New Form ADV Part 2: Post-Filing Post-Mortem and More Fun with Part 1

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INTRODUCTION

A host of problems and unusual approaches came to light this year as investment advisers filed Firm Brochures and Brochure Supplements for the first time under amended Form ADV Part 2. The first half of this article highlights some of the Part 2 issues that were observed in a random sampling of filings, ranging from the more minor and technical to the more significant and substantive. The second half of this article discusses issues relating to Part 1 of Form ADV that continue to challenge advisers attempting to respond to the form.

For logical flow, the issues are arranged in each half of this article in the order in which they might be encountered in the relevant part of Form ADV.

ADV PART 2 FIRM BROCHURES AND SUPPLEMENTS

1. Choosing a Date for the Brochure Cover.

Most advisers dated their Firm Brochure using the same date on which they filed their Brochure via IARD, the electronic filing system for advisers. However, some advisers chose a very different date for the cover. For example, some advisers dated their Brochures December 31, 2010, or January 2, 2011, even though the Brochures were not filed until late March 2011.

Possible explanations for dating a Brochure in this way are:

- For consistency, the adviser might have been trying to date the Brochure with the same date (or close to it) as the “as of” date it used to calculate its assets under management (AUM).

- The adviser might have been trying to use a consistent date for its Part 2 disclosures from year to year and this may be the date it had used in past years.

Surprisingly, neither Form ADV nor the instructions to the form specify what date should be used for the Brochure. Item 1.A. of Part 2A merely requires advisers to state the date of the Brochure on the cover. For annual updating amendments, practical constraints would suggest that the date be not before the relevant fiscal year end and not after the date on which the filing is actually made, within 90 days of fiscal year end. However, anything in between would seem to be fair game.

No matter what date is used on the cover, the information in the Brochure would presumably have to be materially accurate and up-to-date as of the date on the cover <u>and</u> the filing date. If not materially accurate as of the date on the cover, potential anti-fraud issues would be raised, given that readers would likely interpret the Brochure as “speaking” as of the date on the cover, absent disclosure to the contrary. At the same time, if the Brochure were not materially up-to-date on the date of the filing, the adviser would face an immediate requirement to amend the Brochure, in order to comply with Instruction 4 in the Instructions for Part 2A that require Brochures to be updated promptly whenever any information in the Brochure becomes materially inaccurate.[1]

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2. Disclaiming Securities Offering.

Some advisers included a disclaimer on the cover of their Firm Brochure to the effect that nothing in the Brochure is to be construed as an offer of securities. In the past, this disclaimer was not commonly added to an adviser's Part 2 (formerly known as Part II), not only because the format was not conducive to adding disclaimers, but because old Part II was rarely delivered in contexts or contained any disclosures where potential confusion would be a practical concern.

These days, however, a disclaimer of this sort might be wise, particularly for advisers to funds, given that more extensive disclosures are being required in Brochures about funds and their investment risks, which may cause the Brochure to more closely resemble a prospectus, private placement memorandum or other "sales" document offering fund securities. For the same reason, wherever appropriate inside the Brochure, readers should be referred to the actual fund offering documents for more complete disclosures, to minimize the risk the Firm Brochure might be mistaken for a fund "sales" document and the risk that circulating the Firm Brochure might be considered "general advertising" of the fund, inconsistent with private placement exemptions relied on by the fund.

3. Highlighting Material Changes.

In the Material Changes section of the Firm Brochure, many advisers (perhaps following a template) said something to the effect that their entire Brochure was new given that the SEC adopted new form requirements for this year's filing. Relatively few advisers ventured to actually disclose material changes from their Part II disclosure from the year before.

The SEC Staff eventually clarified that advisers need not discuss material changes when filing their first "transition" Firm Brochure.[2] However, this merely defers until next year the decision of how much detail to include in the Material Changes section. To avoid questions about whether a particular change is "material," some advisers may be inclined to list in the Material Changes section more or less every change made in their Brochure from the prior year. Interestingly, though, advisers who listed material changes in this year's Brochure seemed to take a more measured approach, without detailing every revised section, sentence or word, but rather listing in a succinct fashion only truly significant changes, such as changes in personnel, services offered and procedures.

4. Expanding the Table of Contents.

Item 3 of Part 2A requires the Table of Contents to be detailed enough that readers can locate topics easily and to include the headings listed in Part 2A in the order they appear there. Most advisers kept the Table of Contents in their Brochures simple, including only the Part 2A item headings. Others expanded the Table of Contents to reference all the sub-headings they used in their Brochure, which in some cases made the table rather lengthy. While either approach may be technically permissible, making topics easy to locate would seem to require striking a balance between too little and too much detail.

5. Copying "Old" Schedule F.

In old Form ADV Part II, Schedule F contained narrative disclosures about the adviser's business to supplement the "check-the-box" disclosures contained in the earlier parts of the form. When creating the body of their new Firm Brochures, some advisers appear to have simply copied the narrative disclosures from their old Schedule F and pasted them into a Brochure. In fact, some advisers even copied into their Firm Brochure the box-border lines that used to surround old Schedule F, replicating its former appearance as a "type in the box" supplementary schedule.

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Advisers may have used this approach for the sheer ease of it, in order to make sure that nothing in their prior disclosures got lost. However, a "copy and paste" approach runs the risk that Brochure disclosures will be out of sync with the now mandatory Part 2 headings and sequence. More significantly, it runs the risk that important disclosures will be left out of the Brochure since the new Part 2 requires many new disclosures that were not called for nor customarily included in old Schedule F. Advisers inclined to use their old Schedule F disclosures would be prudent to combine the "copy and paste" approach with rigorous double-checking of included disclosures against form requirements.

6. Relying on a Template.

Templates can be a big time saver if created and used properly. However, even the simplest templates should be checked against the actual form to make sure they are accurate and complete. Although this point seems basic, many Firm Brochures were filed with identical typographical errors and heading inconsistencies, perhaps as a result of following templates that were not vetted closely against the actual form before filing.

For example, many Brochures use the heading "Code of Ethics" for Item 11 in both the Table of Contents and the body of the Brochure, even though Form ADV requires the Item 11 heading to read "Code of Ethics, Participation or Interest in Client Transactions and Personal Trading." In many of the same Brochures, the capital "I" is missing in the word "Item 11" as listed in the Table of Contents. The pervasiveness of these glitches suggests that they might have derived from a template.

7. Repeating Instructions.

Some advisers repeated the instructions from Form ADV Part 2A in the body of their Firm Brochures, in some cases, in a different colored print. This, too, may have been a consequence of blindly following a template that provided the form instructions in context as a convenience, never intending that they appear in the actual Brochure. Brochures drafted in this fashion tend to read like a form or questionnaire, rather than like narrative disclosure. Advisers that followed this approach may want to reconsider it for future filings.

8. Referencing Item Numbers.

Most advisers approached the new Brochure format requirements rather mechanically, not only using the mandatory headings in the required order but also listing the item numbers as they appear in Form ADV. As a result, many Brochures list in the Table of Contents three entries – Item 1 Cover Page, Item 2 Material Changes and Item 3 Table of Contents – before even getting to the substantive disclosure about the adviser's business, which oddly then begins with Item 4.

While this may be a permissible approach, readers not familiar with Form ADV might wonder where the item numbers come from and what they mean. The ADV instructions do not require the use of item numbers – only the headings themselves -- and some advisers opted not to include item numbers. This seems less likely to perplex readers and is more consistent with the way, for example, mutual funds create their prospectus disclosures based on the requirements of Form N-1A, following the form and heading requirements without referencing actual item numbers.

Although the Brochure cover says that the Brochure provides information about the adviser, it typically does not explain that the item numbers listed in the Brochure correspond to Form ADV or that, to the extent applicable, the adviser is including disclosures called for by that form. The contents of Form ADV are usually alluded to, if at all, only by advisers trying to explain why they have no disclosure to make in response to particular items, where they might say something like "This item requires advisers to disclose X, which is not applicable to us because we do not have

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X." A better approach might be to explain somewhere at the beginning of the Brochure that it discusses information called for by various items set out in SEC Form ADV to the extent applicable, along with other information the adviser has chosen to convey.

9. Referencing Sub-Parts.

In addition to referencing the required item headings in their Firm Brochure, some advisers also referenced the sub-parts, placing their disclosures in paragraphs marked A., B., C., etc., corresponding to the sub-parts of each Part 2A item and, in cases, repeating the full instructions for each sub-part. The SEC Staff eventually clarified that it was unnecessary for advisers to respond to the sub-parts of each item in order they appear in the form and that sub-parts did not need their corresponding headings.[3] Unfortunately, many advisers were not aware of this guidance before filing.

10. Disclosing AUM.

Calculating an adviser's assets under management (AUM) for the Firm Brochure may seem straightforward. After all, AUM has been disclosed in Item 5.F. of Part 1 of the form for years. However, a number of issues can make calculating AUM tricky. For example:

- According to Item 4.E. in Part 2A, the method used for calculating AUM for a Part 2 Firm Brochure is permitted to be different than the method used for Part 1. Instruction 5.b. to Part 1 spells out a rather mechanical procedure for calculating an adviser's AUM in Part 1, adding in all "securities portfolios" for which the adviser provides "continuous and regular supervisory or management services" as defined. Of course, AUM in Part 1 is used primarily for regulatory purposes, such as determining if an adviser is eligible to register with the SEC (versus the states), depending on whether its AUM is above or below the relevant threshold. The Part 2 Firm Brochure, on the other hand, is largely a client disclosure document and different methods of calculation may be more appropriate to convey to clients the nature of the adviser's business. Advisers are afforded the flexibility to use those other methods, so long as explanatory documentation is kept.

- Part 2 asks advisers to disclose the amount of "client assets" they manage, whereas Part 1 calls for an adviser's "assets under management." The amount of "client assets" an adviser manages may be different than the "assets" it manages if it, for example, manages its own proprietary assets in addition to those of clients.

- The "as of" date advisers should use to value AUM is unclear. Instruction 5.b. to Part 1A of the form tells advisers to include in their AUM calculation all relevant "securities portfolios" they manage <u>as of the date of their Form ADV filing</u> and that the current market value of the assets in those portfolios must be determined <u>within 90 days prior to the date of the filing</u>. Ostensibly, then, an adviser filing on March 31 should <u>not</u> include in its Part 1 AUM any client accounts that the adviser lost prior to March 31, even though it may choose to value the assets in accounts remaining on March 31 as of, say, December 31 of the preceding year.

  Contrast this with AUM in Part 2, where Item 4.E. tells advisers to disclose the "client assets" they manage and the date "as of" which they calculate the amounts. The "as of" date cannot be more than 90 days prior.[4] This could be interpreted to allow advisers to disclose whatever their AUM was "as of" a disclosed date not more than 90 days prior to their filing date, no matter what has happened to market values since then and no matter how many client accounts they have lost since then.

  Aside from how the instructions might be interpreted, cautious advisers will wonder whether they should disclose their AUM calculated in this way if interim losses in market value or interim losses in client accounts have materially decreased their AUM since the "as of" date.

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Significantly, Instruction 5.b. in Part 1A seems to address the issue of interim client losses by requiring advisers to report only "securities portfolio" they manage as of the date of their filing, even though they may value the assets in those portfolios "as of" a date up to 90 days prior. Yet the AUM instructions for both Parts 1 and 2 seem to ignore the interim market losses issue. For instance, neither say (nor imply) that advisers may choose an "as of" date of up to 90 days prior but only if it results in an AUM that is not materially higher than it would be if the adviser chose the filing date for its "as of" date. General anti-fraud principles (avoiding material misstatements or omissions) might point in that direction, but specific Form ADV instructions do not. Moreover, if that logic were applied in the extreme, advisers would be required to update their Brochures every time their AUM changed materially -- for whatever reason -- and Instruction 4 in Part 2A specifically states that that need not be done.

- Certain AUM issues were addressed more recently, in the SEC release that changed the federal registration threshold from $25 million to $100 million in AUM and made corresponding changes to Form ADV.[5] However, none of the changes made in that release clarify the issues raised here, even though the release redefined AUM calculated for purposes of Part 1 under a new defined term – regulatory assets under management (or RAUM) – to distinguish it more clearly from AUM used in Part 2 and for other purposes. While the clarifications made to the instructions were helpful, more SEC guidance is needed to address these lingering issues. Moreover, it remains to be seen whether the changes made will be sufficient to avoid client confusion in cases where an adviser chooses to disclose two different AUMs in its Form ADV.

11. Adding Non-Required Disclosures.

Instruction 3 to the General Instructions for Part 2 encourages advisers to include in their Brochures disclosures beyond those specifically required by the form, by reminding them that, as fiduciaries, they must make full disclosure to clients of all material facts relating to the advisory relationship and therefore may have to disclose to clients information not specifically required by the form or in more detail than the items might otherwise require. By and large, however, advisers appeared to include in their Firm Brochures only those disclosures specifically called for by Part 2A and did not venture much outside that framework.

While this was also largely true of old Part II, disclosures in various areas on old Schedule F did tend to expand over the years beyond the items specifically called for by the form. For example, advisers often included disclosures about allocating investment opportunities among eligible client accounts, allocating partially filled orders among accounts participating in an aggregated trade, sequencing of trades not aggregated for execution and revenue sharing or similar arrangements that technically might not have fit within the instructions calling for soft dollar disclosures.

Since many of those disclosures are now specifically called for by Part 2, advisers need not venture beyond the form requirements in order to address those issues. However, some advisers still added non-required disclosures in their new Firm Brochures in various areas, such as:

- handling of trade errors;
- conflicts inherent in dual roles, such as the CCO of an adviser also acting as the CCO of a client trust or fund;
- the corporate or successor history of the adviser; and
- indemnification or liability limitation provisions appearing in the adviser's Investment Advisory Agreement.

These are all logical areas for additional disclosure where applicable. It remains to be seen how much disclosure creep will expand non-required disclosures in future filings.

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12. Attaching Supplements to the Firm Brochure.

Although SEC-registered advisers are not required to file their Brochure Supplements via the IARD system, some advisers did, following Instruction 6 in the Instructions for Part 2B, which makes it optional for advisers to attach Supplements at the end of the Brochure. Advisers – particularly smaller advisers – may find this approach more convenient, if they expect to deliver all their Brochure Supplements to all their clients since all their ADV deliveries would then all be bundled into one document.

For SEC-registered advisers, the downside to this approach is that their Brochure Supplements become filed on IARD and therefore unnecessarily made public. Supplements may include, for example, sensitive disciplinary information about a supervised person that may not have been previously disclosed in an adviser's Brochure. Arguably, the filing also unnecessarily exposes the adviser to claims under Section 207 of the Investment Advisers Act of 1940 (Advisers Act), which prohibits advisers from filing fraudulent applications or reports with the SEC, if the Supplement is found to contain material misstatements or omissions. Although SEC-registered advisers are required to maintain copies in their files of all their Brochure Supplements, Supplements are not considered "filed" with the SEC merely by placing them in the adviser's files.[6]

For state-registered advisers, Instruction 9 to the Instructions for Part 2B say that a Brochure Supplement must be filed through IARD for each supervised person doing business in that state. Although the states are expected to follow suit and adopt parallel requirements at their level, this is still in the process of being fully played out.

13. Attaching a Privacy Policy to the Firm Brochure.

Some advisers attached their notice of Privacy Policy to the end of their Firm Brochure, presumably to make sure the notice is delivered as required by Regulation S-P. While there is nothing in the Form ADV instructions that specifically permits a Privacy notice to be attached in this way, there is also nothing in the instructions that prohibits it. However, advisers using this approach should consider Reg S-P in the process, to make sure they deliver a "clear and conspicuous" notice as required, particularly when it is combined with other information.

As with Brochure Supplements attached at the end of the Firm Brochure, the downside to this approach is that it makes the Privacy notice part of an SEC filing when it does not need to be, risking unnecessary anti-fraud exposure under Advisers Act Section 207 and potential unnecessary or unwanted public scrutiny.

14. Naming Supervisors in Supplements.

Item 6 of Part 2B requires a Brochure Supplement to explain how the adviser monitors the investment advice given by the individual covered by the Supplement and to name the person responsible for supervising that individual's advisory activities. Notably, some advisers name the firm's Chief Compliance Officer as the person responsible. This may be understandable in certain circumstances:

- Some firms, particularly smaller firms, may have relatively flat (or no) supervisory structures, so there may be no obvious choice to name as an individual's "supervisor."

- Similarly, no obvious choice may exist if the individual covered by the Supplement is the senior-most executive in the firm, such as the CEO, Chairman or founder, or is part of a group of senior members who consider themselves all equal partners not subject to oversight by the others.

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In these circumstances, the CCO may come to mind by default as the only logical choice to name as "supervisor," particularly since the item asks for disclosure about how advice is "monitored" and "monitoring" may well be part of the firm's overall compliance program administered by CCO. However, while it is conceivable that the CCO could "supervise" an advisory employee in any given firm, this is unlikely in many firms even if the CCO "monitors" accounts as part of the compliance program. "Supervisors" in SEC-speak are persons who, under the relevant facts and circumstances, have the requisite degree of responsibility, ability or authority to affect the conduct of the employee whose behavior is at issue.[7] It would be unusual for a CCO have the requisite responsibility and authority in their firm to affect the investment advice given by the firm's advisory employees, particularly advice given by the CEO, Chairman, founder or senior partners. In fact, naming the CCO as "supervisor" in those circumstances may be risky and have unintended consequences, exposing the CCO to claims of failure to supervise if the advisory employee commits a violation or gives bad advice.

No matter who is named as "supervisor" in a Brochure Supplement, wise advisers will consider carefully whether the actual lines of responsibility and authority in the firm support that designation.

<u>CONTINUING CHALLENGES WITH PART 1</u>

1. Disclosing Assets.

The first half of this article highlights a number of issues advisers face when calculating AUM for purposes of the Firm Brochure, as compared to calculating AUM – or RAUM as it is now known – for purposes of Part 1, Item 5.F. Among them are what "as of" date should be used.

Another "as of" date issue comes up in Part 1, Item 9, where advisers must report amounts of client assets as to which they and their related persons have "custody." Neither Item 9 nor the Part 1 instructions clarify what "as of" date should be used for this purpose. No guidance is provided on "as of" dates for reporting private fund assets in Schedule D either. One might assume advisers would automatically use in Schedule D the same "as of" date they used for Item 5.F., but it is obvious that some advisers have not. Some even disclosed in the Schedule D Miscellaneous section the alternative "as of" date that they used (in some cases, the date of the latest audited financials available from the private funds).

As already noted, further SEC guidance clarifying these issues would be of benefit.

2. Disclosing BD Rep Status.

Advisers must disclose other business activities in Item 6.A. of Part 1 by checking the appropriate boxes, including box (2) if the adviser is a registered representative of a broker-dealer. A common mistake advisers make is to check box (2) if they have an <u>employee</u> who is a broker-dealer rep, when in reality the item is asking whether "you" -- the adviser – are a broker-dealer rep.

Checking box (2) would be appropriate if an adviser registered on Form ADV as an individual (a sole proprietorship) and then also associated with a broker-dealer and registered as its broker-dealer rep. In that case, the adviser itself would also be a broker-dealer rep.

Advisers should disclose <u>employees</u> who are broker-dealer reps in Item 5.B.(2) of Part 1, instead of Item 6. A similar approach should be taken with the other boxes in Item 6.A. – for real estate agents, insurance agents, lawyers, accountants, and so on -- if it is the adviser's <u>employees</u> who engage in those activities, rather than the adviser itself. Activities and affiliations of an adviser's employees should be reported in Item 5 or 7, as appropriate.

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3. Reporting Custody.

As already mentioned, advisers face uncertainty reporting custody because they are not told what "as of" date to use to report assets under Item 9 in Part 1. However, Item 9 presents even more difficult issues, explained below, because a related person's custody is attributed to the adviser.

Item 9.A. calls for information about an adviser's custody, whereas Item 9.B. asks about custody of the adviser's related persons. As revised in 2009,[8] however, this item created duplication between Item 9.A. and Item 9.B. whenever an adviser's related person has custody over client assets because the related person's custody would -- by definition – be attributed to the adviser.[9] Consequently, an adviser could never answer "yes" to Item 9.B. disclosing that its related person has custody and simultaneously answer "no" to Item 9.A. reporting that the adviser itself does not since, at a minimum, the adviser would be deemed to have custody over those assets over which its related person has custody.[10] Moreover, the adviser in that case would have to "double-count" in the number of assets and clients reported in Item 9.A. (over which the adviser has custody) all of the assets and clients which are also reported in Item 9.B. (over which the adviser's related person has custody and which are attributed to the adviser under the custody rule).

The SEC recently stated that this duplication between Items 9.A. and 9.B. was inadvertent. In a release issued even before all advisers had made filings responding to the last version of Item 9, the SEC amended Item 9 again in an attempt to correct this duplication.[11] As revised, the instructions underneath Item 9.A.(2), calling for an adviser to report amounts of assets and clients over which it has custody, specifically say: "If your related person has custody of client assets in connection with advisory services you provide to clients, do not include the amount of those assets and the number of those clients in your response to Item 9.A.(2). Instead, include that information in your response to Item 9.B.(2)."

While this latest revision will avoid duplication of amounts reported in Items 9.A. and 9.B. in certain cases, the new instruction notably only applies to Item 9.A.(2), where amounts are disclosed, and not also to Item 9.A.(1), where advisers disclose "yes" or "no" whether they have custody at all. It is unclear whether this is what the SEC intended or whether this is another inadvertent error. If the new instruction was intended to relegate reporting of related person custody to Item 9.B. entirely, it missed the mark. In any event, it will continue to create confusion in certain circumstances, as illustrated below.

Consider, for example, an adviser to a private fund for which its related person serves as general partner. The related person will have "custody" over the private fund assets because it serves as general partner, and the adviser will also have custody over those assets because the related person's custody will be attributed to it.[12] Even if these are the only assets over which the adviser has custody and the only reason it has custody, the adviser will still have to report "yes" it has custody in Item 9.A.(1), because the new instruction diverting related person disclosure to Item 9.B. only applies to Item 9.A.(2). Oddly, Item 9.A.(1) continues to require advisers with attributed custody to report "yes" in that item in the same circumstances it did before. Then, despite reporting "yes" it has custody, the adviser in our example would have to report in Item 9.A.(2) that the number of assets and clients over which it has custody is "0" because the new instruction now diverts disclosure of those amounts to Item 9.B.(2) instead.

The new instruction will also create confusion in certain cases where an adviser has custody over client assets for more than one reason, for example, if its related person trust company acts as trustee for assets in an advised account from which the adviser automatically deducts fees, or as to which an officer of the adviser acts as co-trustee, or over which the adviser itself is deemed to have "custody" for some other reason. Under the old instructions, those assets would be reported in both Items 9.A.(2) and 9.B.(2). Under the new instruction, it is unclear whether they would be reported under Item 9.A.(2) at all. Read literally, the new instruction tells advisers to report those assets in Item 9.B.(2) instead of Item 9.A.(2) because the adviser's related person has custody

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over them. However, this ignores the fact that the adviser has custody over them too, for reasons completely unrelated to its related person.

Even further clarifications to Item 9 will be necessary if the SEC intends Item 9.A. to speak to the adviser's <u>own</u> unattributed custody and Item 9.B. to speak to <u>related person</u> custody. Although duplication between the two items has been unraveled to a degree, questions will still arise in many common scenarios. Importantly, advisers still need guidance on how to report assets over which both the adviser itself (unattributed) <u>and</u> a related person have custody.[13]

4. Adding Miscellaneous Disclosures.

The Miscellaneous section of Schedule D to Part 1 gives advisers an opportunity to supplement answers given elsewhere in Part 1. There is a noticeable trend of advisers making greater use of the Miscellaneous section to make supplemental disclosures. Interestingly, though, many advisers still leave the Miscellaneous section completely blank. At the other extreme are advisers that fill the Miscellaneous section with narrative disclosures befitting a Firm Brochure, explaining virtually every "yes" answer in Part 1. Some, for example, add long narratives about their brokerage, trade allocation and soft dollar practices to supplement "yes" responses in Item 8, include explanations of why the adviser is deemed to have "custody" and therefore reports in Item 9, or make similar disclosures that seem more suitable for Part 2 than Part 1.

Both extremes leave something to be desired. Leaving the section entirely blank is a missed opportunity to avoid potential questions that may well come up, given that Part 1 otherwise tries to boil down an adviser's entire business to a series of check-the-box and short phrase answers. Brief but pithy explanations in the Miscellaneous section might stave off questions or concerns from the SEC Staff when they come to inspect.

The other extreme presents problems as well. While some may believe more disclosure is always better to avoid anti-fraud claims, adding long narratives in the Miscellaneous section can be counterproductive. The Miscellaneous section in Schedule D is not well formatted, so lengthy disclosures added there appear to readers like a sea of run-on sentences in all-cap red letters, hardly an effective way to make disclosure even to those inclined to wade into it. Some advisers try to separate Miscellaneous section disclosures by placing a series of asterisks **************** or other separators between items, but even with separators the section can be daunting if lengthy.

Until Part 1 is revamped to better accommodate more extensive supplemental disclosure, the Miscellaneous section would seem better suited for adding context or clarification for key check-the-box disclosures in Part 1 that otherwise might be misread or misunderstood, rather than aiming to explain every "yes" response in Part 1 or including the type of explanatory disclosure that might more typically be seen in a Part 2 Firm Brochure.

5. Disclosing Dates on Schedule A.

Schedule A of Part 1 requires disclosures about certain officers, directors and owners of an adviser, including the date their particular position or status was acquired. Due to limitations of the form, this becomes tricky if a person has more than one position or status, each acquired at a different date.

For example, if an individual was appointed Executive Vice President of an adviser in 2000, was then elevated to Chief Operating Officer in 2005, then also assumed the position of Chief Compliance Officer in 2008, the question arises of what date should appear in the Date Acquired column on Schedule A for that individual. The form accommodates only one date. One might choose 2008 since that was the date the disclosure was last updated for that particular individual. Or, one might choose 2005 since that was the earliest date relevant to the individual's two current job titles.

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Interestingly, however, SEC Staff guidance indicates that neither of those approaches should be used and that instead advisers should use one of two approaches for Schedule A when an individual's titles have evolved over time:

- Either make multiple entries for the individual, listing each title and the date it was acquired; or
- List the individual once, using their current title(s) and the date the individual first acquired a (different) title that required them to be listed on Schedule A.[14]

The first of those approaches would seem logical for individuals who have simply accumulated titles over time, where all the titles listed are still current. To illustrate using our example, the adviser would list the individual once as Chief Operating Officer with a date acquired of 2005, and list them a second time as Chief Compliance Officer with a date acquired of 2008. However, this would omit from the disclosure the individual's tenure as Executive Vice President from 2000 to 2005. This could not be cured by adding a third entry listing the individual as Executive Vice President with a date acquired of 2000 since that would erroneously imply that the individual currently serves in three positions and has served as Executive Vice President since 2000. Note that the form does not accommodate disclosing the date a job title ended, but only the date it was acquired.

If the adviser in our example used the SEC's second approach instead, it would list the individual once as Chief Operating Officer and Chief Compliance Officer with an acquired date of 2000, since the appointment as Executive Vice President in 2000 was the first appointment requiring the individual to be listed on Schedule A. Awkwardly, however, the date acquired shown on the schedule would then not be accurate relative to either position the individual currently holds.

To grapple with situations like this, some advisers have taken a completely different approach, listing the earliest relevant date in the Date Acquired column, then clarifying the various relevant titles and dates in the Titles column using parentheticals. To illustrate, the adviser in our example would list 2000 in the Date Acquired column for the individual who currently serves as COO and CCO. It would then list the following in the Title column: Executive Vice President (2000-2005), Chief Operating Officer (since 2005) and Chief Compliance Officer (since 2008).

Until Schedule A is revised to better accommodate these types of situations, advisers will have to continue to improvise to get around the limitations of the form.

6. Disclosing Functionally Similar Roles on Schedule A.

When deciding who to disclose on Schedule A, some advisers appeared to adhere strictly to the list of officers in the instructions, which specifically call for disclosure about the adviser's Chief Executive Officer, Chief Financial Officer, Chief Operations Officer, Chief Legal Officer and Chief Compliance Officer. Given that the instructions in Schedule A also call for disclosure of any other individuals with "similar status or functions," it is a wonder why other individuals are sometimes not listed, such as an adviser's General Counsel. Certainly, it is possible in any given firm that the General Counsel may not be considered a C-level executive or may not function similar to a Chief Legal Officer. However, it is unclear whether advisers omitting senior officers have carefully thought through the "similar status or functions" instruction or whether they have omitted them simply because the specific job title does not appear in the instructions.

An opposite sort of problem can arise in similar circumstances, where an adviser may list an officer on Schedule A under the title in the instructions instead of under the officer's actual title. For example, an individual referred to in other places -- such as on the adviser's website -- as General Counsel may be listed on Schedule A with the title Chief Legal Officer. The Senior Vice President of Operations may be listed on Schedule A with the title Chief Operations Officer, even though the form seems to be calling for the officer's actual title.

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Another twist has been observed on Schedule A as well. Instruction 2.(a) on Schedule A specifically says the designated Chief Compliance Officer cannot be more than one individual, which may be read as prohibiting an adviser from appointing, for example, two individuals as Co-Chief Compliance Officers. However, at least one adviser has listed a "Co-Chief Compliance Officer" on its Schedule A. Interestingly, though, that adviser also listed a "Chief Compliance Officer," apparently satisfying the SEC's need for <u>one</u> individual to be named as CCO. In this kind of circumstance, one might guess that the Co-CCO is serving functionally as a Deputy CCO or Assistant CCO, perhaps reporting to the CCO, rather than functioning as a true Co-CCO with "top tier" responsibilities for a portion of the compliance program and reporting, for example, to the CEO. Otherwise, the arrangement would seem inconsistent with the spirit of the requirement for an adviser to have only <u>one</u> CCO who can be held responsible for administering the adviser's compliance program.

7. Specifying "Control" on Schedules A and B.

Both Schedules A and B require an adviser to specify whether or not the persons listed there are "control persons" using the control definition found in the Form ADV glossary. "Control" is defined in the glossary as "[t]he power, directly or indirectly, to direct the management or policies of a person, whether through ownership of securities, by contract, or otherwise." The definition also spells out a number of persons <u>presumed</u> to control a firm, including all its officers, partners and directors exercising executive responsibility (or persons having similar status or functions), trustees and managing agents with respect to trusts, and persons with 25% or more equity ownership of various sorts. Disclosing "control" using this definition raises a number of issues:

- First, determining "control" is often a complex, fact-intensive analysis, contextual in nature, and belied by the simplistic "yes" or "no" response called for by Form ADV.

- Second, the definition of "control" used in the glossary of Form ADV is completely unique and does not match the definition of "control" found in the Advisers Act. Moreover, it does not track the control definition used in the Investment Company Act of 1940 or in regulations promulgated under the Securities Act of 1933 or the Securities Exchange Act of 1934. This means a person could conceivably be designated a "control" person on Form ADV but not have "control" for purposes of any of the relevant laws.

- Third, the Form ADV definition <u>presumes</u> certain persons "control" the adviser whether or not that accords with reality, under any definition. Advisers are not apprised in the instructions or other public guidance whether they are permitted to rebut a control presumption and, if so, how they go about doing so.

Despite these continuing problems, the SEC has not undertaken to revise Schedules A and B. As a result, advisers will have to continue using extraordinary care in making their control designations on those schedules, using the correct definition.

Advisers wishing to rebut a control presumption in cases where the facts do not support a control designation should, at a minimum, document the basis for their rebuttal, perhaps looking for guidance to Item 9 in Part 2A, which tells advisers how to rebut a materiality presumption when making disciplinary disclosures in a Firm Brochure. Cautious advisers may want to discuss their intended approach with the SEC Staff as well, although the Staff may be reluctant to discuss the actual control determination, given the fact-intensive nature of that analysis.

<u>CONCLUSION</u>

One can still hope that the SEC will eventually tear up Form ADV from its roots and start over from scratch, creating a far better disclosure form for advisers. In the meantime, advisers will have to

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grapple with incremental amendments to the existing form, coming now in waves in rapid succession. Undoubtedly, it will take time for all the problems and issues embedded in recent amendments to come to light. However, advisers can learn from the many issues discussed in this article that have already been revealed and continue to press for further action to resolve remaining problems.

Notes

1. The only exception to this requirement is that a Firm Brochure need not be amended between annual updating amendments solely because an adviser's assets under management or fee table have changed. See Instruction 4 to Instructions for Part 2A of Form ADV.

2. See Question II.2. in the SEC FAQs on Part 2 posted at http://www.sec.gov/divisions/investment/form-adv-part-2-faq.htm.

3. See Question II.3 in the SEC FAQs on Part 2, *supra* note 2.

4. Actually Item 4.E. of Part 2A says the "as of" date must not be more than 90 days before the date the adviser "last updated" its Brochure in response to Item 4.E. The phrase "last updated" is a bit confusing there. Presumably, it does not mean that an adviser updating on March 30, 2012, may use an "as of" date of, say, December 31, 2010, if the adviser "last updated" its AUM in a Firm Brochure filed on March 31, 2011. This instruction makes more sense if it means an adviser may use an "as of" date of up to 90 days prior to the date of the filing in which the AUM is being updated, similar to the instruction addressing valuation of assets for AUM in Part 1.

5. See Rules Implementing Amendments to the Investment Advisers Act of 1940, SEC Release No. IA-3221 (June 22, 2011) (the Implementing Release).

6. See Note 268 in Amendments to Form ADV, SEC Release No. IA-3060 (July 28, 2010).

7. See, e.g., In the Matter of John H. Gutfreund, et al., 51 S.E.C. 93, 113, Exchange Act Release No. 31554 (Dec. 3, 1992).

8. See Custody of Funds or Securities of Clients by Investment Advisers, SEC Release No. IA-2968 (Dec. 30, 2009).

9. See Advisers Act Rule 206(4)-2(d)(2).

10. The only exception to this is the narrow circumstance where the adviser has custody solely because its related person acts as qualified custodian for the assets but has been determined to be "operationally independent" of the adviser, in which case Item 9 instructs the adviser that it may report "no" it does not have custody in Item 9.A. even though it would still have to check "yes" reporting its related person's custody in Item 9.B.

11. See Note 317 in the Implementing Release, *supra* note 5.

12. See Advisers Act Rule 206(4)-2(d)(2).

13. Quite aside from those the SEC attempted to address in its latest amendments, many other ambiguities still remain in Item 9. See Lorna Schnase, "Practical Application of the Adviser Custody Rule and How to Report Custody on Form ADV," *The Investment Lawyer*, Vol.17, No.12 (December 2010).

14. See the Date Title or Status Acquired Question in the SEC's Frequently Asked Questions on Form ADV and IARD posted at http://www.sec.gov/divisions/investment/iard/iardfaq.shtml#scheda.

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