



## Legal Risk Management Tip March 2011

### THE SEC ISSUES RESPONSES TO FORM ADV PART 2 AND PAY-TO-PLAY RULE FREQUENTLY ASKED QUESTIONS

On March 18<sup>th</sup> and 22<sup>nd</sup>, the staff of the Securities and Exchange Commission's (SEC) Division of Investment Management published "Staff Responses to Questions about Part 2 of Form ADV"<sup>1</sup> (the "Form ADV Response") and "Staff Responses to Questions about the Pay to Play Rule"<sup>2</sup> (the "Pay-to-Play Response"). The first of these responses clarifies some frequently asked questions regarding compliance, delivery and filing dates of the new Form ADV Part 2, while the second response addresses some frequently asked questions regarding the newly issued Pay-to-Play Rule. Notably, both responses aim to clarify some common questions, and should not be viewed as rules, regulations, or statements of the SEC, which has neither approved nor disapproved this information.<sup>3</sup>

#### Highlights from the Form ADV Response

##### 1. Clarifying Points on Delivery – What are the New Compliance Dates for Delivery?

###### a. Delivery of Form ADV Part 2A – The Brochure

Each adviser currently registered with the SEC whose fiscal year ends on or after December 31, 2010 must include in its next annual updating amendment to its Form ADV a new brochure. Upon filing its new brochure with the SEC, an adviser must (i) begin to deliver the new brochure to *new clients and prospective clients* in lieu of its old brochure, and (ii) deliver to its *existing clients* within 60 days of when an adviser is required to file it. Advisers with fiscal year ends of December 31, 2010 are required to file their annual updating amendment using the new Form ADV Part 2 on or before March 31, 2011. Accordingly, these advisers are required to deliver Form ADV Part 2A to their *existing clients* on or before May 30, 2011 and to *new and prospective clients* once the brochure is filed.

###### b. New Compliance Dates for Form ADV Part 2B - The Brochure Supplements

In response to concerns expressed in a letter to the SEC from the Securities Industry and Financial Markets Association ("SIFMA"), the SEC issued a release on December 28, 2010, indicating that it has agreed to extend the compliance date for the delivery of brochure supplements in order to give advisers "additional time to design, test and implement systems and controls that will assure that each client receives an accurate brochure supplement with respect to the supervised person who provides advice to that client."<sup>4</sup>

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<sup>1</sup> Staff Responses to Questions About Part 2 of Form ADV, March 18, 2011, *available at* <http://www.sec.gov/divisions/investment/form-adv-part-2-faq.htm>.

<sup>2</sup> Staff Responses to Questions about the Pay to Play Rule, March 22, 2011, *available at* <http://www.sec.gov/divisions/investment/pay-to-play-faq.htm>.

<sup>3</sup> *Id.*

<sup>4</sup> SEC, Release No. IA-3129; Amendments to Form ADV; Extension of Compliance Date *available at* <http://www.sec.gov/rules/final/2010/ia-3129.pdf>.

The length of the extension differs depending on whether firms are already registered or newly registering. The new compliance dates are as follows:

- Existing Advisers: All investment advisers registered with the SEC as of December 31, 2010, and having a fiscal year ending on December 31, 2010 through April 30, 2011, have until July 31, 2011, to begin delivering brochure supplements to *new and prospective clients* and until September 30, 2011 to deliver brochure supplements to *existing clients*.
- Newly Registered Advisers: All newly registered investment advisers filing their applications for registration from January 1, 2011 through April 30, 2011, have until May 1, 2011 to begin delivering brochure supplements to *new and prospective clients* and until July 1, 2011 to deliver brochure supplements to *existing clients*.

## 2. Delivery of Form ADV Part 2 for Advisers to Private Funds

When asked whether a registered private fund adviser must deliver its brochure to the funds it advises or to the investors in those funds, the SEC clarified that a federal court has found that a “client” of an investment adviser managing a private fund is the fund itself, not an investor in the fund.<sup>5</sup> An adviser could, therefore, meet its delivery obligation to a fund client by delivering its brochure to a legal representative of the fund, such as the fund’s general partner, manager or person serving in a similar capacity.

## 3. How to Draft the Summary of Material Changes

Item 2 of Form ADV Part 2A, Material Changes, requires a brochure filed as part of an annual updating amendment to identify and discuss material changes to the brochure from the last annual update. The SEC clarified that an adviser may choose not to identify and discuss material changes when it is filing a brochure in connection with the transition to the new Part 2A. Item 2 of Part 2A is designed to identify any material changes from one year to the next of the new narrative brochure. However, if the new narrative brochure contains material information, such as a new conflict of interest or new disciplinary information that is being provided to clients for the first time, an adviser may want to highlight the new information for clients.

## 4. How to Design your Headings, Sub-Parts and Cover Page

The General Instructions to Form ADV Part 2A requires that an adviser respond to each item in Part 2 in the same order with the same heading as they appear in the General Instructions. However, the instruction only requires an adviser to include the heading for each item and to provide responses in the same order as the items appear in Part 2. As a result, an adviser’s brochure does not have to include headings of sub-parts or follow the order of sub-parts within each item in Part 2. In addition, the cover page need not identify it as “Item 1, Cover Page”.

## 5. Authoring Risk Disclosures for Advisers to Pooled Investment Vehicles

Item 8 of Part 2A requires an adviser to explain the material risks for each significant investment strategy or method of analysis the adviser uses. To that end, the SEC stated that an adviser to pooled investment vehicles may satisfy the requirement of Item 8 by providing a brief explanation of the material risks for each strategy and referring clients to the prospectus, offering memoranda, or other documents that a client participating in the pool will or has received that set out a more detailed discussion of risks.

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<sup>5</sup> *Goldstein v. Securities and Exchange Commission*, 451 F.3d 873 (D.C. Cir. 2006).

While the SEC's Form ADV Response was issued with less than a week before many registered advisers are required to upload their new brochure, the information can be very useful as a quality control measure both now and in the years ahead.

### **Highlights from the Pay-to-Play Response**

In the Pay to Play Response, the SEC reiterated that the Pay-to-Play Rule<sup>6</sup> is designed to cover arrangements where investment advisers and the adviser's "covered associates"<sup>7</sup> may seek to obtain advisory business by making or soliciting political contributions to the government officials or politicians responsible for awarding such business. In general, the Pay-to-Play Rule contains three key prohibitions:

1. A two-year prohibition on an adviser being compensated for advisory services following a political contribution to an elected official who is in a position to influence the selection of the adviser;
2. A general prohibition against advisers using third-party solicitors who are not themselves "regulated persons" subject to the Pay-to-Play Rules regulation of political contributions; and
3. A prohibition against an adviser and its covered associates from coordinating campaign contributions from others — a practice referred to as "bundling" — for an elected official who is in a position to influence the selection of the adviser.

Most significantly, the Pay-to-Play Response clarifies that: (1) an investment adviser's parent company and its employees generally are not deemed to be covered associates; (2) family members of the investment adviser's employees are not deemed to be covered associates; (3) an investment adviser's independent contractors are deemed to be covered associates; and (4) interpretations of MSRB Rule G-37 should be considered a useful resource when looking for guidance on the Pay-to-Play Rule, even if the adviser is not subject to MSRB regulations.

In light of the Pay-to-Play Rule, investment advisers should review and, if appropriate, update their policies and procedures manual and codes of ethics. For instance, advisers should consider additional reporting requirements, such as mandatory submission of initial and annual contribution reports in connection with relevant political contributions. Advisers should also consider adopting screening protocols for new hires to help ensure material information is captured prior to employment.

**Author: Brent M. Cunningham, Associate; Editor: Michelle L. Jacko, Esq., Managing Partner, JLG. JLG works extensively with investment advisers, broker-dealers, investment companies, hedge funds and banks on legal and regulatory compliance matters. For more information about this topic and other legal services, please contact us at (619) 298-2880, [info@jackolg.com](mailto:info@jackolg.com) or visit [www.jackolg.com](http://www.jackolg.com). Thank you.**

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<sup>6</sup> SEC Rule 206(4)-5.

<sup>7</sup> "Covered associates" are those persons associated with an investment adviser who are subject to the pay-to-play rule. See Rule 206(4)-5(a)(1).