

## Client Advisory | November 2010

**Investment Advisers: Focus on Your New Disclosures**

The March 31 deadline for most registered investment advisers to file their new “firm brochures” is approaching fast. The brochure is the new Form ADV Part 2 – a narrative description of business practices and conflicts of interest to replace the current, clunky, check-the-box Part II. Registered advisers also need to prepare a “brochure supplement” describing each supervised person responsible for managing client accounts.



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Most of the required information should be readily available, but it will take time to design a format, collect the information and draft the factual details with a consistent, understandable tone. In addition, the form now requires substantially more – and more explicit – analysis of any conflicts of interest and description of how you manage them. Advisers who haven’t started on this project should assign a senior person to own it and dig in. This could be the chief compliance officer, but you may prefer to have someone working with the CCO who writes well and who is not immersed in day-to-day compliance. After all, the brochure will be marketing material as much as a disclosure document.

**Your Deadlines**

You may start using the new Part 2 brochure and brochure supplements now if you wish. You must begin using them on the following schedule:

- File the brochure with the SEC or applicable state(s) via IARD as part of your next annual updating amendment – i.e., by March 31, 2011.<sup>1</sup>
- Start delivering the brochure and brochure supplements to new and prospective clients once you have made the initial filing.
- Deliver the brochure and relevant brochure supplements to existing clients

within 60 days of your initial filing – i.e., by May 30, 2011 at the latest.

**Action Items***Brochure and brochure supplements*

To put together the brochure and brochure supplements:

- Review the forms and instructions; assess the information needed.
- Designate the project team and set a timetable.
  - Involve the CCO, the CFO and the investment committee for the relevant sections.
  - Bring a marketing sensibility to designing the brochure. Graphics can help emphasize a disclosure point. Tables and bullets can help make complex information easier to absorb. Consider adding pictures.
- Collect your existing brochures, investment and trading (including soft dollar) policies, compliance manual, code of ethics, client statements, marketing materials and other documents that describe how your firm does business. You will need to make sure the brochure is consistent and complete.
  - Advisers who sponsor private investment funds need to take the PPMs and other fund literature into consideration for the same reason.<sup>2</sup>

<sup>1</sup> If your current fiscal year ends before December 31, 2010, you need not begin complying until the annual update for your next fiscal year.

<sup>2</sup> Since the brochure will be filed with IARD and publicly available, it should not contain material that could be seen as “general solicitation” or “directed selling efforts” for the sale of fund interests that could negate the fund’s Reg. D private placement or Reg. S foreign safe harbor compliance under the Securities Act of 1933.

- Catalogue all revenues to make sure you don't overlook business that is outside the firm's mainstream.
- You can use your existing Form ADV Schedule F as a starting point, since most of the required disclosures expand upon those. Be ready to scrap the current language and draft from scratch. The new Part 2 calls for information that is similar to, but often goes beyond, what you are already providing. You don't want to be constrained by the present form.
- Be honest with yourselves about conflicts of interest. The brochure specifies quite a few examples of potential conflicts that you should discuss, but don't fail to examine others that may apply to your firm's particular situation.
- Circulate information requests to advisory personnel to obtain the biographical (and any disciplinary) information needed for the brochure supplements.
  - Advisers whose employees are registered "investment adviser representatives" will use Form U-4 as a starting point.
  - SEC-registered advisers who have not needed to register their employees will have to start from scratch.
- Focus at a senior level on who should be designated as a "supervisor" in the brochure supplements. This may be "political" within your firm. If your firm is small, perhaps you are "supervising" each other.
- Consider using an outside reviewer with an objective viewpoint to help examine the assumptions you make about conflicts and to edit your drafting.

### Other compliance items

In addition to drafting and designing the principal documents:

- Your compliance manual will need to be updated to cover your new responsibilities by the time you start using the new brochure.
  - This will include the delivery, filing, updating and recordkeeping requirements for the new documents.
  - It should also include a requirement that supervised persons notify the CCO of any changes to the information in their own brochure supplements and periodically confirm no changes.
- Client documentation – such as investment management agreements – that reflect the old Part II delivery requirements or other obsolete information should be amended.
- You may want to consider obtaining your clients' consent to receive required disclosures by email or by posting on your website.<sup>3</sup>

### Format, Filing and Delivery

The new Part 2 has two main parts.

#### Part 2A: "Firm Brochure"

This requires narrative disclosures about the adviser's business in response to each item of the new form. The discussion should be easy to read, using short sentences, everyday language and the active voice.

You will *file* the brochure with the SEC or applicable state(s) through IARD, and you will *deliver* it to new and existing clients.<sup>4</sup> You will file amendments when there are material changes. You may need to deliver amendments to clients when they occur (depending on the significance), but, in any event, you will need to deliver to clients an annual summary of the material changes.

#### Part 2B: "Brochure Supplement"

This provides information about the individual personnel who either formulate advice and have client contact or who have discretionary authority over a client's account.<sup>5</sup> A brochure supplement is *delivered* to the relevant clients only. Updates must be delivered if the disciplinary history changes; other material changes may also warrant redelivery. SEC-registered advisers are not required to *file* brochure supplements with the SEC nor with their state notices (although a state may require the same information in licensing an investment adviser representative). State-registered advisers likely will need to file brochure supplements with their respective state(s).

#### Appendix: Wrap Fee Program Brochure

Sponsors of wrap fee programs must also prepare a separate brochure for clients in those programs.

### Contents of the Brochure

There is no substitute for reading through Form ADV Part 2 and the related instructions. They are available at [www.sec.gov/about/forms/formadv-part2.pdf](http://www.sec.gov/about/forms/formadv-part2.pdf). If you'd prefer to get a hard copy by mail, you may request it from us at the telephone numbers or email addresses given below.

The new brochure requires all of the information in present Part II and more, often calling for – and fleshing out – disclosures that many advisers currently include based on the "lore" of Form ADV. The most significant additional disclosures include:

#### Advisory business

In addition to describing the types of advisory services offered, you must explain any particular type of advisory service (e.g., financial planning,

<sup>3</sup> A consent may be included in the investment management agreement or an appendix, or in any other suitable communication. Email delivery might be by PDF or a link to your website. Alternatively, you could notify clients by regular mail that a new disclosure has been posted to the website.

<sup>4</sup> The SEC is deliberately vague about whether the brochure should be delivered to investors in funds managed by the adviser, perhaps because an explicit rule is on its way. In our view, an adviser who manages a fund should do this, since investors should receive the conflicts disclosure in the brochure, even if the fund is technically the adviser's "client."

<sup>5</sup> If a team of more than five persons exercises discretionary authority over a client account, you need only prepare supplements for the five "with the most significant responsibility for the day-to-day discretionary advice."

quantitative analysis or market timing) in which you specialize. You also need to explain whether and how you tailor your services to your clients' needs and any restrictions clients may impose.

#### *Performance-based fees and side-by-side management*

If you receive performance-based fees (which would include a carried interest) and also manage accounts that are not charged a performance fee, you must explain the conflicts of interest that arise from that arrangement and describe generally how you resolve them.

#### *Methods of analysis, investment strategies, and risk of loss*

This section requires a description of the methods of analysis and investment strategies used by your firm. You also need to explain the material risks involved with each "significant" strategy or method, or particular type of security that you primarily recommend, adding detail if the risks are significant or unusual.

#### *Code of ethics, participation or interest in client transactions, and personal trading*

You must expand upon existing disclosures to explain in more detail the conflicts of interest involved in your practices and how you address them.

#### *Brokerage practices*

The new form solicits significantly more explicit information about a variety of practices, such as how you handle soft dollars, directed brokerage, and block trades, than the current form. It calls for disclosure of how you address specific conflicts of interest inherent in these practices (as well as any other conflicts peculiar to your business).

The narrative disclosures in the brochure need not be speculative. You must only disclose information about practices that you do, or are reasonably likely to, engage in. Similarly, you need only disclose conflicts of interest that you have or are reasonably likely to have. Supplemental information would be provided later in response to a substantial change in your practices.

#### **Contents of the Brochure Supplement**

Depending on the way your advisory business is structured, you may create a combined supplement for an investment team instead of separate supplements for each individual. An adviser that does not expect the advisory personnel to vary by client may wish to include the content of the supplement at the end of the firm brochure.

The supplements must describe how each individual is compensated and provide information about his or her education, work experience, disciplinary history, outside business activities and any compensation based on sales of investment products. If a particular supplement includes professional designations held by an employee, it must also explain what is involved in earning that designation. Each supplement must also describe how the adviser supervises the individual, including how the adviser monitors the advice he or she provides to clients, and provide contact information for the respective individual's supervisor.

If you would like further information or assistance with preparing your brochure and brochure supplements or revising your compliance procedures, please contact one of the attorneys listed below.

BOSTON MA | FT. LAUDERDALE FL | HARTFORD CT | MADISON NJ | NEW YORK NY | NEWPORT BEACH CA | PROVIDENCE RI  
STAMFORD CT | WASHINGTON DC | WEST PALM BEACH FL | WILMINGTON DE | LONDON UK | HONG KONG (ASSOCIATED OFFICE)

This advisory is for guidance only and is not intended to be a substitute for specific legal advice. If you would like further information please contact the Edwards Angell Palmer & Dodge LLP attorney responsible for your matters or one of the attorneys listed below:

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