



**August 2010/Client Alert**

**Final Amendments to Rules and Content Relating to Form ADV, Part 2 Adopted – Registered Advisers Will Be Required to Prepare and to File Electronically Brochures Using the New Format and to Prepare Brochure Supplements**

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On July 21, 2010, the Securities and Exchange Commission (the “Commission”) adopted amendments to Part 2 of Form ADV, and related rules under the Investment Advisers Act of 1940, as amended (the “Advisers Act”), to require investment advisers registered with the Commission to provide new and prospective clients with a brochure, i. e., Part 2A (as further described below) and brochure supplements written in plain English.<sup>1</sup> The Commission’s Adopting Release detailing the amendments was made public on July 28. The amendments to Part 2 of Form ADV are designed to provide new and prospective advisory clients with clearly written, meaningful, current disclosure of the business practices, conflicts of interest and background of the investment adviser and its advisory personnel. Advisers must file their brochures with the Commission electronically, and such brochures will be publicly available on the Commission’s website just like Part I of Form ADV. The Commission also is withdrawing the Advisers Act rule requiring advisers to disclose certain disciplinary and financial information because the amendments have made such information duplicative.

The revised Part 2 will include two sub-parts, Part 2A and Part 2B.<sup>2</sup> Part 2A contains 18 disclosure items about the advisory firm that must be included in an adviser’s brochure. Part 2B is the “brochure supplement,” which includes resume-like information about the advisory personnel on whom clients rely for investment advice.

Moreover, advisers will be required to provide each client with an annual summary of material changes to the brochure which will be in addition to their existing obligation to offer to provide a complete updated brochure on an annual basis. Alternatively, advisers can provide each client a copy of the current (updated) brochure that includes the summary of material changes.

The amended rules and forms will be effective October 12, 2010.

<sup>1</sup>*Amendments to Form ADV*, Investment Advisers Act Release No. 3060 (July 28, 2010) (“Adopting Release”). See also *Garrity Graham Client Alert*, “SEC Adopts Final Amendments to Form ADV, Part 2” (July 2010).

<sup>2</sup>Part 2 is a uniform form used by investment advisers registered with both the Commission and the state securities authorities. Form ADV Part Certain items and instructions to Part 2 (e.g., Item 19 of Part 2A, Item 10 of Appendix 1 to Part 2A, and Item 7 of Part 2B) apply only to state-registered advisers. State-registered advisers are required by state, rather than federal, law to respond to these items. Completion of these items, therefore, is not an SEC requirement, and as such, these items are not included in the Adopting Release as an SEC rule.

## I. Part 2A: The Brochure

### A. Format

Registered advisers will have to provide prospective and existing clients with a narrative brochure written in “plain English.”<sup>3</sup> Advisers must provide the required information about themselves in a specified format. As such, advisers must present the information in order of the items listed in the new Part 2A of Form ADV, using the headings provided by the form. It is the Commission’s intention that such standardized presentation of information will facilitate comparisons between multiple advisers.

An adviser must respond to each item in the brochure. However, if an item is inapplicable to an adviser, the adviser must include the heading and an explanation that the information is inapplicable. If information an adviser provides in response to one item is also responsive to another item, the adviser may cross-reference the information in the other item.

In addition, the brochure should discuss only conflicts<sup>4</sup> the adviser has or is reasonably likely to have, and practices in which it engages in or is reasonably likely to engage. If a conflict arises or the adviser decides to engage in a practice that it has not disclosed, supplemental information must be provided to the client.

### B. Brochure Items

Part 2A, as adopted, contains 18 separate items, each covering a different disclosure topic. Much of the disclosure required in Part 2A addresses an adviser’s conflicts of interest with its clients, and is disclosure that the adviser, as a fiduciary, must make to clients in some manner regardless of the form requirements.

The Commission is permitting advisers to create separate brochures for different types of advisory clients, each of which may be shorter, clearer, and contain less extraneous information than would a combined brochure.<sup>5</sup> For example, the Commission suggests that advisers with a more complicated offering of advisory services (or business arrangements) might consider including a summary in the beginning of their brochure, followed by a more detailed discussion of each item in the brochure. *As such, advisers that simultaneously manage private funds and separate managed accounts or families of private funds may consider preparing separate brochures for private funds, managed accounts or families of private funds, respectively.*

Item 1. Cover Page. Item 1 requires that an adviser disclose on the cover page of its brochure the name of the firm, its business address, contact information, website (if it has one), and the date of the brochure. The cover page also must include a statement that the brochure has not been approved by the Commission or any state securities authority. If an adviser refers to itself as a “registered investment adviser,” it also must include a disclaimer that registration does not imply a certain level of skill or training.<sup>6</sup>

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<sup>3</sup>In drafting the brochure, advisers, among other things, should use short sentences; definite, concrete, everyday words; and the active voice.

<sup>4</sup>Instruction 3 in the *General Instructions for Part 2 of Form ADV* explains that an adviser must provide the client with sufficiently specific facts so that the client is able to understand the conflicts of interest the adviser has and the business practices in which it engages, and can give his or her informed consent to the transaction or practice that gives rise to the conflict or to reject the transaction or practice.

<sup>5</sup>See Rule 204-3(e) under the Advisers Act (allowing advisers that provide substantially different advisory services to different clients 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). Note that an adviser may not omit any information required by Item 9 of Part 2A (Disciplinary Information) in any brochure provided to any client, and that each brochure must be filed through the Investment Adviser Registration Depository (“IARD”). See Rule 204-3(a) under the Advisers Act; see also Instruction 2 for Part 2A of Form ADV. An adviser that creates separate brochures must file each brochure through the IARD system. See Instruction 9 for Part 2A of Form ADV.

<sup>6</sup>Section 208 of the Advisers Act. See Adopting Release, note 29.

Item 2. Material Changes. When an adviser amends its brochure, such adviser must identify and broadly discuss the “material changes”<sup>7</sup> since the last annual update on the cover page or the following page or as a separate document accompanying the brochure.<sup>8</sup> Item 2 is designed to make clients aware of information that has changed since the prior year’s brochure and that may be important to them. The summary should contain no more than is necessary to inform clients of the substance of the changes to the adviser’s policies, practices or conflicts of interests so that they can determine whether to review the brochure in its entirety or to contact the adviser with questions about the changes.

Item 3. Table of Contents. Item 3 requires each adviser to include in its brochure a table of contents detailed enough to permit clients and prospective clients to locate topics easily. Note that advisers must present the information in the order of the items in the form, using the headings provided by the form.

Item 4. Advisory Business. Item 4 requires each adviser to describe its advisory business, including the types of advisory services offered, whether it holds itself out as specializing in a particular type of advisory service, and the amount of client assets that it manages. Advisers must make additional disclosure if they hold themselves out as specializing in a particular type of advisory service. The Commission is requiring advisers to identify a specialized advisory service because it believes that clients likely will want to understand this before engaging that adviser.

For purposes of Part 2A disclosure, in computing the amount of client assets that it manages, an adviser may use a method that differs from the method used in Part 1A of Form ADV to report “assets under management.”<sup>9</sup> An adviser opting to use a different method must keep documentation describing the method used.<sup>10</sup>

Note that advisers must update the amount of their assets under management annually (as part of their annual updating amendment). Advisers are to make interim amendments for material changes in assets under management if the amount had become materially inaccurate only in instances when they are filing an “other than annual amendment” for a separate reason.

Item 5. Fees and Compensation. Item 5 requires that an adviser describe in its brochure how it is compensated for its advisory services, provide a fee schedule, and disclose whether fees are negotiable.<sup>11</sup> However, an exception to Item 5.A permits an adviser to omit disclosure of its fee schedule and other information in Item 5.A in any brochure that is provided only to clients who are “qualified purchasers.”<sup>12</sup> According to the Commission, brochure fee information is likely not useful to institutional and large, sophisticated clients who are often in a position to negotiate fee arrangements with their adviser and for whom, therefore, a fee table would have little utility.

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<sup>7</sup>The standard of materiality under the Advisers Act is whether there is a substantial likelihood that a reasonable investor (here, client) would have considered the information important. *See S.E.C. v. Steadman*, 967 F.2d 636, 643 (D.C. Cir. 1992). *Cf. Basic Inc. v. Levinson*, 485 U.S. 224, 231-232 (1988); *TSC Industries v. Northway, Inc.*, 426 U.S. 438, 445, 449 (1976). This is a “facts and circumstances” test, requiring an assessment of the “total mix of information,” in the characterization of the Supreme Court. *TSC Industries*, 426 U.S. at 449. Given that materiality depends on the factual situation, which may vary with each situation, the Commission’s position is that it will not specifically define or provide any bright line tests for what is and is not material.

<sup>8</sup>Advisers may include the summary of material changes in their brochure or in a separate document. *See* Item 2 of Part 2A. A summary prepared as a separate document can be used to satisfy an adviser’s annual client delivery obligations. *See* Rule 204-3(b)(2) under the Advisers Act. Summaries provided as a separate document must be filed with the Commission as an exhibit to Part 2. *See* Note to paragraphs (a) and (b) of Rule 204-1 under the Advisers Act and Instruction 6 for Part 2A of Form ADV. If an adviser includes the summary of material changes in its brochure, and amends its brochure on an interim basis between annual updating amendments, the adviser should consider whether to update its summary of material changes to avoid confusing or misleading clients reading the updated brochure. *See* Note to Instruction 6 for Part 2A of Form ADV.

<sup>9</sup>The methodology for calculating assets required under Part 1A is designed for a particular purpose (*i.e.*, for making a determination as to whether an adviser should register with the Commission or with the states), rather than to convey meaningful information about the scope of the adviser’s business. For an explanation of Part 1A’s requirements for computing “assets under management,” *see* Instruction 5.B for Part 1A of Form ADV.

<sup>10</sup>*See* Rule 204-2(a)(14)(ii) under the Advisers Act and Note to Item 4.E of Part 2A.

<sup>11</sup>Item 5.A of Part 2A.

<sup>12</sup>“Qualified purchasers,” as defined under section 2(a)(51)(A) of the Investment Company Act of 1940, as amended (the “Company Act”), include, among others, natural persons who own \$5 million or more in investments and persons who manage \$25 million or more in investments for their account or other accounts of other qualified purchasers.

An adviser must disclose whether it bills clients or deducts fees directly from clients' accounts, and how often it assesses fees (or bills clients).<sup>13</sup> Item 5 also requires each adviser to describe the types of other costs, such as brokerage, custody fees and fund expenses that clients may pay in connection with the advisory services provided to them by the adviser.<sup>14</sup> An adviser charging fees in advance must explain how it calculates and refunds prepaid fees when a client contract terminates.<sup>15</sup>

Item 5 also requires an adviser that receives compensation attributable to the sale of a security or other investment product (e.g., brokerage commissions), or whose personnel receive such compensation, to disclose this practice and the conflict of interest it creates, and to describe how the adviser addresses this conflict. Such adviser also must disclose that the client may purchase the same security or investment product from a broker that is not affiliated with the adviser.<sup>16</sup>

Furthermore, Item 5 requires an adviser that receives transaction-based compensation, or whose personnel receive such compensation, to disclose this practice and the conflict of interest it creates and to describe how the adviser addresses this conflict.<sup>17</sup>

Item 6. Performance-Based Fees and Side-by-Side Management. Item 6 requires an adviser that charges performance-based fees or that has a supervised person who manages an account that pays such fees to disclose this fact. If such an adviser also manages accounts that are not charged a performance fee, Item 6 also requires the adviser to discuss the conflicts of interest that arise from its (or its supervised person's) simultaneous management of these accounts, and to describe generally how the adviser addresses those conflicts.<sup>18</sup> According to the Commission, as fiduciaries, advisers must disclose all material information regarding any proposed performance fee arrangements as well as any material conflicts posed by the arrangements.

Item 7. Types of Clients. Item 7 requires an adviser to describe the types of advisory clients it generally has, as well as the firm's requirements for opening or maintaining an account, such as minimum account size.

Item 8. Method of Analysis, Investment Strategies and Risk of Loss. Item 8 requires that advisers describe their methods of analysis and investment strategies and disclose that investing in securities involves risk of loss which clients should be prepared to bear.<sup>19</sup> Item 8 also requires specific disclosure of how strategies involving frequent trading can affect investment performance.<sup>20</sup> Finally, Item 8 requires that advisers explain the material risks (but *not all* risks) involved for each significant investment strategy or method of analysis they use and particular type of security they recommend, *with more detail if those risks are unusual.*<sup>21</sup>

Items 8.B and 8.C call for detailed discussions of "significant or unusual" risks. This requirement is intended to elicit from the adviser disclosure of significant risks associated with using a particular investment strategy or recommending a particular type of security that otherwise would not be apparent to the client from reading the adviser's brochure. An adviser that describes a wide range of investment advisory activities in its brochure but, in fact, specializes in a specific

<sup>13</sup>See Item 5.B of Part 2A.

<sup>14</sup>See Item 5.C of Part 2A.

<sup>15</sup>See Item 5.D of Part 2A.

<sup>16</sup>See Item 5.E.2 of Part 2A. In addition to the requirement in Item 5.E.2 of Part 2A, an adviser that receives more than half of its revenue from commissions and other sales-based compensation must explain that commissions are the firm's primary (or, if applicable, exclusive) form of compensation. See Item 5.E.3 of Part 2A. An adviser that charges advisory fees in addition to commissions or markups to an individual client must disclose whether it reduces its fees to offset the commissions or markups. See Item 5.E.4 of Part 2A.

<sup>17</sup>According to the Commission, the item simply recognizes that an adviser that accepts compensation from the sale to a client of securities has an incentive to base investment recommendations on the amount of compensation it will receive, rather than on the client's best interests, and thus involves a significant conflict of interest. Furthermore, the Commission believes that Item 5 is not, in substance, different from the previous Item 9 of Part 2, which, in recognition of this conflict, required an adviser to disclose whether the adviser effects securities transactions for clients.

<sup>18</sup>While Item 5 requires disclosure of an adviser's fee arrangements, it will not specifically require disclosure of the conflicts any particular fee arrangement may create other than with respect to transaction-based compensation. See Adopting Release, note 67.

<sup>19</sup>See Item 8.A of Part 2A.

<sup>20</sup>See Item 8.B of Part 2A.

<sup>21</sup>See Item 8.C of Part 2A (emphasis added).

investment strategy, should disclose such information in response to Items 8.B and 8.C.

Note that advisers should disclose material risks associated with their strategies that will be relevant to most clients, regardless of whether they use one strategy or many strategies. Accordingly, Items 8.B and 8.C require that advisers explain the material risks involved for each *significant* investment strategy or method of analysis they use, *rather than* those they *primarily* use.

Item 9. Disciplinary Information. Item 9 requires that an adviser disclose in its brochure material facts about any legal or disciplinary event that is material to a client's (or prospective client's) evaluation of the integrity of the adviser or its management personnel. These requirements incorporate into the brochure the client disclosure regarding disciplinary information required by Rule 206(4)-4 under the Advisers Act.

Items 9.A, B, and C provide a list of disciplinary events that are presumptively material if they occurred in the previous 10 years. An adviser must disclose if it (or any of its management persons) has been *involved* in one of the events listed.<sup>22</sup> Item 9 cautions advisers, however, that the events listed in that item are those that are presumed to be material and do not constitute an exhaustive list of material disciplinary events.<sup>23</sup> The list includes any convictions for theft, fraud, bribery, perjury, forgery, counterfeiting, extortion and violations of securities laws by the adviser or one of its executives.

Additionally, as required by Rule 206(4)-4, Item 9 requires that disciplinary events more than 10 years old be disclosed if the event is so serious that it remains material to a client's or prospective client's evaluation of the adviser and the integrity of its management.

Because Part 2A, as amended, incorporates disciplinary disclosures formerly required by Rule 206(4)-4 directly in the advisory brochure requirements, the Commission is rescinding Rule 206(4)-4.<sup>24</sup>

Item 10. Other Financial Industry Activities and Affiliations. Item 10 requires each adviser to describe in its brochure material relationships or arrangements 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.

If an adviser selects or recommends other advisers to clients, Item 10.D requires such adviser to disclose any compensation arrangements or other business relationships between the advisory firms, along with the conflicts created, and explain how it addresses these conflicts. However, the disclosure under Item 10.D is limited to payments or business relationships *that create material conflicts of interest* with clients, so as not to capture all relationships.<sup>25</sup>

Item 11. Code of Ethics, Participation or Interest in Client Transactions and Personal Trading.

*Code of Ethics.* Item 11A requires each adviser to provide a brief, concise summary of its code of ethics and state that a copy is available upon request.<sup>26</sup> This summary should not be a reiteration of the entire code of ethics, but rather should

<sup>22</sup> "Involved" is defined as "[e]ngaging in any act or omission, aiding, abetting, counseling, commanding, inducing, conspiring with or failing reasonably to supervise another in doing an act." See Form ADV Glossary.

<sup>23</sup>The adviser may rebut this presumption, in which case no disclosure to clients is required. See note to Item 9 of Part 2A (listing four factors an adviser should consider when assessing whether the presumption can be rebutted: (1) the proximity of the *person involved* in the disciplinary event to the advisory function; (2) the nature of the infraction that led to the disciplinary event; (3) the severity of the disciplinary sanction; and (4) the time elapsed since the date of the disciplinary event) (emphasis in original text). An adviser rebutting this presumption must document its determination in a memorandum and retain that record to enable the Commission's staff to monitor compliance with this important disclosure requirement. See Rule 204-2(a)(14)(iii) under the Advisers Act.

<sup>24</sup>The rescission of Rule 206(4)-4 will be effective, with respect to any particular investment adviser, on the date by which that adviser must deliver its narrative brochure to existing clients and begin delivering its brochure to prospective clients under the rule and form amendments.

<sup>25</sup>Emphasis in original text.

<sup>26</sup>See Rule 204A-1 under the Advisers Act and *Investment Adviser Code of Ethics*, Investment Advisers Act Release No. 2256 (July 2, 2004).

provide enough information for the client to determine if it would like to read the full code of ethics and to understand generally the adviser's ethical culture and standards, how the adviser controls sensitive information, and what steps it has taken to prevent employees from misusing their inside positions at clients' expense.

*Participation or Interest in Client Transactions.* If an adviser or a related person<sup>27</sup> recommends to clients, or buys or sells for client accounts, securities in which the adviser or a related person has a material financial interest, Item 11.B requires such adviser to discuss this practice and the conflicts of interest presented. Moreover, the adviser must disclose any practices giving rise to these conflicts, the nature of the conflicts presented, and how the adviser addresses the conflicts.

*Personal Trading.* Items 11.C and 11.D require disclosure of personal trading by the adviser and its personnel. Item 11.C requires an adviser to disclose whether it or a related person (e.g., advisory personnel) invests (or is permitted to invest) in the same securities that it recommends to clients, or in related securities (such as options or other derivatives). If so, the brochure must discuss the conflicts presented and describe how the firm addresses the conflicts. Item 11.D requires a similar discussion, but focuses on the specific conflicts an adviser has when it or a related person trades in the same securities at or about the *same time* as a client. In response to Item 11.D, an adviser should explain how its internal controls, including its code of ethics, prevent the firm and its staff from buying or selling securities contemporaneously with client transactions.

Note that Items 11.B, 11.C, and 11.D will not require disclosure with respect to securities that are not "reportable securities" under Rule 204A-1(e)(10) under the Advisers Act.

Item 12. Brokerage Practices. Item 12 requires that advisers describe how they select brokers for client transactions and determine the reasonableness of brokers' compensation. Item 12 also requires advisers to disclose how they address conflicts of interest arising from their receipt of soft dollar benefits (i.e., research or other products or services they receive in connection with client brokerage).

*Research and Other Soft Dollar Practices.* Item 12.A.1 requires an adviser that receives soft dollar benefits in connection with client securities transactions to disclose its practices.<sup>28</sup> The description must be specific enough for clients and prospective clients to understand the types of products or services the adviser is acquiring and permit them to evaluate 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 Exchange Act, such as services that do not aid in the adviser's investment decision-making process.

Item 12.A.1 also requires that an adviser discuss in its brochure the types of conflicts it has when it accepts soft dollar benefits and explain how it addresses those conflicts. According to the Commission, an adviser accepting soft dollar benefits must explain that (a) the adviser benefits because it does not have to produce or pay for the research or other products or services acquired with soft dollars, and (b) the adviser therefore has an incentive to select or recommend brokers based on the adviser's interest in receiving these benefits, rather than on the client's interest in getting the most favorable execution.

Furthermore, Item 12.A.1 requires the adviser to explain whether it uses soft dollars to benefit all client accounts or only those accounts whose brokerage "pays" for the benefits, and whether the adviser seeks to allocate the benefits to client accounts proportionately to the soft dollar credits those accounts generate. Item 12.A.1 also requires the adviser to explain whether it "pays up" for soft dollar benefits.

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<sup>27</sup>An adviser's related persons are: (1) the adviser's officers, partners, or directors (or any person performing similar functions); (2) all persons directly or indirectly controlling, controlled by, or under common control with the adviser; (3) all of the adviser's current employees; and (4) any person providing investment advice on the adviser's behalf. See Form ADV Glossary. Items 11.B, 11.C, and 11.D are similar to Item 9 of the previous Part 2.

<sup>28</sup>Many advisers receive brokerage and research services in reliance on Section 28(e) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), as well as other soft dollar products and services provided by brokers in connection with client transactions. Use of client securities transactions to obtain research and other benefits creates incentives that result in conflicts of interest between advisers and their clients. Because of these conflicts, the Commission has long required advisers to disclose their policies and practices with respect to their receipt of soft dollar benefits in connection with client securities transactions.

*Brokerage for Client Referrals.* If an adviser uses client brokerage to compensate or otherwise reward brokers for client referrals, Item 12.A.2. requires such adviser to disclose this practice, the conflicts of interest it creates, and any procedures the adviser used to direct client brokerage to referring brokers during the last fiscal year (*i.e.*, the system of controls used by the adviser when allocating brokerage). According to the Commission, it is adopting the requirement as it was proposed so that clients are aware that their adviser may have a bias toward referring brokers, a significant conflict of interest.

*Directed Brokerage.* Item 12.A.3. requires an adviser that permits clients to direct brokerage to describe its practices in this area. Item 12.A.3. also requires that such adviser explain that it may be unable to obtain the most favorable execution of client transactions if the client directs brokerage and that directing brokerage may be more costly for clients.<sup>29</sup> If, however, an adviser *routinely recommends, requests or requires* clients to direct brokerage, Item 12.A.3. requires such adviser to describe this practice in its brochure, to disclose that not all advisers require directed brokerage, and to describe any relationship with a broker-dealer to which the brokerage may be directed that creates a material conflict of interest.<sup>30</sup> An adviser may omit disclosure regarding its inability to obtain best execution if directed brokerage arrangements are only conducted subject to the adviser's ability to obtain best execution.

*Trade Aggregation.* Item 12.B requires an adviser to describe whether and under what conditions it aggregates trades. According to the Commission, aggregation practices may have a material effect on the quality of execution, and therefore, such practices should be disclosed in the brochure. If the adviser does not aggregate trades when it has the opportunity to do so, the adviser must explain in the brochure that clients may therefore pay higher brokerage costs.

Item 13. Review of Accounts. Item 13 requires that the adviser disclose whether, and how often, it reviews clients' accounts or financial plans, and identify who conducts the review. An adviser that does not review accounts regularly must explain what circumstances trigger an account review.

Item 14. Client Referrals and Other Compensation. Item 14 requires an adviser to describe in its brochure any arrangement under which it or its related person compensates another for client referrals and describe the compensation.

An adviser must also disclose any arrangement under which the adviser receives any economic benefit, including sales awards or prizes, from a person who is not a client for providing advisory services to clients. The adviser must describe the arrangement, any conflicts of interests that arise from the arrangement, and how the adviser addresses those conflicts. The Commission extended the disclosure to include benefits from non-clients, *i.e.*, third parties, because the Commission believes that there are significant conflicts of interest when an adviser receives benefits from a third party for providing advisory services to a client, or when an adviser pays a third-party for client referrals.

Item 15. Custody. Item 15 requires an adviser with custody of client funds or securities to explain in its brochure that clients will receive account statements directly from the qualified custodian, such as a bank or broker-dealer that maintains those assets.<sup>31</sup> Advisers must also explain to clients that they should carefully review the account statements they receive from the qualified custodian. In addition, if an adviser also sends clients account statements, the adviser's explanation must include a statement urging clients to compare the account statements they receive from the qualified custodian with those they receive from the adviser.

<sup>29</sup>According to the Commission, clients directing (or agreeing to direct) brokerage need to understand the consequences of directing brokerage, including the possibility that their accounts will pay higher commissions and receive less favorable execution. See Adopting Release, note 145.

<sup>30</sup>Emphasis in original text.

<sup>31</sup>See Rule 204(4)-2 under the Advisers Act, *Custody of Funds or Securities of Clients by Investment Advisers*, Investment Advisers Act Release No. 2968 (Dec. 30, 2009) and *Custody of Funds or Securities of Clients by Investment Advisers*, Investment Advisers Act Release No. 2176 (Sept. 25, 2003).

Rule 206(4)-2(b)(3) under the Advisers Act provides an exception to the account statement requirement for an adviser to a pooled investment vehicle if the pooled investment vehicle is audited annually in accordance with GAAP by an independent public accountant and distributes the audited financial statements to the investors in the pool.

Item 16. Investment Discretion. Item 16 requires an adviser with “discretionary authority”<sup>32</sup> over client accounts to disclose this fact in its brochure, and any limitations clients may (or customarily do) place on this authority. However, if the information is provided in response to Item 4, the adviser may cross-reference the information to avoid duplication.

Item 17. Voting Client Securities. Item 17 requires advisers to disclose their proxy voting practices.<sup>33</sup> Item 17 also requires advisers to disclose whether they have or will accept authority to vote client securities and, if so, to describe briefly the voting policies they adopted under Rule 206(4)-6. Each adviser must describe whether (and how) clients can direct it to vote in a particular solicitation, how the adviser addresses conflicts of interest when it votes securities, and how clients can obtain information from the adviser on how the adviser voted their securities. Item 17 also requires an adviser to explain that clients may obtain a copy of the adviser’s proxy voting policies and procedures upon request. Advisers that do not accept authority to vote securities must disclose how clients receive their proxies and other solicitations.

With respect to the use of third-party services, Item 17 will not require an adviser to provide detailed information about an adviser’s use of third-party proxy voting services and how the adviser pays for proxy voting services. Clients interested in this information are instructed to obtain it from their advisers upon request.

Item 18. Financial Information. Item 18 requires disclosure of certain financial information about an adviser when material to clients. Specifically, an adviser that requires or solicits prepayment of more than \$1,200 in fees must give clients an audited balance sheet showing the adviser’s assets and liabilities at the end of its most recent fiscal year.<sup>34</sup>

Item 18 also requires an adviser to disclose any financial condition reasonably likely to impair the adviser’s ability to meet contractual commitments to clients if the adviser has discretionary authority over client assets, has custody of client funds or securities, or requires or solicits prepayment of more than \$1,200 in fees per client six months or more in advance.<sup>35</sup> Finally, Item 18 requires an adviser that has been the subject of a bankruptcy petition during the past ten years to disclose that fact to clients.

The Commission cautions advisers that the fiduciary duty of full and fair disclosure may require them to continue to disclose any precarious financial condition promptly to *all* clients, even clients to whom they may not be required to deliver a brochure or amended brochure.

## **C. Delivery and Updating of Brochure**

### **1. Delivery**

*Initial Delivery.* Rule 204-3, as amended, requires an adviser to deliver a current brochure before or at the time it enters into an advisory contract with the client.<sup>36</sup> Advisers may deliver the brochure in paper format or electronically.

<sup>32</sup>An adviser has “discretionary authority” if it is authorized to make purchase and sale decisions for client accounts. *See* Form ADV Glossary. This definition of discretionary authority is derived from Section 3(a)(35) of the Exchange Act. An adviser also has discretionary authority if it is authorized to select other advisers for the client. Item 16 is similar to Item 12.A of the previous Part 2.

<sup>33</sup>*See* Rule 206(4)-6 under the Advisers Act and *Proxy Voting by Investment Advisers*, Investment Advisers Act Release No. 2106 (Jan. 31, 2003).

<sup>34</sup>This portion of Item 18 is similar to Item 14 in the previous Part 2. *See* Adopting Release, note 176.

<sup>35</sup>A determination about what constitutes financial condition reasonably likely to impair an adviser’s ability to meet contractual commitments is inherently factual in nature but will generally include insolvency or bankruptcy. *See* Adopting Release, note 177.

<sup>36</sup>Rule 204-3 under the Advisers Act requires a registered adviser to furnish each client and prospective client with a written disclosure statement which may be either a copy of the adviser’s completed Part 2A or a written document containing the information required by Part 2A. Previously, such delivery had to occur at least 48 hours before entering into the advisory agreement, *or* at the time of entering into the agreement if the client has the right to terminate the agreement without penalty within five business days thereafter.

Amended Rule 204-3(c)(1) will not require advisers to deliver brochures to (i) certain advisory clients receiving only impersonal investment advice; (ii) clients that are investment companies registered under the Company Act; and (iii) clients that are business development companies (“BDCs”) that are subject to Section 15(c) of the Company Act.<sup>37</sup>

An adviser also will not have to prepare (or file with the Commission) a brochure if it does not have any clients to whom a brochure must be delivered.

#### *Caution Regarding Hedge Funds and Delivery of the Brochure to Investors*

*Commenters urged the Commission to adopt an exception for hedge funds, or clarify that advisers to hedge funds are not required to deliver copies of brochures to their investors. In the Adopting Release, the Commission noted that Rule 204-3 requires only that brochures be delivered to “clients.” The Commission further notes that the Court of Appeals for the D.C. Circuit stated that the “client” of an investment adviser managing a hedge fund is the fund itself, not an investor in the fund.<sup>38</sup> Nevertheless, for anti-fraud purposes, it would be prudent for advisers to hedge funds to consider delivering a copy of the brochure to investors. The anti-fraud provisions of the Advisers Act prohibit advisers to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative, and these provisions are interpreted broadly.<sup>39</sup> Recently, a federal circuit court reasoned<sup>40</sup> that under certain circumstances, hedge fund advisers can owe a fiduciary duty to fund investors and not only the fund.<sup>40</sup> As a means to demonstrate that current and prospective investors are informed about the adviser, its funds and its operations and practices and that as a fiduciary, full and fair disclosure is being provided, advisers to private funds (hedge funds and other private investment vehicles) should furnish a copy of the brochure to investors and prospective investors or at least offer to provide a copy if requested.<sup>41</sup> Furthermore, from a commercial perspective, investors and prospective investors will likely request a copy of the brochure as part of their due diligence process.*

*Annual Delivery.* Advisers must annually provide (no later than 120 days after the end of the adviser’s fiscal year) to each client to whom they must deliver a brochure either: (i) a copy of the current (updated) brochure that includes or is accompanied by the summary of material changes; or (ii) a summary of material changes that includes an offer to provide a copy of the current brochure. The offer also must be accompanied by a website address and a telephone number and e-mail address for obtaining the complete brochure pursuant to the Instructions for Part 2, as well as the website address for obtaining information about the adviser through the Investment Adviser Public Disclosure (“IAPD”) website.<sup>42</sup> An adviser that elects the latter approach must preserve a copy of the summary of material changes, so that the Commission’s examination staff has access to such separately provided summaries.<sup>43</sup>

Delivery of a brochure and summary of material changes or summary of material changes, along with an offer to provide the brochure to clients may be accomplished electronically in accordance with the Commission’s guidelines regarding electronic delivery of information<sup>44</sup>.

<sup>37</sup>Section 15(c) of the Company Act requires a board of directors to request, and the adviser to furnish, information to enable the board to evaluate the terms of the proposed advisory contract. Because of this safeguard, the Commission expanded the exception to include advisers to BDCs.

<sup>38</sup>See Adopting Release, note 192.

<sup>39</sup>See Section 206 of the Advisers Act. See also Rule 206(4)-8 under the Advisers Act, anti-fraud provisions apply to new and prospective investors of a pooled investment vehicle.

<sup>40</sup>*U.S. v. Lay*, No. 08-3892, 2010 WL 2757123 (6th Cir. July 14, 2010).

<sup>41</sup>Since hedge funds and other private funds are not explicitly listed in amended Rule 204-3(c)(1) as being excepted from the delivery of brochures, registered advisers to private funds that do not deliver a brochure to investors may be questioned by Commission examiners why a brochure was not delivered during routine examinations.

<sup>42</sup>The IAPD website is accessible at: [http://www.adviserinfo.sec.gov/\(S\(cquuxs55y5z5x2b0wby3hk45\)\)/IAPD/Content/IapdMain/iapd\\_SiteMap.aspx](http://www.adviserinfo.sec.gov/(S(cquuxs55y5z5x2b0wby3hk45))/IAPD/Content/IapdMain/iapd_SiteMap.aspx)

<sup>43</sup>If an adviser includes the summary of material changes in its brochure, and amends its brochure on an interim basis between annual updating amendments, the adviser should consider whether it should update its summary of material changes to avoid confusing or misleading clients reading the updated brochure. See Adopting Release, note 194.

<sup>44</sup>*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”).

An adviser that does not include, and therefore file, its summary of material changes as part of its brochure (on the cover page or the page immediately following the cover) must file its summary as an exhibit, included with its brochure when it files its annual updating amendment with the Commission, so that the summary of material changes is available to the public through IAPD.<sup>45</sup>

*Interim Delivery.* Amended Rule 204-3 requires advisers to deliver an updated brochure (or a document describing the material facts relating to the amended disciplinary event) promptly whenever the adviser amends its brochure to add a disciplinary event or to change material information already disclosed in response to Item 9 of Part 2A. According to the Commission, the disclosure of disciplinary information is highly relevant to clients because it reflects on the integrity of the investment adviser, may affect a client's trust and confidence in the adviser, and may be of even greater interest to clients if the adviser is adding disciplinary information frequently.

## **2. Updating Part 2A of Form ADV**

The amended rules require advisers to keep the brochures they file with the Commission current by updating them at least annually, and updating them promptly when any information in the brochures (except the summary of material changes and the amount of assets under management, which only has to be updated annually) becomes materially inaccurate.

However, if there are no material changes to make to the brochure, such adviser would not have to prepare and file an updated firm brochure as part of its annual updating amendment. Also, if the adviser has not filed any interim amendments to its brochure since the last annual amendment and the brochure continues to be accurate in all material respects, such adviser would not have to prepare or deliver a summary of material changes to clients.

Note that although previously filed versions of an adviser's brochures will remain in the IARD system, only the most recent version of an adviser's brochure will be available to the public through the Commission's website. As such, to the extent an adviser prepares, files and delivers to clients separate brochures for the various different advisory services it offers, the most recent version of *each* of its brochures will be available via the public disclosure website.

## **II. Part 2A Appendix 1: The Wrap Fee Program Brochure**

Advisers that sponsor wrap fee programs continue to be required to prepare a separate, specialized firm brochure (a "wrap fee program brochure" or "wrap brochure") for clients of the wrap fee program in lieu of the sponsor's standard brochure. Specifically, advisers whose entire advisory business is sponsoring wrap fee programs will prepare a wrap brochure but will not be required to prepare a standard advisory firm brochure.<sup>46</sup> However, an adviser will have to prepare both a standard firm brochure and a wrap fee program brochure if it both sponsors a wrap fee program *and* provides other types of advisory services, and will deliver both a standard and a wrap brochure to a client who receives both types of services. Wrap fee sponsors would, like other advisers, be required to provide brochure supplements to their wrap fee clients.

### **A. Content**

The items in Appendix 1 to Part 2A contain the requirements for a wrap fee program brochure, and are substantially similar to those previously in Schedule H, the separate wrap fee program brochure in previous Part 2. However, Schedule H has been revised to incorporate many of the adopted amendments to the Part 2A firm brochure.

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<sup>45</sup>The adviser must upload its brochure and the summary (as an exhibit) together in a single, text-searchable file in Adobe Portable Document Format (PDF) on IARD. *See* Instruction 6 for Part 2A of Form ADV.

<sup>46</sup>*See* Instruction 10 of Instructions for Part 2A of Form ADV.

Under the amended rules, an additional disclosure requirement to the wrap fee program brochure requires 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 advisers engaged in wrap fee programs must make the additional disclosure. Furthermore, this item requires advisers to disclose whether related person portfolio managers are subject to the same selection and review criteria as the other portfolio managers who participate in the wrap fee program and, if they are not, how they are selected and reviewed.

## **B. Delegation of Delivery and Recordkeeping**

An adviser can delegate its brochure delivery requirement to the sponsor of the wrap fee program. Such adviser can also satisfy its recordkeeping obligations that evidence delivery of the brochure by such records being retained in the offices of the sponsor and not the adviser, as long as the sponsor, upon request of the Commission's staff, will produce promptly the records for the staff at the appropriate office of the adviser or the sponsor. However, this delegation does not relieve the adviser of its legal delivery obligation, and thus the adviser should take steps to assure itself that the sponsor is performing the tasks the adviser has delegated.

## **III. Part 2B: The Brochure Supplement**

Amended Rule 204-3 under the Advisers Act also requires that each firm brochure be accompanied by brochure supplements (the "supplements") providing information about the advisory personnel on whom the particular client receiving the brochure relies for investment advice. Among other things, the brochure supplements will contain information about the educational background, business experience, and disciplinary history (if any) of the *particular* "supervised persons"<sup>47</sup> who provide advisory services to the client.<sup>48</sup>

If there is disciplinary information regarding a supervised person that is already publicly disclosed via BrokerCheck or the IAPD system, an adviser may disclose in a supplement delivered electronically that such supervised person has a disciplinary event and provide a hyperlink to either the BrokerCheck or the IAPD systems.<sup>49</sup>

### **A. Format**

The supplements are to be drafted in plain English, but advisers are given the flexibility in presenting information in a format that is best suited to each particular advisory firm. Advisers may include supplement information within the firm's brochure, an approach that may be attractive to smaller firms with few persons for whom they will be required to prepare supplements.<sup>50</sup> Advisers may also elect to prepare a supplement for each supervised person. Alternatively, advisers can prepare separate supplements for different groups of supervised persons (e.g., all supervised persons in a particular office or work group). However, to promote comparability of brochure supplements, the Commission is requiring that a brochure supplement must be organized in the same order, and contain the same headings, as the items appear in the form, whether provided in a brochure or separately.

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<sup>47</sup>Supervised person is defined as "[a]ny of your officers, partners, directors (or other persons occupying a similar status or performing similar functions), or employees, or any other person who provides investment advice on your behalf and is subject to your supervision or control." See Form ADV Glossary.

<sup>48</sup>The Commission believes that disclosure of generalized information about the firm's associated persons is unlikely to be meaningful to clients seeking to understand the background, particular conflicts and outside business activities of the individual providing investment advice to them.

<sup>49</sup>See Instruction 3 for Part 2B of Form ADV. IAPD was recently enhanced to allow investors to obtain disciplinary history of supervised persons.

<sup>50</sup>If provided in a brochure, the Commission instructs that supplements must be included at the end of the brochure and be sequenced for each supervised person. See Instruction 1 of General Instructions for Part 2 of Form ADV and Instruction 6 for Part 2B of Form ADV.

## B. Supplement Items

Item 1. Cover Page. Each supplement's cover page must include information identifying the supervised person (or persons) covered by the supplement as well as the advisory firm.

Item 2. Educational Background and Business Experience. Item 2 requires the supplement to describe the supervised person's formal education and his or her business background for the past five years. Furthermore, advisers *may* include information about professional designations in the supplement if they so choose.<sup>51</sup> If the supervised person either has no high school education, no formal education after high school, or no business background, the adviser must disclose this fact in the supplement. The business background section must identify the supervised person's positions at prior employers and not merely list the names of prior employers.

Item 3. Disciplinary Information. Item 3 requires disclosure of any legal or disciplinary event that is material to a client's evaluation of the supervised person's integrity. Such disclosure includes certain disciplinary events that the Commission presumes are material to such an evaluation if they occurred during the last 10 years.<sup>52</sup>

However, Item 3 of Part 2B permits an adviser to rebut the presumption with respect to a particular event, in which case no disclosure to clients about the event will be required. The Commission requires an adviser rebutting a presumption of materiality to document that determination in a memorandum and to retain that record in order to better permit Commission staff to monitor compliance with this disclosure requirement. As under Item 9 of Part 2A, a note in Item 3 explains four factors the adviser should consider when assessing whether the presumption can be rebutted.

The supplement also requires the disclosure of any event for which the supervised person had ever resigned or otherwise relinquished a professional attainment, designation or license in anticipation of it being suspended or revoked (other than for suspensions or revocations for failure to pay membership dues) but this disclosure need only be made if the adviser knew or should have known that the supervised person relinquished his or her designation or license.

Item 3 permits advisers that send supplements electronically to clients to include hyperlinks to disciplinary information available through the FINRA BrokerCheck system as well as the IAPD system. To take advantage of this provision, the brochure supplement must be delivered electronically and must include: (i) a statement that the supervised person has a disciplinary history, the details of which can be found on BrokerCheck or the IAPD (as the case may be); and (ii) a hyperlink to the relevant system with a brief explanation of how the client can access the disciplinary history.

Item 4. Other Business Activities. Item 4 requires advisers to describe other business activities of its supervised persons. Item 4 specifically requires disclosure with respect to other capacities in which the supervised person participates in any investment-related business and any material conflicts of interest such participation may create. In addition, Item 4 requires an adviser to provide information about any compensation, including bonuses and non-cash compensation, the supervised person receives based on the sales of securities or other investment products, as well as an explanation of the incentives this type of compensation creates. According to the Commission, disclosure of any such compensation is important because it creates an incentive for the supervised person to base investment recommendations on his or her own compensation rather than on clients' best interests.

<sup>51</sup>If professional designations are disclosed in the supplement, the Commission requires that the supplement must also provide a sufficient explanation of the minimum qualifications required for the designation to allow clients and potential clients to understand the value of the designation. The Commission notes that the required credentials, training, and experience associated with different designations vary widely and thus refers to FINRA which has established and maintains a database of designations used across the financial services industry that contains basic information about the designation, such as the issuing organization, prerequisites, and educational requirements. <http://apps.finra.org/DataDirectory/1/prodesignations.aspx>. See Adopting Release, note 230.

<sup>52</sup>This list parallels the list of legal and disciplinary events in Item 9 of Part 2A that must be disclosed in the firm brochure and which are derived from the prior disclosure requirements set out in Rule 206(4)-4. The list also is substantially similar to the list of disciplinary events advisers and their advisory affiliates are already required to disclose in response to Item 11 of Form ADV, Part 1A.

In addition, advisers will be required to disclose *other* business activities or occupations that the supervised person engages in if they involve a “substantial” amount of time or pay.<sup>53</sup> The Commission believes that investors will find this information helpful in assessing the conflicts created by such other business activities or occupation because clients may have different expectations of an individual whose sole business is providing investment advice than of an individual who is engaged in other substantial business activities.

*We recommend that advisers begin to review the outside business activities and occupations of their supervised persons in order to respond to Item 4. Advisers may consider circulating an internal questionnaire to elicit information required under Item 4 from current employees and new employees going forward.*

**Item 5. Additional Compensation.** Advisers must describe in the supplement arrangements in which someone other than a client gives the supervised person an economic benefit (such as a sales award or other prize) for providing advisory services.<sup>54</sup>

**Item 6. Supervision.** Advisers must explain how the firm monitors the advice provided by the supervised person addressed in the brochure supplement. Item 6 also requires advisers to provide the client with the name, title, and telephone number of the person responsible for supervising the advisory activities of the supervised person. The Commission believes that providing the name and telephone number of a specific individual responsible for supervising the representative’s advisory activities will ensure that the client has ready access to the supervisor if the client has any complaints or concerns.

## C. Delivery of the Brochure Supplement

### 1. Delivery

An adviser must furnish to a client a brochure supplement for each supervised person who: (i) formulates investment advice for that client and has *direct client contact*,<sup>55</sup> or (ii) makes discretionary investment decisions for that client’s assets, even if the supervised person has no direct client contact.<sup>56</sup> The brochure supplement, like brochures, may be delivered on paper or electronically.<sup>57</sup>

In situations where investment advice is provided by a team comprised of more than five supervised persons, brochure supplements need only be provided for the five supervised persons with the most significant responsibility for the day-to-day advice provided to the client.<sup>58</sup>

However, advisers are not required to deliver supplements to three types of clients: (i) clients to whom an adviser is not required to deliver a firm brochure (*e.g.*, registered investment companies and business development companies); (ii) clients who receive only impersonal investment advice<sup>59</sup>; and (iii) certain “qualified clients” who also are officers,

<sup>53</sup>See Item 4.B of Part 2B. The Commission is allowing advisers to make a presumption that if the other business activities represent less than 10 percent of the supervised person’s time and income, they are not substantial. See Item 4.B of Part 2B.

<sup>54</sup>Bonuses based (in part or whole) on sales, client referrals or new accounts trigger required disclosure, but other bonuses do not. Regular salaries need not be disclosed. See Adopting Release, note 244.

<sup>55</sup>See Rule 204-3(b)(3)(i) under the Advisers Act (emphasis added). An adviser must provide a brochure supplement for each supervised person that has direct client contact regardless of whether the investment advice is discretionary or non-discretionary because the Commission believes that the brochure supplement assists the client in evaluating the value of that investment advice, an evaluation clients make regardless of whether the advice is non-discretionary. See Adopting Release, note 256.

<sup>56</sup>See Rule 204-3(b)(3)(ii) under the Advisers Act and Instruction 1 for Part 2B of Form ADV.

<sup>57</sup>See Instruction 5 for Part 2B of Form ADV.

<sup>58</sup>Rule 204-3(b)(3) under the Advisers Act.

<sup>59</sup>This exception from the supplement delivery requirement differs slightly from the exception from the brochure delivery requirement, in that it does not depend on the cost of the impersonal advisory services involved. This is because in situations involving impersonal advisory services, the nature of the services are such that supervised persons of the adviser are unlikely to be directly providing advisory services to clients. As a result, the Commission believes that in such situations requiring supplement delivery will result in an unnecessary expense with little appreciable benefit. However, delivery of a firm brochure is required where the cost of the impersonal advisory services is significant, that is \$500 or above. See Adopting Release, note 257.

directors, employees and other persons related to the adviser.<sup>60</sup> An adviser that does not have any clients to whom a supplement will have to be delivered will not have to prepare any supplements.<sup>61</sup> Similarly, an adviser will not have to prepare a supplement for any supervised person who does not have clients to whom the adviser must deliver a supplement.

*In the context of hedge funds and other private funds, advisers to such private funds should consider preparing and delivering brochure supplements based on the same principles underpinning the delivery of the brochure to a private fund's investors. Brochure supplements should be prepared for each person who exercises investment discretion with respect to a fund's portfolio. If the private fund's portfolio is managed by a team of more than five portfolio managers, brochure supplements should be prepared for the five portfolio managers with the most significant responsibility for the portfolio's management.*<sup>62</sup>

## **2. Timing of Delivery**

The supervised person's supplement initially must be given to each client at or before the time when *that* specific supervised person begins to provide advisory services to *that* specific client.<sup>63</sup>

## **3. No Annual Delivery of the Brochure Supplement**

The Commission believes that most information in the supplement is unlikely to become materially inaccurate over time, and as such, advisers are not required to deliver supplements to existing clients annually.

## **D. Updating the Brochure Supplement**

Advisers must deliver an updated supplement to clients only when there is new disclosure of a disciplinary event, or a material change to disciplinary information already disclosed, in response to Item 3 of Part 2B.<sup>64</sup>

New clients must receive the updated version of the supplement (or an "old" supplement and a sticker).

### **1. Disciplinary Event/Material Changes to Disciplinary Information already Disclosed**

A new disclosure of a disciplinary event, or a material change to disciplinary information *already disclosed*, in response to Item 3 of Part 2B triggers the delivery of an updated brochure supplement to clients. If the supplement refers to BrokerCheck or IAPD, a change in disclosure required by Part 2B would require the adviser to electronically deliver an updated supplement (or sticker) to clients when BrokerCheck or IAPD has been updated with new disclosure of a disciplinary event, or a material change to disciplinary information already disclosed, with the updated supplement (or sticker) indicating that the disciplinary information for the supervised person has changed and providing a hyperlink to BrokerCheck or IAPD.

<sup>60</sup>Rule 205-3(d)(1)(iii) under the Advisers Act also defines certain related persons of an adviser as "qualified clients," including: (i) any executive officers, directors, trustees, general partners, or persons serving in a similar capacity, of the advisory firm; or (ii) any employees of the advisory firm (other than employees performing solely clerical, secretarial or administrative functions) who, in connection with their regular functions or duties, participate in the investment activities of the firm and have been performing such functions or duties for at least 12 months. *See* Adopting Release, note 258.

<sup>61</sup>*See* note to Rule 203-1(a) and (b); Instruction 1 for Part 2B of Form ADV.

<sup>62</sup>*See* Rule 204-3(b)(3) under the Advisers Act as a basis supporting this suggestion.

<sup>63</sup>*See* Rule 204-3(b)(3) under the Advisers Act and Instruction 3 for Part 2B of Form ADV.

<sup>64</sup>Rule 204-3(b)(4) under the Advisers Act. The Commission notes that an adviser's fiduciary duty may require it to inform a client of material changes to disclosures in the supplement even if Rule 204-3 will not require delivery of an updated supplement to clients. *See* Adopting Release, note 264.

## **2. Material Change**

As with the brochure, advisers must amend a brochure supplement promptly if information in it becomes materially inaccurate.<sup>65</sup>

## **IV. Filing Requirements and Public Availability of the Brochure; the Brochure Supplement**

### **A. The Brochure**

#### **1. Electronic Filing of the Brochure**

Advisers are required to file new brochures using the amended format with the Commission electronically through the IARD system.<sup>66</sup>

#### *Caution regarding Hedge Funds and Other Private Funds*

*The Commission noted that commenters expressed concern that a fund adviser's required public disclosure of Part 2 through IARD could jeopardize the reliance of any private funds that it advised on the private offering exemption in the Securities Act of 1933, as amended (the "Securities Act") and the safe harbor for offshore transactions from the registration provisions in Section 5 of that statute.<sup>67</sup> According to the Commission, registrants can provide information required by Part 2 without jeopardizing reliance on those exemptions. Nevertheless, the Commission warns advisers to private funds that inclusion of private fund information beyond that required in Part 2, however, such as subscription instructions, performance information, and financial statements, may jeopardize such reliance by constituting a public offering or conditioning the market for the securities issued by those funds. As such, advisers to hedge funds and other private funds should be careful with regards to the particularities of a private fund when drafting their disclosures in the brochure. Furthermore, it would be prudent to include as a footnote a disclaimer informing the recipient and online users that the information provided is required and does not constitute a public offer or solicitation to invest in any of the private funds an adviser manages.*

#### **2. Initial Filing**

The IARD will accept brochure filings using the text-searchable Adobe Portable Document Format ("PDF"). The IARD provides advisers with online access to the Part 2A Items and instructions. Instead of completing Part 2A online, advisers will create their brochure on their own computers, convert it to a PDF, and then attach the completed document to their filing on IARD, much like attaching a document to an e-mail.

#### **3. Annual Filings**

To update brochures, advisers will make the necessary changes to the source file on their own computers and then attach the revised versions to their IARD filing.

When filing annual updates of the brochure, IARD requires advisers to make certain representations. The IARD will not accept an annual updating amendment without an updated brochure, a representation by that adviser that the brochure on file does not contain any materially inaccurate information, or a representation that the adviser does not have to prepare a brochure because it does not have to deliver it to any clients (*e.g.*, the adviser's clients are limited to registered

<sup>65</sup>See Instruction 4 for Part 2B of Form ADV.

<sup>66</sup>See amended Rule 204-1 under the Advisers Act.

<sup>67</sup>Regulation D provides a safe harbor from the registration requirement of Section 5 of the Securities Act. Rule 502(c) of Regulation D prohibits the general solicitation or general advertising of an offering of securities by the issuer. Regulation S provides a safe harbor from the Securities Act's registration requirement for the offers and sales of securities that occur outside the United States, and where no directed selling efforts are made in the United States.

investment companies). The IARD also will not accept an annual updating amendment without a representation that the summary of material changes is attached as an exhibit to or included in the updated brochure or a representation that no summary of material changes is required because there have been no material changes to the adviser's brochure since its last annual updating amendment.<sup>68</sup>

#### **4. Discontinued Use of a Brochure**

If an adviser is no longer required to prepare a brochure for delivery, the IARD system will permit the adviser to eliminate that brochure from its current filing. Likewise, if an adviser using multiple brochures discontinues using a particular brochure, the IARD system will permit the adviser to eliminate that brochure from its current filing.

#### **B. Brochure Supplement and Supplement Amendments Are Not Required to Be Filed with the Commission**

Advisers are not required to file brochure supplements or supplement amendments with the Commission, and as such, the supplements will not be available on the Commission's public website.<sup>69</sup> Nevertheless, advisers are required to maintain copies of all supplements and amendments in their files.<sup>70</sup>

#### **V. Amendments to Rule 204-2 (Recordkeeping)**

The Commission has also adopted conforming amendments to Rule 204-2 under the Advisers Act to require registered investment advisers to retain copies of each brochure, brochure supplement, and each amendment to the brochure and supplements that are prepared as required under Rule 204-3.<sup>71</sup> Such records and additional documentation as described below must be maintained in the same manner, and for the same period of time, as other books and records required to be maintained under Rule 204-2(a).

The amendments require registered advisers to prepare and preserve documentation of the method they use to calculate managed assets for purposes of Item 4.E in Part 2A of Form ADV, if that method differs from the method used to calculate "assets under management" in Part 1A of Form ADV.

Advisers must also prepare and preserve a memorandum describing any legal or disciplinary event listed in Item 9 in Part 2A and Item 3 in Part 2B for the period the event is presumed material, if such event is not disclosed in the adviser's brochure or the relevant brochure supplement.

#### **VI. Impact on Non-US Advisers Registered with the Commission**

The Commission is updating the Glossary of Terms for Form ADV *inter alia* to correct a discrepancy in the definition of "Non-Resident" to make it consistent with the definition in Rule 0-2 which is the Advisers Act rule related to the procedures for serving process, pleadings, and other papers on non-resident investment advisers, and advisers' non-resident general partners and managing agents.<sup>72</sup> The definition of "Non-Resident" will be changed to include "a

<sup>68</sup>If the adviser's summary of material changes is a separate document, the adviser must attach the summary as an exhibit to its brochure and upload the brochure and the summary in one single, text-searchable, PDF file on IARD.

<sup>69</sup>See Rules 203-1(a) and 204-1(b) under the Advisers Act and Instruction 9 for Part 2B of Form ADV. Because brochure supplements would not be filed with the Commission, they would not be deemed filed and would not be required as part of any state notice filing. Section 307(a) of the National Securities Market Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (1996) (state securities authorities may only require SEC-registered advisers to file with the states copies of those documents advisers have filed with the Commission). See Adopting Release, note 268.

<sup>70</sup>See Rule 204-2(a)(14)(i) under the Advisers Act and Instruction 9 for Part 2B of Form ADV.

<sup>71</sup>Rule 204-2(a)(14)(i) under the Advisers Act. The rule also will require advisers to keep and maintain a copy of the summary of material changes that is not included in the brochure, as well as a record of the dates that each brochure, amendment, and summary of material change was given to any client. See Adopting Release, note 288.

<sup>72</sup>At the time the Glossary was originally adopted, the Commission's intent was that the definition of "Non-Resident" in the Glossary be the same as that in Rule 0-2 under the Advisers Act.

corporation incorporated in *or* having its principal place of business in any place not subject to the jurisdiction of the United States.”<sup>73</sup> As a consequence, this corrective amendment may potentially result in an increased number of corporate entities qualifying as non-resident general partners or managing agents of registered advisers. Accordingly, certain entities will need to file Form ADV-NR with the Commission to appoint agents for service of process because they relied on the glossary definition and therefore were not required to file the form.

## **VII. Effective Date and Compliance Dates with the Amended Rules and Form**

### **A. Effective Date**

The amended rules and forms will be effective October 12, 2010.

### **B. Compliance Dates**

#### **1. New Investment Advisers**

Each adviser applying for registration with the Commission after January 1, 2011 must file a brochure or brochures that meet the requirements of amended Part 2A as part of the application for registration on Form ADV.<sup>74</sup> Such advisers must, upon registering, begin to deliver to their clients and prospective clients a brochure and brochure supplements that meet the requirements of the amended form in accordance with the amended rules.<sup>75</sup>

#### **2. Advisers Currently Registered with the Commission**

Each adviser registered with the Commission whose fiscal year ends on or after December 31, 2010, must include in its next annual updating amendment to its Form ADV a brochure or brochures that meet the requirements of the amended form.<sup>76</sup> Accordingly, each adviser with a fiscal year end of December 31, 2010 must file an annual updating amendment with the new brochures no later than March 31, 2011. Moreover, within 60 days of filing such amendment, the adviser must deliver to its existing clients a brochure and brochure supplement that meet the requirements of amended Form ADV.<sup>77</sup> As such, depending on when an adviser files its annual updating amendment with the new brochure, existing clients should receive the brochure and supplements no later than May 30, 2011. With regards to new clients and prospective clients, after initial filing of its brochure, an adviser must begin to deliver to them a new brochure and brochure supplements in order to satisfy its obligations under the brochure rule.<sup>78</sup>

*Advisers that are currently registered with the Commission will have at least 8 months (from the end of July 2010 through the end of March 2011) to prepare and file narrative brochures. Drafting the brochure and brochure supplements in plain English in order to convey the conflicts of interest, risks, relationships and business operations of an adviser to clients and prospective clients will take time and effort. During the next several months, advisers should conduct an internal review at the firm level of their operations and products so as to respond to the 18 items required in Part 2A. Moreover, advisers should conduct a review at the employee level with regards to persons who are supervised persons that provide investment advisory services to clients so as to respond to the 6 items required in Part 2B. Advisers should also start to contact clients to confirm if they wish to receive the brochure and the brochure supplements electronically to ensure that electronic delivery will be in compliance with the conditions set forth in the Electronic Media Release.*

<sup>73</sup>See Rule 0-2(b)(2) under the Advisers Act (emphasis added).

<sup>74</sup>Rule 203-1(b) under the Advisers Act. This requirement applies only if the adviser is required to deliver a brochure. See note to Rule 203-1.

Note that advisers to private funds that are required to register as investment advisers with the Commission as a result of the elimination of the *de minimis* exemption under the Dodd-Frank Wall Street Reform and Consumer Protection Act must have an effective SEC registration under the Advisers Act by the first anniversary of the Act's enactment, i.e., by July 21, 2011.

<sup>75</sup>Rule 204-3(b) under the Advisers Act.

<sup>76</sup>Rule 204-1(c) under the Advisers Act. This filing requirement applies only if the adviser is required to deliver a brochure. See note to Rule 203-1.

<sup>77</sup>Rule 204-3(g)(1) under the Advisers Act.

<sup>78</sup>Rule 204-3(g)(2) under the Advisers Act.

*To demonstrate compliance with the anti-fraud rules and fulfillment of their fiduciary duty to provide full and fair disclosure, it would be prudent for advisers to private funds to consider delivering the brochure and brochure supplements to fund investors and prospective investors. Registered advisers to pooled investment vehicles should be mindful of the anti-fraud provisions under Rule 206(4)-8 under the Advisers Act which prohibits advisers from making false or misleading statements to, or engaging in other fraud on, investors or prospective investors in a pooled investment vehicle they manage.<sup>79</sup>*

If you have any questions regarding this client alert, or require assistance with any other issue relating to private funds and investment advisory issues, please contact the author Roderick J. Cruz (rc@garritygraham.com; (973) 576-9615) or any of the members of the Investment Management practice group:

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<sup>79</sup>*Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles*, Investment Advisers Act Release No. 2628 (Aug. 3, 2007). Rule 206(4)-8(a)(1) under the Advisers Act prohibits any investment adviser to a pooled investment vehicle from making an untrue statement of a material fact to any investor or prospective investor in the pooled investment vehicle, or omitting to state a material fact necessary in order to make the statements made to any investor or prospective investor in the pooled investment vehicle, in the light of the circumstances under which they were made, not misleading.