



Risk Management Update August 2010

THE NEW FORM ADV PART 2: THE NEXT CHAPTER FOR INVESTMENT ADVISER REQUIREMENTS

Introduction

Following years of discussion, rule proposals and comments, the Securities and Exchange Commission (SEC) at long last approved its significant overhaul of Form ADV Part 2. The amendments to Part 2 include, among other things, requirements for:

1. Improved format of and updates to the brochure;
2. Expanded content to provide details most relevant to the clients of investment advisers;
3. Brochure supplements to include resume-like information about the individuals servicing the advisory account; and
4. Electronic access to the brochure.¹

The SEC approved the changes to Form ADV Part 2 on July 21, 2010, simultaneous with the President's signing of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The effective date of the rule is October 12, 2010. Advisers whose fiscal year ends on December 31, 2010, must file their ADV Part 2 no later than March 31, 2011, utilizing the new "Plain English" format. For new firms formed after January 1, 2011, the new ADV Part 2 must be used.

This article is designed to highlight those areas that advisers should pay close attention to when deciphering the amended ADV Part 2 changes.

What Has Changed

The current Form of ADV Part II generally is not available to the public and is delivered only to clients and prospects of the advisory firm. Now, the amended Form ADV Part 2 will be made publicly accessible on the Investment Adviser Registration Depository ("IARD") website in a searchable PDF format. Importantly, the brochure will no longer have a check the box format, but rather shall appear in a "plain English" narrative form. As a result, drafters of the new Form ADV Part 2 will need to familiarize themselves with the SEC's *Plain English Handbook* on how to write clear disclosures which can be found at <http://www.sec.gov/pdf/handbook.pdf>. This will require advisers to use:

- Clear, concise and uniform language;
- Shorter sentences;
- Everyday words;
- An active voice; and
- Tables or lists for more complex material.

The new Form ADV Part 2 is divided into two sections. Part 2A, the Firm Brochure, contains 18 separate items about the firm's business structure and strategies. Subpart 2B, the Brochure Supplement, will contain six items specific to the advisory personnel who will be providing advisory services to the individual clients. Below are some of the key provisions for advisers to take particular note, which may require strategic discussions and input from various business units or personnel.

¹ Please see <http://www.sec.gov/news/press/2010/2010-127.htm>

A. The Firm Brochure: Part 2A

Unlike the current Form ADV Part II, the new Part 2A does not have a sample template for advisers to use. Rather, advisers must use the disclosure item headings as determined by the SEC², and present them in the order required under the new Part 2A. Should an item not apply to the adviser's business model, the adviser still must include the heading and indicate that the item is not applicable. Though these 18 items are similar to the items previously used on Part 2, there are material additions and expanded items that should be noted by all advisers. A few of the more significant changes include, among others:

- Item 2 - Summary of Material Changes
 - *Advisers to identify and discuss those material changes to the brochure since the last annual update; may appear on the cover page, following page or separate document*
- Item 4 – Advisory Business
 - *Advisers to describe if it specializes in any services (e.g., financial planning), whether clients are allowed to impose restrictions on investments, and whether the firm's assets under management (AUM) is calculated differently in Part 2 compared to Part 1.*
- Item 5 - Fees and Compensation
 - *Advisers to discuss its compensation arrangements, including any inherent conflicts, how they are addressed and a description of all other costs a client may pay*
- Item 6 - Performance Based Fees and Side by Side Management
 - *Advisers to disclose if performance based fees are used and how any potential conflicts are addressed*
- Item 8 – Methods of Analysis, Investment Strategies and Risk of Loss
 - *Advisers must explain that investing in securities involves certain risks, including the risk of loss, that clients should be prepared to bear the risk of loss, and those material risks involved in a particular type of security or strategy (e.g., derivatives)*
- Item 9 - Disciplinary Information
 - *Advisers must relay material facts about legal or disciplinary events that could influence the client's evaluation of the integrity of the Adviser*
- Item 12 – Brokerage Practices
 - *Advisers must disclosure its soft dollar arrangements and describe those incentives the adviser may have to select a particular broker, and if such benefits are not proportionally used to service all clients*

In addition, for every conflict identified in new Part 2A, advisers are required to outline how each is addressed within the firm. Due to the extensiveness of all these changes, advisers should begin drafting the information required in Part 2A sooner rather than later.

For a complete list of brochure format and content changes, please see the full release.³

² SECURITIES AND EXCHANGE COMMISSION, 17 CFR Parts 275 and 279, [Release No. IA-3060; File No. S7-10-00], as last seen on August 25, 2010: <http://www.sec.gov/rules/final/2010/ia-3060.pdf>.

³ *Id.*

B. The Brochure Supplement: Part 2B

Investment advisers should prepare now for delivering Part 2 B, which is a new brochure supplement, to all new and prospective clients. This document consists of six items and must be completed for each individual who will be providing investment advisory services⁴ on behalf of the firm. Similar to a resume, the supplemental information will include educational background, business experience and other business activities, along with disciplinary history of the individual. Details of this information are provided so that clientele can more easily assess the advisory representative's background and qualifications. In addition, contact information for the advisory representative's supervisor along with an explanation of how the firm supervises its personnel must be provided.

Similar to Part 2A, advisers must meet the "plain English" requirement when writing the required brochure supplements and present disclosures in accordance with the six required item headings, which include:

1. Cover Page;
2. Educational Background and Business Experience;
3. Disciplinary Information;
4. Other Business Activities;
5. Additional Compensation; and
6. Supervision.

Unlike Part 2A which must be filed with the SEC, Part 2B is only required to be distributed to clients based on the advisory personnel providing services to them and must be made available to the SEC upon request.

Delivery Requirements

In its adoption of amendments to Rule 204-3 of the Investment Adviser's Act of 1940, those advisers registered with the SEC must deliver the Part 2A disclosure brochure to a client "before or at the time the adviser enters into an advisory contract with the client" and the Part 2B brochure supplement to a client at or before the time that specific advisory representative begins to provide advisory services to that specific client.⁵ At a minimum, an annual summary of material changes to Part 2A must be provided to the client, along with an offering to provide clients a copy of the updated brochure. The annual delivery must be made no later than 120 days after the end of its fiscal year.⁶ However, in 2011, the SEC is permitting an additional 60 days from a firm's required filing date to deliver the new ADV Parts 2A and 2B to clients. Consequently, investment advisers registered with the SEC whose fiscal year-end is December 31st must submit their filings through the IARD system by March 31, 2011 and deliver the required disclosure documents to its clientele by May 31, 2011.

Conclusion

In its release the SEC estimated that the time for firms to prepare for these updates for the new ADV Part 2 will take approximately 15 hours for smaller firms defined as advisers with 10 or fewer associated persons. However, given the types and amount of significant changes, it may likely take longer. It is our strong recommendation that investment advisers start the process now. For those advisers who are registered with the states, or will be switching to state registration, it is important to check with those

⁴ The brochure supplement needs to be provided for those persons who formulate investment advice and have direct client contact, and for those persons who have discretionary authority over client assets.

⁵ Advisor's Act of 1933, Rule 204-3(b)

⁶ *Id.*

jurisdictions to see whether or not they are requiring the new ADV Part 2 for annual amendments. For example, as of the date of this publication, California is not.

CCLS will continue to provide updates regarding the changes to ADV Part 2 requirements. For more information or for assistance with your Form ADV Part 2 updates, please contact us at (619) 278-0020. Thank you.

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