

MEMO# 11792

April 7, 2000

SEC PROPOSES REVISIONS TO FORM ADV; ELECTRONIC FILING BY ADVISERS

1 Investment Adviser Release No. IA-1862 (April 5, 2000) (the "Release"). [11792] April 7, 2000 TO: INVESTMENT ADVISERS COMMITTEE No. 12-00 RE: SEC PROPOSES REVISIONS TO FORM ADV; ELECTRONIC FILING BY ADVISERS

The Securities and Exchange Commission has proposed substantial revisions to Form ADV and new rules under the Advisers Act relating to the form.¹ The Commission's proposal is intended to facilitate the implementation of an electronic filing system for investment advisers, the Investment Adviser Registration Depository ("IARD"). The IARD will permit investment advisers to satisfy their initial and continuing filing obligations with the SEC and state regulators through the submission of Internet filings. In addition to revising Form ADV for its use with the IARD, the proposed revisions to the form are intended to reflect regulatory changes since the form was last amended, and to improve the quality of information advisers must provide to their clients and prospective clients. A copy of the Commission's Release, which is summarized below, is attached. Comments are due to the SEC on its proposal no later than June 13, 2000. If you have comments you would like to be considered for the Institute's comment letter, please submit them to Tamara Reed by phone (202-326-5825), fax (202-326-5839) or e-mail (tamara@ici.org) no later than Monday, May 15th.

I. PROPOSED REVISIONS TO FORM ADV As proposed by the SEC, Form ADV, which currently consists of only two parts, Part I and Part II, would be divided into four parts: Parts 1A, 1B, 2A and 2B. Part 1A, which would be filed by all advisers, would be similar to the current Part I of Form ADV, and would provide clients information about the advisory firm. Part 1B would only be filed by state-registered advisers. Part 2A would specify the information required to be included in the adviser's brochure that must be provided to clients. And Part 2B would be a supplemental disclosure document containing information about the supervised person(s) of the adviser who provide advisory services to that client. Importantly, the disclosure required by Parts 2A and 2B of the revised form must be provided in a plain-English narrative format. Advisers would no longer be permitted to satisfy the brochure rule under the Advisers Act by distributing a completed copy of Part 2 of the form. Each of these proposed parts of Form ADV is discussed in detail below.

A. Part 1A As proposed, each adviser: (1) would complete either a criminal, civil, or regulatory Disciplinary Reporting Page ("DRP") if it responds affirmatively to a disciplinary question; (2) would report those disciplinary events occurring in the past ten years, including actions of foreign courts and regulatory authorities and cease-and-desist orders issued by the SEC; and (3) would no longer report an unsatisfied judgment or lien, bankruptcy, or bond denial, payout or revocation or disclose disciplinary information for advisory affiliates no longer associated with the adviser. Part 1A would be completed by all advisers (both federally-registered and state-registered). It would require an adviser to provide information about its

business through a series of fill-in-the-blank, multiple-choice, and check-the-box questions. While the 12 items of information that would be required to be disclosed by Part 1A are similar to the information disclosed in the current Part I of Form ADV, Part 1A would require the following new disclosures: the adviser's CRD number (if it has one), its web site address(es), an e-mail address of a person who could be contacted about the form, the adviser's fax number and the information currently required on Schedule I of the form, which relates to the adviser's eligibility for SEC registration. In addition, there have been substantial revisions to the disclosure requirements relating to the adviser's disciplinary history.² Also, this portion of the form would no longer include the education and business background of the adviser's personnel -- this information would instead be moved to Part 2A of the form -- and disclosure concerning the adviser's control persons would be revised. As a result, an adviser would generally no longer be required to report an indirect owner unless the indirect owner owned 25% of a direct owner.

B. Part 1B Part 1B has been prepared by the North American Securities Administrators Association ("NASAA") on behalf of the state securities authorities. Only state-registered advisers would be required to complete Part 1B. It would require those advisers subject to state registration to provide information necessary to obtaining such registration.

C. Part 2A -- The Firm Brochure Some of the more significant changes proposed by the SEC are contained in Parts 2A and 2B of the form. Proposed Part 2A would consist of nineteen disclosure items, though, with the exception of the first two items, the adviser would not be required to present its disclosure in any particular order. These nineteen items are as follows:

- ! Item 1 -- Cover Page. This page would require identifying information about the advisory firm (e.g., address, telephone number), the date of the brochure, and the name of a person who could be contacted for additional information.
- ! Item 2 -- Material Changes. The brochure would be required to include a summary of material changes since the last annual update in order to help clients identify new or revised information. This summary would be required to appear on the cover page of the brochure or immediately thereafter.
- ! Item 3 -- Table of Contents. A table of contents must be included in each brochure.
- ! Item 4 -- Advisory Business. The brochure would be required to provide information about the firm, including how long it has been in business, the names of its principal owners, and a description of the firm's advisory business, including information relating to any areas of specialization, amount of assets subject to the adviser's investment discretion, and information relating to wrap-fee arrangements.
- ! Item 5 -- Fees and Compensation. The brochure would describe how the adviser is paid for its services including any fee tables, whether fees are negotiable, billing procedures, and frequency of fee assessment. Also, any fees the client may incur in addition to advisory fees (e.g., brokerage commissions, custody fees, etc.), must be disclosed. Advisers who receive transaction-based compensation must also disclose this practice, any conflicts of interest arising from it, and the firm's procedure for addressing such conflicts.
- ! Item 6 -- Types of Clients. The adviser must describe the types of advisory clients the firm generally has, as well as any minimum account requirements.
- ! Item 7 -- Methods of Analysis, Investment Strategies and Risk of Loss. In addition to describing in narrative form the adviser's methods of analysis and investment strategies, disclosure would be required of the risks a client faces in following the adviser's advice or in permitting the adviser to manage assets. It would not, however, require advisers that offer a wide variety of advisory services to list the risks involved in each type of security or trading strategy.
- ! Item 8 -- Disciplinary Information. An adviser would be required to disclose information about the firm's disciplinary history that is material to a client's or prospective client's evaluation of the adviser's business and the integrity of its management.
- ! Item 9 -- Other Financial Industry Activities and Affiliations. The brochure would be required to disclose information about the adviser's other financial industry activities and affiliations (e.g., registration as a broker or commodities professional); any

material conflicts of interest that the relationship or arrangement might create; and, the restrictions or other control procedures the adviser uses to address any such conflict. Also, if the adviser refers clients to another adviser, it must disclose any compensation or business arrangements with such other adviser and any conflicts created thereby. ! Item 10 -- Participation or Interest in Client Transactions; Personal Trading. The adviser would be required to discuss any conflicts of interest the adviser faces when the advisory firm or a "related person" has a financial interest in, or trades in, securities the adviser recommends to clients. Procedures and controls designed to address such conflicts must also be disclosed. ! Item 11 -- Brokerage Practices. The brochure would be required to describe the adviser's policies and practices in selecting brokers for client transactions and in determining the reasonableness of brokers' compensation. In particular, the brochure would have to provide specific disclosure in the following areas: the adviser's soft dollar practices; client referrals; transaction costs; directed brokerage; and commission recapture. In each of these areas, the brochure must discuss any conflicts of interest created by the arrangement and any procedures the adviser uses to address such conflict. The specific disclosures required in these areas as follows: ! Soft Dollars. The brochure would disclose any policies and practices with respect to the adviser's use of soft dollars, including any conflicts of interest that result. The description of an adviser's soft dollar practices must be specific enough for clients to understand the types of products or services the adviser is acquiring and to permit the client to evaluate any conflicts. Disclosure must be more detailed for products or services not used in the adviser's investment decision-making process. Also, the adviser would be required to disclose: whether all -- or only certain -- clients benefit from soft dollars and how the adviser allocates such benefits, and whether it "pays up" for soft dollar benefits. ! Client Referrals. The brochure would discuss the adviser's practices in using client brokerage to reward brokers that refer clients to the adviser. ! Transaction Costs. The adviser would discuss any benefits it receives from negotiating lower commissions or from bunching trades to obtain volume discounts. If applicable, the brochure must also explain that clients may pay higher commissions if the adviser either does not bunch trades when it has the opportunity to do so or does not negotiate or limits the extent to which it negotiates commissions. ! Directed Brokerage. If an adviser permits clients to direct brokerage, the brochure would explain that the adviser may not be able to obtain best execution and the arrangement may cost clients more money. If, however, the adviser routinely requests or requires clients to direct brokerage, the brochure must describe the adviser's policies in this area, including any conflicts of interest. ! Commission Recapture. An adviser that utilizes commission recapture would describe how this works, explain its benefits, and explain how a client may participate in recapture programs. ! Item 12 -- Review of Accounts. The brochure would be required to disclose whether, and how often, the adviser reviews clients' accounts or financial plans and identify who conducts such review. Advisers that do not regularly review accounts must explain what circumstances would trigger a review. ! Item 13 -- Payment for Client Referrals. The brochure would describe any payment -- in cash or otherwise -- the adviser or a related person makes for client referrals and whether the adviser receives any benefit from a non-client for providing advisory services to clients. ! Item 14 -- Custody. Advisers that accept custody would disclose this in their brochure and describe any special reports they give to their custodial clients. Advisers that require custody of client assets must also explain that most advisers do not impose this requirement and disclose that clients face greater risk than if an independent custodian held the assets. ! Item 15 -- Investment Discretion. Advisers with discretionary authority over client accounts would be required to disclose that fact in their brochure as well as any limitations clients may place on this authority. ! Item 16 -- Proxy Voting Policies. Disclosure of the adviser's proxy voting policies would be required. ! Item 17 -- Investment Performance. Advisers that advertise or report

their investment performance would be required to describe any standards they use to calculate or present such performance, and any third-party review of such performance information. ! Item 18 -- Financial Information. While the SEC proposes to continue requiring advisers who have custody of client assets or who require the prepayment of fees to provide clients an audited balance sheet, excluded from this requirement would be banks, insurance companies, and federally- registered broker-dealers. Also, advisers with discretionary authority over client assets would disclose any financial condition reasonably likely to impair the adviser's ability to meet contractual commitments to clients. ! Item 19 -- Index. Part 2A requires that the adviser provide to SEC staff -- but not to clients -- an index of the Items required by Part 2A, to facilitate the staff's review of the adviser's compliance with this part. ! Appendix 1 -- Wrap Fee Program Brochures. Those advisers that sponsor wrap fee programs would be required to prepare a separate, specialized firm brochure, which would be provided to clients of the wrap fee program in lieu of the adviser's standard advisory firm brochure. The contents of the wrap fee brochure are set forth in Appendix 1 to Part 2A. D. Part 2B -- The Brochure Supplement As proposed by the SEC, advisers would be required to prepare and provide to clients a supplementary brochure on those supervised persons of the adviser who provide advisory services to that client (even if the supervised person does not have any direct contact with the client). Each supplement would contain seven items of background information about an individual or group. An adviser would be generally free to structure the disclosure of these items in a manner that best conveys the information. (A smaller advisory firm that chooses to include information about all advisory personnel in its firm brochure would not need to use any supplements.) The items that must be included in a brochure supplement are as follows: ! Item 1 -- Cover Page. This would identify the subject(s) of the disclosure. ! Item 2 -- Educational Background and Business Experience. The supplement would disclose the formal education and business experience for the past five years of the supervised person(s), as well as any professional designations or attainments. ! Item 3 -- Disciplinary Information. The supervised person's disciplinary history would be disclosed, including any proceeding revoking or suspending a professional attainment, designation, or license. ! Item 4 -- Other Business Activities. In addition to disclosing the supervised person's other business activities, the supplement would describe the nature of any conflicts resulting from such other activities and the procedures the adviser uses to address such conflicts. The supplement would also disclose whether the supervised person receives any transaction-based compensation, including bonuses and non-cash compensation. ! Item 5 -- Additional Compensation. The supplement would describe arrangements in which someone other than a client gives the supervised person an economic benefit (e.g., a sales award or prize) for providing advisory services. ! Item 6 -- Investment Advice and Supervision. The supplement would disclose who formulates the advice given to clients and how the firm monitors the advice provided. In addition, the name, title, and telephone number of the person who supervises the supervised person would be included in the supplement. ! Item 7 -- Financial Information. The supplement would disclose whether the supervised person was the subject of a bankruptcy petition within the past ten years. II. The IARD A. Generally; Use of the System will be Mandatory As mentioned above, the Form ADV is being revised, in large part, in order to facilitate implementation of the IARD system, the SEC's proposed electronic filing system for investment advisers. The IARD will be an Internet-based system that an adviser will use to apply for registration, amend its registration, and withdraw from registration. An SEC-registered adviser will also be able to submit its state notice filings through the IARD. Advisers will be able to complete their Form ADV, and any amendments thereto, on-line and immediately transmit the form electronically to the SEC. Once the revised Form ADV is adopted and the IARD becomes operational, all SEC-registered advisers would be required to file a revised Form ADV with the SEC through the IARD. With respect to amendments to

its Form ADV, an adviser would access its form through the IARD, type the new information over the old, and electronically transmit the information to the SEC. The IARD would replace the stale information with the new information and record the date of the change. Information contained in filings made through the IARD will be stored in a database that members of the public will be able to access free of charge through the Internet. Once it becomes operational, SEC-registered advisers will be required to make all Form ADV filings through the IARD. The only exceptions will be in the event of hardship -- either temporary hardship due to, for example, computer malfunction or electrical outage; or a continuing hardship, in the event use of the IARD would create an undue hardship on the adviser.

B. Proposed IARD Roll Out The SEC proposes to roll out the IARD in the following order:

- ! Release 1 -- SEC-registered advisers and applicants for SEC registration will begin using the IARD to file Part 1A of Form ADV with the SEC and to submit notice filings to the states. The SEC expects that the IARD will begin to receive filings pursuant to Release 1 later this year;
- ! Release 2 -- Public access would be provided via the Internet to the IARD database. This is expected to occur a few months after the first filings are made on the system.
- ! Release 3 -- Investment adviser representatives could electronically submit their state registration applications via the system once Release 3 is rolled out.
- ! Release 4 -- The IARD will begin to accept Part 2 of Form ADV.

C. Fees While the SEC has paid for the development of the system, which is being built and will be operated and maintained by NASDR, Inc., filing fees will be assessed to pay for the system's operation and maintenance. NASDR will charge fees based upon an adviser's assets under management and the number of states to which notice filings are submitted, for initial applications and annual updating amendments. The SEC expects the annual filing fee to run \$200-\$400. IARD filing fees and state notice filing fees, which would also be paid through the system, would be paid by NASDR debiting the adviser's NASDR account, which the adviser would be required to establish and maintain in connection with using the IARD.

III. Proposed Revisions to the "Brochure Rule" Under the Advisers Act As discussed above, the SEC has proposed to require all advisers to provide clients with a plain English narrative brochure and supplemental brochure containing disclosure about the advisory firm and its supervised persons. In addition to offering to clients at least annually a copy of the adviser's current brochure and supplemental brochure, the SEC has proposed to amend the brochure rule (i.e., Rule 204-3 under the Advisers Act) to require an adviser to provide its clients with a written brochure update, which may take the form of a reprinted brochure or a sticker, whenever information in such brochures becomes materially incorrect.

IV. Miscellaneous

A. Transition Issues Once the SEC adopts its proposed amendments, it will publish a schedule by which all advisers will be required to re-submit their registration forms to the SEC through the IARD. The SEC does not expect to require advisers to file their brochures with the SEC until such time as the adviser makes its first annual update after the IARD begins to accept Part 2A (which is not expected to be until 2002). In the meantime, in lieu of filing brochures in hardcopy with the SEC, advisers will be required to maintain them (as part of the adviser's recordkeeping requirements pursuant to Rule 204-2 under the Advisers Act) and make them available to SEC staff upon request.

B. Form ADV-W The SEC has proposed revisions to Form ADV-W, Notice of Withdrawal from Registration as an Investment Adviser, and to require it that it be filed through the IARD. In addition, the SEC has proposed to make such withdrawal effective upon filing, rather than 60 days after filing, which is the current procedure. * * * * Tamara K. Reed Associate Counsel Attachment