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Form ADV Changes Approved by the SEC

After years of speculation regarding when the proposed changes to the Form ADV Part II would be implemented, the Securities and Exchange Commission (SEC) unanimously adopted the proposed changes on July 21, 2010. The changes will raise the bar on how disclosures will be made to investment advisory clients and will result in all investment advisers making major modifications to their existing Form ADV Part II.

In the [SEC Release 2010-127](#), SEC Chairman, Mary Schapiro said “these changes are designed to provide clients with greater information about the individuals who will provide them with investment advice, and will help transform the brochure into a plain English narrative that is well-suited to serve investors’ needs and describes the adviser’s conflicts, compensation, business activities, and disciplinary history”.

The implementation date of the amended rules and forms (the “Amended Rule”) will be effective 60 days after publication in the Federal Register. The SEC has postponed publication of the revised Form ADV, Part II for five business days in order to work with the states to accommodate technical, state-specific changes to the items and instructions on the form. However, the SEC made it clear that they intend for investment advisers to be distributing and publicly posting new brochures in the first quarter of 2011.

Under the Amended Rule, advisers will have to provide new and prospective clients with brochures that are organized in a consistent and uniform manner, and that contain expanded plain English disclosures of the adviser’s business practices, fees, conflicts of interest, and disciplinary information. Advisory firms must also provide “brochure supplements” to clients containing information about the employees who will provide the advisory services.

The Amended Rule adopted by the SEC addresses the following matters:

Internet Availability to Advisory Clients

Advisers will be required to file brochures electronically, which will be publicly available on the SEC’s website.

Supplements to Brochure

Advisers will be required to deliver “brochure supplements” to new and prospective clients, including providing them with information about the specific individuals who will provide services to the clients, and contact information for the person’s supervisor in case the client has a concern about the person.

Improved Disclosure Format

Advisers will be required to prepare a plain English, narrative, brochure, presented in a consistent and uniform manner that will make it easier for clients to compare different advisers’ disclosures.

Brochure Updating Requirements

Advisers will still be required to deliver the brochure to a client before or at the time the adviser enters into an advisory contract with the client. However, advisers will also be required to provide each client with an annual summary of material changes to the brochure, plus offer to or actually deliver a complete updated brochure to their clients.

Expanded Content Disclosure

The Amended Rule requires that the revised Form ADV Part II address those topics the SEC believes are most relevant to clients. Under the Amended Rule, an investment adviser will need to provide expansive information and disclosures related to:

- the description of its advisory business.
- fees and compensation (including a fee schedule).
- performance-based fees, or supervising an individual who accepts such fees. If the investment adviser also manages accounts that are not charged a performance fee, the adviser must explain the conflicts of interest that arise from the simultaneous management of these accounts and must describe how it will address those conflicts.
- the methods of analysis and investment strategies, including a disclosure regarding the fact that investing in securities involves risk of loss which clients should be prepared to bear. To the extent the investment adviser uses a particular method of analysis or strategy, or recommends a particular type of security, the adviser will be required to explain the material risks involved and discuss the risks in detail if those risks are unusual.
- any legal or disciplinary event that is material to a client’s evaluation of the advisory business or to the integrity of its management personnel.
- its code of ethics, including:
 - recommendations to clients, or buys or sells for client accounts of securities in which the adviser or an affiliate has a material financial interest and the conflicts of interest associated with that practice.

- any investment by the adviser or affiliates in the same securities that it recommends to clients or in related securities, such as options or other derivatives, in addition to the conflicts involved and how it will address those conflicts.
 - if the investment adviser trades in securities recommended at or around the same time as the client, an explanation of how it addresses conflicts of interest will be necessary.
- its brokerage practices, including:
 - the factors considered in selecting or recommending broker-dealers for client transactions and a determination of the reasonableness of the brokers' compensation.
 - soft dollar practices (research or other products or services, other than execution, provided by brokers or a third party to the investment adviser in connection with client transactions).
 - client referrals (using client brokerage to compensate brokers for client referrals).
 - directed brokerage (asking or permitting clients to send trades to a specific broker for execution).
 - trade aggregation (bundling trades to obtain volume discounts on execution costs).

Ultimately, the Amended Rule will require substantial revisions to advisers Form ADV Part II. Since the SEC anticipates compliance with the requirements of the modifications to the rule by first quarter 2011, we would recommend that advisers review the new form by August 1, 2010 and commence the process of addressing the expanded disclosure requirements as soon as possible. As the Amended Rule requires the new Form ADV Part II be filed electronically, and available to the public on the SEC web site, it will clearly be obvious to the SEC if your Form ADV Part II is not posted timely.

We hope that this information has been helpful to you. Should you have any additional questions or concerns, please feel free to contact Daniel E. LeGaye or Michael Schaps by e-mail or phone, at 281-367-2454, or consult with your legal counsel or third party consultant.

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