



SECURITIES REGULATION & LAW



REPORT

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INVESTMENT ADVISERS

With Eye on New Applicants, SEC Overhauls Registration Form For Investment Advisers . . . And Misses an Opportunity



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The Dodd-Frank Act was on the minds of the five Commissioners of the U.S. Securities and Exchange Commission as they voted in July to overhaul Form ADV, the application and disclosure form used by investment advisers when registering with the agency. The Commissioners were anticipating a swell of new SEC registrations from fund managers and other investment advisers scheduled to see their registration exemptions stripped by provisions of the Dodd-

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Frank Act that go into effect July 2011. Moreover, holding their meeting on the very day that Dodd-Frank was signed into law, the Commissioners must have had an eye on the shrinking window of time available before the coming crush of studies, new rules and consultations that would be demanded of the agency.

The outcome is, taken as a whole and certainly when measured against the benchmark of the outdated Form ADV in use today, positive for all parties involved (including the SEC, investment adviser firms that prepare the form, and their advisory clients and prospects). But leaving the form as a one-size-fits-all proposition—and one that fails to capture the distinct business model for the private fund managers targeted by Dodd-Frank for SEC registration—was also something of a missed opportunity. With that in mind, this article both outlines

the coming changes to the form and envisions at least two possible alternatives that, while not to be in the near-term, could have been well received.

Brief Background

Form ADV, the existence (but not the format) of which is mandated by the U.S. Investment Advisers Act of 1940, is a two-part investment adviser registration form. Form ADV is used for both initial registrations and as an ongoing client disclosure document that must be updated by investment adviser firms at least annually. “Part 1” collects basic firm information. “Part 2”—sometimes called the firm’s brochure—provides more detail on the firm’s business and is the required disclosure document used with clients. It is the longer, more detailed Part 2 that is the subject of the current overhaul.¹

Currently registered investment advisers must follow the new Part 2 format when they make annual updates to their registrations next year, which for most firms will be in March 2011. For newly registering firms, the new format applies from January 1, 2011 forward. Firms also can voluntarily adopt the new format any time on or after October 12, 2010.

The Goal: A More User-Friendly Format

Recognizing that the form had become outdated, the SEC proposed overhauling Form ADV Part 2 twice in the last ten years (most recently in 2008). Throughout that ten-year process, the agency’s overriding goal for Form ADV has been that it should be more user-friendly. That goal appears to have been met, especially for readers of the resulting disclosure document (as opposed to its preparers, who will probably appreciate the changes over time, but in the meantime bear the burdens of the transition). Among the improvements are the following:

- **Goodbye check-the-box, hello plain-English.** Part 2 brochures will be entirely narrative, rather than the odd mix of check-the-box and narrative disclosures used today. Just as important, all disclosures in the new form will be in “plain English.” (According to the SEC, plain English means using “short sentences; definite, concrete, everyday words; and the active voice” and, ultimately, a “succinct and readable” document.)

- **New explanation of changes made.** When an adviser updates its Part 2 brochure each year, the adviser will prepare a synopsis of the changes made and share that synopsis with the firm’s clients.

- **Expanded risk and conflict of interest disclosures.** While many firms have long emphasized the risks underlying their investment programs and the conflicts of interest that are a part of their business (ei-

ther in Part 2 or other client disclosure documents), the new format mandates these disclosures.

- **New information about firm personnel tailored to each client.** A firm’s Part 2 brochure will be broken into the full brochure and one or more “brochure supplements.” Each supplement will include biographical and other information about the personnel who service a particular client’s (or prospect’s) account, with a separate supplement to be prepared for each individual. Currently, no such document is required.

- **Standardized format.** Part 2 brochures will look very much alike firm-to-firm in terms of their basic architecture and topics covered. That standardization is intended to allow more straightforward comparisons across firms (but also comes at a price, as discussed below).

- **Easier access to firm disciplinary information.** Part 2 brochures will include information about disciplinary events affecting the firm and its personnel and affiliates. Previously, that information was required only in Form ADV Part 1. As the brochures are delivered to clients, while Part 1 is not, this represents a significant change in practice.

- **Online availability.** Currently, Part 2 is available to a firm’s clients and prospective clients, but generally not to the public. Under the new requirements, Part 2 will be filed with the SEC and the filings will be available online. Presumably the brochures will be at www.adviserinfo.sec.gov, where Part 1 filings can be found today. The new brochure supplements will not be filed with the SEC.²

Private Fund Managers—The Square-Peg, Round-Hole Problem, and a Missed Opportunity

The listing of the new format requirements at the end of this article should make clear that the SEC has mandated a tightly controlled structure for the Part 2 brochure. This is in the name of allowing readers of the brochures to most effectively compare firms one to the other. But while standardization serves that purpose when comparing *incremental* firm-to-firm differences, it can be a weakness when there are more fundamental differences among firms. Shoehorning a “square-peg” firm into the round hole of a set disclosure format can actually obscure, rather than reveal, differences.

To bring this home to the Dodd-Frank context: The provisions that will drive new investment adviser registrations target a large pool of currently unregistered private investment fund managers (primarily in the hedge fund and private equity fund industries). Yet Form ADV basically contemplates an advisory business in which the firm contracts directly with individual clients, rather than the quite different fund management business model in which the firm’s sponsored funds are its clients and the fund investors are one step removed

¹ The full SEC release is available at <http://www.sec.gov/rules/final/2010/ia3060.pdf>. A copy of the instructions for the new Part 2 brochure is Appendix C to that file.

While the Part 2 brochure is used by both SEC-registered investment advisers and state-registered investment advisers, some elements of the form differ between those two groups of firms. This article focuses solely on SEC-registered firms. Certain aspects of the form that relate to “wrap programs,” including a required wrap program appendix, also are not discussed here.

² Although pressed to do so, the SEC declined to expand the electronic delivery options available to firms in respect of the Part 2 brochure and the brochure supplements. Existing guidance continues to apply, which largely limits electronic delivery to instances when there is client consent to the delivery format.

– a classic instance of the square-peg, round-hole problem.³

Sections of the Part 2 brochure have for years presented interpretive issues for a fund manager trying to apply the Form ADV questions and instructions to its business. Just as two longstanding examples that have carried over into the new format: The brochure asks about custody arrangements, but continues to focus on traditional custody arrangements, rather than the “deemed” custody that can exist in the context of a fund manager’s actual or implicit control over assets of the managed private investment funds. Most fund managers rely on an annual third-party audit of their funds to address asset custody concerns, but the form’s instructions do not acknowledge that approach. In the same vein, the brochure asks about client referrals, but its instructions leave unaddressed the longstanding ambiguity of whether there has been a “client referral” when a firm compensates someone for referrals of prospective investors in the firm’s investment funds (since fund investors are generally not “clients” under current law).

Moreover, delivery of the brochure is not even required to fund investors. While there are valid reasons for this as a matter of legal analysis (again, because fund investors are generally not considered clients of the firm), it certainly calls into question the value of the Part 2 brochure in the fund management context. That is especially so given that there is already a detailed disclosure document in wide use by fund managers, who put considerable care into the preparation of the “offering memorandum” (a form of prospectus for private placements) used to solicit a fund’s investors.

What could have been done differently? At least two alternatives warranted more consideration, and not seriously taking them up goes to the heart of the missed opportunity embedded in the Form ADV overhaul.

- **Tailoring the form for private fund managers.** More attention could have been paid to crafting a Part 2 that fund managers would have recognized as “theirs.” Why could there not, as an incremental example, have been form instructions tailored to the types of disconnects (e.g., deemed custody versus actual custody) illustrated above? Or, going a big step further, could there have been one Form ADV for firms that are predominately fund managers and another one for firms that are not, with different questions and instructions that acknowledge the different business models?

- **Scrapping the Part 2 for these managers altogether.** Taken to its logical conclusion, the tailoring approach just outlined might have given way to the realization that private fund managers – at least those who solely advise their own private funds (i.e., private funds established or “sponsored” by and affiliated with the particular manager) - do not need Part 2 brochures, and the SEC does not need Part 2 from them. But what could have taken the brochure’s place for these managers? The SEC instead could have requested that these firms confirm that all information from Part 2 is in fact being provided to fund investors in the fund offering memoranda or other prominent disclosure docu-

³ Particularly stark is the disconnect between Form ADV and the business of private equity fund managers, given the emphasis in parts of the brochure on trading strategies and the absence (typically) of any real trading activity in a private equity portfolio.

ments – or even that copies of fund offering memoranda be filed with the SEC at a fund’s launch (on what presumably would have to be a non-public basis to respect the “private offerings” that they represent).⁴ Under one of these approaches, firms, their clients and the SEC all would have benefited from avoiding the duplication of effort that a Part 2 brochure – which might never be delivered to outsiders – represents for private fund managers, while at the same time implicitly raising the bar on the core documents actually in use in the industry. Turning solely to the SEC’s perspective, the fact that firms filing their offering memoranda (assuming that alternative to the brochure were adopted at some point) might grumble at revealing what they view as highly proprietary materials by itself illustrates the value of the information that the SEC would have collected.⁵ And as some reassurance to firms, it bears noting that the SEC already has ready access to these documents on request.

Overview of the New Format – Main Brochure

In keeping with the SEC’s goal of greater standardization, the ordering and content of the brochure is organized around 18 specified headings (referred to as “items” in the Form ADV instructions). If a heading’s subject matter is irrelevant to a firm, the heading is still required, with an explanation that the topic is not applicable. Likewise, if information would be duplicated under multiple headings, the headings are still required but cross-references may be used to streamline the presentation. That said, some steps may be taken to tailor the brochure to a firm’s individual requirements, including that the firm may:

- Develop its own introductory summary to use in addition to the required headings.

- Include other information of its choosing (i.e., going beyond information responsive to the required headings), so long as the additional information is relevant and does not obscure required content.

- Use different versions of its brochure with different audiences. (The SEC appears to encourage this practice, which it hopes will mean tailored brochures with “shorter, clearer and less extraneous information” relative to a single, one-size-fits-all document used across a firm.)

A summary of the brochure’s required content follows.

- **Item 1 – Cover Page.** Provides basic identifying information about the firm and certain required disclaimers (notably that the brochure has not been approved by the SEC or any state securities authority and that the

⁴ Under this approach, the SEC also would still receive Form ADV Part 1 from all investment advisers, including private fund managers, which would satisfy the statutory requirement that the SEC receive a registration form from all investment advisers registering with the agency.

⁵ To rebut a contrary argument that might have been made, if the SEC was concerned that it might – from a data analysis perspective – find fund offering documents less useful than heavily standardized Part 2 brochures, the agency had various means of dealing with that. For example, it could have moved some of the information to Part 1 (which would continue to be standardized), or it could have directed fund managers filing their offering memoranda to also file an index cross-referencing the 18 Part 2 disclosure items with the relevant content.

fact that a firm is SEC registered “does not imply skill or training”).

■ **Item 2 – Material Changes** (applies only to updates). Outlines changes made in the update relative to the iteration of the brochure. Identifying which developments to include and then striking the “Goldilocks” balance between saying too little or too much about each at this point in the brochure will be among the more challenging aspects of Form ADV compliance going forward. Concerned that firms will be overinclusive in flagging and describing changes, the SEC specifically says that the disclosure should not be “lengthy” or “replicate the brochure itself.”

■ **Item 3 – Table of Contents.** In the order and using the headings prescribed by the new form.

■ **Item 4 – Advisory Business.** Provides certain descriptive information, such as how long the firm has been in business, who the principal owners are, the types of services offered, and the amount of client assets managed.

■ **Item 5 – Fees and Compensation.** Describes how the firm is compensated for its advisory services and includes its standard fee schedule, states whether fees are negotiable, and discusses billing practices, including whether fees are deducted from client accounts automatically. The firm also must discuss other types of fees and expenses that will be borne by clients (e.g., custody fees). Firms serving only certain sophisticated clients can significantly trim back this section.

■ **Item 6 – Performance-Based Fees and Side-By-Side Management.** Discloses the existence of performance fee arrangements in which the firm shares in the upside it generates for clients (e.g., taking a percentage of profits earned as a success fee). Recognizing that the opportunity to share in profits creates an incentive to favor performance fee accounts over non-performance fees accounts, firms also have to discuss how they manage the conflicts of interest embedded in such “side-by-side management.”

■ **Item 7 – Types of Clients.** Discusses the firm’s client base, staying at a high level.

■ **Item 8 – Methods of Analysis, Investment Strategies and Risk of Loss.** Describes the methods of analysis and investment strategies used, notes that investments present the risk of loss, and explains the material risks specific to its strategies. Specific disclosures are required in respect of frequent trading. The SEC also cautions that a firm should “discuss only conflicts the adviser has or is reasonably likely to have, and practices in which it engages or is reasonably likely to engage.” This conforms with the agency’s view that disclosure devoted in too great a measure to things that the firm “may” do risks obscuring what the firm actually does.

■ **Item 9 – Disciplinary Information.** Discloses disciplinary events, including private litigation, involving the firm, its personnel and certain of its affiliates.

■ **Item 10 – Other Financial Industry Activities and Affiliations.** Discusses the firm’s different lines of business (e.g., banking, brokerage, insurance, etc.) and broadly outlines its affiliate businesses. Conflicts of interest are required to be discussed in reasonable detail.

■ **Item 11 – Code of Ethics, Participation or Interest in Client Transactions and Personal Trading.** Discusses whether the firm, its affiliates or its personnel trade on their own behalf in the same markets as cli-

ents. Again, conflicts of interest are required to be discussed in reasonable detail.

■ **Item 12 – Brokerage Practices.** Discusses how the firm selects brokers and trading venues and how it allocates trading opportunities among clients. Again, conflicts of interest are required to be discussed in reasonable detail.

■ **Item 13 – Review of Accounts.** Discusses who reviews client accounts and how frequently (referring primarily to the investment professional(s) responsible for an account).

■ **Item 14 – Client Referrals and Other Compensation.** Describes who the firm uses in seeking client referrals, how it compensates those parties, and the different types of compensation the firm receives from nonclients in the course of delivery of the firm’s advisory services.

■ **Item 15 – Custody.** Describes standard custody arrangements, including whether the firm or its affiliates hold client cash or securities.

■ **Item 16 – Investment Discretion.** Describes whether the firm trades on behalf of clients at its discretion or only subject to limitations.

■ **Item 17 – Voting Client Securities.** Describes practices as to voting proxies in respect of securities held in client portfolios.

■ **Item 18 – Financial Information.** Describes any financial condition reasonably likely to affect the firm’s ability to meet its client commitments, with disclosure required of any bankruptcy petition to which the firm has been subject in the past ten years. In addition, a balance sheet for the firm is provided when the firm accepts prepayment of certain fees (on the theory that receiving a significant pre-payment puts the client at risk of loss of the payment if the firm’s finances are not stable).

Overview of the New Format – Brochure Supplements

The “brochure supplement” is a newly required document that will accompany (or in some cases be incorporated into) the brochure. It is not filed with the SEC or available on the SEC website. The supplement will include information about the personnel who service a particular client’s (including a prospect’s) account, so that the client will receive a supplement for:

■ Each person “who formulates investment advice” for the client and has direct client contact, and

■ Each person who has discretionary authority over a client’s assets even if the person has no direct client contact.⁶

The brochure supplement can be either a stand-alone document or incorporated into the firm’s brochure. For smaller firms, use of a single, combined brochure/supplement package will likely be the approach followed. For larger firms, the benefits of not having to divide out supplements for client-by-client mailings favors a single combined brochure/supplement package;

⁶ A client need not receive a supplement for any individual who has no direct client contact and has authority over a client’s assets *only* as part of a team. In addition, when discretionary advice is provided by a team of more than five individuals, brochure supplements need be delivered only for the five individuals with the most significant responsibility for the day-to-day delivery of advice.

on the other hand, if there are hundreds of supplements, the sheer size of the combined package may discourage its use.

Under the new rules, the supplement must be delivered to a client “before or at the time” the firm personnel described by the supplement begin to provide advisory services to the client and then must be updated “promptly” to reflect material changes over time. The compliance headaches associated with these timing requirements, especially for updates prompted by changes in personnel, will be significant.

Like the Part 2 brochure, a supplement is largely standardized in form, with its content as follows.⁷

■ **Item 1 – Cover Page.** Provides the name and contact details of the individual described by the supplement and a cross-reference noting that more information is available in the full brochure.

■ **Item 2 – Educational Background and Business Experience.** Provides the individual’s name, age (or year of birth), formal education after high school, and business background, including *specific* positions held, for the preceding five years.

■ **Item 3 – Disciplinary Information.** Discloses any material legal or disciplinary events relevant to the individual.

■ **Item 4 – Other Business Activities.** If the individual is actively engaged in certain types of investment-related activities, e.g. as a registered representative with a broker-dealer or an associated person of a commodities firm, describes those activities. With the intent being to ferret out distractions from the individual’s advisory business, other (i.e., non investment-related) business activities will be described only if they

⁷ As with the Part 2 brochure, a firm is permitted to include other information of its choosing in a brochure supplement (i.e., going beyond information that is specifically required), so long as the additional information is relevant and does not obscure required content.

Note to Readers

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provide a substantial source of the individual’s income or involve a substantial amount of the individual’s time.⁸ Conflicts of interest are required to be discussed in reasonable detail.

■ **Item 5 – Additional Compensation.** Identifies and “generally describes” financial incentives relating to management of the client’s account that go beyond the individual’s regular salary and bonus. Bonus components tied to the number or amount of sales, client referrals or new accounts are not considered a regular bonus for this purpose and require disclosure. It perhaps goes without saying, but all matters relating to personal compensation are sensitive, so it will be interesting to see how disclosure approaches here will develop.

■ **Item 6 – Supervision.** Explains how the firm supervises the individual, including as to monitoring investment advice given, and includes the name, title and telephone number of the individual’s supervisor. The SEC contemplates that the client should have the ability to directly contact the supervisor, so is encouraging firms not to list general firm phone numbers.

Conclusion

For years, the Part 2 brochure format has been sufficiently off-putting that firms understandably focused their marketing and client service energies elsewhere. Given these latest improvements, could a virtuous circle now develop in which, as the form is viewed as more useful and more clients and prospects pay it attention, firms react to the increased interest and improve the material still further? That would be the SEC’s fondest hope, and some movement in that direction is to be expected. But if the experience with mutual fund prospectuses, another SEC-mandated form in a related industry, is any guide, the Part 2 brochure is more likely – all of the above improvements and cosmetic work aside – to retain the fundamental character of a legal disclosure document.

The larger “failing” in the new Form ADV, though, is simply that it held its ground as a one-size-fits-all form. Certainly there would have been conflicting goals and drivers around the suggestions offered above to tailor the Part 2 brochure to the needs of a specific group of managers (or, more radically, to scrap parts of the form altogether for some audiences). But given the context – and literally thousands of private fund managers waiting in the wings to use Form ADV for the first time – it still would have been a useful regulatory undertaking to give more attention to these kinds of alternative approaches.

⁸ Activities representing less than 10 percent of the individual’s income or time are presumed to be not substantial.