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# SEC Adopts New Part 2 of Form ADV: Disclosure Requirements for SEC and Connecticut Registered Investment Advisers

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The Securities and Exchange Commission ("**SEC**") recently adopted amendments to Part 2[1] of Form ADV. The amendments signify meaningful changes to Form ADV in not only the form of disclosure provided, but the content and level of accessibility to the public. The amendments are described in greater detail below.

Part 2 of Form ADV is divided into two sub-parts -- Part 2A and Part 2B. Part 2A, or the "**brochure**," contains 18 required disclosure items about the investment adviser including information about the adviser's qualifications, its investment strategies, the education and business backgrounds of its principals, and its business activities.[2] Part 2B, which is referred to as the "**brochure supplement**," includes information about certain advisory personnel, such as educational background, business experience and disciplinary history (if any). The amendments also require investment advisers that are registered with the SEC to file their new brochures (*i.e.*, the new Part 2A) with the SEC electronically through the Investment Adviser Registration Depository ("**IARD**") system.[3]

## Part 2A - The Brochure

The disclosure items in Part 2A require an adviser to disclose in "plain English" the investment adviser's conflicts of interests with its clients, its services, business practices, and disciplinary history and is disclosure that the adviser, as a fiduciary, must make to clients in some manner regardless of the form requirements. The SEC has generally described "plain English" as using definitive, concrete and everyday words, using active voice and generally avoiding legal or business jargon. Set forth below are key aspects of the disclosure requirements of Part 2A:

- ***Item 2 - Summary of Material Changes***. Investment advisers that are amending their brochures must identify and discuss how the information in the amendment materially differs from the last annual update of its Form ADV.
- ***Item 4 - Advisory Business***. Item 4 requires that investment advisers describe their advisory business, including, types of advisory services offered, whether the investment adviser holds itself out as a specialist in a particular type of advisory

1 Part 2 of Form ADV was previously designated as "Part II."
2 Please see Amendments to Form ADV, Investment Advisers Act Release No. 3060 (July 28, 2010), available at http://www.sec.gov/rules/final/2010/ia-3060.pdf (the "Adopting Release").
3 While SEC-registered investment advisers are not required to file brochure supplements (i.e., the new Part 2B) with the SEC through the IARD system, state-registered investment advisers must file their brochure supplements through the IARD System.

service, and the amount of client assets that it manages. The calculation of the amount of client assets that an investment adviser manages may be calculated by a method that is different than the method used to calculate "assets under management" for the purposes of disclosure under Part 1A of Form ADV.[4]

- ***Item 5 - Fees and Compensation***. Disclosure under Item 5 requires that an investment adviser identify how it is compensated for the provision of advisory services, provide a fee schedule, and disclose whether its fees are negotiable. Investment advisers are also required to disclose how often they assess fees and whether they bill clients or deduct fees directly from clients' accounts. Additionally, investment advisers that receive, or that have personnel that receive, brokerage commissions, must disclose this practice and the conflicts of interest that it creates. In response to commenters who argued that fee information is likely not useful to institutional clients who may negotiate differing fee arrangements, the amendments provide an exception allowing an adviser to omit the disclosure of its fee schedule and other information in Item 5.A in any brochure provided to clients that are "qualified purchasers," as defined under Section 2(a)(51) of the Investment Company Act of 1940, as amended.
- ***Item 6 - Performance-Based Fees and Side-by-Side Management***. To the extent that an investment adviser receives performance-based fees or has a supervised person that manages an account that pays performance-based fees, the investment adviser must disclose this fact. Furthermore, if the investment adviser also simultaneously manages an account that does not pay performance-based fees, the investment adviser must disclose this fact and discuss the conflicts of interest that arise from its (or its supervised person's) simultaneous management of accounts that pay performance-based fees. The investment adviser must also disclose how it addresses these conflicts.
- ***Item 8 - Methods of Analysis, Investment Strategies and Risk of Loss***. Investment advisers must disclose their methods of analysis and investment strategies and the material risks involved in each significant investment strategy. Further, to the extent a particular risk is unusual, the investment adviser must provide a more extensive disclosure.
- ***Item 9 - Disciplinary Information***. Investment advisers must disclose the material facts of any legal or disciplinary event that is "material to a client's evaluation of the integrity of the investment adviser or its management personnel." Item 9 provides a list of disciplinary events that are presumptively material if they occurred in the previous 10 years (e.g., theft, fraud, bribery, perjury, forgery, counterfeiting, extortion and violations of securities laws).
- ***Item 10 - Other Financial Industry Activities and Affiliations***. Investment advisers must disclose any material relationships or arrangement that they (or any of their management personnel) have with related financial industry participants. Moreover, such investment advisers must disclose any material conflicts of interests that such relationships or arrangements create and how the investment adviser addresses those conflicts.
- ***Item 11 - Code of Ethics, Participation or Interest in Client Transactions and Personal Trading***. Investment advisers must

4 The methodology for calculating "assets under management" under Part 1A of Form ADV was designed for the specific purpose of determining whether an investment adviser should register with the SEC or state securities authorities. For example, when calculating assets under management for purposes of Part 1A, an investment adviser may only include the entire value of a managed portfolio if at least 50% of the portfolio consists of securities, cash and cash equivalents. This methodology was not intended to convey meaningful information about the scope of the investment adviser's business, which is the intent of Item 4 of Part 2 of Form ADV.

describe, briefly, their code of ethics and state that a copy of their code of ethics is available for review upon request. Moreover, if the investment adviser or a related person recommends to clients, or buys or sells for client accounts, securities in which the adviser or a related person has a material financial interest, the investment adviser must discuss this practice and the conflicts of interests that it presents. Additionally, an investment adviser must disclose its personal trading and that of its personnel in the same securities that the investment adviser recommends to its clients.

- ***Item 12 - Brokerage Practices***. Investment advisers must disclose the manner in which brokers are selected for client transactions and the determination of the reasonableness of brokers' compensation. Investment advisers must also discuss how the investment adviser addresses the conflicts of interest arising from its receipt of soft dollar benefits and must disclose information about directed brokerage arrangements and trade aggregation.
- ***Item 14 - Client Referrals and other Compensation***. Investment advisers must disclose any arrangement through which they or a related person compensates another client for client referrals and must describe the compensation. Additionally, the brochure must describe arrangements under which the investment adviser receives an economic benefit (e.g., sales awards or prizes) from a person who is not a client for providing advisory services to clients.
- ***Item 15 - Custody***. An investment adviser that has custody of clients' funds or securities must explain that its clients will receive account statements directly from the qualified custodian, such as a bank or broker-dealer, that maintains those assets.
- ***Item 17 - Voting Client Securities***. Investment advisers must disclose their proxy voting practices, including whether the investment adviser has or will accept authority to vote client securities and, if so, what voting policies the investment adviser has adopted under Rule 206(4)-6 under the Investment Advisers Act of 1940, as amended (the "**Advisers Act**"). Additional disclosure must discuss whether, and how, clients can direct the investment adviser to vote in a particular solicitation, how it addresses conflicts of interest when it votes client securities and how clients can obtain information from the investment adviser on how the investment adviser voted the client's securities.
- ***Item 18 - Financial Information***. Investment advisers that require prepayment of fees in excess of $1,200[5] per client and more than six months in advance must provide clients with an audited balance sheet showing the investment adviser's assets and liabilities at the end of the most recent fiscal year. Additionally, "any financial condition that is reasonably likely to impair the adviser's ability to meet contractual commitments to clients" must be disclosed if the investment adviser has discretionary authority over client assets, has custody of client funds or securities, or requires or solicits prepayment of more than $1,200[6] in fees per client and six months or more in advance.

## Brochure Delivery Requirements

Under amended Rule 204-3 of the Advisers Act (also known as the "brochure delivery" rule), investment advisers must deliver the brochure prior to or at the time the client executes the advisory agreement. An investment adviser is not required to deliver a brochure to clients that are registered investment companies or clients that receive only impersonal investment advice for which the investment adviser charges fees that do not exceed $500 per year. The SEC staff noted in the Adopting Release that investment advisers that provide

5 For state-registered investment advisers, the threshold for prepayment of fees is $500 per client rather than $1,200 per client.
6 See supra note 5.

advice to private investment funds (e.g., hedge funds or private equity funds) need only provide brochures to their "clients" under Rule 204-3 (*i.e.*, the private investment funds the advisers manage) and not fund investors. Notwithstanding the foregoing, advisers opting to forego delivery of the brochure directly to investors should carefully review the offering documents of the funds they manage to ensure that the fund offering documents disclose all material information found in the brochure.

Within 120 days of the adviser's fiscal year end, such adviser must deliver to those clients to whom such adviser owes a duty to deliver a brochure, either: (i) a current updated brochure including or accompanied by a summary of material changes; or (ii) a summary of material changes including an offer to provide a copy of the current brochure.

Like the previous rule, the amended rule requires investment advisers to update the brochure at least annually and to update it promptly when any information in the brochure becomes materially inaccurate.

## Wrap Fee Program Brochure

Investment advisers that provide wrap fee programs[7] must prepare a separate, specialized brochure[8] for delivery to clients of the wrap free program in lieu of the standard brochure required under Part 2A. The requirements for the wrap free program brochure were amended to incorporate many of the amendments to Part 2A of Form ADV.

## Part 2B - The Brochure Supplement

Part 2B of Form ADV accompanies the brochure and provides information about the educational background, business experience and disciplinary history of certain personnel of the investment adviser that provide advisory services to clients. Investment advisers do not file brochure supplements with the SEC, but investment advisers must preserve them and they are subject to examination. Investment advisers must give a brochure supplement to clients about each "supervised person"[9] who (i) formulates investment advice for that client and has direct client contact or (ii) makes discretionary investment decisions for that client's assets, even if the supervised person has no direct client contact. To the extent that an investment adviser does not have any supervised persons for which it must prepare a brochure supplement, the investment adviser need not prepare or deliver brochure supplements. An investment adviser must give a brochure supplement to each client at or before the time the supervised person provides services to a client. Further, if Part 2A of Form ADV addresses each of the disclosure items required to be disclosed in the brochure supplement, the investment adviser need not prepare a separate brochure supplement.

## Connecticut Registered Investment Advisers

Effective October 12, 2010, the Securities and Business Investments Division of the Connecticut Department of Banking adopted the new Part 2 of Form ADV[10] that was released by the SEC on July 28, 2010.

Pursuant to Sec. 36b-31-5c of the Regulations under the Connecticut Uniform Securities Act (the "**Regulations**"), Connecticut registered investment advisers must furnish a written disclosure statement, which may be a copy of Part 2 of the investment adviser's Form ADV, or a written document containing at least the information then

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7 Wrap fee programs are generally characterized as arrangements between broker-dealers, investment advisers, banks and financial institutions (acting as sponsors of such programs) and affiliated and unaffiliated investment advisers (or portfolio managers) through which customers of such firms receive discretionary investment advisory, custodial, execution and clearing services in a "bundled form." In exchange for bundled services, customers pay an all-inclusive "wrap" fee based on a percentage of assets held.

8 The form of the separate, specialized brochure for wrap fee programs is set forth in Appendix 1 to Part 2A of Form ADV.

9 A "supervised person" is defined as "any of [an investment adviser's] officers, partners, directors (or other persons occupying a similar status or performing similar functions), or employees, or any other person who provides investment advise on [such investment adviser's] behalf and is subject to [such investment adviser's] supervision or control." See Form ADV: Glossary.

10 See Securities and Business Investments Division, Securities Bulletin, New Part 2 of Form ADV: Notice to State Registered Investment Advisers and Applicants for State Investment Adviser Registration, Vol. XXIV, No. 3, Fall 2010 (the "Securities Bulletin") available at http://www.ct.gov/dob/cwp/view.asp?a=2248&q=468096#Part2.

so required by Part 2 of Form ADV, to each of its advisory clients and prospective advisory clients. While Connecticut does not require that investment advisers file an annual updating amendment, Section 36b-31-14e(a) of the Regulations requires that investment advisers amend their Form ADV when it becomes materially inaccurate or incomplete. In addition, Section 36b-31-5c(d)(1) of the Regulations requires advisers to deliver or offer to deliver the brochure to their clients each year.

***Additional Disclosures for State-Registered Investment Advisers***.
Parts 2A and 2B of Form ADV each contain an additional disclosure item that applies only to state-registered investment advisers.

***Part 2A: Item 19 - Requirements for State-Registered Advisers.***

- ***Executive Officers and Management Persons***. Investment advisers must identify their principal executive officers and management persons[11] and describe their formal education and business background.
- ***Other Business Activities.*** To the extent that the investment adviser is involved in any business other than the investment advisory business, the investment adviser must disclose, these businesses along with the approximate time devoted to each business.
- ***Performance-Based Fees.*** In addition to the fee disclosures in Item 5 of Part 2A, if the investment adviser or a supervised person receives performance-based fees for advisory services, the adviser must explain the calculation of those fees. Further, the investment adviser must specifically disclose that performance-based compensation may create an incentive for the investment adviser to recommend an investment that may carry a higher degree of risk to the client.
- ***Involvement in Certain Arbitration and other Proceedings.*** Investment advisers must disclose all material facts regarding the investment adviser's or a management person's involvement in certain enumerated events that resulted in the investment adviser or the management person being found to be liable in either (A) an arbitration claim alleging damages over $2,500 or (B) a civil, self-regulatory or administrative proceeding. Such enumerated events include investments or investment-related businesses or activities; fraud, false statements or omissions; theft, embezzlement, or other wrongful taking of property; bribery, forgery, counterfeiting, or extortion; or dishonest, unfair, or unethical practices.
- ***Certain Relationships and Arrangements.*** In addition to the disclosure required by Item 10.C. of Part 2A with respect to relationships or arrangements with related persons, investment advisers must describe any relationship they or a management person has with any issuer of securities not listed in Item 10.C. of Part 2A.

## Part 2B: Item 7 - Requirements for State-Registered Advisers.

- ***Involvement in Certain Arbitration and other Proceedings***. Part 2B must also include the same disclosure regarding the investment adviser's or a management person's involvement in certain arbitration and other proceedings as is required by Item 19 of Part 2A.
- ***Bankruptcy Petitions***. If a supervised person is the subject of a bankruptcy petition, the investment adviser must disclose that fact, the date the petition was first brought and the current status of the petition.

## Compliance Dates for Connecticut Registered Investment Advisers

***New Applicants for Investment Adviser Registration in Connecticut***. Each adviser applying for registration after January 1, 2011 must file a new Part 2 of Form ADV as part of its

11 "Management Person" is defined as "[a]nyone with the power to exercise, directly or indirectly, a controlling influence over [the investment adviser's] management or policies, or to determine the general investment advice given to the clients of [the investment adviser]."

application for registration as an investment adviser in Connecticut. As required by Part 2 of Form ADV prior to the amendment, Part 2 of Form ADV (which includes both the brochure and the brochure supplement) must be filed through IARD.

***Investment Advisers Registered in Connecticut on or Before December 31, 2010***. All investment advisers that were registered in Connecticut on or before December 31, 2010 will be required to update their Form ADV to incorporate new Part 2. This update should be included in the investment adviser's next Form ADV filing amendment and, if the investment adviser uses Part 2 of Form ADV as their brochure, in its next brochure delivery to its advisory clients. In each case, investment advisers must complete this transition before June 1, 2011. As required by Part 2 of Form ADV prior to the amendment, Part 2 of Form ADV (which includes both the brochure and the brochure supplement) must be filed through IARD.

## Compliance Dates for SEC Registered Investment Advisers

Each adviser applying for registration after January 1, 2011 must file a brochure that meets the requirements of new Part 2A and must deliver brochure supplements that meet the requirements of new Part 2B to its clients and prospective clients.

Existing SEC-registered investment advisers with a fiscal year ending on December 31, 2010 must file an annual updating amendment with new brochures no later than March 31, 2011. At the time of the release of new Part 2 of Form ADV, SEC-registered investment advisers were required to deliver brochure supplements to existing clients within 60 days of filing of the annual updating amendment. However, on December 28, 2010, the SEC issued a final rule extending the compliance dates for delivery of brochure supplements. The extension generally grants SEC-registered investment advisers an additional four months to comply with the brochure supplement delivery requirements.

***Existing Registered Investment Advisers***. Investment advisers registered with the SEC as of December 31, 2010 and with a fiscal year ending on December 31, 2010 through April 30, 2011 have until July 31, 2011 to begin delivering brochure supplements to new and prospective clients. These investment advisers will have until September 30, 2011 to deliver brochure supplements to their existing clients. The compliance dates for investment advisers registered with the SEC as of December 31, 2010 and with a fiscal year ending after April 30, 2011 remain unchanged.

***Newly-registered Investment Advisers***. Investment advisers registering with the SEC between January 1, 2011 and April 30, 2011 have until May 1, 2011 to begin delivering brochure supplements to new and prospective clients. These investment advisers will have until July 1, 2011 to deliver brochure supplements to existing clients. The compliance dates for any investment advisers registering with the SEC after April 30, 2011 remain unchanged.

## Questions or Assistance:

If you would like to discuss these issues in further detail, please contact Peter Bilfield at (203) 324-8151, or pbilfield@goodwin.com, Michael Fritz at (860) 251-5786, or mfritz@goodwin.com or Donna Brooks (860) 251-5917 or dbrooks@goodwin.com.



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