<u>NEW FORM ADV PART 2</u>
10 Tips for Coping with the 2010 Amendments

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After delaying for over 10 years, the SEC finally adopted new Part 2 to Form ADV,[1] in a bid to provide clients with more clearly written, meaningful and current disclosures about investment advisers.

Under new Part 2, advisers must prepare a "firm brochure" in plain English, disclosing information in response to 18 specific items in the order dictated by the form. Advisers must also create "brochure supplements" disclosing key information about certain advisory personnel.

In addition to significant changes in format, new Part 2 signals a fundamental change in approach to the scope and timing of adviser disclosure. This paper offers 10 tips for coping with those changes.

TIP 1: Read the SEC's plain English handbook.

Bye-bye, check the box. Hello, plain English.

For many advisers, new Part 2 will be their first experience with writing in plain English. Those advisers in particular would benefit from reading the SEC's plain English handbook before getting started. Even advisers with plain English experience would likely benefit from a refresher before tackling new Part 2.

The SEC's handbook is available online[2] and is still useful today, even though it was originally issued in 1998 when plain English was first required for mutual fund prospectuses. The handbook offers not only writing tips like "use active voice," but also helpful ideas on how to design a document for readability.

Other resources are also available for learning plain English, such as the Federal Plain Language Guidelines.[3] Wise drafters will take advantage of all of these resources before taking on new Part 2.

TIP 2: Rethink rather than merely rearrange.

Rethinking Part 2 entirely will result in a better written, more complete brochure than merely rearranging existing disclosures from old Part II. Rearranging existing disclosures will only result in a lot of required disclosures being omitted. (I know, I've tried it.) This is because new Part 2 calls for many disclosures that were simply not required by old Part II. Some are entirely new items, such as Disciplinary Information (Item 9). Others are new details about old items, such as material risks involved with each of the adviser's significant investment strategies (Item 8.B.). Either way, disclosures will come up missing if old Part II is just rearranged.

Start rethinking the brochure by outlining what information is necessary to respond to all required items, as well as additional disclosures that may be necessary taking the "prospectus" approach referenced below in Tip 3. Carry over responsive disclosures from old Part II only if they have been thoroughly vetted to make sure they are accurate, current and the <u>best</u> <u>way</u> to convey that information. That way, existing and new disclosures can be integrated into a more cohesive and coherent whole.

In the end, there will be no substitute for carefully parsing through the new Part 2, item by item, word by word, to make sure all necessary disclosures are included and plain English principles are applied. No doubt that effort will be more successful if the brochure is rethought rather than merely rearranged.

TIP 3: Approach new Part 2 like a "prospectus."

In old Part II, advisers often provided answers for each required item and offered very little, if anything, more. Contrast that with new Part 2, where the instructions state several times that, as fiduciaries, advisers must make disclosure to clients of "all material facts" regarding the advisory relationship. To satisfy this obligation, advisers may have to disclose information <u>not specifically required by Part 2</u> or <u>in more detail than the brochure items might otherwise require</u>. Disclosures not specifically called for by Part 2 can be made in Part 2 or by other means. (See General Instruction 3 to Part 2)

The "all material facts" standard applied to the brochure is very reminiscent of the standard applied to disclosure document like prospectuses. Couple that with the fact that the brochure must be updated whenever it becomes materially inaccurate (see Instruction 4 to Part 2.A.) and can be amended with a "sticker" in certain circumstances (see Instruction 2 to Part 2.A.), and the brochure starts to look even more like a prospectus.

These changes signal a fundamental shift in the overall approach to adviser disclosure. Gone is the old model that relied primarily on specific, item-by-item disclosures in a check-the-box Part II updated as infrequently as once a year. The new model instead contemplates broader, on-going plain English disclosures, updated as developments warrant not less than once a year. Advisers will fare better if they shift their thinking and approach accordingly.

TIP 4: Beef up disclosures about conflicts.

Advisers must disclose to clients all their material conflicts of interest. Moreover, Part 2 now expressly calls for conflicts to be disclosed with sufficient specificity that clients can understand them and either give their informed consent to them or reject them. For that reason, it is more crucial than ever for advisers to have robust procedures for identifying and disclosing conflicts.

Several items in new Part 2 – for example, Item 5.E. -- provide explicit instructions on how to disclose conflicts, requiring some if not all of the following:

STEP 1: State the facts.
For example: "We accept commissions for the purchase and sale of securities in our clients' accounts."

STEP 2: State that this presents a conflict of interest.
For example: "This presents a conflict of interest for us and our employees…"

STEP 3: State the nature of the conflict presented.
For example: "…to the extent that it gives us a financial incentive to recommend purchases and sales in a client's account based on the commissions we receive, rather than based solely on the client's best interests."

STEP 4: State how the adviser addresses or mitigates this conflict.
For example: "We monitor client accounts in an effort to identify trading that is inconsistent with the client's investment objectives, risk tolerance or account restrictions, or is otherwise not in the client's best interest. In addition, clients are urged to monitor trading in their own accounts by reviewing written trade confirmations delivered to them within X days of each trade and by reviewing account statements delivered to them directly from the custodian each quarter."

Given how pervasive this approach is in new Part 2, it may well become the "new norm" for disclosing conflicts.

TIP 5: Don't try to "cover the waterfront."

We have all read (and maybe even drafted) long, complex disclosures about all the securities an adviser "may" invest in, all the strategies an adviser "may" use and all the conflicts an adviser "may" have. Of course, advisers use this "cover the waterfront" approach to maximize their flexibility, so they can engage in a wider range of practices without their disclosures being considered deficient. However, this approach also tends to make disclosures longer, denser and less meaningful for clients.

The SEC addresses this problem in General Instruction 2 to new Part 2, directing advisers to discuss in their brochure only conflicts the adviser <u>has or is reasonably likely to have</u> and practices in which the adviser <u>engages or is reasonably likely to engage</u>. Similarly, advisers that have a conflict or engage in a practice with respect to some -- but not all -- clients are instructed to indicate that, rather than merely state they "may" have the conflict or engage in the practice.

All this leans away from a "cover the waterfront" approach and toward an approach that focuses more narrowly on what clients will reasonably likely need to know. Unfortunately, narrowing disclosure will also narrow the opportunities an adviser can pursue supported by that disclosure. General Instruction 2 even says that if a conflict arises or the adviser decides to engage in a practice that has not been disclosed, supplemental disclosure must be provided to clients to obtain their consent.

As a result, brochures will have to strike a balance, between unhelpful "cover the waterfront" disclosures that describe everything the adviser may do, and narrow disclosures that are so inflexible that too many supplemental disclosures become necessary, with the attendant delay, cost and confusion.

TIP 6: Keep your radar on for inconsistencies between Parts 1 and 2.

I once heard an OCIE Staffer say that among the deficiencies they look for in inspections are inconsistencies in an adviser's responses between Parts 1 and 2 of Form ADV. If you thought that the 2010 amendments would have eliminated the overlaps between Parts 1 and 2 that create the potential for those inconsistencies, you'd be wrong. Instead, there are still significant redundancies between the two parts and advisers will still have to be vigilant to avoid inconsistencies.

Much of the information that used to be called for twice is still called for twice, in both Parts 1 and 2. Examples include, just to name a few:

- the types of clients the adviser serves,
- the adviser's financial industry affiliations,
- certain participations in client transactions, and
- certain brokerage practices, including "soft dollars."

Worse yet is the information called for in both Parts 1 and 2 where different definitions or instructions apply between the two parts, significantly heightening the risk for inconsistencies. Examples include:

- the adviser's assets under management (AUM), where Part 1 uses a particular definition of "securities portfolios" for determining whether an adviser meets the AUM threshold for federal registration, and Part 2 allows advisers to compute their AUM using a different method, so long as documentation is kept of the method used, and

- disciplinary disclosures, where Part 1 generally requires disclosures about a broader range of persons (including "advisory affiliates") than Part 2, and Part 2 slices and dices the wording of the operative disclosures in a significantly different way.

Admittedly, the purposes of Parts 1 and 2 are different. Part 1 is oriented toward disclosures important to the SEC for regulatory oversight and Part 2 is, of course, a client disclosure document. Unfortunately, none of that makes the redundancies any less cumbersome for advisers or confusing for clients, or any less a risk for deficiencies on inspection.

TIP 7: Remember – not all advisory personnel described in "brochure supplements" are necessarily IARs.

Personnel who are "providing advisory services" to clients are potentially subject to disclosure on a "brochure supplement" under new Part 2.B. of Form ADV. However, that does not mean they are necessarily "investment adviser representatives" (IARs) potentially required to register with the states. This distinction is crucial on at least two fronts and unless it is intuitive to you, read on.

Brochure supplements -- The SEC does not require separate federal registration for individuals working for an adviser, so-called "supervised persons" (generally, the adviser's officers, directors and employees and others who provide investment advice on behalf of the adviser under its supervision and control), even if they are providing advisory services to clients. However, with few exceptions, advisers must disclose on "brochure supplements" under new Part 2.B. of Form ADV those supervised persons who are "providing advisory services" to clients, meaning they:

- formulate investment advice for clients and have direct client contact, or
- make discretionary investment decisions for clients, even if they have no direct client contact. (See Rule 204-3(b)(3))

SEC-registered advisers are not required to file their brochure supplements with the SEC. In contrast, Instruction 9 to Part 2.B. says that advisers registering with one or more states must file through IARD (the electronic filing system) a copy of the brochure supplement for each supervised person doing business in that state. (This instruction seems to reflect an expectation that states will be adopting brochure supplement requirements for state-registered advisers, although that has not yet fully played out.)

State IAR Registration -- Even more confusingly, supervised persons who work for an adviser and fit the definition of "investment adviser representative" (IAR) may have to register with the states as IARs, even if they work for a federally-registered adviser and regardless of whether they are disclosed on a brochure supplement.

Here's why: When a supervised person works for a state-registered adviser, the state's definition of IAR applies. States often use a very broad definition of IAR. Indeed, a typical state IAR definition includes anyone who provides investment advice to an adviser's clients and anyone who solicits clients for an adviser.

In contrast, when a supervised person works for a federally-registered adviser, the SEC's definition of IAR applies. The SEC's definition of IAR is narrower than the typical state definition and includes supervised persons whose clients meet certain parameters (generally, when more than 5 in number and more than 10% are "natural persons" (i.e., individuals)). If the supervised person does not meet the SEC's definition of IAR, the states are prohibited from requiring that person to register with the states as an IAR. On the other hand, if the supervised person does meet the federal definition of IAR, states are allowed to require them to register as an IAR with any state in which they have a "place of business."[4]

Note that the criteria making someone an IAR are not the same as those making them a supervised person "providing advisory services" to clients and therefore subject to being disclosed on a brochure supplement, at least not under federal law. (We will have to wait to see what brochure supplement requirements are adopted by the states under state law.) The following table summarizes this briefly:

Supervised persons "providing advisory services" to clients and therefore subject to being disclosed on a brochure supplement	Supervised persons meeting the IAR definition and therefore potentially subject to state registration as an IAR
Supervised persons are "providing advisory services" if they: (i) formulate investment advice for a client and have direct client contact; or (ii) make discretionary investment decisions for clients, even if they have no direct client contact. See Advisers Act Rule 204-3(b)(3) for details. (This is the requirement under federal law applicable to federally-registered advisers and their supervised persons. We will have to see whether states adopt similar brochure supplement requirements for supervised persons of state-registered advisers.)	<u>Supervised persons of federally-registered advisers</u>: An IAR is a supervised person who has more than 5 clients that are natural persons and more than 10% of whose clients are natural persons. Certain clients can be counted as "one" for this purpose and certain clients are exempted from the count altogether, such as "qualified clients" under Rule 205-3(d)(1)(iii). Supervised persons who do not solicit, meet with or otherwise communicate regularly with clients of the adviser, or who provide only "impersonal" investment advice, are specifically excluded from the IAR definition under federal law. See Advisers Act Rule 203A-3 for details. <u>Supervised persons of state-registered advisers</u>: "Investment adviser representative" means* an individual employed by or associated with an investment adviser or federal covered investment adviser and who makes any recommendations or otherwise gives investment advice regarding securities, manages accounts or portfolios of clients, determines which recommendation or advice regarding securities should be given, provides investment advice or holds herself or himself out as providing investment advice, receives compensation to solicit, offer, or negotiate for the sale of or for selling investment advice, or supervises employees who perform any of the foregoing. The term does not include an individual who: (A) performs only clerical or ministerial acts; (B) is an agent whose performance of investment advice is solely incidental to the individual acting as an agent and who does not receive special compensation for investment advisory services; (C) is employed by or associated with a federal covered investment adviser, unless the individual has a "place of business" in this State as that term is defined by rule adopted under Section 203A of the Investment Advisers Act of 1940 and is (i) an "investment adviser representative" as that term is defined by rule adopted under Section 203A of the Investment Advisers Act of 1940; or (ii) not a "supervised person" as that term is defined in Section 202(a)(25) of the Investment Advisers Act of 1940; or (D) is excluded by rule adopted or order issued under this Act. * This is the IAR definition from the Uniform Securities Act of 2002, which is used here as an example of a typical state IAR definition. Actual IAR definitions vary by state.

From the table, you can see how a supervised person subject to being disclosed on a brochure supplement might not be an IAR subject to state registration. This could happen, for example, if a supervised person of a federally-registered adviser were providing advisory services only to institutional clients. They would typically be subject to disclosure on a brochure supplement but not meet the federal definition of IAR and therefore not have to register as an IAR with any state.

The opposite scenario -- where an IAR is required to register with a state but would not have to be disclosed on a brochure supplement – seems rarer. However, this could conceivably happen, for example, if the individual is a third-party solicitor acting on behalf of a state-registered adviser. In that case, the individual might well fall within the state's IAR definition and have to register with the state as an IAR. However, a third-party solicitor would not typically be considered a "supervised person" "providing advisory services" for the adviser and therefore would not be subject to disclosure on a brochure supplement. Note that this assumes the state uses definitions similar to those used by the SEC for determining who must be disclosed on a brochure supplement. If the state adopts different definitions, a different outcome could of course result.

The bottom line is that advisers will have to sort carefully through which of their supervised persons must be disclosed on brochure supplements and which ones must register with the states as IARs, since the criteria for the two are not necessarily the same.

TIP 8: Electronic access ≠ delivery.

Although advisers are permitted to use electronic means for delivering firm brochures and supplements, the SEC declined to adopt an "access equals delivery" model for Part 2. The most flexible version of that model would have allowed advisers to fulfill their obligation to deliver Part 2 to clients by simply filing it electronically via IARD.

Instead, advisers delivering brochures electronically must continue to parse through 14-year-old SEC guidance that allows electronic media to be used for required deliveries if specific requirements are met.[5] Unfortunately, there has been lingering uncertainty about crucial aspects of that guidance, such as how advisers can obtain adequate client "consent" to electronic deliveries and what will suffice as "evidence of delivery."

Despite numerous calls for the SEC to update and clarify the old electronic delivery guidance, uncertainties remain, and advisers will have to continue to grope their way through the haze of authority governing this area.

TIP 9: Distinguish updating from filing from delivering.

New Part 2 establishes a new rhythm for updating, filing and delivering firm brochures and brochure supplements. Currently, advisers often update their Part II only once a year and simultaneously deliver it or offer to deliver it to clients. Part II is never physically filed with the SEC, although placing it in the adviser's own records is deemed to constitute filing for purposes of the Advisers Act. Brochure supplements are not even contemplated under the current system.

In contrast, new Part 2 requires advisers to update, file and/or deliver firm brochures -- and for the first time, brochure supplements – following a significantly different pattern. Here are some key elements:

Firm Brochures:

- Advisers must file their annual updated brochure within 90 days after the adviser's fiscal year end.
- Advisers must deliver to existing clients their annual updated brochure -- or a summary of material changes with additional information on how to get the full brochure -- within 120 days after the adviser's fiscal year end.

- Advisers must update and file their brochures promptly whenever information in them becomes materially inaccurate, even in the interim between annual updates.
- Advisers must start delivering updated brochures to new clients as soon as the update is made.
- Advisers must deliver interim updated brochures to existing clients only if the update amends disciplinary disclosures.

Brochure Supplements:

- SEC-registered advisers are never required to file their brochure supplements with the SEC.
- In contrast, state-registered advisers must file brochure supplements for each supervised person doing business in that state.
- Advisers do not need to update brochure supplements annually.
- However, advisers must update their brochure supplements promptly whenever information in them becomes materially inaccurate.
- Advisers must start delivering updated brochure supplements to new clients as soon as the update is made.
- Advisers must deliver updated brochure supplements to existing clients only if the update amends disciplinary disclosures.

In light of these new requirements, advisers would be wise to review and update as necessary their compliance procedures for preparing, filing and delivering regulatory documents. Throughout the process, advisers should keep in mind the caveat discussed above in Tip 3 that, as fiduciaries, advisers may need to make disclosures even if they are not specifically called for by Form ADV.

TIP 10: Don't trip on transition deadlines.

Transitioning into the new Part 2 requirements is governed by its own set of rules. First, each adviser registered with the SEC whose fiscal year ends on or after December 31, 2010, must electronically file its new Part 2 brochure as part of its next annual updating amendment to Form ADV.[6] Advisers must begin delivering their new brochures and brochure supplements to new and prospective clients as of the date by which the adviser is first required to electronically file its brochure with the SEC.

In addition, within 60 days of the date on which it is first required to electronically file its brochure, the adviser must deliver to each existing client its new brochure and all new brochure supplements required by new Part 2.[7] Note that this 60-day period in transition is more time than an adviser would normally have to deliver an annual update to clients. As referenced above in Tip 9, advisers would normally have 90 days after fiscal year end to file an annual update, but only an additional 30 days thereafter (meaning within 120 days of fiscal year end) to make required deliveries to existing clients. In transition, however, the SEC gives advisers an extra 30 days for existing client deliveries to make sure they have enough time to comply with the new requirements.

For many advisers, the transition calendar will look something like this:

12/31/2010	Adviser's fiscal year end
3/31/2011	Filing deadline for Form ADV annual updating amendment including a new Part 2 brochure, and deadline as of which adviser must start delivering new brochures and supplements to new and prospective clients
5/30/2011	Transition deadline by which adviser must deliver brochures and supplements to existing clients

Once past transition, advisers should adjust their regulatory calendars to target existing client deliveries within 120 days after fiscal year end.

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Inevitably, the 2010 amendments to Form ADV Part 2 will pose many challenges. The tips discussed, however, will help to cope with those challenges.

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[1] See Electronic Filing by Investment Advisers, Proposed Amendments for Form ADV, Release No. IA-1862 (April 5, 2000); Amendments to Form ADV, Release No. IA-2711 (March 3, 2008); and Amendments to Form ADV, Release No. IA-3060 (July 28, 2010).

[2] See http://www.sec.gov/pdf/handbook.pdf.

[3] See http://www.plainlanguage.gov/howto/guidelines/bigdoc/fullbigdoc.pdf.

[4] Advisers Act Section 203A(b)(1)(A).

[5] See Use of Electronic Media by Broker-Dealers, Transfer Agents, and Investment Advisers for Delivery of Information, Release Nos. 33-7288; 34-37182; IC-21945; IA-1562 (May 9, 1996) and releases cited therein. See also the Electronic Signatures in Global and National Commerce (E-SIGN) Act enacted by Congress in 2000 (Public Law 106–229) (June 30, 2000).

[6] Rule 204-1(c).

[7] Rule 204-3(g)(1) and (2).