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Investment Adviser Newsletter

A Thompson Coburn LLP Investment and Financial Services Group Newsletter
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SEC Adopts Revised Form ADV Part II

On July 21, 2010, the SEC voted unanimously to adopt changes to Form ADV Part II, the disclosure form required to be provided to clients of registered investment advisers. The revised Form ADV Part II is designed to present information to clients and potential clients in a more user-friendly, accessible format. Key changes adopted include:

- **Narrative, Plain English Format.** Advisers are required to provide clients with a narrative, plain English brochure that presents information about the adviser in a consistent, uniform manner, which is designed to make it easier for clients to compare different advisers' disclosure statements.

- **Delivery**. Advisers will be required to deliver the brochure to a client prior to, or in conjunction with, the execution of the advisory contract. Advisers annually must provide each client with a summary of material changes to the brochure and either deliver or offer to deliver an updated version.

- **Filing and Availability**. Advisers will now be required to file their Form ADV Part II electronically in a text-searchable PDF format. The ADV Part II will be filed through the IARD system. After filing the ADV Part II through the IARD, it will be publicly available on the SEC's website.

- **Expanded Content.** Advisers are required to expand the breadth and depth of the disclosures made in the Form ADV, including
    - Advisory business: The Part II must include a description of the adviser's business, the types of services offered, the assets under management, and state whether the adviser holds itself out as a specialist in a particular area.
    - Fees and Compensation: The adviser is required to disclose how it is compensated, provide a fee schedule and state whether fees are negotiable. The Part II must include a description of additional fees and expenses that clients may pay, such as brokerage, custody and mutual fund fees. The adviser must disclose performance fee arrangements, explain any resulting conflicts of interest and how the adviser addresses those conflicts.
    - Investment Strategies: The adviser must describe its methods of analysis,

investment strategies and material risks involved. The adviser must state that investing in securities involves the risk of loss which clients should be prepared to bear.
    - Code of Ethics and Conflicts of Interest: Advisers must include a brief description of their Code of Ethics and state that it is available upon request, as well as disclosure regarding conflicts of interest related to recommendations and transactions of the adviser and its employees and how the adviser addresses those conflicts.
    - Disciplinary Information: The adviser must disclose material facts about 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. The adviser must promptly provide updated disclosure to clients about disciplinary events.
    - Brokerage Practices: Part II must include a description of the factors considered in selecting or recommending broker-dealers for client transactions and determining the reasonableness of brokers' compensation. Advisers must disclose their soft dollar practices, whether they direct client transactions to certain brokers in exchange for client referrals, information about directed brokerage and block trades, and how the adviser addresses the various conflicts of interest associated with these practices.

- **Supplements.** Advisers are required to provide supplements to new and prospective clients containing information about specific individuals who will provide services to those clients. Similar to a resume, the supplement will highlight the education, business experience and disciplinary history of the individuals providing advisory services. It will also include contact information for the person's supervisor in case the client has a concern.

- **Compliance Dates**. Advisers with a December 31 fiscal year end must file the updated brochure with their annual amendment, due by March 31, 2011. Advisers with a fiscal year end other than December 31 must file the updated brochure with their annual amendment filing for the 2011 year end.

The revised Form ADV Part II and its instructions are available here.

Wall Street Reform Act Changes Registration Requirements for Advisers

As part of the Wall Street Reform And Consumer Protection Act that was signed into law on July 21, 2010, advisers that provide investment advice to clients (excluding investment and business development companies) will not be permitted to register with the SEC if the adviser (a) has less than $100 million in assets under management and (b) would be required to register with the state in which it maintains its principal office and place of business (and subject to examination by the state). Federally-registered advisers that do not meet the new minimum level of assets under management must deregister with the SEC and register with the appropriate states. However, if an adviser would be required to register with 15 or more states as a result of not registering with the SEC, then the adviser shall be permitted to register with the SEC.

The act has eliminated the "private adviser" exemption that allowed many advisers of private funds to avoid registration altogether, provided that the advisers did not hold themselves out as advisers and had fewer than 15 clients in the preceding 12 months. Now, advisers who manage only private funds and who have less than $150 million in assets under management will be excluded from federal registration but will be subject to state registration.

The Act provides a one-year transition period before its provisions take effect. Federally-registered advisers with less than the required level of assets under management may be required to deregister with the SEC and register with the appropriate states by July 21, 2011. Advisers that are excluded from federal registration under these exemptions will remain subject to certain disclosure and recordkeeping requirements to be determined by the SEC.

If you would like assistance in determining your registration, disclosure or recordkeeping requirements under the Wall Street Reform Act, please contact one of the Investment and Financial Services Group attorneys listed in the **About Our Attorneys** section below.

SEC Updates Guidance on Custody Rule

The SEC's Division of Investment Management Staff has provided informal guidance on the application of revised Rule 206(4)-2 (the "Custody Rule") in its "Staff Responses to Questions About the Custody Rule." In May, the Staff updated its guidance to clarify its position on how the Custody Rule applies to certain operational situations as briefly discussed below. The full text of the SEC Staff Responses to Questions About the Custody Rule can be found here: http://www.sec.gov/divisions/investment/custody_faq_030510.htm.

The Custody Rule states that an adviser is deemed to have custody if it has the authority to withdraw client assets upon its instructions to the custodian; however, the Staff has clarified in the Responses that it does not interpret the "authority to withdraw assets" to include the adviser's limited authority to transfer its client's assets between the client's accounts maintained at one or more qualified custodians provided that:

a) The client has authorized the adviser in writing to make such transfers; and
b) A copy of the authorization has been provided to the qualified custodians, specifying the client accounts maintained with qualified custodians.

The Staff's updates included the following guidance:

- An adviser is not deemed to have custody where the adviser has the authority to instruct the qualified custodian maintaining a client's account to remit the account assets to the same client at the client's address of record if:
    - the client has granted such authority to the adviser in writing and a copy of that authorization is provided to the qualified custodian; and
    - the adviser has neither the authority to open an account on behalf of the client nor the authority to designate or change the client's address of record with the qualified custodian.

- Where the adviser manages assets legally and beneficially owned by a related natural person of the adviser (such as a portfolio manager), the fact that the related person has access to his or her own account assets will not impute custody to the adviser.
- If an adviser does not calculate the advisory fee or send a fee bill, but rather the client has instructed its custodian to make the fee calculation based on the advisory contract and debit the client's account for advisory fees each quarter, the adviser is not deemed to have custody, provided that the qualified custodian is not affiliated with the adviser.
- An adviser would be deemed to have custody if the adviser has access to a client's "user ID and password" to a client's 401(k) or other pension fund account for the purposes of rebalancing and adjusting investments in the account if such access provides the adviser with the ability to withdraw funds or securities or transfer them to an account not in the client's name.
- An investment adviser to a pooled investment vehicle (a "pool") that does not distribute audited financial statements of the pool to investors can comply with the Custody Rule if:
    - it has a reasonable basis, after due inquiry, for believing that the pool's qualified custodian sends quarterly account statements to each investor in the pool; and
    - the adviser obtains an annual surprise examination with respect to the pool's assets.

The Staff also noted in the Responses that the adviser to an unaudited pool must maintain privately offered securities owned by the pool with a qualified custodian.

SEC Adopts Pay to Play Proposal

The SEC announced on June 30 that it had adopted new Rule 206(4)-5 (the "Rule"), which is designed to limit the influence of "pay to play" practices. In a pay to play arrangement, investment advisers make political contributions to government officials or candidates with the objective of influencing the process for selecting advisers to manage public pensions funds, 529 plans and public retirement plans. The new Rule was adopted substantially as proposed except that the ban on third party solicitors was relaxed and the amount of the de minimis contribution exception was increased. The new Rule applies to all advisers managing assets of a government entity, including advisers managing any publicly offered registered investment company if the investment company fund is an option for participants in a government plan.

The main provisions of the new Rule are outlined below:

1. The Rule prohibits advisers from providing their services for compensation, either directly or through a fund, to public pension plans and similar government investment accounts if the adviser or its "covered associates" make a political contribution to any incumbent or candidate for elected office who is or would be in a position to influence the selection of the adviser. "Covered associates" include the adviser's general partner, managing member, executive officers, any employee with similar status or function, any employee soliciting government entities on behalf of the adviser, and any political action committee controlled by the adviser or a covered associate.

2. The Rule prohibits advisers and their covered associates from soliciting or coordinating campaign contributions from other persons or political action committees for (a) any elected official who is in a position to select the adviser and to (b) any political party in the state or municipality where the adviser is seeking to provide advisory services to the government. The Rule also specifically prohibits advisers and their covered associates from funneling contributions through third parties such as spouses, lawyers or companies affiliated with the adviser, if such contributions would violate the Rule if done directly.

3. The Rule prohibits an adviser from paying a third party such as a solicitor or placement agent to solicit a government client on behalf of the adviser unless the third party is registered with the SEC as a broker/dealer or investment adviser and subject to the same pay to play restrictions.

4. The Rule permits an executive or employee of the adviser to make de minimis contributions of up to $350 per election per candidate if the contributor is entitled to vote for the candidate and up to $150 per election per candidate if the contributor is not entitled to vote for the candidate. The SEC will have broad exemptive authority to address inadvertent violations.

Advisers do not have to maintain records related to the Rule if they have no government entity clients, nor are advisers required to maintain records of unsuccessful solicitations. The new Rule becomes effective September 13, 2010. Advisers must be in compliance with the Rule within six months of September 13, 2010, except that compliance with the provisions of the Rule applicable to advisers of registered investment companies subject to the Rule will not be required until September 13, 2011.

About Our Attorneys

Our Investment and Financial Services Group represents various financial services companies, including investment advisers, financial planners, broker/dealers, and registered investment companies with respect to federal and state regulations, FINRA and SEC registration, compliance and enforcement issues. We also represent investment advisers and institutional investors in connection with investments in private equity, venture capital, real estate and hedge funds.

If you have any questions related to the topics in this newsletter, or would like to receive previous issues of our Investment Adviser Newsletter, please contact the Investment and Financial Services Group.

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