SEC PROPOSES FORM ADV AMENDMENTS AND ELECTRONIC FILING REQUIREMENTS FOR INVESTMENT ADVISERS

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The U.S. Securities and Exchange Commission (the "SEC") and state securities authorities are creating a single Internet-based system of electronic filing for both federal and state registration of investment advisers. In a Release issued on April 5, 2000 (the "Release"), the SEC announced the creation of a new electronic filing system named the Investment Adviser Registration Depository (the "IARD") and proposed several amendments to Form ADV. The SEC also proposed a new form of narrative brochure written in plain English, which must be delivered to clients along with brochure supplements providing information about advisory personnel. This memorandum summarizes the key proposals in the Release. Comments on the proposals are due by June 13, 2000.

IARD REGISTRATION AND FILING SYSTEM

IMPLEMENTATION OF IARD

The IARD will be used by investment advisers to register with the SEC, amend registration and withdraw from registration. The IARD will also be used for state adviser registrations and for SEC-registered advisers to send state notice filings and pay state fees. The IARD will provide a website, a blank Form ADV and a "help" function with an on-line glossary. If an investment adviser is also registered as a broker-dealer, the adviser can link certain responses on the IARD to its responses on Form BD on the Web Central Registration Depository, which is used by broker-dealers to file with the SEC and state securities authorities. All information provided by an investment adviser will be available to the public free of charge on the IARD website.

NASD Regulation, Inc. ("NASDR"), which is developing the system, plans to roll out the IARD in four steps. First, investment advisers will be required to use the IARD to file Part I of Form ADV and any required notice filings to state authorities. Second, NASDR will release the public disclosure system. Third, NASDR will release the state investment adviser representative licensing system. Fourth, investment advisers will be required to use the IARD to file their narrative brochures.

FILING REQUIREMENTS

The SEC has not yet set an effective date for the commencement of operations of the IARD. Upon commencement, investment advisers will be required to file all new applications for registration on Form ADV through the IARD. Advisers who are already registered on Form ADV will have to re-submit their filing unless they can meet a hardship exemption. Registered investment advisers will also be required to file amendments to their Form ADV through the IARD at least once per year. To amend its Form ADV, an adviser would access its Form ADV through the IARD and simply type over the stale information. The adviser would then electronically "sign" the form and submit it to the IARD, which would replace the stale information with the new information submitted and record the date of change.

Initially, advisers will not be required to submit narrative brochures (which are discussed in more detail below) to the SEC but will be required to keep brochures and make them available to the SEC staff. However, state securities authorities may require SEC-registered advisers to file a paper copy with them. It is not currently anticipated that brochure supplements will be submitted to the IARD.

FILING FEES

One important new requirement is the imposition of initial and annual filing fees. The fees will be based on the amount of assets under management and the number of states to which the adviser submits notice filings. The SEC estimates that annual filing fees most likely will range between $200 and $400. Advisers will be required to establish an account with NASDR, and any IARD fees and state fees will be deducted directly from an adviser's account.

PROPOSED AMENDMENTS TO FORM ADV

PART I OF FORM ADV

The SEC proposed that Part I of Form ADV will be divided into Part 1A, which would be completed by all advisers, and Part 1B, which would be completed only by state-registered advisers. Part 1A would be divided into 12 items that request information similar to that required by the current Form ADV. Information concerning the education and business background of an adviser's personnel that is currently required by Part I would be incorporated as part of the narrative brochure required under Part II.

Disciplinary Actions

Certain changes have been proposed to the disclosures regarding disciplinary actions involving the adviser and certain of its advisory personnel. If an adviser answers affirmatively to any disciplinary questions, it would complete a Disciplinary Reporting Page, which replaces

current Schedules D and E. An adviser need only report disciplinary actions that occurred within the past 10 years. It should be noted, however, that even if a disciplinary action occurred more than 10 years ago, an adviser may be required to disclose it in its firm brochure or brochure supplement if the disciplinary action is material to a client's evaluation of the firm.

Advisers will no longer be required to report unsatisfied judgments and liens or a bond denial, payout or revocation. Also, findings by self-regulatory organizations that the adviser violated a "minor" rule will not need to be reported if the sanction is less than $2,500. Under the current Form ADV, there is no specified manner in which to remove a formerly filed Schedule D for an advisory affiliate who is no longer affiliated with the adviser. The revised Part I of Form ADV will permit an adviser to omit disciplinary disclosures relating to former affiliates.

Ownership Information

Schedules A, B and C, which give details on an adviser's ownership structure, will be amended to clarify the rules for determining those persons who own or control the investment adviser and the requirements for imputing beneficial ownership of an adviser for reporting purposes. Currently, advisers are required to provide information about all direct and indirect 5% owners. Under the proposed amendments, an adviser would only be required to report indirect owners that own at least 25% of a 5% direct owner.

PART 2 OF FORM ADV

Perhaps the most significant amendment to Form ADV is the new requirement for a narrative brochure written in plain English instead of the multiple choice and fill-in-the-blank format of the current Part II. Similar to the current Part II, the new Part 2 narrative brochure will require the adviser to disclose information about the investment adviser's fees, business practices and conflicts of interest. The new adviser brochures will be divided into Part 2A, a firm brochure, and Part 2B, a brochure supplement for each individual who provides advisory services to clients on behalf of the adviser.

PART 2A: THE FIRM BROCHURE

Part 2A of the proposed amended Form ADV consists of 19 items, which specify the required disclosures on a variety of topics. While the disclosures required by Part 2A should provide guidance on an adviser's statutory disclosures, the SEC reminded advisers in the Release that they may not fully satisfy such obligations. The brochure must be written in narrative form and in plain English, and advisers will generally be free to structure the disclosure and order the topics to best describe their business.

The brochure will generally include background information about the firm and a description of the firm's advisory business. Any adviser that holds itself out as specializing in a particular service must explain its specialty in detail, and any adviser that provides only advice

about a limited type of securities must explain its services and their limitations. Set forth below is a description of the principal differences from the disclosure currently required in Part II of Form ADV.

- **Summary of Changes.** A summary of material changes since the most recent annual update must appear on the cover page, immediately thereafter or in a separate letter sent to clients accompanying the brochure.

- **Client Costs and Adviser Compensation.** In addition to the information about advisory fees that is currently required to be disclosed, the proposal would require an adviser to include information about the types and amounts (or ranges) of costs other than the adviser's fees that will be imposed upon clients in connection with advisory services, such as brokerage and custody fees. Additionally, if the adviser receives transaction-based compensation, it must disclose this practice, the related conflict of interest and the firm's procedures for addressing the conflict.

- **Risk of Loss.** Under the new proposal, an investment adviser must describe the risks that a client faces in following the adviser's advice or permitting the adviser to manage assets. If an adviser uses a particular method of analysis, strategy or type of security, the adviser must explain specifically any significant or unusual risks.

- **Disciplinary and Financial Information.** An adviser must disclose any disciplinary information that is material to a client's evaluation of the firm and any financial condition likely to impair its contractual commitments to clients. The disciplinary events and financial conditions that must be disclosed are similar to, but somewhat broader than, those currently required by Rule 206(4)-4, which would be rescinded. Like Rule 206(4)-4, certain events will be presumed to be material, and the Release sets out four factors which should be analyzed in determining materiality. The presumption of materiality may be rebutted, but if an adviser determines that a past event is not material, it must create a memorandum regarding its decision and keep it as part of its required books and records. If an adviser or its management personnel has been subject to an SEC administrative order, the adviser must distribute copies of the SEC order to all new and existing clients for one year from the date of the order.

- **Conflicts of Interest.** The proposed amendments emphasize disclosure of various conflicts of interest that may arise in advisory relationships. These would include, among other things, an adviser's other financial industry activities and affiliations as well as financial interests that the firm or its personnel may have in certain securities recommended to clients. The adviser must disclose all material conflicts of interest and any procedures and controls instituted to address these conflicts.

- **Soft Dollars.** An investment adviser would be required to describe its soft dollar policies and practices and any resulting conflicts of interest. Specifically, an adviser

must disclose whether it receives a benefit for using soft dollars, has an incentive to select a particular broker-dealer because of soft dollar considerations and may cause clients to pay higher commissions in exchange for soft dollar benefits. The adviser must also describe whether it uses soft dollars to benefit all clients or only the clients whose commissions generated the benefit and must disclose how it allocates soft dollar benefits. The disclosure should include a description of the types of products and services acquired with soft dollars.

- **Other Brokerage Arrangements.** An adviser must disclose any practices of using client brokerage to reward brokers that refer clients, the conflict that this creates and the procedures in place to address the conflict. The adviser must also disclose (i) whether it negotiates lower commissions on behalf of clients, (ii) whether it engages in order aggregation, in which the adviser "bunches" trades to obtain volume discounts, (iii) any arrangement of directed brokerage transactions (either directed by the client or the adviser) and a description of the adviser's practice or policy with regard to directed brokerage transactions and (iv) its policies relating to commission recapture, and, in each case, the effect such practices will have on the clients' commission costs.

- **Custody of Client Funds.** If an adviser has, or is deemed to have, custody of client funds or securities, the adviser must disclose the additional risks as a result of this arrangement. Advisers that are banks, insurance companies or broker-dealers would be excluded from the balance sheet requirement otherwise applicable to advisers that have custody of client funds or securities.

- **Proxy Voting.** Advisers would be required to disclose whether they vote proxies for clients and, if so, their voting policies, practices and procedures. An adviser that votes proxies for clients should also disclose whether a client can direct the vote in a proxy solicitation and whether a client can request information about how the adviser voted their securities on a given issue.

- **Performance Advertising.** If an adviser advertises its investment performance, it must describe any industry or proprietary standards used to calculate or present performance results. The adviser must also disclose whether any third party reviews the performance information and, if so, the name of the third party and the nature of the review conducted.

PART 2B OF FORM ADV: THE BROCHURE SUPPLEMENT

Form ADV currently requires disclosure of background information only for firm executives and members of the firm's investment committee. Part 2B of amended Form ADV will require advisers to prepare separate supplements for each of the adviser's officers, partners or directors (or other persons occupying a similar status or performing similar functions), employees, or any other person who provides investment advice on the adviser's behalf

("supervised persons"). The supplements would be approximately one page in length and contain background information about the individual providing advisory services.

Part 2B consists of seven items that specify the disclosures that must be made about supervised persons of the adviser. The supplement would include biographical, educational and professional business information. Similar to the disclosures required in the narrative brochure on the firm, the brochure supplement requires disclosures about the supervised person's disciplinary history, including any proceeding revoking or suspending a professional attainment, designation or license of the supervised person.

The brochure supplement would also include a description of any other business activities of the supervised person, particularly any other capacities in which the supervised person participates in the financial markets and any related conflicts of interest. Additionally, the supplement would disclose whether the supervised person receives transaction-based compensation, including bonuses and non-cash compensation, and any arrangements in which someone other than a client gives the supervised person an economic benefit for providing advisory services. Certain details about the person responsible for supervising the advisory activities of the supervised person would also be included in the supplement.

DELIVERY REQUIREMENTS

Registered advisers will be required to deliver the narrative brochure about the firm to a client before or at the time that it enters into an advisory agreement with the client and to offer to deliver a copy of the current firm brochure and brochure supplements to each client once per year. The proposal eliminates the current five-day right of recission. However, clients generally have the right to terminate an advisory relationship at any time without penalty. The SEC clarified that any adviser that acts as the general partner for a limited partnership must provide a brochure to each limited partner.

Updates to the firm brochure must be delivered to clients whenever the brochure becomes materially inaccurate and must be included with brochures delivered to prospective clients. These updates can be delivered in the form of a reprinted brochure or a "sticker." Advisers that deliver their brochures to clients electronically could also deliver stickers electronically. Furthermore, as part of its annual updating amendment, an adviser must revise (and reprint) its firm brochure so that a "clean" document will be available to clients.

Advisers must also deliver to each client a brochure supplement on certain supervised persons who provide investment advice to that client. The supplement would be delivered to a client only if it is expected that the supervised person will either (i) regularly communicate investment advice to that client or (ii) formulate investment advice for that client, including exercising investment discretion over that client's assets. Advisers will not be required to deliver supplements for supervised persons who have no client contact and formulate advice only as part of a team.

NON-U.S. INVESTMENT ADVISERS

Non-U.S. investment advisers would no longer be required to file a separate form appointing the SEC as agent for service of process or a separate undertaking to provide the SEC with books and records. Instead, these would be incorporated into the new Form ADV. Additionally, Form 7-R, which is used by non-U.S. general partners or managing agents of all SEC-registered investment advisers to appoint the SEC as their agent for service of process, will be revised and renamed Form ADV-NR.

FORM ADV-W FOR WITHDRAWAL OF REGISTRATION

Form ADV-W will be revised to reflect the current practice of using it to withdraw from registration with the SEC, switch from SEC registration to state registration and withdraw registration from one or more states while remaining registered with other states. Withdrawal of registration would be effective on filing, thus, eliminating the current 60 day waiting period.

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