SEC Adopts Amendments to Form ADV Part 2 to Implement Narrative Disclosures and Electronic Filing

On July 28, 2010, the Securities and Exchange Commission (the “SEC”) adopted a series of significant amendments to the current version of Form ADV Part 2, commonly referred to as an adviser’s “brochure.” The amendments were proposed on March 3, 2008, and were largely reproposals of an initial proposal dating back to April 2000. Most importantly, the new Form shifts the current “check-the-box” format to a more narrative format, adds a supplement to the brochure describing the registrant’s investment professionals, and requires electronic filing of Part 2A of the brochure.

Each investment adviser registered with the SEC whose fiscal year ends on or after December 31, 2010 must file a compliant Form ADV Part 2A with its next annual updating amendment. This means that, for each such adviser, the annual updating amendment containing the compliant Form ADV Part 2A must be filed no later than March 31, 2011. Within 60 days of filing the annual updating amendment, an adviser must deliver to all of its current clients, copies of both parts of the new Form ADV.

Introduction

Currently, Form ADV Part 2 requires registered advisers to respond to a series of multiple-choice and fill-in-the-blank questions and to provide some supplemental narrative disclosures that have evolved piecemeal over the years in response to SEC enforcement actions, no-action letters and guidance. As Chairman Mary Schapiro noted in her statement on the new Form, the SEC believes that the disclosures required by the old Form do not describe an adviser’s business or conflicts in a way that is accessible or useful to the investor.

The new Form transforms Part 2 from its current “check-the-box” format into a publicly viewable, two-part brochure with narrative disclosures provided in response to specific items or areas. Part 2A, the “firm brochure,” contains eighteen items that an adviser must address, in the order prescribed. Part 2B, the “brochure supplement,” contains six items advisers must address. The brochure supplement is intended to provide investors with specific information about supervised persons who provide the investors with investment advice (referred to herein as the “portfolio managers”). The effect of all the items, taken as a whole, is to compel an adviser to

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make comprehensive disclosures that describe both
the conflicts of interest it faces and how it addresses
those conflicts, as well as the adviser’s investment
strategies and the risks they present.

The disclosures required by the new Form should be
succinct and in plain English. The instructions to
Part 2 indicate that the disclosures should be in the
form of short sentences; should use definite,
concrete, every day words; and should be written in
the active voice. Advisers are cautioned, however,
that providing succinct and concise disclosures
creates a tension with the expanded disclosure
requirements of the new Form. Disclosures that are
too cursory or too succinct may not be complete and
thus may, in fact, violate the new requirements of
the Form.

In short, the new Form requires advisers to conduct
a complete overhaul of their Form ADV Part 2 and
to prepare narrative responses to each item.
Although the level of disclosure has increased
markedly under the new Form,³ advisers should be
cautions that making the required disclosures will
not guarantee compliance with the anti-fraud
provisions of the Investment Advisers Act of 1940
(the “Advisers Act”) — rather, an adviser will still
have an obligation to disclose material conflicts of
interest to the extent such information is not
specifically required by an item on Form ADV
Part 2.

³ Advisers should not view the narrative disclosures as an
opportunity to sell their funds through Form ADV Part 2. In the
Adopting Release, the SEC lukewarmly indicated that it
believes registrants can provide the information required by
Part 2 without jeopardizing reliance on the registration
exemptions provided by the Securities Act of 1933, as
amended. But this is weak protection. The SEC has made
clear in other contexts that posting information about funds on
the Internet constitutes a general solicitation. In the Adopting
Release, the SEC declined to provide a safe harbor for
information provided in Form ADV Part 2. Advisers should,
therefore, be warned that the inclusion of private fund
information beyond that which is required by Part 2, such as
subscription instructions, performance information, and
financial statements, could jeopardize some funds’ registration
exemptions by constituting a public offering or conditioning the
market for the securities issued by those funds. While the
language in the Adopting Release may provide a defense
against an SEC or state ‘blue sky’ commission enforcement
action, it is less useful when confronting private litigation.

Overview

Filing Requirements. Advisers must file the firm
brochure electronically in searchable PDF format.
The firm brochure will be publicly accessible on the
Investment Adviser Registration Depository
(“IARD”) website operated by the Financial
Industry Regulatory Authority. Among other
matters, the SEC believes that the public availability
of the firm brochure will enhance accessibility and
ease the comparison of advisers by investors.

Delivery Requirements. An adviser is required to
deliver the firm brochure to clients initially (see
attached chart for initial filing obligations) and
annually thereafter within 120 days of the end of the
adviser’s fiscal year. Other than the initial and
annual delivery requirements, an adviser must
deliver a firm brochure to current clients when it
amends the firm brochure to reflect a disciplinary
event or to change materially information already
disclosed in a previous firm brochure. An adviser
must also prepare and deliver a brochure
supplement, with disclosures regarding certain key
investment professionals of the adviser, such as its
portfolio managers, to clients when a new portfolio
manager begins to manage a client’s money or when
the adviser materially changes the information
within a brochure supplement.

Part 2A: The Firm Brochure

As adopted, Part 2A contains eighteen separate
items, each covering a different disclosure topic that
advisers must address. If an item is inapplicable,
rather than deleting the item, advisers must include
the heading and indicate that the information is
inapplicable. If the information provided in
response to one item is also responsive to another
item, an adviser may cross-reference the
information in the other item.

Set forth below are the key provisions of Part 2A as
adopted, their differences from the old Form and, in
certain cases, noted differences with the 2000 and
2008 proposals.

Disclosure Items

General: Conflicts. The new Form calls for a
succinct, easy-to-understand narrative, in
plain English, of the conflicts of interest
that may arise in the course of an

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exemptions by constituting a public offering or conditioning the
market for the securities issued by those funds. While the
language in the Adopting Release may provide a defense
against an SEC or state ‘blue sky’ commission enforcement
action, it is less useful when confronting private litigation.
adviser’s business and how the adviser addresses such conflicts. Information must be presented in the specified format, and an adviser should discuss only conflicts it has or is reasonably likely to have and the practices in which it engages or is reasonably likely to engage.

Advisers must be cautious in selecting which conflicts to disclose. While over-inclusion would be inconsistent with the succinct disclosure approach required by the SEC, omitting conflicts could violate the requirements of the new Form and expose an adviser to claims that it did not sufficiently disclose relevant conflicts.

General: Multiple Brochures. Advisers that provide substantially different advisory services to different clients are allowed to provide clients with different brochures as long as each client receives all information about the services and fees that are applicable to that client. Advisers may not omit from any brochure provided to a client any information required by Item 9 (see below). Each brochure must be filed through IARD.

Item 2: Material Changes. An adviser that amends its firm brochure must identify and discuss the material changes to the firm brochure since the last annual update. This summary is not required if an adviser has not filed any interim amendments to its firm brochure and if the firm brochure continues to be accurate in all material respects.

The summary must be presented either on the cover page, the page immediately following the cover page, or as a separate document accompanying the firm brochure. Advisers that include the summary of material changes within the firm brochure (either on the cover page or the page immediately thereafter) and then amend the firm brochure on an interim basis should consider whether an update to the summary should be made to avoid confusing or misleading clients reading the updated firm brochure.

Item 4: Advisory Business. An adviser must continue to describe its advisory business, including (among other items) its assets under management, and now must also disclose whether it holds itself out as specializing in a particular type of advisory service.

In calculating assets under management for the purposes of this item only, advisers may use a calculation method that differs from the method used to calculate assets under management for the purposes of Form ADV Part 1A. Advisers must update the amount of assets under management annually and make interim amendments for material changes in assets under management when filing an “other than annual amendment” for a separate reason.

Item 5: Fees and Compensation. As under the old Form, an adviser must disclose its fee schedule, whether fees are negotiable and how clients pay for such fees (i.e., whether the client is billed for such fees or whether such fees are deducted directly from the client’s account). The Form as adopted permits an adviser to omit disclosure of its fee schedule and other information required by Item 5 in any firm brochure provided only to clients who are “qualified purchasers” under the Investment Company Act of 1940, as amended (the “Company Act”). Conflicts inherent in compensation arrangements must be addressed.

Item 6: Side-by-Side Management. An adviser that charges (or has a portfolio manager who charges) performance fees must disclose that fact. If an adviser (or a portfolio manager) also manages accounts that are not charged a performance fee (e.g., mutual funds), the adviser must describe the conflicts of interest implicated by managing the two accounts with disparate fee structures, such as the adviser’s

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*Advisers must maintain documentation describing the method used to compute assets under management if the method differs from the method used to compute assets under management for the purposes of Form ADV Part 1A.*
incentive to favor and/or take greater risks in managing accounts that pay a performance fee.\(^5\) In particular, an adviser must include disclosures regarding conflicts in the allocation of trades and investment opportunities.

**Item 7: Types of Clients.** As with the old Form, the new Form requires advisers to describe the types of advisory clients the firm has, as well as any requirements for opening or maintaining an account. Importantly, this item will require advisers to state that they manage funds that rely on one of the private placement exemptions under the Securities Act of 1933. This disclosure may implicate the risks associated with over-disclosure discussed above in footnote 3.

**Item 8: Methods of Analysis, Investment Strategies and Risk of Loss.** Advisers must disclose significant investment strategies and the material risks that each strategy presents. Based on comments received in response to the 2008 Proposing Release, the SEC modified this item to require disclosure of significant investment strategies (rather than of primary investment strategies), as the SEC believed that this threshold for disclosure better captures those methods of analysis or strategies that will be most relevant to an adviser’s clients.

Under the new Form, advisers also must specifically disclose how strategies involving “frequent trading” can affect investment performance. While the SEC declined to define “frequent trading,” it suggested that it would expect advisers to provide the required information if their “intended investment strategies involved frequent trading of securities that a reasonable client would otherwise not expect in light of the other disclosures contained in the brochure.”

In keeping with its requirement that disclosures remain succinct, the SEC noted in the Adopting Release that the brochure may not always be the best place for a multi-strategy adviser to disclose risks associated with all of its methods of analysis or strategies. Moreover, advisers should be aware that it will be difficult to balance the requirements of the new Form with the more detailed disclosures contained within their private funds’ offering memoranda. Since the disclosure for purposes of Item 8 must be succinct, it would generally not be advisable to repeat all of the risk factors contained in an offering memorandum. However, this leaves the door open for a claim by the SEC, a state regulator or a private plaintiff that not all relevant risks were adequately disclosed.

Advisers must disclose that investing in securities involves risk of loss that clients should be prepared to bear.

**Item 9: Disciplinary Information.** Advisers must provide material facts about legal and disciplinary events that would be material to a client’s evaluation of the investment adviser. This Item incorporates into the brochure the disclosure regarding disciplinary information required by Rule 206(4)-4 under the Advisers Act. Disciplinary actions are presumptively material if they occurred within the previous ten years, while a disciplinary event more than ten years old need only be disclosed if the event is so serious that it remains material to a client or prospective client’s evaluation of the adviser and the integrity of its management. Advisers still need not disclose if any of their employees have been sanctioned by professional organizations (CFA Institute, Certified Financial Planner Board of Standards, etc.) unless the adviser believes it is material information relevant to a client.\(^6\) However, if an employee resigns to avoid a sanction,

\(^5\) In the 2008 Proposing Release, the SEC referenced specific issues such as the timing of trades (“front running”), contrasts in strategies (a hedge fund short selling a stock in which a mutual fund holds a long position), and trade allocation (“cherry picking”).

\(^6\) This disclosure was not required under Rule 206(4)-4.
and the adviser knew or should have known this was the reason for the resignation, the adviser must disclose this fact. Lastly, advisers should note that they may have a fiduciary duty to report all material sanctions.

Items 10 and 11: Other Financial Industry Activities and Affiliations and Code of Ethics; Participation or Interest in Client Transactions and Personal Trading.
Pursuant to Item 10, each adviser must disclose and describe material relationships or arrangements that the adviser (or any of its management persons) has with related financial industry participants, any material conflicts of interest that these relationships or arrangements create, and how the adviser addresses the conflicts. This item is similar to Item 8 of the old Form. As with the old Form, Item 11 requires advisers to describe their codes of ethics and state that a copy is available upon request. Also in keeping with the requirements of the old Form, if an adviser or a related person recommends to clients, or buys or sells for client accounts, securities in which the adviser or a related person has a material financial interest, advisers must describe this practice and the conflicts of interest presented. Advisers must also disclose any personal trading by the adviser or its personnel. These disclosures will be particularly important for advisers that use affiliated brokers or recommend or invest in affiliated funds.

Item 12: Brokerage. The amended Form requires advisers to describe, among other items, (1) how they address the conflicts arising from the use of “soft dollars,” (2) their client brokerage practices, (3) their directed brokerage practices, and (4) their trade aggregation policies.

Item 12 requires an adviser that receives soft dollar benefits in connection with client securities transactions to disclose its practices. The description must be specific enough for investors to understand the types of products or services the adviser is acquiring and to permit investors to evaluate the associated conflicts of interest. Disclosure must be more detailed for products or services that do not qualify for the safe harbor in Section 28(e) of the Securities Exchange Act of 1934, as amended. In addition to other new, express disclosure requirements (including the requirement that an adviser disclose whether it “pays up” for soft dollar benefits), advisers must now explain whether they use soft dollars to benefit all accounts proportionately.

Under the new Form, an adviser must disclose if it uses client brokerage to compensate or otherwise reward brokers for client referrals. It must include in its disclosure a description of the conflicts of interest created by client brokerage and the system of controls used by the adviser when allocating brokerage. The old Form did not specifically require that an adviser discuss the conflicts of interest created.

In addition, if applicable, advisers that permit clients to direct brokerage must describe their directed brokerage practices. Perhaps more importantly, advisers must disclose if they routinely recommend, request or require clients to direct brokerage. Advisers that do so must further disclose that not all advisers require directed brokerage and must describe any relationship with a broker-dealer that could create a material conflict of interest. The new Form permits advisers to omit disclosures regarding their inability to obtain best execution if all of the directed brokerage arrangements are subject to best execution, whether recommended by the adviser or directed by the client.

Finally, advisers must describe whether, and under what circumstances, they aggregate trades. If an adviser does not aggregate trades when it has the opportunity to do so, it must explain that clients may, as a result, pay higher brokerage costs.
Item 13: Review of Accounts. Advisers must disclose their policies for reviewing accounts, including who is responsible for account reviews. This disclosure item will likely push advisers whose review procedures have been driven by context or whose procedures are less regimented to consider instituting more formal account review procedures.

Item 14: Client Referrals and Other Compensation. An adviser must describe arrangements pursuant to which it compensates another party, other than an employee, for client referrals. It is important to note that this new requirement goes beyond the requirements of the Cash Solicitation Rule under the Advisers Act\(^7\) in that it requires disclosure of non-cash compensation for client referrals. Advisers will need to consider their current practices to determine whether any of their actions could be considered compensation (including non-cash compensation) to a party that refers a client. The Adopting Release does not contain any de minimis exception.

Item 15: Custody. This item requires that if an adviser has custody of client funds or securities and the client receives account statements directly from the custodian, the adviser must explain that the clients will receive account statements directly from the qualified custodian that maintains those assets and that clients should carefully review these statements and compare them to any statements provided by the adviser. If the client does not receive account statements directly from the custodian, then the adviser need not provide this disclosure. The SEC believes that comparing statements will allow clients to determine whether account transactions, including deductions to pay advisory fees, are proper.

Item 16: Investment Discretion. An adviser that has discretionary authority over client accounts must disclose these arrangements and describe any limitations clients may place on the adviser’s authority.

Item 17: Proxy Voting. Advisers must describe their proxy voting policies and practices, consistent with existing requirements under Rule 206(4)-6. Unlike in proposed Form, the Form as adopted does not require an adviser that uses third party proxy voting services to describe how the providers are selected, whether clients may direct the use of a particular provider, or how payment is made for such services.

Item 18: Financial Information. An adviser with discretionary power or custody of client assets or who requires prepayment of fees must disclose any financial condition reasonably likely to impair the adviser’s ability to meet contractual commitments to clients. This item effectively requires advisers to disclose information that will be difficult to disclose – for example, that they are subject to a judgment large enough to cause concern that they can no longer meet their obligations to clients.

Part 2A Appendix 1. The Wrap Fee Program Brochure. The SEC has revised the requirements of current Form ADV Schedule H to incorporate the amendments to Part 2A. The SEC will also now require an adviser to identify whether any of its related persons is a portfolio manager in the wrap fee program and, if so, to describe the associated conflicts.

Delivery and Updating of Brochures

Initial Delivery to Clients. An adviser must deliver a current brochure before or at the time it enters into an advisory contract with a client. The current rule requiring delivery either 48 hours before entering into a contract with a client, or upon entering into a contract if the client can terminate within five days without penalty, has been eliminated.

Advisers need not deliver the brochure to (1) advisory clients receiving only impersonal investment advice who pay the

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\(^7\) Rule 206(4)-3.
adviser less than $500 per year, (2) investment companies registered under the Company Act, or (3) business development companies subject to Section 15(c) of the Company Act. An adviser need not prepare a Form ADV Part 2A if all of its clients fall into one or more of these categories.

Annual Delivery to Clients. Advisers must annually provide each client to whom they are required to provide a firm brochure either: (1) a copy of the current (updated) firm brochure that includes, or is accompanied by, the summary of material changes to the firm brochure; or (2) the summary of material changes to the firm brochure that includes an offer to provide a copy of the current firm brochure. This delivery must be made within 120 days of the end of the adviser’s fiscal year.

Interim Delivery to Clients. Advisers must deliver an updated firm brochure promptly whenever the firm brochure is amended to add a disciplinary event or to change material information already disclosed in response to Item 9.

Updating the Brochure. Advisers must keep the firm brochures filed with the SEC current by updating them at least annually and promptly when any information in the firm brochures becomes materially inaccurate.

Part 2B: Brochure Supplement

One of the more significant aspects of the adopted Form is the requirement that advisers prepare and deliver brochure supplements containing disclosures about certain key investment professionals of the investment adviser. The SEC has left to the adviser’s discretion how to group disclosures about its professionals into separate supplements. Advisers may elect to prepare a supplement for each portfolio manager or they can prepare separate supplements for different groups of portfolio managers. Part 2B consists of six items, highlights of which are set forth below.

Application. Each item of Part 2B must be answered for every portfolio manager of the adviser that either: (1) formulates investment advice for client assets and has direct client contact; or (2) makes discretionary investment decisions for client assets, even if there is no direct client contact. If investment advice is provided by a team comprised of more than five portfolio managers, the brochure supplement need only be provided for the five portfolio managers with the most significant day-to-day responsibility.

Delivery. A portfolio manager’s supplement initially must be given to each client at or before the time when that specific portfolio manager begins to provide advisory services to that specific client. An adviser is not required to deliver a brochure supplement to a client to whom delivery of the firm brochure is not required or to certain “qualified clients” who are also officers, directors, employees and other persons related to the adviser. If an adviser has no clients to whom a brochure supplement must be delivered, then it need not prepare a brochure supplement. Advisers are permitted to deliver the brochure supplement electronically; in this case, advisers may disclose that a portfolio manager has a disciplinary event and provide links to BrokerCheck and the Investment Adviser Public Disclosure (“IAPD”) website.

Updating. An adviser must amend a brochure supplement to reflect any changes that render it materially inaccurate. An adviser need only make an interim delivery to existing clients when there is a new disclosure of a disciplinary event or a material change to disciplinary information already disclosed.

Advisers who provide the brochure supplement electronically and provide links to BrokerCheck and IAPD cannot rely on the link alone to meet the delivery-of-updates requirement (e.g., when there is a new disciplinary event); rather an adviser would be required to deliver an updated supplement or sticker to clients. This
requirement creates a duty to update information in the supplement beyond merely providing the link.

This requirement will create compliance challenges since only certain clients will receive certain supplements, depending on which portfolio manager is advising them. Advisers will have to track carefully which supplements have been sent to which clients in order to provide them with appropriate updates.

**Filing.** Advisers are not required to file brochure supplements, and the brochure supplements will not be available on the SEC’s website. The brochure supplement must be retained in an adviser’s files.

**Item 2: Educational Background and Business Experience.** An adviser must disclose information about the portfolio manager’s formal education and business background for the past five years. If an adviser chooses to include information about a portfolio manager’s professional designation, it must provide a sufficient explanation of the minimum qualifications required for the designation so that the value of the designation might be understood.

**Item 3: Disciplinary Information.** Advisers must disclose legal and disciplinary events that are material to a client’s evaluation of the integrity of the adviser. Unlike in proposed Form, the Form as adopted only requires advisers to disclose why a portfolio manager has relinquished a designation or license if the adviser knew or should have known that the designation or license was relinquished.

**Item 4: Other Business Activities.** An adviser must disclose non-investment-related business in which the portfolio manager engages if the other business activity represents more than 10 percent of the portfolio manager’s time and income.

**Item 5: Additional Compensation.** Each adviser’s supplement must describe any arrangement in which someone other than a client gives the portfolio manager an economic benefit (such as a sales award or other prize) for providing advisory services. The SEC believes that clients need to know if their individual adviser benefits from these arrangements in order to assess the advisory services of that particular portfolio manager.

**Item 6: Supervision.** This item requires an adviser to explain how it monitors the portfolio manager’s advice. This requirement creates public accountability for the named supervisors. It may also create compliance burdens if the supervisory chain changes frequently or is ambiguous, as is the case with many smaller advisers.

Please see chart below for more information regarding the effective dates of this amendment.
# Effective Dates

## New Investment Advisers

### FILING REQUIREMENTS

| 1. Initial Filing | Each adviser applying for registration with the SEC after January 1, 2011 must file a compliant Form ADV Part 2. |
| 2. Filings Thereafter | Comply with filing requirements applicable to currently registered advisers (see below). |

### DELIVERY REQUIREMENTS

| 1. Firm Brochure & Brochure Supplement | Deliver firm brochure and brochure supplement to existing clients within 60 days of filing firm brochure with the SEC. |

## Currently Registered Advisers

### FILING REQUIREMENTS

| 1. Initial Filing | File firm brochure with the annual amendment made after the first fiscal year end that occurs on or after December 31, 2010. |
| 2. Regular Annual Amendments | File updated firm brochure with annual updating amendment (within 90 days after adviser’s fiscal year end) *only if* adviser has filed an interim amendment since the last annual update or if the firm brochure is no longer accurate in all material respects. |
| 3. Other-Than-Annual Amendments | Update promptly when any information becomes materially inaccurate. |

### DELIVERY TO CLIENTS: FIRM BROCHURE

| 1. Initial Delivery | *Current Clients*: Deliver within 60 days of initial filing with SEC.  
*New Clients*: Deliver to new or prospective clients before or at the time an advisory contract is entered into. |
| 2. Annually Thereafter | Deliver updated firm brochure (or summary of material changes and an offer to provide full brochure) within 120 days after fiscal year end. |
| 3. Other-Than-Annual Delivery | Deliver updated firm brochure (or summary of material changes and an offer to provide full brochure) promptly if amendment adds disclosure of a disciplinary event or materially revises disciplinary information already disclosed. |

### DELIVERY TO CLIENTS: BROCHURE SUPPLEMENT

| 1. Initial Delivery | Deliver to current and new clients along with firm brochure. |
| 2. Delivery Thereafter | *New Portfolio Manager*: Deliver current brochure supplement for a portfolio manager at or before the time that the portfolio manager begins providing advice with respect to the client’s account.  
*New Information*: Deliver updated brochure supplement promptly if amended to add disclosure of an event or to revise materially information already provided. |