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SEC PROPOSES AMENDMENTS TO PART II OF FORM ADV AND RELATED RULES UNDER THE INVESTMENT ADVISERS ACT OF 1940

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I. Summary

In recent years, the U.S. Securities and Exchange Commission (the “SEC”) has become increasingly concerned that the disclosure statements that registered investment advisers (“RIAs”) are required to provide to their advisory clients (“clients”) – in Part II of their Form ADVs² (“Part II”) – are often not sufficiently clear or meaningful to enable clients to make fully-informed investment decisions. Today, there are nearly 20 million clients who rely upon such disclosures (as provided by upwards of 10,500 RIAs³) to select suitable investment RIAs, negotiate fee arrangements, and evaluate conflicts of interest.

In March 2008, the SEC proposed a series of amendments (the “Proposed Amendments”) to (i) overhaul the structure and format of Part II, and (ii) revise several related rules (as discussed

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² Form ADV is the form that RIAs use to register with the SEC under the Investment Advisers Act of 1940, as amended (the “Advisers Act”). Form ADV has two parts: Part 1 of Form ADV provides the SEC with the information that it requires to process RIA registrations. Part II of Form ADV (“Part II”) contains disclosure statement requirements that RIAs are required to provide to prospective clients, and to offer to existing clients annually. Pursuant to rules 203-1 and 204-1 under the Advisers Act, RIAs must keep their Form ADVs current by filing periodic amendments while they remain registered.

³ The SEC has estimated that approximately 1,000 new applicants apply for registration as investment advisers each year, so the proposals described herein would affect a growing population. *See, Amendments to Form ADV*, Investment Advisers Act Release No. IA-2711, p. 81 (Mar. 3, 2008) (the “Release”).

herein) under the Investment Advisers Act of 1940, as amended (the “Advisers Act”).⁴ Under the Proposed Amendments, RIAs would be required to provide each client with a narrative brochure (a “Brochure”), written in “plain English,” describing nineteen discrete items such as their business practices, conflicts of interest, and disciplinary histories. Brochures would also be made available to the general public through the SEC’s Investment Adviser Public Disclosure (“IARD”) website. Concurrently, the SEC is proposing to withdraw rule 206(4)-4 under the Advisers Act (“rule 206(4)-4”) – a rule requiring RIAs to disclose any legal or disciplinary events that could be material to their clients’ evaluations of their integrity – as the Brochures would include such disclosure. Additionally, under the Proposed Amendments, RIAs would be required to provide clients with one or more concise brochure supplements (“Brochure Supplements”) containing details about specific personnel within their firms who provide advisory services to clients. Further, the SEC is proposing modifications to the rules governing RIAs’ delivery and updates of their disclosure statements.

II. Legal and Factual Background

Since 1979, the SEC has required RIAs to provide clients with a disclosure statement containing specific details about their business practices, the fees they charge, and conflicts of interest.⁵ RIAs can satisfy this requirement by delivering to clients either (i) Part II of Form ADV, or (ii) another document containing at least the information disclosed in Part II of Form ADV.⁶

Part II, in its current format, directs RIAs to provide responses to a series of multiple choice and fill-in-the-blank questions (organized in a “check-the box” format), some of which can be supplemented with brief narrative responses.

The SEC, in April 2000, to enable clients to make more informed investment decisions, proposed requiring RIAs to provide clients with Brochures written in “plain English” – in lieu of Part II – in which they would provide more detailed disclosure regarding the nature of their businesses, conflicts of interest (including conflicts attributable to their receipt of “soft dollars”) certain risk factors, disciplinary histories, and other material information (the “April 2000 Proposed Amendments”).⁷ The April 2000 Proposed Amendments were never enacted. In March 2008, in *Amendments to Form ADV*, the SEC once again expressed concern that many clients are still not receiving sufficiently clear and meaningful disclosure statements from their RIAs.⁸ Consequently, it repropose many of the April 2000 Proposed Amendments, and it also proposed modifications to some of these amendments as well.

⁴ *See id.*

⁵ Rule 204-3 under the Advisers Act (the “Brochure Rule”). Under the Brochure Rule, RIA disclosure statements must be provided to clients either (i) at least forty-eight hours before entering into any written or oral contract with a client, or (ii) at the time of entering into the contract with a client if the contract permits the client to terminate the contract without penalty within five business days after entering into it.

⁶ The SEC believes that the vast majority of RIAs satisfy the Brochure Rule by completing Part II and delivering it to clients, and that few RIAs provide clients with the required disclosure entirely in narrative form. *See, i.e.*, the Release, p. 5.

⁷ *See Electronic Filing by Investment Advisers; Proposed Amendments to Form ADV*, Investment Advisers Act Release No. 1862 (Apr. 5, 2000). The SEC received more than 70 comments in response to the April 2000 proposal.

⁸ *See* the Release, p. 1.

In the Release, the SEC put forward a series of proposals for revamping Part II (which would be renamed as “Part 2”). It proposed requiring RIAs to provide disclosure statements in Brochures in “plain English” narrative form – instead of the current check-the-box format – addressing nineteen discrete items. Additionally, it proposed requiring RIAs to disclose details regarding some of their internal personnel in Supplementary Brochures so that clients can become more fully informed about the individuals within advisory firms who provide assistance to them.

III. Proposed Amendments to Form ADV Part II

A. *Part 2A: Requiring RIAs to Provide Brochures to Clients*

Under the Proposed Amendments, RIAs would be required to provide clients with narrative disclosure statements by way of a Brochure, in place of the current Part II form. RIAs would be required to file such Brochures electronically with the SEC, and the Brochures would then be made available to the public through the SEC’s IARD website. The SEC is currently requesting public comments on the proposed Brochure narrative format, and it would like to know whether the public believes that the narrative format represents “the right approach” to clearer and more meaningful adviser disclosure.⁹

Under the Proposed Amendments, the SEC would provide RIAs with instructions on how to complete their Brochures. However, in contrast to the present situation, it would not provide RIAs with a standard form to use in providing their required disclosures.

In drafting their Brochures, RIAs would have to disclose details covering nineteen discrete items including their backgrounds, business practices, fees, and conflicts of interest with clients. RIAs would be required to deliver Brochures to clients at the start of an advisory relationship, and thereafter, on an annual basis. RIAs would be required to deliver updates of their Brochures only upon the occurrence of certain disciplinary events or material changes relating to their disciplinary histories.

The summary below provides a description of the nineteen items that the SEC is proposing to require RIAs to include in Brochures:

1. Cover page: The cover page of each Brochure would disclose the name of the RIA’s firm, its business address, its telephone number, and the date of the Brochure.¹⁰ Additionally, the cover page would include a statement that the Brochure itself has not been approved by the SEC or any state securities authority. If RIAs have websites, the addresses for such websites would be disclosed here. Further, RIAs would be required to disclose the name and telephone number of a person or service center that existing or prospective clients can contact for further information regarding the RIA.

⁹ The specific questions posed by the SEC to the public regarding the use of narrative brochures as a vehicle for RIA disclosures include: (1) whether the flexibility of the Brochure form will allow RIAs to present clear and meaningful disclosure to their clients, and (2) whether the flexibility of the Brochure form will minimize the burden on RIAs in preparing their required disclosure. The SEC is also soliciting feedback as to whether certain RIA disclosures are best made in non-narrative formats – such as tabular formats – and whether the Proposed Amendments contain sufficient flexibility to allow for other types of non-narrative disclosures.

¹⁰ This information is required in the current Part II.

2. Material Changes: RIAs would be required to provide clients with summaries of any material changes to the disclosure items discussed herein. The SEC is seeking to ensure, through this proposal, that clients will have a clear and definite way to know about potentially significant changes to the services that they receive and/or the risks of new conflicts to them.

3. Table of Contents: RIAs would be required to provide a table of contents in each Brochure containing sufficient details to enable existing or prospective clients to easily locate topics.¹¹ The SEC is not calling for the adoption of a uniform format for such tables of contents here because it believes that the wide variety of business activities engaged in by RIAs makes this specific suggestion impractical.

4. Advisory Business: RIAs would be required to describe various aspects of their advisory businesses including:

- (i) the types of advisory services offered;
- (ii) whether it holds itself out to the public as a specialist in particular types of advisory services; and
- (iii) the total client assets under management.¹²

For purposes of (iii) immediately above, the SEC is proposing to allow RIAs to report their total client assets under management using a method other than the “assets under management” method that they are currently required to use in Part I of their Form ADVs. The SEC believes this would enable certain RIAs to provide disclosures that are more descriptive about the nature of their businesses – *i.e.*, in situations when RIAs manage assets in “non-securities” portfolios.

5. Fees and Commissions: RIAs would be required to describe (i) how they are compensated for providing advisory services, and (ii) the types of other costs (*i.e.*, brokerage fees, custody fees, and fund expenses) that clients may pay in connection with such advisory services. RIAs would also be required to disclose their fee schedules and additional details such as whether their fees are negotiable, whether their firms bill clients or deduct fees directly from clients’ accounts, and the frequency with which they assess fees. Additionally, RIAs (or their employees) who receive compensation from the sale of securities or other investment products, such as brokerage commissions, must disclose this practice to clients, the conflicts of interest that this practice creates, and how they address such conflicts.

6. Performance Fees and Side-By-Side Management: RIAs who charge performance fees (or RIAs who have supervised persons managing accounts that charge such fees) would be required to disclose this. Additionally, if an adviser (or a supervised person) (i) manages certain accounts that are charged performance fees while (ii) simultaneously managing other accounts that are not charged performance fees, RIAs would be required to discuss any conflicts attributable to such circumstances, and how these conflicts are addressed. As an illustration of a potential conflict, the SEC explained that RIAs may have incentives to direct their best investment ideas to those accounts that pay performance fees to them. The SEC also explained that RIAs may have

¹¹ The current Part II includes a Table of Contents.

¹² Part II, in Items 1 and 3, currently requires certain disclosures regarding RIAs’ advisory services, the types of investments that they provide advice upon, and their investment strategies.

conflicts stemming from their clients' different investment strategies (*i.e.*, certain clients may engage in significant short-selling while others may only hold long portions.) Accordingly, RIAs would be required to disclose conflicts that are attributable to their simultaneous management of advisory client accounts.

7. Types of Clients: RIAs would be required to provide descriptions of their clients along with their requirements for opening and maintaining accounts, such as minimum account sizes.¹³

8. Methods of Analysis, Investment Strategies, and Risk of Loss: RIAs would be required to disclose their methods of analysis and investment strategies.¹⁴ Additionally, RIAs would also have to disclose the risks associated with their services. RIAs that offer a wide array of securities-related services could simply explain that investing in securities involves a risk of loss. However, RIAs who primarily employ particular strategies or methods of analysis would be required to explain the specific material risks inherent in such strategies or methods (along with additional details if such risks are significant or unusual.) Moreover, if applicable, RIAs would be required to disclose how certain strategies involving frequent trading can affect investment performance. RIAs would also be required to provide a concise and general discussion of their general practices relating to cash balances in client accounts under circumstances when clients have not provided them with specific instructions or directions for handling cash balances.

9. Disciplinary Information: RIAs would be required to disclose any legal or disciplinary events that could be material to a client's evaluation of their integrity (or the integrity of their management).¹⁵ Rule 206(4)-4 currently requires RIAs to provide such disclosure – either orally or in writing. Due to the inclusion of this particular item in the Brochures, requiring RIAs to separately comply with rule 206(4)-4 would require them to duplicate their work, so rule 206(4)-4 would be rescinded. Advisors would also be required to provide a list of disciplinary events that occurred within the preceding 10 years that are “presumptively material.” The class of presumptively material disciplinary events includes, without limitation, any convictions for theft, fraud, bribery, perjury, forgery, and violations of securities laws. If an adviser believes that a certain disciplinary event does not compromise its integrity, it may rebut the presumption of materiality¹⁶ and withhold disclosing this event to clients. Under such circumstances, the SEC would require that the adviser document its determination in a memorandum and then retain it as part of its books and records.

10. Other Financial Industry Activities and Affiliations: RIAs would be required to disclose material relationships or arrangements with related financial industry participants, any material conflicts of interests stemming therefrom, and how these conflicts will be addressed.¹⁷

¹³ This information is currently required in Part II, Items 2 and 10.

¹⁴ Similar disclosure is currently required in Part II, Item 4.

¹⁵ Currently, this disclosure must be provided to the SEC in Part 1A of Form ADV.

¹⁶ In the Release, the SEC explained that four factors that RIAs should consider in evaluating whether a presumption of materiality should attach to a particular disciplinary event are: (1) the proximity of the person involved in the disciplinary event to the advisory function; (2) the nature of the infraction that led to the disciplinary event; (3) the severity of the disciplinary sanction; and (4) the time that has elapsed since the date of the disciplinary event.

¹⁷ Part II, in Item 8, currently requires RIAs to disclose their material relationships or arrangements with related financial industry participants, but they are not required to describe any related conflicts of interest and how such conflicts are addressed.

Additionally, whenever RIAs select or recommend other RIAs to clients, they would be required to disclose any compensation arrangements or other business relationships between themselves and the RIAs they select or recommend, along with any conflicts attributable to such relationships.

11. Code of Ethics, Participation or Interest in Client Transactions and Personal Trading: RIAs would be required to briefly describe their code of ethics and to state that a copy of such code is available upon request.

a. Participation in Client Transactions: If RIAs (or related persons) recommend securities to clients, or if RIAs buy or sell securities for clients in which they (or related persons) have material financial interests, they would be required to discuss such transactions and any conflicts arising from such transactions.¹⁸ The SEC highlighted that RIAs should disclose when they recommend investment vehicles that they separately advise or for which they serve as general partners.

b. Personal Trading: RIAs and their personnel would be required to provide disclosure regarding their personal trading. The SEC has emphasized that RIAs, due to the information they possess, are in a position to abuse clients' positions (*i.e.*, by placing their own trades before, at the same time as, or after client trades to benefit from price movements caused by clients' trades). Accordingly, the SEC maintains that engaging in personal trading can affect the objectivity of RIAs' recommendations, and it can harm clients by adversely affecting the prices at which their trades are executed. If RIAs can invest in the same securities that they recommend to clients (or if they can invest in related securities such as options upon the securities that they can recommend to clients), they would be required to disclose this fact, along with the ways in which they address related conflicts.¹⁹

12. Brokerage Practices: RIAs would be required to disclose why they select certain brokers to execute client transactions and how they determine the reasonableness of such brokers' compensation. Additionally, RIAs would be required to disclose specific arrangements that they enter into with brokers (and how they address conflicts arising in connection with such arrangements), including the receipt of soft dollars, client referrals from brokerage firms, trade aggregation, and client-directed brokerage arrangements.

a. Soft Dollars: Section 28(e) of the United States Securities Exchange Act of 1934, as amended, establishes a safe harbor (the "Section 28(e) safe harbor") that allows RIAs to use client funds, by way of commission dollars, to purchase certain "brokerage and research services." RIAs' use of client securities transactions to receive soft dollar benefits can lead to conflicts of interest between themselves and their clients. Accordingly, the SEC has required RIAs to disclose their specific policies and practices regarding their receipt of soft dollars in connection with their clients' securities transactions.²⁰ More detailed disclosure would be required for products or services that fail to qualify for the Section 28(e) safe harbor, including research products or services that do not assist RIAs in their investment decision-making processes. RIAs would also have to disclose conflicts arising in connection with their receipt of soft-dollars, and how they address such conflicts.

¹⁸ Similar disclosure is currently required in Part II, Item 9.

¹⁹ Similar disclosure is currently required in Part II, Item 9.E.

²⁰ *See, i.e.*, Part II, Item 12.

b. Client Referrals: If RIAs reward brokers for client referrals with client brokerage, RIAs would be required to disclose this practice, conflicts stemming from it, and how they address such conflicts.

c. Trade Aggregation: By way of background, clients may benefit when their RIAs negotiate lower brokerage commissions or aggregate trades to obtain volume discounts on execution costs. RIAs would be required to disclose whether and under what circumstances they aggregate trades. Additionally, if RIAs do not aggregate trades to obtain volume discounts when they can do so, they would be required to disclose to their clients that they may wind up paying higher brokerage costs as a result.

d. Directed Brokerage: RIAs would be required to disclose to clients who direct them to send certain transactions to specific broker-dealers (“client directed brokerage”) (*i.e.*, as a favor or to indirectly compensate such broker-dealers for services provided) that such clients may pay higher commissions or receive less favorable executions that they might ordinarily pay or receive. RIAs may also directly benefit from directed brokerage when they initiate it to affiliated broker-dealers (“adviser directed brokerage”). If such adviser directed brokerage is routine, or if RIAs request or require client directed brokerage, then appropriate disclosure and a discussion of any relationships between RIAs and affiliated broker-dealers that would create a material conflict of interest would be required.

13. Review of Accounts: RIAs would be required to disclose the frequency with which they review clients’ accounts or financial plans, and to identify the parties conducting such reviews.²¹

14. Payment for Client Referrals: RIAs would be required to describe any cash payments or other payments that they or any related persons distribute in exchange for client referrals. Additionally, RIAs would have to disclose whether non-clients provide their firms with any benefits (including sales awards or prizes) for providing advisory services to clients.²²

15. Custody: Presently, to satisfy the custody requirements provided under rule 206(4)-2, most RIAs who have custody of clients’ securities or funds utilize the services provided by qualified custodians (e.g., a broker-dealer or a bank). If such qualified custodians send account statements directly to clients, instead of to RIAs beforehand, RIAs should disclose this practice to their clients and inform them that they should review such account statements carefully. Additionally, if clients do not receive account statements covering all of the funds and securities over which their RIAs have custody from such qualified custodians, RIAs would then be required to disclose that they have custody over certain funds and securities, and explain the accompanying risks to clients as well.

16. Investment Discretion: When RIAs have discretionary authority over client accounts, they would be required to disclose the types of arrangements that they enter into with clients in their Brochures, along with any limitations that clients may (or typically do) place on such discretionary authority.²³

²¹ Similar disclosure is currently required in Part II, Item 11.

²² Similar disclosure is current required in Part II, Item 13.

²³ Similar disclosure is current required in Part II, Items 12A and 12B.

17. Voting Client Securities: RIAs would be required to disclose whether they accept authority to vote client securities. If so, they would have to provide a brief description of the specific proxy voting policies that they have adopted under rule 206(4)-6 of the Investment Advisers Act, along with the following:

- (i) whether (and how) clients can direct their RIAs to vote in particular situations;
- (ii) how their RIAs deal with conflicts of interest; and
- (iii) how clients can obtain information from their RIAs regarding how they voted clients' securities.

RIAs who accept authority to vote client securities would be required to inform investors that they are entitled to receive a copy of such RIAs' proxy voting policies and procedures upon request. RIAs who do not have authority to vote client securities would be required to inform clients how they will receive their proxies and other solicitations. Additionally, if RIAs typically rely upon third-party proxy voting services to advise them in connection with voting client securities, such RIAs would be required to list the proxy voting services that they use and how such services are selected. Moreover, RIAs would be required to disclose whether they permit clients to direct the use of proxy voting services with respect to securities that they are holding in client accounts. Lastly, RIAs would have to disclose the manner in which they pay for proxy voting services.

18. Financial Information: Similar to Item 10 above, RIAs would be required to disclose certain material financial information to their clients. Additionally, RIAs requiring prepayments of at least \$1,200 in fees from clients at least six months in advance would have to provide audited balance sheets to their clients detailing such RIAs' assets and liabilities at the end of its most recent fiscal year. Further, RIAs who (i) require prepayments of at least \$1,200 at least six or more months in advance, or (ii) have discretionary authority over client assets, or (iii) have custody of client funds or securities would be required to disclose any financial conditions that are reasonably likely to impair such RIAs' abilities to satisfy contractual commitments to clients. RIAs would also be required to disclose if they have been the subject of a bankruptcy petition within the preceding ten years.

19. Index: RIAs would be required to provide the SEC with indices containing details regarding each of the foregoing items – *i.e.*, identifying where in their Brochures each of the foregoing items are addressed.²⁴ These indices would not have to be provided directly to clients, but they would be required to be appended to Brochures when they are filed through the IARD.

B. *Part 2A Appendix 1: The Wrap Fee Program Brochure*

In wrap fee programs (otherwise known as “separately managed accounts”), RIAs charge clients an overall specified fee or fees (“wrap fees”) for services that may include portfolio management, advice concerning the selection of other RIAs, custody, and/or execution of client transactions. Essentially, under wrap fee programs, advisory and brokerage services are wrapped or bundled under one contract – for a flat wrap fee. Such wrap fees are typically based on the amount or type of client assets under management, not upon the quantity of client transactions

²⁴ The proposed Index would be similar to the index that is currently required in Part II, Schedule H.

executed.²⁵ In 1994, the SEC began requiring RIAs who sponsor wrap fee programs (“wrap fee advisers”) to provide separate brochures (“wrap brochures”) to their clients (“wrap fee clients”).²⁶ Under the Proposed Amendments, the SEC would still continue to require wrap fee advisers to provide separate wrap brochures to wrap fee clients, instead of the narrative Brochures that it is proposing to require RIAs to provide to their standard clients.²⁷ However, under the Proposed Amendments, the SEC would require wrap fee advisers to disclose, in their wrap brochures, whether any of the portfolio managers in their wrap fee programs are related persons (“related portfolio managers”). If so, RIAs would be required to describe any conflicts stemming therefrom. The SEC noted that wrap fee advisers may have incentives to select related persons to participate as portfolio managers based primarily upon their affiliation with such wrap fee advisers rather than based upon their expertise. Additionally, under the Proposed Amendment, RIAs would be required disclose whether related portfolio managers are subject to the same selection and review processes as other portfolio managers who participate in such wrap fee programs, and, if they are not, how such related portfolio managers are selected and reviewed.

IV. Proposed Amendments to the Delivery and Updating Of Brochures

The SEC is also proposing a series of amendments to rule 204-3 under the Advisers Act (“rule 204-3”)²⁸. This is the rule under the Adviser Act governing how RIAs must update and deliver their disclosure statements to clients.

A. Delivering Part 2 of Form ADV to Clients

1. Initial Delivery

Under rule 204-3, RIAs must currently furnish each client with written disclosure statements either in the form of (i) a copy of their completed Part IIs, or (ii) a written document containing all of the information required in Part II. Additionally, RIAs must furnish disclosure statements to clients either (i) at least 48 hours prior to entering into an advisory agreements with them, or (ii) when entering into agreements with them *and* provided that they have the right to terminate such agreements without penalty within the next 5 business days (*i.e.*, when clients have what is known as a five day “free look” period.) Under the Proposed Amendments, the SEC would simplify the initial delivery requirements described above by requiring RIAs to deliver Brochures to clients only before or at the time of entering into advisory agreements with them.

The SEC is also proposing to expand the class of persons who would not be required to receive Brochures under rule 204-3. Presently, RIAs are not required to deliver to disclosure statements to clients receiving only impersonal investment advice or clients who are investment companies registered under the Investment Company Act of 1940, as amended (the “Company Act,” and such companies are “registered investment companies” (“RICs”)). The SEC is proposing

²⁵ As wrap fees may include brokerage commissions, companies with active trading accounts often find wrap fee programs appealing because they do not have to pay commissions on each transaction executed in their accounts under such programs.

²⁶ See *Disclosure by Investment Advisors Regarding Wrap Fee Programs*, Investment Advisers Act Release No. 1411 (Apr. 19, 1994).

²⁷ RIAs who provide both standard and wrap fee advisory services to the same clients would be required to provide such clients with standard narrative brochures *and* wrap brochures.

²⁸ Proposed Rule 204-3(b)(1) under the Advisers Act.

to expand the latter exception to include RIAs to business development companies (“BDCs”) who are subject to section 15(c) of the Company Act.

2. Annual and Interim Delivery

Rule 204-3 currently requires RIAs to deliver – or offer to deliver upon request – either (i) a copy of its completed Part II, or (ii) a written document containing the information required by Part II to each of its clients on an annual basis. Under the Proposed Amendments, RIAs would be required to deliver Brochures to existing clients at least once each year, no later than 120 days after the end of the adviser’s fiscal year.

Thereafter, RIAs would have to deliver interim updates of their Brochure to clients only when they amend their Brochures to include additional disciplinary events or when they materially revise information relating to their disciplinary histories (as explained in Section III.A. above).²⁹

B. *Updating Part 2 of Form ADV*

The Proposed Amendments would require RIAs to update their Brochures on an annual basis, just as Part II is required to be updated on an annual basis. As noted in the preceding paragraph, RIAs may also be required to provide clients with interim updates due to material changes in their disciplinary histories. Under the Proposed Amendments, RIAs could submit revised versions of their Brochures electronically through IARD. Thereafter, only the most recently revised version would be made available to the public through the SEC’s website; the SEC would store RIAs’ previously-filed versions.

V. *The Brochure Supplement (Part 2B of Form ADV)*

The SEC is sensitive to the fact that many clients do not currently receive certain information that they seek or require regarding RIAs’ supervised persons³⁰ – either through Part II or the proposed Brochures – because such disclosures pertain to RIAs’ *firms*, and not their supervised persons. To address this concern, the SEC has proposed that “plain English” Brochure Supplements should accompany the Brochures. Such Brochure Supplements would contain information about Supervised Persons upon whom clients have contact with or rely for investment advice (the “Supervised Advisers”). The Brochure Supplements would typically be less than one page long, and they would contain specific information about each Supervised Adviser’s educational background, business experiences, and disciplinary history.

A. *Delivery and Updating of Brochure Supplements*

RIAs would be required to provide every client with a Brochure Supplement containing details about each Supervised Adviser who:

²⁹ The SEC explained that RIAs’ revisions to their disciplinary histories warrant a formal delivery requirement because of the primary importance of disciplinary information to clients.

³⁰ To an investment adviser, a “supervised person” is any officer, partner, director (or other person occupying a similar status or performing similar functions), or employees, or any other person who provides investment advice on its behalf, and is subject to its supervision or control. *See* the Release, p. 73, fn. 212.

- (i) formulates investment advice for that client or has direct contact with that client; or
- (ii) makes discretionary investment decisions for that client's accounts (regardless of whether the Supervised Adviser has direct contact with that client or not.)

RIAs would not have to provide Brochure Supplements to four types of clients:

- (i) clients who receive only impersonal investment advice;
- (ii) clients to whom RIAs are not required to deliver Brochures (such as RICs, as noted in Section IV.A.1 above);
- (iii) clients who are "qualified purchasers"³¹;
- (iv) certain "qualified clients"³² who are not officers, directors, employees, or other persons related to the adviser.

RIAs could choose to provide clients with Brochure Supplements for each Supervised Adviser, or alternatively, they could provide clients with separate Brochure Supplements for each different group of Supervised RIAs who work within the same office or group.

In contrast to the annual delivery requirement for Brochures, Brochure Supplements would not have to be delivered annually; the SEC believes that they are less likely to become materially inaccurate over time. Additionally, RIAs would be required to deliver updates only under the same narrow criteria that would apply to Brochures – *i.e.*, when disclosure of a disciplinary event is required or in response to a material change in RIAs' disciplinary histories. Further, the SEC would require RIAs to file Brochure Supplements through its IARD system, and it would then make them available to the public through its website.

The SEC did not prescribe a specific format for Brochure Supplements because it is aiming to allow RIAs to present details regarding their Supervised RIAs in a format that is best suited for their needs.

Under the Proposed Amendments, the Brochure Supplements would be required to contain the following disclosures pertaining to Supervised RIAs:

- (i) a cover page identifying who they are;
- (ii) details regarding their educational backgrounds and business experiences;
- (iii) their disciplinary histories;
- (iv) any other business activities or occupations in which they engage for pay;
- (v) any arrangements through which someone other than a client provides them with an economic benefit for providing advisory services; and

³¹ Section 2(a)(51)(A) of the Investment Company Act defines "Qualified Purchasers" to include, among others, natural persons who own \$5 million or more in investments and persons who manage \$25 million or more in investments either for their own account or other accounts of other qualified purchasers.

³² Rule 205-3(d)(1)(iii) under the Advisers Act defines "Qualified Clients" as certain related persons of an adviser including executive officers, directors, trustees, and general partners, and employees of the advisory firm who, in connection with their regular functions or duties, participate in the investment activities of the firm and have been performing such functions for at least 12 months.

- (vi) how the advisory firm monitors the advice that they provide (along with the contact details of a person responsible for supervising their advisory activities.)

VI. Amendments to Form ADV Instructions and Glossary

In conjunction with the foregoing, the SEC is proposing to add certain changes into the *General Instructions* and *Glossary of Terms* for Form ADV. The changes to the *General Instructions* would include instructions regarding filing of the Brochure and the Brochure Supplements. The changes to the *Glossary of Terms* would include the addition of terms such as “brochure,” “brochure supplement,” and “supervised person.”

VII. Amendments to Rule 204-2

Furthermore, the SEC is proposing conforming amendments to rule 204-2 under the Advisers Act (the rule requiring RIAs to maintain and preserve certain books and records.) The proposed amendments to rule 204-2 would require RIAs to retain copies of each Brochure, Brochure Supplements, and the amending Brochures and Brochure Supplements. The proposed amendments to rule 204-2 would also require RIAs to document the method that they utilize to calculate their total assets under management – to conform with the disclosure requirements required by Item 4 (“Advisory Business”) in the Brochures (as explained above in Section III.A.) Additionally, to satisfy Item 9 (“Disciplinary Information”) in the Brochures, RIAs would be required to prepare and preserve memoranda detailing any legal or disciplinary events that were not disclosed to clients whenever RIAs choose to rebut the presumption of materiality that ordinarily attaches to them (as explained above in Section III.A).

VIII. Conclusion

The enactment of the Proposed Amendments would dramatically change the form and manner in which RIAs currently provide disclosure statements to clients through Part II. The SEC is currently requesting public comments upon the Proposed Amendments by May 16, 2008. It is specifically soliciting comments upon whether there are ways to enhance the utility, quality, and clarity of the additional information that it hopes to collect from RIAs. The SEC is also requesting feedback regarding the burdens that the Proposed Amendments would impose on smaller RIAs, and whether the effects of the Proposed Amendments on small RIAs could become economically significant.

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If you wish to discuss the Release with us or have any comments that you would like us to convey to the SEC, please do not hesitate to contact us.