

August 25, 2010

SEC Adopts Amendments That Overhaul Form ADV Part 2

The Securities and Exchange Commission (SEC) has adopted amendments to Form ADV Part 2 and related rules (Amendments). Investment advisers use Form ADV to register with the SEC and with state securities regulators.

The amended Form ADV Part 2 (previously known as Part II), which will be used by advisers to satisfy their disclosure obligations to clients pursuant to Rule 204-3 under the Investment Advisers Act of 1940, as amended (the Act), consists of two sub-parts: a “brochure” (Part 2A) and one or more “brochure supplements” (Part 2B). The brochure will include information about the adviser and its business and will be filed with the SEC electronically on the Investment Adviser Registration Depository (IARD) system. The brochure supplement, which is a brief disclosure document about certain personnel of the adviser who provide investment advice, will be provided to clients to whom such persons provide such advice, but will not be filed.

Effective and Compliance Dates

Effective Date. The amended rules and forms will be effective October 12, 2010, at which time voluntary compliance is permitted.

Currently Registered Advisers. Each registered adviser whose fiscal year ends on or after December 31, 2010, must include in its next annual updating amendment to its Form ADV a brochure that meets the requirements of amended Form ADV Part 2A. Each adviser with a fiscal year-end of December 31, 2010, must file an annual updating amendment with the new brochure no later than March 31, 2011. Within 60 days after this initial filing date for the annual updating amendment, an adviser will be required to deliver the brochure and brochure supplement(s) to its clients. In subsequent years, an adviser will be required to deliver a brochure and brochure supplement(s) to its clients annually, within 120 days of the end of its fiscal year.

New Investment Advisers. An adviser applying for SEC registration after January 1, 2011, must file a brochure that meets the requirements of amended Form ADV Part 2A as part of its application for registration. Such advisers must, upon registering, begin to deliver to their clients and prospective clients a brochure and brochure supplements.

The SEC release announcing adoption of the amendments has been published in the Federal Register and is available at: <http://frwebgate2.access.gpo.gov/cgi-bin/PDFgate.cgi?WAISdocID=KnTdJD/o/2/o&WAIAction=retrieve>.

The adoption of the new Form ADV Part 2 effects significant changes in the format and substance of disclosures required of registered investment advisers. For assistance with registration as an investment adviser or revision of your Form ADV to meet the new requirements, please contact your Katten Muchin Rosenman LLP attorney or any of the following members of the [Financial Services Practice](#):

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Key Aspects of the Amendments to Form ADV Part 2

The Amendments will make significant changes to the format and substance of Form ADV Part 2 and make the form itself accessible to clients and potential clients on the SEC's Investment Adviser Public Disclosure (IAPD) website.

The key aspects of the Amendments are as follows:

- They underscore that an adviser is a fiduciary. An adviser has a duty to deal fairly with its clients and potential clients and make full disclosure of any material conflicts or potential conflicts of interest. Much of the added disclosure required by the Amendments relates to such conflicts or potential conflicts of interest.
- They divide Form ADV Part 2 into two sub-parts. Part 2A, the brochure, contains information about the adviser, including, among other things, its business, fees, types of clients, strategies, risks, conflicts of interest with its clients and a disciplinary history of the adviser and its officers, directors, employees and affiliates and must include or be accompanied by a "summary of material changes" from the last annual updating amendment. Part 2B, the brochure supplement, contains biographical information about the adviser's supervised persons who manage client portfolios.
- They provide that the adviser must deliver (i) the brochure to a client before or at the time of entering into an advisory contract with such client, and (ii) the brochure supplement of a supervised person to a client at or before the time when that supervised person begins to provide advisory services to that specific client.
- They require that clients receive a summary of the material changes made to the brochure annually.
- They provide that the adviser must deliver to clients an updated brochure or brochure supplement whenever the adviser amends either such document to add, or make a material change to, a disciplinary event or other previously reported information.
- They provide that the adviser may create and file separate brochures for different types of advisory services, may disclose more than is required by the form, and may include a summary in the beginning of the brochure, followed by a more detailed discussion of each item.
- They require that the brochure and brochure supplement be written in a narrative "plain English" format. This new format is in contrast to the "check-the-box" format of current Part II, which advisers supplement with narratives.
- They require that Part 2A be filed with the SEC electronically on the IARD system, making it publicly available on the SEC website in text-searchable PDF format. Part 2B will not be filed, but must be provided to clients.
- They clarify that under Rule 204-3, brochures are only required to be delivered to "clients" and reiterate the holding of *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006), that the "client" of an adviser managing a hedge fund is the fund itself, not an investor in the fund.

Part 2A—The Brochure

Part 2A contains 18 separate items, each covering a different disclosure topic that must be addressed in the order in which the items are listed, using the headings provided. If the adviser provides information in response to one item that is responsive to another item, the information may be cross-referenced. As a fiduciary, an adviser must make full disclosure to its clients of any material information, including material conflicts or potential conflicts of interest. If a conflict arises or the adviser decides to engage in a practice that it has not disclosed, it must provide clients with appropriate supplemental information in a brochure. Please see the Appendix for details of the 18 required disclosure items.

Delivery and Updating Requirements of Part 2A

Delivering Part 2A

Initial Delivery. Amended Rule 204-3 of the Act provides that an adviser must deliver the brochure before or at the time of entering into an advisory contract with a client. Under old Rule 204-3(b) the adviser was required to deliver the brochure at least 48 hours before entering into the advisory contract, or at the time of entering into the contract if the client had the right to terminate the contract without penalty within five business days thereafter.

Annual Delivery. An adviser must annually provide to each client to whom it must deliver a brochure either (i) a copy of the current updated brochure that includes or is accompanied by the summary of material changes, or (ii) a summary of material changes and an offer to provide a copy of the current brochure. The adviser generally must make this annual delivery no later than 120 days after the end of its fiscal year and may do so electronically in accordance with the SEC guidelines.

Interim Delivery. Amended Rule 204-3 requires an adviser to deliver an updated brochure promptly whenever the adviser amends its brochure to add a disciplinary event in response to Item 9 of Form ADV Part 2A or to change material information already disclosed.

Updating Part 2A

Advisers must keep the brochures they file current by updating them at least annually and promptly whenever any information in the brochure becomes materially inaccurate. Advisers will make changes to their brochures using their own computer systems and then file the revised version of their brochures through IARD. If an adviser has not filed any interim amendments to its brochure since its last annual amendment and the brochure continues to be accurate in all material respects, the adviser would not have to prepare or deliver to clients a summary of material changes nor would it have to prepare and file an updated brochure as part of its annual updating amendment. However, if the adviser had filed an interim amendment or the brochure contained a material inaccuracy, the adviser would have to file a summary of material changes describing the interim amendments along with an updated brochure, as part of its annual amended filing. Only the most recent version of an adviser's brochure will be available to the public through the IAPD.

Part 2B—The Brochure Supplement

Part 2B, the brochure supplement, is a newly required document that contains six separate items and provides biographical information, including disciplinary history (if any), about each supervised person who (i) formulates investment advice for a client and has direct client contact, or (ii) makes discretionary investment decisions for the client's assets, even if the supervised person has no direct client contact. If investment advice is provided by a team comprised of more than five supervised persons, brochure supplements need only be provided for the five supervised persons with the most significant responsibility for the day-to-day advice provided to the client. Advisers may prepare a brochure supplement for each supervised person, or for different groups of supervised persons. Advisers must carefully consider their own organization and structure in deciding which brochure supplement to provide to which clients. The brochure supplement must accompany the adviser's brochure. Alternatively, advisers may include the brochure supplement information within the firm's brochure (an approach that may be attractive to smaller firms). Like the brochure, the items must be organized in the same order and contain the same headings as they appear in the brochure supplement form. Please see the Appendix for details of the six required items.

Delivery and Updating Requirements of Part 2B

Delivering Part 2B

The brochure supplement of a supervised person must be provided to a client at or before the time when that specific supervised person begins to provide advisory services to that specific client. Advisers that do not have any clients to whom a brochure supplement has to be delivered will not have to prepare any brochure supplements. Similarly, an adviser will not have to prepare a brochure supplement in respect of any supervised person who does not have clients to whom the adviser must deliver a supplement.

Updating Part 2B

Advisers are required to amend and deliver promptly an updated brochure supplement to clients when there is new disclosure of a disciplinary event or a material change to disciplinary or other information already disclosed. It is likely that if the brochure supplement must be updated to reflect a new disciplinary event or a material change to a disciplinary event

previously disclosed, a similar update to Item 9 of the brochure would be required. If an adviser references BrokerCheck or IAPD for disclosure of a supervised person's disciplinary information and there is a change in the BrokerCheck or IAPD disciplinary disclosure, an adviser would be required to electronically deliver an updated brochure supplement (or sticker) to clients, indicating that the disciplinary information for the supervised person has changed and provide a hyperlink to BrokerCheck or IAPD.

Advisers are not required to deliver brochure supplements to existing clients annually. Brochure supplements, like brochures, may be delivered on paper or electronically.

Filing Requirements

Advisers must file their new brochures with the SEC electronically by uploading a PDF through the IARD system. Advisers are not required to file brochure supplements or supplement amendments with the SEC, but are required to maintain copies of all supplements and amendments in their files.

Advisers that manage private funds can provide the information required by Form ADV Part 2 without jeopardizing the reliance of the private funds on the private offering exemption in the Securities Act of 1933 (the Securities Act) and the safe harbor for offshore transactions in Regulation S under the Securities Act. However, if the adviser provides private fund information beyond that required by Form ADV Part 2 (such as subscription instructions, performance information and financial statements), it may jeopardize such reliance if the information is deemed to be "constituting a public offering or conditioning the market for the securities issued by those funds."

APPENDIX

These are the 18 disclosure items required by Form ADV Part 2A:

Item 1. Cover Page. The cover page requires the following information:

- The adviser's name, business address, contact information, website (if available) and the date of the brochure.
- A statement that the brochure has not been approved by the SEC or any state securities authority.
- A disclaimer that registration does not imply a certain level of skill or training for any adviser that refers to itself as a "registered investment adviser."

Item 2. Material Changes. An adviser must provide a summary of the material changes since the last annual update.

- The summary is designed to make clients aware of information that has changed since the prior year's brochure that may be important to them.
- The summary should provide clients with a brief explanation of the substantive changes to the adviser's policies, practices or conflicts of interest.
- The summary may be included on the cover page or the following page, or as a separate document accompanying the brochure. A summary prepared as a separate document can be used to satisfy an adviser's annual client delivery obligations.

Item 3. Table of Contents. The table of contents must be sufficiently detailed to enable clients and potential clients to locate topics easily. Information in the brochure must be presented in a uniform format using the headings provided by the form to facilitate comparison of multiple advisers by clients and potential clients.

Item 4. Advisory Business. An adviser must describe its advisory business, including the following information:

- The type of advisory services offered, including whether the adviser specializes in a particular type of advisory service.
- The amount of client assets under management (discretionary and non-discretionary). The adviser may use a method of calculation that differs from the method used in Form ADV Part 1, but advisers who do so must retain documentation describing the method used.

The amount of assets under management must be updated annually (as part of the annual updating amendment) and on an interim basis only for material changes when an adviser files an "other than annual amendment" for a separate reason.

Item 5. Fees and Compensation. An adviser must describe its compensation arrangements by disclosing the following information:

- The adviser's standard fee schedule and a statement explaining whether fees are negotiable.
- The methods for assessing and deducting fees (whether the adviser bills clients or deducts fees directly from client accounts and how often).
- Other fees and expenses (i.e., brokerage fees, custody fees and fund expenses) that clients may pay.
- If an adviser itself or its personnel receive brokerage commissions or transaction-based compensation, brokerage practices, the conflicts of interest they create and how the adviser addresses the conflicts.

An adviser may omit disclosure of its fee schedule if the brochure is provided only to "qualified purchasers" as defined in the Investment Company Act of 1940, as amended.

Item 6. Performance-Based Fees and Side-by-Side Management. An adviser must disclose performance-based fee arrangements with its clients. If the adviser also manages accounts not charged a performance fee, the adviser must discuss the conflicts of interest that arise from the simultaneous management of those accounts and describe how it manages those conflicts.

Item 7. Types of Clients. An adviser must describe the types of advisory clients and the requirements for opening and maintaining an account with the adviser.

Item 8. Methods of Analysis, Investment Strategies and Risk of Loss. An adviser must:

- Describe its methods of analysis and investment strategies, and disclose that investing in securities involves risk of loss.
- Disclose, if applicable, how strategies involving frequent trading can affect investment performance.
- Explain the material risks for *each* “significant” investment strategy or method of analysis it uses and the particular types of securities it recommends, meaning, risks associated with using a particular investment strategy or recommending a particular type of security that otherwise would not be apparent to a client reading the adviser’s brochure. More details are required for significant and unusual risks.

Item 9. Disciplinary Information. An adviser must disclose any material facts about any legal or disciplinary event that is material to the evaluation of the integrity of the adviser or its management personnel.¹

- This item provides a non-exclusive list of disciplinary events that are presumptively material if they occurred within the past 10 years. In a departure from the current Part II, an adviser may rebut this presumption based on an analysis of several specified factors and not disclose the event in the brochure, but it must document its determination and retain those records for SEC inspection.
- Disciplinary events more than 10 years old will still need to be disclosed if the event remains material to a client’s or prospective client’s evaluation of the adviser and the integrity of its management personnel.²

Item 10. Other Financial Industry Activities and Affiliations. An adviser must describe material relationships or arrangements with related financial industry participants, any material conflicts that these relationships or arrangements create and the adviser’s procedures for addressing those conflicts. An adviser must disclose whether it recommends or selects other advisers for clients, what compensation arrangements it has with other advisory firms, and what material conflicts of interest are created and how it addresses them.

Item 11. Code of Ethics, Participation or Interest in Client Transactions and Personal Trading.

- An adviser must describe briefly its code of ethics and state that a copy is available upon request.
- An adviser must disclose if it or a related person recommends to clients or buys or sells for client accounts, securities in which it has a material financial interest, the conflicts of interest presented and how it addresses these conflicts.
- An adviser must disclose if it or a related person invests, or is permitted to invest, in the same securities that it recommends to clients or in related securities, what conflicts are presented by such arrangements and how it addresses the conflicts. In addition, an adviser should explain how its internal controls prevent it from buying or selling securities contemporaneously with client transactions. This item does not require disclosure with respect to securities that are “not reportable” under Rule 204A-1(e)(10) of the Act (such as shares in unaffiliated mutual funds).

Item 12. Brokerage Practices. An adviser must describe how it selects brokers, how it determines the reasonableness of brokers’ fees, its soft dollar arrangements, client referrals, directed brokerage, trade allocation, the conflicts of interest created by such practices and how it addresses those conflicts.

- **Soft Dollar Practices**—An adviser must disclose its receipt of soft dollars, that it benefits from such use and therefore has an incentive to select brokers based on the adviser’s interest in receiving such benefits. Disclosure must be more detailed for products or services that do not qualify for the “safe harbor” in Section 28(e) of the Securities Exchange Act of 1934, as amended. An adviser must disclose whether it uses soft dollars to benefit all client accounts or only those that “pay” for the benefits and whether the adviser seeks to allocate the benefits to client accounts proportionately. An adviser must disclose if it “pays up” for soft dollar benefits.

¹ An adviser is required to disclose disciplinary events in Form ADV Part 1 regardless of whether they are material.

² The SEC is rescinding Rule 206(4)-4 of the Act because the disciplinary disclosures required have been incorporated in the brochure requirements.

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- **Client Referrals**—An adviser must disclose if it uses client brokerage to compensate brokers for client referrals. In a change from current Part II, the adviser must discuss the conflicts of interest created.
 - **Directed Brokerage**—An adviser must disclose if it permits clients to direct brokerage and to describe the practice. An adviser must explain that it may be unable to obtain the most favorable execution of client transactions if the client directs the brokerage and that directing brokerage may be more costly to the client. If an adviser routinely recommends, requests or requires clients to direct brokerage, it must describe this practice as well.
 - **Trade Aggregation**—An adviser must describe whether and under what conditions it aggregates trades. If an adviser does not aggregate trades but has the opportunity to do so, it must disclose that clients may, therefore, pay higher brokerage costs.

Item 13. Review of Accounts. An adviser must disclose whether and how often it reviews client accounts and identify who conducts the reviews. An adviser that does not regularly review accounts must explain what circumstances trigger an account review.

Item 14. Client Referrals and Other Compensation. An adviser must describe any arrangements under which it or a related person compensates a third party for client referrals and describe the compensation. The adviser must also disclose whether it receives any economic benefit from a person who is not a client for providing advisory services to clients. The conflicts of interests that arise from such arrangements must be disclosed along with an explanation of how the adviser addresses those conflicts.

Item 15. Custody. An adviser with custody of client funds or securities must explain to clients that they will receive account statements directly from the qualified custodian that maintains their assets and that they should carefully review those account statements. In addition, if the adviser also sends clients its own account statements, it must urge clients to compare the two sets of account statements.

Item 16. Investment Discretion. An adviser with discretionary authority over client accounts must disclose this fact together with any limitations clients may place on such authority.

Item 17. Voting Client Securities. An adviser must disclose its proxy voting practices, and whether it has or will accept authority to vote client securities. If so, an adviser is required to describe briefly its voting policies. In addition, the adviser must:

- Explain that clients may obtain a copy of the adviser's proxy voting policies and procedures upon request.
- Describe whether and how clients can direct the adviser to vote in a particular solicitation, how the adviser addresses conflicts of interest when it votes securities, and how clients can obtain information from the adviser on how the adviser voted their securities.
- Disclose how clients will receive their proxies and other solicitations if the adviser does not accept authority to vote securities.

An adviser is not required to provide information regarding its use of third-party proxy voting services.

Item 18. Financial Information. An adviser must disclose certain financial information about the adviser that is material to clients, including the following:

- If an adviser requires prepayment of fees of more than \$1,200 per client six months or more in advance, it must give clients an audited balance sheet showing the adviser's assets and liabilities as at the end of its most recent fiscal year.
- Any financial condition reasonably likely to impair the adviser's ability to meet contractual commitments to clients if the adviser has discretionary authority over client assets, has custody of client funds or securities, or requires or solicits prepayment of more than \$1,200 in fees per client and six months or more in advance.
- Whether the adviser has been the subject of a bankruptcy petition during the past 10 years.

Part 2A Appendix 1: The Wrap Fee Program Brochure. The SEC will continue to require an adviser that sponsors a wrap fee program to prepare a separate specialized brochure (“a wrap brochure”) for clients of the wrap program in lieu of its standard brochure. An adviser must identify if any of its related persons is a portfolio manager in the wrap fee program, and, if so, to describe the conflicts of interest.

These are the 6 items required by Form ADV Part 2B:

Item 1. Cover Page. Each brochure supplement must include on the cover page or at the top of the first page of the brochure supplement the name of the supervised person covered by the supplement as well as the name of the adviser.

Item 2. Educational Background and Business Experience. An adviser must describe the supervised person’s formal educational and business background, including a list of specific positions held for the past five years. Provided it is not misleading, an adviser may include information about professional designations of supervised persons. However, if the adviser does so, it must include additional explanatory information to allow clients to understand the value of the designations.

Item 3. Disciplinary Information. An adviser must disclose any legal or disciplinary events that are material to a client’s evaluation of a supervised person’s integrity. This includes certain disciplinary events that are presumptively material if they occurred during the last 10 years (the list parallels the list in Item 9 of the brochure that must be disclosed). Disclosure must also be made of any event for which the supervised person resigned or relinquished a professional designation or license in anticipation of it being suspended or revoked, if the adviser knew or should have known the supervised person relinquished his or her designation or license. Advisers that send clients supplements electronically may provide a hyperlink to disciplinary information available through the FINRA BrokerCheck or the IAPD, provided the supplements include (i) a statement that the person has a disciplinary history, the details of which can be found on BrokerCheck or the IAPD system, and (ii) a hyperlink to the relevant system with a brief explanation of how the client can access the disciplinary history.

Item 4. Other Business Activities. An adviser must disclose other business activities of its supervised persons, including the following information:

- Other capacities in which the supervised person participates in any investment-related business and any material conflicts of interest such participation may create.
- Any compensation, including bonuses and non-cash compensation that the supervised person receives based on the sales of securities or other investment products, and the incentives this type of compensation creates.
- Other business activities or occupations that the supervised person engages in if they involve a “substantial” amount of time or pay. Advisers may make a presumption that if the other business activities represent less than 10 percent of the supervised person’s time and income, they are not substantial.

Item 5. Additional Compensation. An adviser must describe arrangements in which someone other than a client gives the supervised person an economic benefit, such as a sales award, for providing advisory services.

Item 6. Supervision. An adviser must:

- Explain how it monitors the advice provided by the supervised person addressed in the brochure supplement.
- Provide the client with the name, title and telephone number of the person responsible for supervising the advisory activities of the supervised person. If a supervised person has more than one direct supervisor, the adviser may identify any one of those supervisors, provided the supervisor identified has the authority to respond to a client’s question or complaint.

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