



Form ADV, Part 2
New perspectives

New form ADV, part 2

The U.S. Securities and Exchange Commission (“SEC”) has adopted changes to Part 2 of Form ADV, the second component of the registration form and the client disclosure document used by investment advisers under the Investment Advisers Act of 1940 (the “Advisers Act”). The new Form ADV, Part 2 (the “Brochure”) requires registered advisers to provide most clients and prospective clients¹ with “clearly written, more meaningful, current disclosures” of their business practices, potential conflicts of interest, and personnel backgrounds.² Instead of the current “check-the box” format, the new Brochure must be written in a narrative, “plain English” format, will be publicly available for the first time on the SEC’s web site and must include certain background information on certain supervised persons providing advisory services to clients, including their disciplinary history, outside business activities and compensation arrangements.

Advisers must file a Brochure meeting the new requirements within 90 days of their first fiscal year end on or after December 31, 2010, and deliver Brochures to their clients within 60 days of such filing (the client delivery requirement changes to 30 days for subsequent Form ADV filings). Depending on the date of their Form ADV filings, the new Brochure requirements are likely to apply to advisers registering for the first time as a result of the Dodd-Frank Act.

Narrative brochure written in “plain english”

The SEC believes that a narrative format will provide advisers with greater flexibility to present information in a

more meaningful and relevant way to investors.³ Certain SEC Commissioners have observed that for the narrative requirement to be effective, advisers will need to adopt the “spirit” of the requirement and move away from the standard boilerplate language often used by advisers to protect against legal liability.⁴ Toward this end, the new Brochure requires advisers to use “plain English” (e.g., short sentences, everyday words and the active voice).⁵ The SEC has also instructed advisers to only disclose those conflicts and business practices that the adviser has (or is reasonably likely to have) to avoid cluttering the Brochure with irrelevant disclosures or practices.

Key changes to the brochure’s content

In addition to changing the format of the Brochure, the new Form ADV, Part 2 includes several new disclosure requirements and altered many other disclosure items currently required. The new Brochure now includes two parts: Part 2A and Part 2B. Part 2A consists of 18 disclosure items related to the adviser’s activities as whole, referred to as the “Firm Brochure.” Part 2B consists of six new disclosure items specific to the experience and activities of certain supervised persons⁶ that provide advisory services to clients, referred to as the “Brochure Supplement.”

Firm brochure updates

Summarized below are selected additions and changes to the Firm Brochure. Advisers must respond to each of the Firm Brochure’s 18 disclosure items. If a disclosure item does not apply to an adviser, an adviser must indicate that the item is not applicable.

¹ Brochures are not required for mutual fund and business development company clients.

² Amendments to Form ADV; Final Rule, Release Nos. IA-3060 (July 28, 2010).

³ The SEC discusses the limitations of the current “check the box” approach to the Brochure in the Proposed Amendments to Form ADV, Release Nos. IA-1862 (Apr. 5, 2000) (“Proposing Release”) at Section II.D.2.

⁴ SEC Open Meeting, July 21, 2010, available at: <http://www.sec.gov/news/openmeetings/2010/072110openmeeting.shtml>

⁵ General Instruction #2 of Part 2 of Form ADV directs advisers to “Write your brochure and supplements in plain English, taking into consideration your clients’ level of financial sophistication. Your brochure should be concise and direct. In drafting your brochure and brochure supplements, you should: (i) use short sentences; (ii) use definite, concrete, everyday words; (iii) use active voice; (iv) use tables or bullet lists for complex material, whenever possible; (v) avoid legal jargon or highly technical business terms unless you explain them or you believe that your clients will understand them; and (vi) avoid multiple negatives.” The SEC’s Office of Investor Education and Advocacy has also published A Plain English Handbook for advisers at www.sec.gov/news/extra/handbook.htm.

⁶ Instruction #1 of the Brochure Supplement requires an adviser to prepare a Brochure Supplement for: (1) any supervised person who formulates investment advice for and has direct contact with the client; and (2) any supervised person who has discretionary authority over a client’s assets, even if the person has no direct client contact.

Item 2. Material changes: Advisers are required to prepare and deliver an annual summary of “material changes” to the Brochure. This summary may be presented on the cover page of the Brochure, following the cover page, or as a separate communication to clients. If presented as a separate communication to clients, advisers must file the summary of the “material changes” with the SEC as an exhibit to the Firm Brochure.

Item 5. Fees and compensation: Advisers are required to disclose how they are compensated for advisory services and to describe any other types of fees or expenses clients may incur in connection with the advisory services provided, such as brokerage, custody, and fund expenses. Additionally, if the adviser or its personnel receive brokerage commissions for selling investment products or receive transaction-based compensation, the adviser must disclose this practice, the conflicts they create, and how the adviser addresses these conflicts.

Item 6. Performance fees and side-by-side management: If applicable, advisers are required to disclose potential conflicts of interest presented by the side-by-side management of accounts (i.e., the management of two accounts (or funds) following similar investment strategies, where one account/fund charges a performance fee) and their processes for addressing such conflicts. Such disclosures may include information about the allocation of investment opportunities, trades, and resources between the two types of accounts/funds.

Item 8. Methods of analysis, investment strategies and risk of loss: Advisers must disclose material risks of their “significant” investment strategies and methods of analysis. The new requirements do not require advisers that offer multiple investment strategies to make similar disclosures to limit the length of the Brochure. Multi-strategy firms are only required to make general disclosures applicable to many, if not all of, their investment strategies. The SEC noted that multi-strategy firms may still need to make separate strategy specific disclosures in other communications with clients.

Item 8 also requires advisers to disclose how strategies that employ “frequent trading” impact investment performance. The SEC chose not to define the term “frequent trading,” as the SEC indicated the definition may not be flexible enough since, “frequent trading” is relative to the investment strategy, client, and the security being traded.

Item 9. Disciplinary information: Advisers must disclose legal and disciplinary events material to a client’s evaluation of the integrity of the adviser or its management personnel. The SEC provides a listing of disciplinary events that need to be disclosed within Items 9.A, 9.B., and 9.C of the Brochure. These disciplinary events need to be disclosed for at least 10 years after the date of the event.⁷ The SEC notes that the list of disciplinary events is not exclusive and other events not listed may still require disclosure if the adviser deems the disciplinary event material to the client’s evaluation. The SEC noted that advisers may omit immaterial disciplinary information from the Brochure, but the adviser would have to separately document why it felt the disciplinary information was immaterial and provide this information to the SEC upon request during an inspection.

Item 10. Financial industry activities and affiliations: Advisers must provide enhanced information regarding their financial industry activities and affiliations with entities, such as broker dealers, investment companies, limited partnerships and pension consultants. Advisers now need to describe potential conflicts of interest resulting from such financial industry activities and affiliations and disclose how they are addressed.

Item 12. Brokerage practices: If applicable, advisers must disclose practices with respect to soft dollars, trade aggregation, directed brokerage, and the use of client brokerage to compensate brokers for client referrals. Below is a summary of specific activities that must be disclosed:

- Soft dollars — Advisers must make certain disclosures if soft dollar arrangements are used, including:

⁷ For purposes of calculating this ten-year period, the “date” of an event is the date that the final order, judgment, or decree was entered, or the date that any rights of appeal from preliminary orders, judgments or decrees lapsed.

- That the adviser receives a benefit by not paying for the research or products itself;
- That the adviser may have an incentive to select brokers offering research or products as opposed to seeking best execution for clients;
- Whether clients pay higher commissions in return for research and products;
- The types of research and products received with client brokerage commissions; and
- Procedures to direct client transactions to a broker-dealer in return for soft dollar benefits.
- Trade aggregation — Advisers must describe under what conditions trade orders are aggregated for client accounts. If advisers do not aggregate orders, they need to disclose the costs to clients associated with not aggregating transactions.
- Directed brokerage — If an adviser permits directed brokerage arrangements for clients, the adviser must describe the consequence of such arrangements, including the potential for clients to pay higher commissions and receive less favourable execution. If the adviser recommends or requires clients to enter directed brokerage arrangements, the adviser must disclose any material conflicts of interest, such as those resulting from affiliated broker-dealer relationships, and to disclose that not all advisers require directed brokerage.
- Client referrals — If an adviser uses client brokerage to compensate brokers for client referrals, the adviser must disclose the practice and additionally describe the conflict of interest created by such arrangements and explain its procedures for directing client transactions for client referrals.

Item 15. Custody: If an adviser has custody of client funds or securities, the adviser must explain that clients will receive account statements directly from a qualified custodian and that these statements should be carefully reviewed. If the adviser sends its own account statements to clients, the adviser must include a statement urging clients to compare the statements to the custodian statements.

Item 18. Financial information: An adviser must provide clients with an audited balance sheet if the adviser requires the prepayment of more than \$1,200 in fees per client, six months or more in advance. Advisers must also disclose whether a bankruptcy petition has occurred in the past 10 years or whether its financial condition would reasonably prevent the adviser from meeting its contractual arrangements.

Brochure supplements

Advisers must supply tailored Brochure Supplements disclosing background information on certain supervised persons that provide advisory services to clients.⁸ Previously, the Brochure only required advisers to disclose background information on executives and members of investment committees. The SEC indicated that this was not relevant to clients, especially those clients of larger asset management firms, who receive advisory services primarily from supervised persons who are not executives or members of the investment committee.

The Brochure Supplement includes 6 disclosure items:

1. Cover Page — List of supervised persons covered by the Brochure Supplement;
2. Education/Business Experience — Description of each supervised person’s formal education and business experience over the past 5 years, including name(s) of previous employer(s) and title(s) held;
3. Disciplinary History — Material legal or disciplinary history of each supervised person over the past 10 years;
4. Other Business Activities — Disclosures on whether the supervised person participates in any other substantial investment-related businesses activity and a description of the potential conflicts of interest that such participation may create, including any compensation received due to the supervised persons’ sale of securities and/or investment products;⁹
5. Additional Compensation — Description of any arrangements in which someone other than the client gives the advisory person additional compensation for providing advisory services; and

⁸ See footnote 6

⁹ Although the SEC did not provide specific guidance on the definition of “substantial” investment-related business activity, the SEC permits an adviser to assume that other business activities representing less than 10% of supervised person’s time and income are not substantial.

6. Supervision — Description of how the advisory person is supervised and the contact information for each advisory person’s supervisor.

The Brochure Supplements must be delivered before or at the beginning of when the supervised person(s) provides advisory services to a client.¹⁰ Any updates to the disciplinary information in the Brochure Supplement must be sent to clients immediately. Additionally, if any other material changes occurred during the year, the adviser is required to deliver an updated Brochure Supplement to the applicable clients on annual basis. Advisers are not required to file Brochure Supplements with the SEC, although advisers must make Brochure Supplements available during an SEC inspection.

The Brochure Supplement(s) may prove to be operationally challenging for advisers with many investment professionals or investment strategies as advisers will need to closely monitor the supervised persons assigned to each client account or group of accounts. If the supervised persons assigned to client accounts change, advisers will need to provide clients with a new Brochure Supplement before or at the beginning of that supervised person managing the client account. Additionally, advisers will need to establish separate processes to ensure that the six disclosure items in the Brochure Supplement are complete and accurate on an ongoing basis. This may include obtaining periodic certifications from supervised persons.

Key changes to delivery requirements

The SEC has also changed how and when advisers distribute Brochures to clients as described below.

- **Initial delivery:** Advisers are required to deliver a Firm Brochure and Brochure Supplements before or concurrent to the moment the adviser enters into an investment management agreement with a new client.

- **Initial and annual filing:** Advisers must file their Firm Brochure electronically with the SEC as part of their initial registration and at least annually thereafter via the Investment Advisory Registration Depository (“IARD”). The Firm Brochure will then be made available to the public through the SEC’s web site. The annual filing is due no later than 90 days after the adviser’s fiscal year end. The SEC does not require advisers to file the Brochure Supplements with background information on supervised persons, although this information must be available upon the SEC’s request during an inspection.
- **Annual delivery:** In addition to filing the Firm Brochure with the SEC, advisers must annually deliver to clients a summary of material changes to the Firm Brochure along with an offer to provide the entire Firm Brochure upon request. The summary and offer of the Firm Brochure will be required to be delivered within 120 days after the adviser’s fiscal year end (for 2011, advisers have 150 days from their fiscal year ends to deliver the Firm Brochure to clients). Advisers are not required to deliver Brochure Supplements on an annual basis to clients, unless there are material changes to the Brochure Supplements (however, Brochure Supplements must be provided to clients immediately upon changes to the disciplinary event section).
- **Electronic delivery:** The SEC permits Firm Brochures and Brochure Supplements to be delivered electronically to reduce operational costs for advisers (e.g., printing and postage expenses). In doing so, advisers need to follow the SEC’s guidance on electronic delivery.¹¹ For example, advisers need to maintain current e-mail listings of their clients and gain assurance that Brochures are delivered in a complete and timely manner.

¹⁰ If a client receives investment advice by a team of more than five supervised persons, advisers are only required to provide Brochure Supplement(s) for the five supervised persons with the most significant responsibility for providing the day-to-day discretionary advice.

¹¹ Use of Electronic Media by Broker-Dealers, Transfer Agents, and Investment Advisers for Delivery of Information, Investment Advisers Act Release No. 1562 (May 9, 1996) (“Electronic Media Release”).

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The SEC believes that a narrative format will provide advisers with greater flexibility to present information in a more meaningful and relevant way to investors.

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