain qualified clients who are also officers, directors, employees and other persons related to the adviser. If an adviser has no clients to whom a brochure supplement is required to be delivered, the adviser does not have to prepare a brochure supplement; nor does the adviser have to prepare a brochure supplement for any supervised person who does not have clients to whom a brochure supplement must be delivered. A supervised person's brochure supplement must be given to each client at or before the time when that supervised person begins to advise that specific client.

## Requirements to Update

An adviser must deliver an updated brochure supplement to clients only when there is new disclosure pertaining to a disciplinary event or a material change to disciplinary information that has already been disclosed in Item 3 of Part 2B. If an adviser makes reference to BrokerCheck or Investment Adviser Public Disclosure (IAPD) when disclosing a supervised person's disciplinary information, the adviser must notify clients if and when BrokerCheck or IAPD is updated with new disciplinary information.

If any information contained within the brochure supplement becomes materially inaccurate, an adviser must promptly amend the brochure supplement.

## ***C. Filing Requirements for Brochures and Brochure Supplements***

Brochures must be filed with the SEC electronically through IARD and will be publicly available on the SEC's website once filed. Brochures must be created by advisers on their own computers, converted to PDF format and attached to their IARD filing. If a brochure needs to be updated, an adviser must make the necessary changes to the brochure and attach the revised version to its IARD filing. IARD will not permit an adviser to file an annual updating amendment without attaching an updated brochure, representing that the brochure on file does not contain any materially inaccurate information or representing that the adviser does not have to prepare a brochure because it is not required to deliver one to any of its clients. IARD will also not permit an annual updating amendment without a representation that the summary of material changes is either attached as an exhibit or included in the brochure, or a representation that no summary of material changes is needed because no material changes have occurred. If an adviser who uses multiple brochures discontinues its use of a particular one, the adviser can remove that brochure from its current filing.

Brochure supplements do not have to be filed with the SEC and will not be publicly available. Advisers must maintain copies of all brochure supplements, and any amendments thereto, in their files.

## II. AMENDMENTS TO FORM ADV INSTRUCTIONS AND GLOSSARY

In addition to amending Part 2 of Form ADV, the Amendments also revise Form ADV's General Instructions and Glossary of Terms to include instructions regarding the new brochure filing requirements and the definitions of new terms used within the form.

## III. AMENDMENTS TO RULE 204-2

The Amendments also expand Rule 204-2 under the Advisers Act to require registered investment advisers to retain copies of each brochure, brochure supplement and any amendments thereto. The Amendments also require advisers to create and retain documentation of (1) the method used to calculate managed assets for purposes of Item 4.E of Part 2A and (2) any legal or disciplinary event listed in Item 9 of Part 2A and Item 3 of Part 2B for the period of time during which the event is presumed material, if such event has not been disclosed in the brochure or brochure supplement. Such records must be maintained in the same manner and for the same period of time as other books and records required to be maintained under Rule 204-2(a) of the Advisers Act.

## IV. COMPLIANCE WITH THE AMENDMENTS

### A. *New Investment Advisers*

An adviser that applies for registration with the SEC after January 1, 2011, will be required to file a brochure that complies with the amended Part 2A as part of its application for registration on Form ADV. Upon registration, the adviser must begin delivering to its prospective and existing clients a brochure and brochure supplement that meet the amended requirements.

### B. *Registered Investment Advisers*

An adviser who is already registered with the SEC, and whose fiscal year ends on or after December 31, 2010, must include a brochure that meets the amended requirements for Part 2A with its next annual updating amendment to Form ADV. Therefore, advisers with fiscal year ends of December 31, 2010, must file compliant brochures by March 31, 2011, and must deliver those brochures, along with brochure supplements, to existing clients within 60 days of their being filed.

*This advisory was prepared by David J. Baum, 202.756.3346, [david.baum@alston.com](mailto:david.baum@alston.com), and Maureen Whalen, 704.444.1294, [maureen.whalen@alston.com](mailto:maureen.whalen@alston.com).*

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If you have any questions or would like addition information, please contact your Alston & Bird attorney or any one of the following members of the Financial Services and Products Group.

## Investment Management Group

Paul M. Architzel  
[paul.architzel@alston.com](mailto:paul.architzel@alston.com)  
202.756.3492

Jennifer D. Lawrence  
[jennifer.lawrence@alston.com](mailto:jennifer.lawrence@alston.com)  
704.444.1337

Timothy P. Selby  
[tim.selby@alston.com](mailto:tim.selby@alston.com)  
212.210.9494

David J. Baum  
[david.baum@alston.com](mailto:david.baum@alston.com)  
202.756.3346

Clay A. Littlefield  
[clay.littlefield@alston.com](mailto:clay.littlefield@alston.com)  
704.444.1440

Matthew A. Stevens  
[matthew.stevens@alston.com](mailto:matthew.stevens@alston.com)  
202.756.3553

Willa Cohen Bruckner  
[willa.bruckner@alston.com](mailto:willa.bruckner@alston.com)  
212.210.9596

Matthew W. Mamak  
[matthew.mamak@alston.com](mailto:matthew.mamak@alston.com)  
212.210.1256

James H. Sullivan, Jr.  
[james.sullivan@alston.com](mailto:james.sullivan@alston.com)  
212.210.9522

Anjali D. Desai  
[anjali.desai@alston.com](mailto:anjali.desai@alston.com)  
202.756.3056

Kristin P. Manzano  
[kris.manzano@alston.com](mailto:kris.manzano@alston.com)  
704.444.1332

Maureen Whalen  
[maureen.whalen@alston.com](mailto:maureen.whalen@alston.com)  
704.444.1294

Martin A. Hewitt  
[martin.hewitt@alston.com](mailto:martin.hewitt@alston.com)  
212.210.1228

Colin W. Roberts  
[colin.roberts@alston.com](mailto:colin.roberts@alston.com)  
212.210.9538

Sarah Whitlock  
[sarah.whitlock@alston.com](mailto:sarah.whitlock@alston.com)  
212.210.9574

### ATLANTA

One Atlantic Center  
1201 West Peachtree Street  
Atlanta, GA 30309-3424  
404.881.7000

### CHARLOTTE

Bank of America Plaza  
Suite 4000  
101 South Tryon Street  
Charlotte, NC 28280-4000  
704.444.1000

### DALLAS

Chase Tower  
Suite 3601  
2200 Ross Avenue  
Dallas, TX 75201  
214.922.3400

### LOS ANGELES

333 South Hope Street  
16th Floor  
Los Angeles, CA 90071-3004  
213.576.1000

### NEW YORK

90 Park Avenue  
New York, NY 10016-1387  
212.210.9400

### RESEARCH TRIANGLE

Suite 600  
3201 Beechleaf Court  
Raleigh, NC 27604-1062  
919.862.2200

### SILICON VALLEY

275 Middlefield Road  
Suite 150  
Menlo Park, CA 94025-4004  
650.838.2000

### VENTURA COUNTY

Suite 215  
2801 Townsgate Road  
Westlake Village, CA 91361  
805.497.9474

### WASHINGTON, D.C.

The Atlantic Building  
950 F Street, NW  
Washington, DC 20004-1404  
202.756.3300

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