The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 22342

March 14, 2008

SEC Proposes Amendments to Part 2 of Form ADV; Conference Call Scheduled for March 28, 2008

[22342]

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TO: COMPLIANCE ADVISORY COMMITTEE No. 6-08INVESTMENT ADVISERS COMMITTEE No. 4-08SEC RULES COMMITTEE No. 22-08SMALL FUNDS COMMITTEE No. 9-08 RE: SEC PROPOSES AMENDMENTS TO PART 2 OF FORM ADV; CONFERENCE CALL SCHEDULED FOR MARCH 28, 2008

The Securities and Exchange Commission recently published for comment proposed amendments to Part 2 of Form ADV, the investment adviser registration form.[1] The proposed amendments would replace the current "check-the-box" format and related disclosure schedules with a plain English, narrative brochure that describes the business practices, conflicts of interest, and background of investment advisers and their advisory personnel. Brochures would be electronically filed through the Investment Adviser Registration Depository ("IARD") and made available to the public through the SEC's website. The Commission also is proposing to withdraw, as duplicative, Rule 206(4)-4 under the Investment Advisers Act of 1940, which requires advisers to disclose certain disciplinary and financial information. The proposal incorporates comments the SEC received, including many from the Institute,[2] on the amendments to Part 2 originally proposed in 2000 but never approved.

Comments on the proposal are due to the SEC by May 16, 2008. We will hold a conference call on Friday, March 28, from 2:00 – 3:00 p.m. Eastern time to discuss the Institute's comments relating to the SEC's proposal. The dial-in number for the conference call will be 1-888-603-7027 and the passcode for the call will be 19818. If you plan to participate on the call, please contact Jennifer Odom by email at jodom@ici.org or by phone at

202-326-5833.

Part 2 would consist of three different sections, each of which is described more fully below:

- Part 2A – known as “the brochure,” would be a narrative document in plain English containing specified information about the adviser and its business practices.

- Appendix 1 to Part 2A – would replace Schedule H of current Form ADV and would contain disclosure applicable to wrap-fee programs.

- Part 2B – known as the “brochure supplement,” would require an adviser to provide specific information regarding supervised persons who provide investment advice to clients.

Part 2A – The Firm Brochure

As proposed, Part 2A, the firm brochure, would contain 19 separate disclosure items that relate to a firm’s advisory business.[3] According to the Release, much of the information that would be required in the brochure concerns conflicts between an adviser’s own interests and those of its clients and is disclosure the adviser already makes to clients as a fiduciary.

Under the proposal, an adviser must respond only to the items that apply to its business and need not repeat information that is responsive to more than one item. Additionally, an adviser may use multiple brochures when the adviser provides “substantially different types of advisory services,” so long as each client receives all applicable information about services and fees.

An adviser does not need to provide a firm brochure to advisory clients to whom it provides only impersonal advice, nor must the adviser provide a brochure to registered investment companies or business development companies (“BDCs”). Furthermore, an adviser that has no clients to whom it must deliver a firm brochure is not required to prepare a brochure. The following are highlights of the proposal.

- Item 4 – Advisory Business. An adviser would be required 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. This item would eliminate the current requirement that advisers list and describe all periodicals or periodic reports that they issue about securities.

- Item 5 – Fees and Compensation. An adviser would be required to describe how it is compensated for its services and other costs, such as brokerage, custody fees, and fund expenses, that clients pay in connection with the advisory services they receive. An adviser, however, would not be required to disclose the amount or range of mutual fund fees or other third-party fees that clients may pay. An adviser that receives compensation attributable to the sale of a security or other investment product (e.g., brokerage commissions) must disclose this practice, the conflicts of interest it creates, and how it addresses those conflicts.

- Item 6 – Performance Fees and Side-by-Side Management. An adviser that charges performance fees must disclose this fact. If the adviser also manages other accounts that are not charged a performance fee, the adviser must discuss the conflicts (e.g., trade allocation, trade sequencing) that arise from its simultaneous management of these accounts and describe generally how it addresses those conflicts.

- Item 8 – Methods of Analysis, Investment Strategies and Risk of Loss. An adviser would be required to describe its methods of analysis and investment strategies and discuss the risks clients face in following its advice or permitting it to manage assets, including the effect of frequent trading and cash management strategies. In addition, an adviser that uses primarily a particular method of analysis, strategy, or type of security would be required to explain the specific material risks involved, including any significant or unusual risks.

- Item 9 – Disciplinary Information. An adviser would be required to 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 incorporates into the brochure the provisions of Rule 206(4)-4 under the Advisers Act and, as a result, the SEC is proposing to withdraw that rule.[4] Item 9 would provide a list of disciplinary events that are presumptively material if they occurred in the previous 10 years. The list, which is not intended to be exclusive, would include any convictions for theft, fraud, bribery, perjury, forgery, and violations of securities laws by the adviser or one of its executives. An adviser may rebut the presumption so long as it documents its determination that a particular disciplinary event is not material.

- Item 12 – Brokerage Practices. An adviser would be required to describe how it selects brokers for client transactions, determines the reasonableness of brokers' compensation, and addresses the conflicts arising from the use of soft dollars. The Release notes that disclosure must be more detailed for products and services that do not qualify for the safe harbor in Section 28(e) of the Securities Exchange Act of

1934. Item 12 also would require an adviser to disclose the receipt of client referrals from broker-dealers, whether the adviser aggregates (or bunches) trades, and certain directed brokerage arrangements.

- Item 17 – Voting Client Securities. Consistent with Rule 206(4)-6 under the Advisers Act, an adviser would be required to disclose its proxy voting practices, including any associated conflicts of interest. In addition, an adviser would be required to list any third-party proxy voting services that it uses, describe how it selects the proxy voting service, whether it permits clients to direct the use of a particular proxy voting service, and how it pays for these services.

- Item 18 – Financial Information. An adviser that requires or solicits prepayment of more than $1,200 in fees per client six months or more in advance would be required to include an audited balance sheet for its most recent fiscal year. An adviser also must disclose any financial condition reasonably likely to impair its 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 prepayment of fees. Finally, an adviser that has been the subject of a bankruptcy petition during the past ten years would be required to disclose that fact to clients.

- Item 19 – Index. An adviser would be required to include an index of the items required by Part 2A, indicating where in the brochure it addresses each item. An adviser would not be required to provide the index to its clients. The index would, however, be required to be appended to the brochure as filed through the IARD.

Part 2A Appendix 1 – The Wrap Fee Program Brochure

An adviser that sponsors wrap fee programs would continue to be required to prepare a separate, specialized firm brochure for clients of the program in lieu of its standard advisory firm brochure. The items in proposed Appendix 1 would be substantially similar to those currently in Schedule H, except an adviser also would be required to disclose conflicts of interest associated with using related persons as portfolio managers.

Part 2B – The Brochure Supplement

The proposal would require an adviser to send to each of its clients (with certain exceptions noted below) a brochure supplement that provides information about the advisory personnel on whom the client relies for investment advice.[5] The proposed disclosure is required for each supervised person who (i) formulates investment advice for a particular client and has direct contact with that client; or (ii) makes discretionary decisions for a particular client's assets (unless as part of a team), even if the supervised person has

no direct contact with that client.

An adviser would not be required to deliver supplements to: (i) clients to whom it is not required to deliver a firm brochure (e.g., registered investment companies and BDCs); (ii) clients who receive only impersonal investment advice; (iii) clients who are "qualified purchasers," as defined under Section 2(a)(51)(A) of the Investment Company Act of 1940; and (iv) certain "qualified clients," as defined under Rule 205-3(d)(1)(iii) under the Advisers Act, who are officers, directors, employees, and other persons related to the adviser. An adviser that does not have a client to whom a supplement would have to be delivered would not have to prepare any supplements, nor would it have to prepare a supplement for any supervised person who does not have clients to whom the adviser must deliver a supplement.

Part 2B would consist of six items, including those relating to a supervised person's educational background and business experience, disciplinary information, and other business activities. Specifically, an adviser would be required to disclose any "legal or disciplinary event that is material to a client's evaluation of the supervised person's integrity." The disclosure requirements for the supervised person's disciplinary history are substantially the same as those proposed for the firm's disciplinary history.

An adviser also would be required to describe other investment-related business activities of its supervised person, including any associated conflicts of interest with clients. The proposal would require the supplement to include information about any compensation, including bonuses and non-cash compensation, the supervised person receives based on the sale of securities as well an explanation of the incentives this type of compensation creates. Other business activities that are not investment related, but which provide a substantial source of income, also would need to be disclosed. Finally, an adviser would be required to describe arrangements in which someone other than a client gives the supervised person an economic benefit (such as a sales award or other prizes based on sales, client referrals, or new accounts) for providing advisory services.

SEC Filing Requirements

An adviser would file Part 2A, the firm brochure, and/or Appendix 1 (and any amendments to either) electronically in PDF format through the IARD, where it would be accessible on the SEC's website. Part 2B, the brochure supplement, would not be filed with the SEC and therefore would not be available on the SEC's website. Advisers would be required, however, to maintain copies of all brochure supplements and amendments to supplements in their files.

Delivery Requirements

- Initial Delivery. An adviser would be required to deliver Part 2A and/or Appendix 1 and Part 2B before or at the time it enters into an advisory contract with the client.

- Annual and Interim Delivery.

Part 2A: An adviser would be required to deliver Part 2A and/or Appendix 1 (identifying changes from the previous year) to existing clients annually within 120 days of the adviser's fiscal year. An adviser would be required to deliver an interim update to clients only when it amends its brochure and/or Appendix 1 to add a disciplinary event or materially change information already disclosed in response to Item 9 of Part 2A. The Release notes that, 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 between annual updating amendments, even if those changes do not trigger delivery of an interim update.

Part 2B: Part 2B, the brochure supplement, would not be required to be delivered annually. An adviser would be required to deliver Part 2B on an interim basis when there is new disclosure of a disciplinary event or a material change to disciplinary information already disclosed in the brochure supplement.

Updating Requirements

An adviser would be required to update Part 2A and/or Appendix 1 at least annually and promptly whenever any information in the brochure or wrap brochure becomes materially inaccurate. Similarly, an adviser would be required to amend a brochure supplement promptly if information in it becomes materially inaccurate and deliver the updated supplement to any new clients.

Proposed Implementation

New SEC-registered investment advisers would not be required to include their brochures as part of their initial application until six months after the Part 2 amendments become effective. Advisers currently registered with the SEC would be required to comply with the new Part 2 requirements by the date of their first annual update to Form ADV occurring six months or more after the new Part 2 becomes effective.

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[1] See Amendments to Form ADV, SEC Release Nos. IA-2711 and 34-57419 (March 3, 2008) (“Release”), available on the SEC’s website at http://sec.gov/rules/proposed/2008/ia-2711.pdf.

[2] See Memorandum to Investment Adviser Associate Members No. 17-00 and Investment Adviser Members No. 18-00, dated June 14, 2000 [11945].

[3] Additionally, at the request of state securities regulators, the proposed form includes a separate item containing additional requirements for state-registered advisers (Item 20).

[4] The SEC requests comment about whether to retain the rule to clarify the disclosure obligations of advisers that have clients to whom they are not required to deliver a brochure, e.g., registered investment companies and BDCs.

[5] The SEC received a large number of comments on the brochure supplement proposal as originally proposed in 2000. According to the Release, based on these comments, the SEC has modified the delivery requirement, reduced the types of clients to whom advisers would be required to provide supplements, clarified the format of the supplements to maximize the amount of flexibility advisers have in preparing them, and limited the information that would have to be included in them.