

## SUPPORTING STATEMENT FORM ADV

### A. JUSTIFICATION

#### 1. Necessity for the Information Collection

The Securities and Exchange Commission (the “Commission”) is proposing to amend Part 1A of Form ADV under the Investment Adviser Act of 1940.<sup>1</sup> In connection with the proposal to amend the investment adviser custody rule,<sup>2</sup> the Commission proposes these amendments to provide more complete information about the custody practices of advisers registered with the Commission, and to provide the Commission with additional data to improve our ability to identify compliance risks.<sup>3</sup>

Form ADV is the two-part investment adviser registration form. Part 1A of Form ADV contains information used primarily by Commission staff, and Part 2 is the client brochure. The collections are necessary to provide advisory clients, prospective clients, and the Commission with information about the adviser, its business, and its conflicts of interest.

The title of the affected collection of information is: “Form ADV” under the Investment Advisers Act of 1940. Its OMB control number is 3235-0049. An agency

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<sup>1</sup> 17 CFR 279.1.

<sup>2</sup> Rule 206(4)-2 [17 CFR 275.206(4)-2].

<sup>3</sup> See Custody of Funds or Securities of Clients by Investment Advisers, Investment Advisers Act Release No. 2876 (May 20, 2009) [74 FR 25354 (May 27, 2009)].

may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number.

## **2. Purpose of the Information Collection**

The purpose of this collection of information is to provide advisory clients, prospective clients, and the Commission with information about the adviser, its business, and its conflicts of interest. We use the information to determine eligibility for registration with us and to manage our regulatory, examination, and enforcement programs. Clients use certain of the information to determine whether to hire or retain an adviser.

This collection of information is found at 17 CFR 279.1 and it is mandatory. Responses are not kept confidential. Respondents to the Form ADV collection of information are investment advisers registered with the Commission or applying for registration with the Commission. The information collected takes the form of disclosures to their clients, potential clients, and the Commission.

## **3. Role of Improved Information Technology**

Investment advisers currently file their Form ADV, Part 1A electronically through the Investment Adviser Registration Depository (“IARD”) system. This method of collecting information reduces the regulatory burden upon investment advisers by (i) permitting them to electronically file applications for registration, and amendments thereto, at one central location, rather than filing Form ADV separately with the Commission, and the states for notice filing purposes, and (ii) enabling advisers to update only the information that is changed for purposes of the annual amendment or other types of amendments to Form ADV.

**4. Efforts to Identify Duplication**

The collection of information requirements of the proposed form amendments are not duplicated elsewhere.

**5. Effect on Small Entities**

The requirements of the proposed amendments to Form ADV are the same for all investment advisers registered with the Commission, including those that are small entities. It would defeat the purpose of Form ADV to exempt small entities from these requirements.

**6. Consequences of Less Frequent Collection**

The collection of information required by the form is necessary to protect investors by providing clients and potential clients, as well as the Commission, with information about the adviser, its business, and its conflicts of interest. The consequences of not collecting this information would be that clients and prospective clients may not have the information they need in order to evaluate the adviser's business practices and to determine whether to select or retain that adviser. In addition, if the information is either not collected or is collected less frequently, the Commission's ability to protect investors would be reduced.

**7. Inconsistencies with Guidelines in 5 CFR 1320.5(d)(2)**

Not applicable.

**8. Consultation Outside the Agency**

In its release proposing amendments to rule 206(4)-2, Form ADV, and other related rules, the Commission requests public comment on the effect of information collections under these amendments. In addition, the Commission and the staff of the Division of Investment Management participate in an ongoing dialogue with

representatives of the investment adviser industry through public conferences, meetings and informal exchanges. These various forums provide the Commission and the staff with a means of ascertaining and acting upon paperwork burdens confronting the industry.

**9. Payment or Gift to Respondents**

None.

**10. Assurance of Confidentiality**

The information collected pursuant to Form ADV is through filings with the Commission. These disclosures are not kept confidential.

**11. Sensitive Questions**

Not applicable.

**12. Estimate of Hour Burden**

Form ADV is the investment adviser registration form. The currently approved collection of information in Form ADV is 109,678 hours. Based on the proposed amendments, we estimate an increase to this collection of information, to 132,599 hours.<sup>4</sup>

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<sup>4</sup> This number also includes a burden of 26,753 hours associated with the requirement of delivering to clients copies of the adviser's code of ethics upon clients' request. The currently approved hour burden associated with this requirement is 78,973 hours, based on the estimates that there were 11,787 advisers subject to this burden (10,787 currently registered advisers + 1,000 new advisers). We estimated that each adviser had 670 clients and that 10 percent of those clients would request the adviser's code of ethics. We further estimated that satisfying each delivery request would impose a burden of 0.10 hour.  $(10,787 + 1,000) \times (670 \times 0.10) \times 0.10 = 78,973$ .

Based on data from the IARD, we now estimate that 12,272 advisers (11,272 currently registered advisers + 1,000 new advisers) are subject to this burden and that each adviser has 1,092 clients. We further estimate that 10 percent of the clients would request their adviser's code of ethics and that satisfying each delivery request would impose a burden of 0.02 hour. The total burden under the new estimates would be 26,753 hours.  $(11,272 \text{ currently registered advisers} + 1,000 \text{ new advisers}) \times (1,092 \text{ clients} \times 0.10) \times 0.02 \text{ hours} = 12,272 \times 109 \times 0.02 = 26,753 \text{ hours}$ .

The increased burden would result from the shortening of the amortization period currently in use for the approved collection of information, increases to our estimates of the number of advisers and advisory clients, and the proposed amendments to Part 1A and Schedule D of Form ADV.

We are proposing several amendments to Part 1A of Form ADV that are designed to provide us with additional details regarding the custody practices of advisers registered with the Commission, and to provide additional data to assist in our risk-based examination program. The proposed amendments would revise Item 7 of Part 1A, under which advisers report certain financial industry affiliates, to require an adviser to report all related persons who are broker-dealers and to identify which, if any, serve as qualified custodians with respect to the advisers' client assets.<sup>5</sup> We also propose to amend Item 9 to require advisers that have custody (or whose related persons have custody) of client assets to provide additional information about their custodial practices under proposed rule 206(4)-2. In addition, the proposed amendments to Schedule D of Form ADV would require an adviser, depending on the adviser's response to Item 9, to provide additional details including information about the accountants that perform annual audits or surprise examinations or that prepare internal control reports,<sup>6</sup> whether a report prepared by an independent public accountant contains an unqualified opinion,<sup>7</sup> and information about any related person that serves as a qualified custodian for the adviser's clients.<sup>8</sup>

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<sup>5</sup> Proposed Section 7 A. of Schedule D of Form ADV.

<sup>6</sup> Proposed Section 9 C. of Schedule D of Form ADV.

<sup>7</sup> Id.

<sup>8</sup> Proposed Section 9 D. of Schedule D of Form ADV.

Investment advisers should already have the information that we would require them to report on Form ADV, so the increased collection of information burden should not be significant. We estimate that these amendments would increase the average collection of information burden for the initial application and annual amendment of Form ADV from the currently approved 22.25 hours per adviser to 22.50 hours per adviser. We also estimate that there would be 12,272 advisers subject to this information collection.<sup>9</sup> The total annual burden for initial filing and annual amendments would therefore be 276,120.<sup>10</sup> For the currently approved hour burden, the Commission staff chose a fifteen-year amortization, however, for purposes of our proposal, we are amortizing the estimated burden over a shorter period of time – three years.<sup>11</sup> Therefore the annual burden, after amortizing it over the three year period, would be 92,040 hours or 7.5 hours per adviser.<sup>12</sup>

In addition to the burden associated with the initial filing and annual amendments to Form ADV, we estimated for the currently approved collection of information that, on average, each adviser filing Form ADV through the IARD system would likely amend its form 1.5 times during the year.<sup>13</sup> We estimated that the collection of information burden for such amendments would be 0.75 hours per amendment. We believe our proposal

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<sup>9</sup> See supra note Error: Reference source not found.

<sup>10</sup>  $22.5 \times 12,272 = 276,120$ .

<sup>11</sup> Every three years, we must submit for approval by the OMB collections of information imposed by our rules and thus the three-year period reflects the effective period of OMB's approval of this collection of information.

<sup>12</sup>  $276,120 / 3 = 92,040$ ;  $92,040 / 12,272 = 7.5$ .

<sup>13</sup> In addition to the required annual update of their Form ADV, advisers must amend their Form ADV by filing additional amendments promptly if information they provided in response to certain items of Form ADV becomes inaccurate in any way. See General Instructions to Form ADV.

would not increase the hour burden per adviser in connection with such amendments. The total hour burden in connection with such amendments would therefore be 13,806 hours.<sup>14</sup> Adding the annual burden of 26,753 hours associated with the requirement of delivering to clients the advisers' code of ethics upon clients' request,<sup>15</sup> the total annual hour burden for Form ADV under the proposed amendments would be 132,599 hours.<sup>16</sup> This represents an increase of 22,921 hours from the currently approved annual hour burden, primarily due to the shortening of the amortization period from 15 year to three years, the increase in our estimates of the numbers of advisers and advisory clients, and the proposed amendments to Part 1A of Form ADV.<sup>17</sup>

The Commission staff expects that Form ADV will be filled out by advisers' compliance clerks. Based on an average salary including fringe benefits of \$63 per hour,<sup>18</sup> the total cost of the information collection requirement of Form ADV is estimated to be approximately \$8,353,737.<sup>19</sup>

### **13. Estimate of Total Annual Cost Burden**

We estimate that some advisers may incur a one-time initial cost including outside legal fees in connection with preparation of Form ADV (including preparation of Part 2).

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<sup>14</sup>  $12,272 \times 1.5 \times 0.75 = 13,806$ .

<sup>15</sup> See supra note Error: Reference source not found.

<sup>16</sup>  $92,040 + 13,806 + 26,753 = 132,599$  hours.

<sup>17</sup>  $132,599 - 109,678 = 22,921$  hours.

<sup>18</sup> Data from the Securities Industry and Financial Markets Association's Office Salaries in the Securities Industry 2008, modified by Commission staff to account for an 1800-hour work-year and multiplied by 2.93 to account for bonuses, firm size, employee benefits and overhead, suggest that cost for this position is \$63 per hour.

<sup>19</sup>  $\$63 \times 132,599 = \$8,353,737$ .

As we discuss above, advisers subject to the Form ADV requirements vary widely in terms of the size, complexity and nature of their advisory business, and thus, the amount of disclosure required, would vary substantially among advisers. Accordingly, the amount of time, and thus cost, required for outside legal review is likely to vary substantially among those advisers who elect to obtain outside legal assistance. We estimate that the initial per adviser cost related to preparation of Form ADV may range from as little as \$1,200 for smaller advisers, to \$4,400 for medium-sized advisers, to as much as \$10,400 for larger advisers.<sup>20</sup> Similarly, whether an adviser even seeks outside legal services in drafting their Form ADV will depend on the size, complexity and nature of their advisory business. We believe that a substantial percentage of advisers, particularly smaller advisers, are unlikely to seek such outside legal services. Based on IARD data and adding our estimated 1,000 new registrants, we estimate that there are approximately 8,726 small advisers, 3,446 medium-sized advisers, and 100 large advisers.<sup>21</sup> We estimate that only a quarter of smaller advisers, or about 2,182 advisers, are likely to seek outside legal services.<sup>22</sup> Similarly, we estimate that approximately half of medium-sized advisers, or 1,723 advisers, are likely to seek such services.<sup>23</sup> On the other hand, advisers with more significant conflicts are more likely to engage outside

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<sup>20</sup> Outside legal fees are in addition to the projected hourly per adviser burden discussed above. \$400 per hour for legal services x 3.0 hours per small adviser = \$1,200. \$400 per hour for legal services x 11 hours per medium-sized adviser = \$4,400. \$400 per hour for legal services x 26 hours per large adviser = \$10,400. The hourly cost estimate of \$400 is based on our consultation with advisers and law firms who regularly assist them in compliance matters.

<sup>21</sup> For purposes of this estimate, we have categorized small advisers as those with 10 or fewer employees, medium-sized advisers as those with between 11 and 999 employees, and large advisers as those with 1,000 or more employees.

<sup>22</sup> 8,726 small advisers x 0.25 = 2,182.

<sup>23</sup> 3,446 medium-sized advisers x 0.5 = 1,723.



legal services to assist in preparation of Form ADV. On this basis we estimate that all of the 100 larger advisers registered with the Commission are likely to incur costs related to such outside legal services. Thus, we estimate that approximately 4,005 advisers, will elect to obtain outside legal assistance, for a total cost among all respondents of \$11,239,600.<sup>24</sup>

**14. Estimate of Cost to the Federal Government**

There are no costs to the government directly attributable to Form ADV.

**15. Explanation of Changes in Burden**

The total burden hours for all respondents has increased from the currently approved 109,678 hours per year to 132,599 hours per year. This increase is mainly due to the following factors: (1) the increase of the total number of advisers filing Form ADV; and (2) the shortening of the amortization period from the current 15 years to three years; and (3) the adjustment of our estimate of the average collection of information burden for the initial application and annual amendment of Form ADV per respondent from 22.25 hours to 22.50 hours.

**16. Information Collection Planned for Statistical Purposes**

Not applicable.

**17. Approval to not Display Expiration Date**

Not applicable.

**18. Exceptions to Certification Statement**

Not applicable.

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<sup>24</sup> (\$1,200 x 2,182 advisers) + (\$4,400 x 1,723 advisers) + (\$10,400 x 100 advisers) = \$11,239,600.

**B. COLLECTIONS OF INFORMATION EMPLOYING STATISTICAL METHODS**

Not applicable.