

Form ADV Part 2

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Client Advisory

September 27, 2010 by Faith Colish, Guy P. Lander, Della P. Richardson, Ethan L. Silver and Andris J. Vizbaras

Introduction

On July 28, 2010, the Securities and Exchange Commission adopted a new Part 2 of Form ADV.^[1] The new Part 2 has two subparts, Part 2A, the "Brochure," which must be filed electronically with the IARD and will be available to the public, and Part 2B, the "Brochure Supplement" that gives information about specific personnel of the adviser who will provide services to a particular client. Unlike former Part II, which had mostly a "check-the-box format," new Part 2 is a narrative that must be drafted by each adviser. However, many of the topics are familiar to those who have experience working with the old Part II. New Part 2 is also required in the states that formerly required Part II.

Part 2 must be used for any filings on or after October 12, 2010. An adviser whose fiscal year ends on or after December 31, 2010, must file Part 2A with its next annual updating amendment (within 90 days after its fiscal year end) and must then use Part 2A and Part 2B for new and prospective clients. Advisers must deliver new Part 2A and Part 2B to existing clients within 60 calendar days after Part 2A has been filed.

Part 2A: The Brochure – Contents.

Part 2A contains 18 items, all of which are mandatory and which must appear in the specified sequence. The main focus of these disclosure requirements is conflicts of interest that the adviser may have with clients. The adviser must not only identify the conflicts that it has or is reasonably likely to have in each item, but must also explain how it will deal with those conflicts. Responses must be in succinct, plain English. If an item is inapplicable, the Brochure can state "Not Applicable" but no items can be omitted. Cross-references can be used to avoid repeating information.

Advisers that provide different kinds of advisory services may use different Brochures so long as each client receives information on the services and fees applicable to that client.

Following are the 18 categories of information that must be in Part 2A:

- Item 1: Cover Page.
- Item 2: Material Changes. This must include any material changes in the adviser since the last annual update. The SEC has not provided guidance as to what changes are "material."
- Item 3: Table of Contents.
- Item 4: Advisory Business. This must describe the advisory services offered, whether the adviser holds itself out as specializing in a particular service, and assets under management. The method for computing assets under management for Part 2

may be different from the method used in Part 1A, but the adviser must keep documentation describing the different methods used. The SEC has provided detailed instructions on how to make this computation.

- Item 5: Fees and Compensation. This must contain the normal fee schedule, whether fees are negotiable, how often the adviser bills clients, and whether the adviser can deduct its fees from client accounts. If fees are charged in advance, the adviser must explain how it calculates and refunds fees when a contract is terminated. Part 2 must also disclose costs and fees to be borne by the client, such as brokerage and custody fees and fees of fund advisers, and any compensation the adviser or its personnel receives from the sale of securities or other investment products. Fee schedules and other information required by this Item 5 do not need to be disclosed in a Brochure provided only to clients who are “qualified purchasers.”
- Item 6: Performance-Based Fees and Side-By-Side Management. These must be described, if applicable, and also whether a person supervised by the adviser manages an account that pays such fees.
- Item 7: Types of Clients. This includes requirements for opening and maintaining accounts, such as minimum account size.
- Item 8: Methods of Analysis, Investment Strategies and Risk of Loss. Part 2 must contain a statement that investing in securities involves risk of loss. Any material or unusual risks that accompany each strategy or type of investment, and that would not be apparent to a client, must be explained.
- Item 9: Disciplinary Information. An adviser must describe any legal or disciplinary event that occurred within the past 10 years and that would be material to a client’s or prospective client’s evaluation of the adviser or its management personnel. The Form provides a non-exhaustive list of disciplinary events that are presumed to be material.
- Item 10: Other Financial Industry Activities and Affiliations.
- Item 11: Code of Ethics, Participation or Interest in Client Transactions and Personal Trading. The adviser must describe its Code of Ethics and indicate that the Code is available to clients upon request. The adviser must also disclose any participation or interest it has in clients’ securities transactions and its policies relating to trading by the firm or its personnel for their own accounts.
- Item 12: Brokerage Practices. Part 2 must state how the adviser selects brokers for client transactions and how it determines the reasonableness of brokers’ compensation. This includes discussion of the use of soft dollars, payments for client referrals, directed brokerage, and trade aggregation.
- Item 13: Review of Accounts. The adviser must describe how often it reviews clients’ accounts and who conducts the review. An adviser that does not review accounts on a regular basis must describe under what circumstances they will conduct an account review.
- Item 14: Client Referrals and Other Compensation. An adviser must disclose any arrangements under which it compensates a non-employee for client referrals, and describe the compensation. It also must disclose any benefits it may receive from a non-client, including sales awards or prizes, for providing advisory services to clients.
- Item 15: Custody. An adviser that maintains custody of client funds or securities must explain the review of account statements that clients will receive directly from a qualified custodian. As in the past, arrangements in which the adviser directs a custodian to pay the adviser’s fee on behalf of the client do not have to be reported as custody in Part 2.
- Item 16: Investment Discretion. This must be disclosed, if applicable, including any limitations on the adviser’s authority.

- Item 17: Voting Client Securities. An adviser must disclose any proxy voting practices, including whether it will accept to authority to vote client securities and, if so, a brief description of its policies and procedures and how the client can direct a vote.
- Item 18: Financial Information. An adviser with discretionary authority, custody of client assets, or that requires payment of more than \$1,200 in fees per client at least six months in advance, must disclose any material financial condition that may impair its ability to meet contractual commitments to clients. An adviser that requires such prepayment of fees must provide an audited balance sheet as of the end of its most recent fiscal year.

Part 2A: Appendix 1 – The Wrap Fee Program Brochure.

This is a revision of Schedule H of Form ADV. While most of the disclosure items will remain the same, the adviser will now be required to state if any of its related persons is a portfolio manager in the wrap fee program, and must address any resulting conflicts of interest. The adviser must also disclose if the process for selecting portfolio managers in the wrap fee program is the same as the review for other portfolio managers or, if not, must explain the selection and review process.

Part 2A: The Brochure – Filing and Delivery.

- Filing. Part 2A is filed electronically in searchable PDF format. It will be publicly accessible on the IARD website.
- Initial delivery to new clients and prospective clients. The adviser must deliver Part 2A to each new client at or before the time it enters into an advisory contract with a client.^[2]
- Annual delivery or proffer. Within 120 days after the end of the adviser's fiscal year the adviser must send an annual delivery. This can consist of either the Brochure with a summary of material changes, or a summary of the material changes and an offer to provide the entire updated Brochure. The adviser also must send clients an updated Brochure whenever it is amended to reflect a disciplinary event or material change of information in Item 9 of the Brochure.

Part 2B: The Brochure Supplement – Contents.

Each Brochure (Part 2A) must be accompanied by a Brochure Supplement (Part 2B), providing information about the advisory personnel on whom the client relies for investment advice. Part 2B must also be written in plain English and organized in the same order with the same headings as is presented in the form. Part 2B consists of the following six items:

- Item 1: Cover Page. This must identify the supervised person and advisory firm.
- Item 2: Educational Background and Business Experience. This must describe the supervised person's formal education and business background for the past five years.
- Item 3: Disciplinary Information. Like Item 9 of Part 2A, any legal or disciplinary event that occurred within the last 10 years and that is material to a client's evaluation of the supervised person's integrity must be disclosed.
- Item 4: Other Business Activities. This must include any other investment-related businesses in which the supervised person participates, including any compensation the supervised person receives based on the sale of securities or other investment products, and any incentives this compensation creates. Non-investment-related business activities must also be disclosed if they involve a substantial amount of time or pay. These activities are presumed not substantial if they account for less than 10% of the supervised person's time and income.

- Item 5: Additional Compensation. An adviser must disclose any arrangements in which someone other than a client gives a supervised person an economic benefit for providing advisory services.
- Item 6: Supervision. An adviser must explain how it monitors advice provided to clients by the supervised person. The adviser must give the name and contact information of the person who supervises the supervised person.

Part 2B: The Brochure Supplement – Filing and Delivery.

Advisers are not required to file the Brochure Supplement with the SEC, but they must retain them in their files. The Brochure Supplement must be provided to each client at or before the adviser provides advisory services to the client and it may be provided electronically so long as links to any disciplinary information is also disclosed. An adviser does not need to provide the Brochure Supplement to clients who do not need to receive the Part 2A Brochure. The Brochure Supplement must be updated for any material changes. Advisers need only make interim delivery to existing clients when there is a new disciplinary event or material change to disciplinary information that has already been disclosed.

This summary is not intended to address all aspects of new Part 2. Please get in touch with any of us if you have questions. We are available to give you any guidance and assistance in the preparation of your new Part 2.

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Endnotes

[1] Amendments to Form ADV, Investment Advisers Act Release No. 3060 (July 28, 2010). New Part 2 replaces former Part II of Form ADV.

[2] Solicitors paid by the adviser under Investment Advisers Act Rule 206(4)-3 must deliver the Brochure and other disclosures at the first contact with the prospective client.

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