"Plain English" Plain and Simple:

The U.S. Securities and Exchange Commission's Attempt to Demystify Disclosures Under the '40 Acts

June 2009

These plain English amendments to Part 2 of Form ADV and related rules under the Investment Advisers Act are designed to require advisers to provide clients and prospective clients with clear, current, and more meaningful disclosures of the business practices, conflicts of interest (including those related to soft dollar practices) and background of investment advisers and their advisory personnel.

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In an effort to demystify disclosures and to make them more readily accessible to investors, the U.S. Securities and Exchange Commission is moving towards a system of more meaningful and transparent disclosures to investment advisory clients. What effect, if any, will this initiative have on the liability of investment advisers and investment companies?

The move to plain English disclosures is found in two key areas of disclosure obligations. First, the Commission has adopted new rules, which went into effect on March 31, 2009, that affect the format and method of filing mutual fund prospectuses. Second, the Commission has proposed new rules that would change the structure, updating, and delivery requirements for investment advisers in connection with their disclosure requirements to their advisory clients in their Part 2 of the Form ADV.

The Summary Prospectus

These rules are part of a broader Commission effort, dubbed its 21st Century Disclosure Initiative, to increase the quality and availability of investment-related disclosures. The first effort, which became effective on March 31, 2009, changes the Form N-1A to require that certain specific information appear in a standardized format at the beginning of a mutual fund's statutory prospectus, written in 3-4 pages of plain English under section 421(d) of the Securities Act. This summary section must include, in the following order, information about the fund's: investment objectives; costs; principal investment strategies, risks, and performance; investment advisors and portfolio managers; purchase, sale and tax information; and financial intermediary compensation.

Exchange Traded Fund prospectuses must also include disclosures regarding their unique characteristics and the relationship between their performance, Net Asset Value, and share price. Those funds that are used as investment options for retirement plans or variable insurance contracts may omit information in the summary section about the purchase and sale of fund shares and certain tax information that is not relevant to such funds.

In addition to their content requirements, the new rules also provide an additional option for the delivery of prospectuses to investors. Investment funds may continue to deliver their statutory prospectuses as they have under section 5(b)(2) of the Securities Act, which prohibits the sale of a security unless "accompanied or preceded" by a statutory prospectus. Under the new rules, delivery of a Summary Prospectus to an investor and posting of the lengthier statutory prospectus online would satisfy this requirement. A Summary Prospectus is the same as the summary section of the statutory prospectus, with the exception that it must also have a cover page identifying it as a Summary Prospectus and describing how an investor may obtain the fund's statutory prospectus. The new rules require that the Summary Prospectus be given "greater prominence"

than other accompanying materials, and that a statutory prospectus be sent to anyone upon request. However, a failure to comply with either of these two requirements would result only in a violation of the new Commission rules, and not of section 5(b)(2), thereby precluding a private right of action for such violations.

While the new rules do not provide any general safe harbors for good faith compliance, they also do not create any new causes of action, enforcement mechanisms, or specific penalties. Funds are still liable under the Securities and Investment Company Acts for proper disclosure; the new rules simply modify the existing obligations under those laws. There are, however, two noteworthy provisions that will lessen a fund's compliance burden. First, there is a safe harbor for temporary technical difficulties with the internet posting requirement, provided that the fund has taken reasonable steps to ensure the materials are available online. Second, while the rules go into effect at the end of March 2009, full compliance is not required until 2010 or 2011, depending on whether the filings are for new or existing registration statements.

The new summary section of the statutory prospectus and the Summary Prospectus are both subject to the plain English requirements of Rule 421(d). Rule 421(d) of the Securities Act requires the issuer of a prospectus to use plain English principles in the organization, language and design of the front and back cover pages, the summary and the risk factors sections of the prospectus. Such principles include the use of short sentences; concrete, everyday words; the active voice; tabular presentation or bullet lists for complex issues, wherever possible; no legal or highly technical jargon; and no multiple negatives.

Part 2 of the Form ADV

The Commission's proposed changes to Part 2 of the Form ADV similarly would have investment advisers provide more information and greater clarity to their investment advisory clients. As a move away from the "check the box" approach to disclosure, an adviser would be required to discuss and to make specific disclosures in connection with 19 separate topics, including sources of compensation, soft dollar arrangements, and other types of compensation.

Proposed in March 2008, the Part 2[1] proposal would affect thousands of registered investment advisers. It would also affect hedge fund managers who are also registered as investment advisers. The proposed changes would require those hedge fund managers to make such disclosures in plain English to its investment advisory clients. Some commentators have noted that those disclosures could increase scrutiny of the conflicts of interest that may arise between an adviser's obligations to its hedge fund clients (who pay performance fees) and investment advisory clients (who may not).

For instance, one of the specific topics that must be disclosed and discussed is so-called side-by-side management of accounts of hedge fund clients and investment advisory clients. The Commission and commentators have suggested that this particular disclosure was motivated by the Commission's concern that advisers may favor hedge fund accounts or clients (over investment advisory clients) because of the fees associated with hedge fund accounts. By making the adviser disclose this information, the investment advisory clients are able to assess any purported conflicts of interest that arise when one adviser is managing both types of accounts – and collecting a higher, performance-based fee from one or more of its clients that it is not collecting from others.

Of course, what everyone wants to be assured of is that the new rules would somehow prevent another "Madoff." The plain English rules were proposed (and adopted in the case of the Summary Prospectus) long before anyone (other than Harry Markopolos, apparently) thought that Madoff was running a spectacular Ponzi scheme. When Madoff was not registered as an investment adviser, and only acting as a broker dealer, he was not required to make disclosures under Part 2 of the Form ADV. Moreover, it is questionable whether the new Sum-mary Prospectus or proposed Part 2 rules would prevent anyone from falsifying their disclosures if that were their goal. Finally, as noted above, the goal of the plain English rule is not necessarily to catch fraud. It is meant to provide more accessible and current information to investors in the form of clear, current, and more meaningful disclosures.

In conclusion, given the requirements of the Summary Prospectus and that there is no private right of action for the failure to comply with the new rules, we anticipate that there will be little liability exposure directly arising from these new rules

and regulations. As long as the prospectus disclosures are adequate, which has been a consistent requirement, then the new plain English rules will not generate any increased scrutiny or liability. Nevertheless, with respect to the Part 2 proposal, the disclosures required from investment advisers who charge performance fees on some accounts (such as hedge funds) but not others may lead to more intense scrutiny of these arrangements and the purported conflicts of interest that could develop as a result.

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[1]The Part 2 amendments have not yet been formally adopted by the Commission.