

The New Form ADV Part 2 and the “Plain English” Movement of the SEC, FINRA, and Michigan’s OFIR

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Introduction

This Article examines the changes to Part 2 of the Form ADV by the United States Securities & Exchange Commission (“SEC”). The SEC requires all investment advisers (“RIAs” or “advisers”) registered with the SEC to complete and file a Form ADV with the SEC and deliver Part 2 of that form to each adviser customer or prospective customer. The Securities Division of the Michigan Office of Financial and Insurance Regulation (“OFIR”), responsible for implementing the state adviser rules and regulations under the Michigan Uniform Securities Act, requires advisers in Michigan to file the same Form ADV and deliver Part 2 to their customers.¹ The Financial Industry Regulatory Authority (“FINRA”), the private regulatory body for broker-dealers, indicates it too wants a disclosure document for broker dealers similar in form and content to the Form ADV Part 2. The SEC, FINRA, and OFIR seek disclosures to financial customers that are written in “plain English.” By examining the details of the new Form ADV Part 2 designed by the SEC, this article provides some practical definition to what the SEC means by “plain English,” and an outline of the new Form ADV Part 2 requirements for advisers and their lawyers.

Relevant Background

The Form ADV is the Heart of an Adviser’s Fiduciary Duty

The securities laws in the United States are not based on regulating the financial merits of securities or securities products—for the most part neither the government nor the SEC will tell the securities industry which securities they can and cannot sell.² Rather, the U.S. securities regulatory regime is premised on disclosure of material facts relating to securities. In other words, U.S. securities laws seek to ensure that the people or entities selling securities adequately disclose “the appropriate facts and terms of the product being sold.”³

When the Investment Advisers Act of 1940 was passed, investment advisers, unlike

broker-dealers, were viewed as fiduciaries to their clients because, according to Congress in 1940, advisers provided “investment advice and counsel to what were perceived as largely less knowledgeable retail customers.”⁴ Broker-dealers, on the other hand, are viewed by Congress in the 1934 Exchange Act as “effect[ing] transactions in securities for the accounts of others” or buying and selling securities for their own accounts.⁵ Thus, broker dealers were viewed in 1934 as order-takers engaging in arm’s-length business transactions with customers, not as fiduciaries. And any investment advice provided by a broker dealer was considered “incidental” to its brokerage function.⁶

The Obama Administration takes the position that broker dealers should be governed by the same fiduciary duties and rules currently governing advisers because “there is no longer a meaningful difference between the broker-dealer that provides ‘incidental advice’ on securities, and the investment adviser who provides ‘primary advice,’ as existed in the 30’s and 40’s.”⁷

Consistent with the theme of U.S. securities regulation, the heart of the SEC’s fiduciary standard for advisers has been a “disclosure-based” regime, rather than a “merits-based” one. In other words, the SEC for the most part will not tell advisers which products and services they can sell, only that the advisers must “make full disclosure of all material conflicts of interest between [the adviser] and [its] clients that could affect the advisory relationship.”⁸

Inadequate disclosures are annually one of the most frequent deficiencies found in SEC adviser exams.⁹ This is one of the most important items the SEC examines because it goes to the heart of the SEC’s priority list—preserving the adviser’s fiduciary duty¹⁰ and avoiding conflicts of interest.

The central disclosure document for advisers is the Form ADV.¹¹ The SEC examinations of RIAs involve a thorough review the adviser’s Form ADV, and then a comparison of the RIA’s actual business and compliance practices discovered during the examination

with how those practices are disclosed and described in the adviser's Form ADV.¹²

What is a Form ADV?

The Form ADV is a requirement of the Investment Advisers Act of 1940 and its implementing SEC regulations.¹³ The Form ADV has two Parts. Part 1 provides basic information about the RIA, such as its legal name, its principal place of business, number of employees, assets under management, etc. Part 2 provides more detail about the RIA's business and must be delivered to each client or prospective client.¹⁴ Part 2 is sometimes called the RIA's "brochure." It is Part 2 of the Form ADV that is the subject of the SEC's recent overhaul, which the SEC has dubbed "the brochure rule."

SEC Staff Study to Congress Recommends Disclosure Document for Broker Dealers "Analogous to Form ADV Part 2"

Congress, in Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd Frank Act"), requires the SEC to complete a study that will determine whether broker dealers should be governed under the same fiduciary standard that governs investment advisers.¹⁵ Section 914 of the Dodd-Frank Act also requires the SEC to study "enhancing investment adviser examinations."¹⁶ The SEC Staff completed the studies in January 2011, and recommended in the Section 913 Study that the SEC adopt a "uniform fiduciary standard of conduct for broker dealers and investment advisers when providing personalized investment advice about securities to retail customers."¹⁷ The SEC Staff analyzed in detail the new Form ADV Part 2 disclosure requirements and recommends that broker-dealers be required to complete a document "analogous to Form ADV Part 2."¹⁸

FINRA Moving Toward Form ADV-Type "Plain English" Disclosure Document for Broker Dealers

Reflecting congressional policy as expressed in Dodd-Frank, and the position of the SEC Staff and some SEC commissioners who want to treat broker dealers more like investment advisers, the Financial Industry Regulatory Authority ("FINRA") is seeking comment on its concept proposal to create a disclosure document for broker dealers "similar in purpose to [the] Form ADV."¹⁹ Currently, FINRA is a self-regulatory organization for registered broker-dealers. Similar to the new SEC Form ADV, FINRA proposes a disclo-

sure document for broker dealers "that sets forth in plain English a firm's accounts and services, its associated conflicts of interest and any limitations on duties owed to the customer."²⁰

FINRA has also recommended to the SEC to "establish one or more self regulatory organizations (SROs) for investment advisers" in order to "augment the government's efforts in overseeing advisers...."²¹ FINRA cites the small percentage of advisory examinations completed by the SEC, the lack of SEC resources, and the benefits of SRO oversight as reasons supporting FINRA's position.²² However, many advisers think that the SEC is better suited than an SRO to regulate advisers because SRO examiners lack the benefit of the SEC's internal knowledge and experience, and the SEC (unlike an SRO) is "directly accountable to Congress and the public."²³ The Investment Adviser Association objects to SRO oversight of advisers, cautioning the SEC not to equate more frequent SRO examinations with quality of oversight.²⁴

The SEC Staff recommends in its January 2011 study, completed pursuant to Section 914 of the Dodd Frank Act, that Congress consider three approaches to the SEC's RIA examination program: "(1) Authorize the Commission to impose user fees on SEC-registered investment advisers to fund their examinations by [the SEC Office of Compliance Inspections and Examinations]; (2) Authorize one or more SROs to examine, subject to SEC oversight, all SEC-registered investment advisers; or (3) Authorize FINRA to examine dual registrants for compliance with the Advisers Act."²⁵

Michigan Adopts the New Form ADV Part 2 and the "Plain English" Movement

The Michigan Office of Financial and Insurance Regulation is charged with issuing and administering rules to implement the Michigan Uniform Securities Act of 2002 ("MUSA"), which was adopted effective October 1, 2009.²⁶ To that end, OFIR has issued a series of transition orders that include various rules and regulations for investment advisers under MUSA.²⁷ In December 2009, pursuant to its authority under section 411(7) of MUSA, OFIR issued a transition order requiring advisers registered with OFIR to deliver to clients and prospective clients "a copy of Part II of the investment adviser's Form ADV or a written document containing at least the information required by Part II of the Form ADV."²⁸ After the SEC issued its new requirements for the Form ADV Part

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2, OFIR adopted the SEC rule with specific dates for Michigan advisers to comply with the new SEC requirements.²⁹ OFIR notes that the new Form ADV Part 2 narrative disclosures should be “written in plain English.”³⁰

The New Form ADV Part 2

In General

The new Form ADV Part 2 is a whole new ball game. Prior to the SEC amendment, Form ADV Part 2 was essentially a “check-the-box” form, with the option of providing any necessary supplementary narrative in a “Continuation Sheet” at “Schedule F.” The prior Form ADV Part 2 contained fourteen specific items in a “check-the-box” format.

Recognizing that the Form ADV Part 2 had become outdated, the SEC has worked over the last decade to propose changes to it. This effort has culminated in an SEC Final Rule amending the Form ADV Part 2.

The SEC’s goal was to make the Form ADV Part 2 more understandable to adviser customers and better enable them to compare the costs, risks, and services of different advisers. Thus, the new Form ADV Part 2 is entirely narrative—the SEC has discarded the “check-the-box” form. The SEC directs RIAs to provide narrative disclosures in 18 specified subject headings, which must be “written in plain English,” a newly defined term by the SEC.³¹

Timing of the Amendments

RIAs currently registered with the SEC, and whose fiscal year ends on or after December 31, 2010, must file a Form ADV Part 2 that conforms to the new amendments on or before March 31, 2011. The SEC has extended the delivery date of the brochure supplement to new and prospective clients to July 31, 2011, and existing clients to September 30, 2011.³² The RIA must also deliver to existing clients the revised Form ADV Part 2, or a firm brochure that meets the new SEC disclosure requirements, within 60 days of filing the amended Part 2 with the SEC. RIAs must “begin to deliver” the new Part 2 brochure to clients and prospective clients “after the initial filing with the SEC,” or the RIA will not “satisfy its obligations” under the new brochure rule.³³ In other words, they will be out of compliance. Advisers in Michigan must file the new Form ADV application materials with OFIR on or before January 1, 2011, and have the revised Form ADV submitted on or before April 1, 2011.³⁴

Summary of Significant Changes

18 Narrative Disclosure Items

Part 2A contains “18 disclosure items about the advisory firm that must be included in the adviser’s brochure.”³⁵ Each of these new disclosure items is summarized below in the section entitled “Summary of Material Terms of the New Disclosure Items and Requirements.” Although narrative, each category is standardized to allow customers to more readily compare the costs and services of different advisers.

Brochure Supplement Disclosing Individual Advisory Personnel

Part 2B is a “brochure supplement” that must contain certain information about “advisory personnel on whom clients rely for investment advice.”³⁶ The brochure supplement is also a narrative format and includes six required disclosure categories: cover page, educational background and business experience, disciplinary information, other business activities, additional compensation, and supervision.³⁷ The brochure supplement disclosure must be provided for each supervised person who:

- “formulates investment advice for a client and has direct client contact,” or
- “has discretionary authority over a client’s assets, even if the supervised person has no direct client contact.”³⁸

Plain English Narrative Disclosures

The SEC requires RIAs to draft the new brochure and brochure supplement item narratives in “plain English.”³⁹ The term is defined in the General Instructions for Part 2 as follows:

Plain English. The items in Part 2 of Form ADV are designed to promote effective communication between you and your *clients*. Write your *brochure* and supplements in plain English, taking into consideration your *clients’* level of financial sophistication. Your *brochure* should be concise and direct. In drafting your *brochure* and *brochure supplements*, you should: (i) use short sentences; (ii) use definite, concrete, everyday words; (iii) use active voice; (iv) use tables or bullet lists for complex material, whenever possible; (v) avoid legal jargon or highly technical business terms unless you explain them or you believe that your *clients* will understand them; and (vi) avoid multiple negatives. Consider providing examples to illustrate a description of your practices or policies. The

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brochure should discuss only conflicts the adviser has or is reasonably likely to have, and practices in which it engages 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 disclosure must be provided to clients to obtain their consent. If you have a conflict or engage in a practice with respect to some (but not all) types of classes of clients, advice, or transactions, indicate as such rather than disclosing that you “may” have the conflict or engage in the practice.⁴⁰

The SEC believes clients want to know whether an RIA has a specialized advisory service in considering whether to hire an RIA, and requires that it be listed.

Immediately after this definition, the SEC references its August 1998 publication entitled: “A Plain English Handbook: How to Create Clear SEC Disclosure Documents.”⁴¹ Though tailored more towards corporate SEC financial statements and prospectuses, the SEC’s publication provides some excellent examples of how to craft “plain English” disclosures, with specific “before and after” examples of some particularly complex disclosures.

Disclosure of Disciplinary History to Customers and Prospective Customers

Item 9 of the new Form ADV Part 2 requires disclosure of certain disciplinary information about the adviser, its personnel, or its affiliates. However, the SEC has determined that arbitration awards can be presumptively excluded from the adviser’s disciplinary history, *unless* the award “reflects on the integrity of the adviser and should be disclosed in the brochure or by other means.”⁴² Historically, advisers only needed to disclose their disciplinary history on Part 1 of the ADV, which was not required to be disclosed to customers. Item 9 rescinds Rule 206(4)-4, which historically contained disciplinary disclosure requirements for advisers. So Item 9 marks a significant change for advisers.

Summary of Material Terms of the New Disclosure Items and Requirements

Introduction

This Section discusses changes to the three main sections of the Form ADV Part 2: Brochure Items (Part 2A); Wrap Free Program Brochure (Part 2A, Appendix 1); and Brochure Supplement Items (Part 2B).

Part 2A: Brochure Items

Cover Page

An adviser must include basic identifying information about the firm—business address, contact information, phone number, Web address, etc. At the request of larger firms, the SEC did not require listing the name and phone number of the specific individual or service center responsible for the client’s account for questions about the brochure because this would prove “cumbersome.” RIAs must note that the brochure has not been approved by the SEC or any state securities authority. And if the RIA describes itself as a “registered investment adviser” in the cover page, “it also must include a disclaimer that registration does not imply a certain level of skill or training.”⁴³

Material Changes

RIAs must include in the cover page or as a separate document a list and discussion of the “material changes” since the RIA’s last annual update. “This item is designed to make clients aware of information that has changed since the prior year’s brochure and that may be important to them.”⁴⁴

The SEC defines “material changes” in accordance with the definition of that term as developed by the courts—whether there is a substantial likelihood that a reasonable customer would consider the information important in the “total mix of information” available.⁴⁵ The SEC cautions advisers to “broadly discuss” material changes and not include a “lengthy discussion that replicates the brochure itself.”⁴⁶ The SEC notes the material change summary “need contain no more than 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.”⁴⁷

Table of Contents

Item 3 requires RIAs to include a uniform table of contents detailed enough to permit customers to locate the 18 item descriptions easily. The SEC thinks this “will facilitate investors’ comparison of multiple advisers.”⁴⁸

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.”⁴⁹ RIAs can use the “assets under management” (AUM) formula provided by the SEC or another formula as long as the RIA keeps appropriate documen-

tation. RIAs must update their AUM annually, or on an interim basis, if there are “material changes” to an RIA’s AUM.⁵⁰

The SEC believes clients want to know whether an RIA has a specialized advisory service in considering whether to hire an RIA, and requires that it be listed.⁵¹

Fees and Compensation

RIAs must disclose the following related to their fees and compensation:

- how it’s compensated for providing advisory services
- its fee schedule
- whether the fees are negotiable
- whether the RIA bills clients or deducts fees directly from their accounts, and how often clients are billed or charged
- other costs such as brokerage, custody, or fund expenses
- if the RIA charges fees in advance, it “must explain how it calculates and refunds prepaid fees when a client contract terminates”
- if the RIA is paid fees attributable to the sale of a certain product (brokerage commissions, etc.), then the RIA must disclose this practice, the conflict it creates, how the adviser addresses the conflict, and that the product is available from a broker that is not affiliated with the RIA.⁵²

However, RIAs do not have to make these standard fee disclosures to “qualified purchasers” as defined under section 2(a)(51)(A) of the Investment Company Act—“natural persons who own \$5 million or more in investments and persons who manage \$25 million or more in investments for their own account or other accounts of other qualified purchasers.”⁵³ The SEC provides the “qualified purchaser” exception because it believes larger institutional or more sophisticated investors are in a position to negotiate different fee arrangements and for whom standard fee tables would have “little utility.”⁵⁴

Performance-Based Fees and Side-by-Side Management

RIAs must disclose if they charge “performance-based” fees—compensation based on the performance of an account or investment strategy, rather than simply an asset-based fee. If the RIA simultaneously manages both performance and nonperformance-based accounts, it must disclose this fact and generally describe how it addresses these conflicts. According to the SEC, because an RIA has the potential for greater fees from accounts with a performance-based structure, RIAs have an incentive to “direct the best invest-

ment ideas” or most favorable “sequence of trades” in a performance-based account and must disclose this conflict. The SEC lists various enforcement actions it has brought against RIAs that fail to disclose this conflict.⁵⁵

Types of Clients

“Item 7 requires that the brochure describe the types of advisory clients the firm generally has [e.g., individuals, trusts, pension plans, etc.], as well as the firm’s requirements for opening or maintaining an account, such as minimum account size.”⁵⁶

Methods of Analysis, Investment Strategies and Risk of Loss

Item 8 requires an adviser to describe its “methods of analysis and investment strategies,” “significant or unusual risks” of loss with those strategies, and if the RIA’s strategy involves “frequent trading,” how that can affect investment performance.⁵⁷

An adviser must describe its investment strategies “for each *significant* investment strategy,” rather than only those primarily used by the RIA.

The SEC defines “significant or unusual risks” as follows: the “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.”⁵⁸

The SEC defines “frequent trading strategies” as those that “involve frequent trading of securities that a reasonable client would otherwise not expect in light of the other disclosures contained in the brochure.”⁵⁹

Disciplinary Information

As discussed above, Item 9 rescinds SEC Rule 206(4)-4, the previous rule governing adviser disciplinary information.⁶⁰ Item 9 requires disclosure of “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.”⁶¹ Disclosing disciplinary information in Part 2, which is provided to customers and prospective customers, is a significant change from the prior practice of only including it in Part 1.

Items 9A-C provide a nonexhaustive list of disciplinary events that are presumptively material, which include “convictions for theft, fraud, bribery, perjury, forgery, counterfeiting, extortion and violations of securities laws by the adviser or one of its executives.”⁶²

RIAs may rebut the presumption that the disciplinary events listed in Item 9 should be disclosed, in which case the disclosure is

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not required. “An adviser rebutting this presumption must document its determination in a memorandum and retain that record to enable [the SEC] staff to monitor compliance with this important disclosure requirement.”⁶³

Because arbitration claims are relatively easy to make, and because arbitration awards may not contain findings of wrongdoing, the SEC does not require RIAs to disclose arbitration awards in Item 9. But the SEC does not provide this exception without a warning: “Advisers should, however, carefully consider whether particular arbitration awards or settlements do, in fact, involve or implicate wrongdoing and/or reflect on the integrity of the adviser, and should be disclosed to clients in the brochure or through other means.”⁶⁴ Moreover, Item 18 requires disclosure of any arbitration award “sufficiently large that payment of it would” create a financial condition that would be “reasonably likely to impair the adviser’s ability to meet contractual commitments to clients....”⁶⁵ Item 19 requires an adviser registered with any state securities authority to disclose an arbitration award alleging damages in excess of \$2,500 and which involves certain investment-related activity, fraud, theft, bribery, or dishonest practices.⁶⁶

Other Financial Industry Activities and Affiliations

Item 10 requires RIAs to disclose any “material relationships or arrangements” it or its management persons have with “related financial industry participants” (broker dealers, investment companies, banks, accountants or lawyers, pension consultants, etc.), any “material” conflicts these relationships or arrangements create, and how the RIA addresses the conflicts. RIAs must disclose if they are paid compensation for recommending or referring other advisers, the conflicts this practice creates, and how the RIA addresses those conflicts.⁶⁷

The SEC is under intense scrutiny as a result of Bernard Madoff’s inappropriate use of adviser and broker-dealer affiliates and other unregistered entities to conceal sources, custody, and flow of investor assets—what the SEC has dubbed “affinity frauds.” Therefore, the SEC is targeting for examination advisers that are also registered as broker-dealers, advisers that use affiliates to provide brokerage and advisory services, or where there is a flow of funds between or among registered and unregistered entities.⁶⁸ The SEC Director of Compliance Inspections and Examinations has also indicated that the SEC will refer examinations to the Enforcement Division if the

examiners cannot determine or understand the relationship or flow of funds among the various entities:

[W]e recently expanded exams of joint or dual registrants to assure that we have ‘eyes on’ all activities, particularly advisers that use an affiliated broker-dealer for custody of advisory clients’ assets. *Firms should also expect to be asked about any overlap between registered and unregistered entities, particularly where we see the flow of funds between registered and unregistered entities, and any indication that the firm is seeking to conceal fraudulent activity in an unregistered entity. In situations where examiners can’t get comfortable with what they see and don’t see and there are any indicators of possible fraud, we will make a referral to enforcement staff so that the matter can be investigated.*⁶⁹

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

Item 11 is similar to the disclosures required by Item 9 of the previous Part 2.

Code of Ethics: Item 11.A requires advisers to provide a “brief, concise summary of the code of ethics” for prospective clients who may not want to request or read the entire code of ethics, or may help them determine if they should.⁷⁰

Participation or Interest in Client Transactions: Item 11.B requires advisers to disclose when they or a related person have a “material financial interest” in securities the adviser recommends or buys and sells for a client’s account. The adviser must disclose these conflicts, explain their nature, and how the adviser will address them.⁷¹

Personal trading: Item 11.C requires RIAs to disclose whether they or a related person invests or is permitted to invest in the same or related securities as those the RIA is recommending to the client. In addition, the RIA must describe how it addresses this conflict. Item 11.D requires RIAs to disclose when they or related persons make trades in the same securities as the client at or about the same time. Thus, Item 11.C discusses the RIA’s personal trading of securities similar to those of the client, and Item 11.D discusses the timing of that trading. Item 11 only requires disclosure of “reportable securities” under Rule 204A-1(e)-10.⁷²

Brokerage Practices

RIAs must describe how they select brokers for transactions and determine the reasonableness of the brokers’ compensation, as defined in four categories.

Congress created a “safe-harbor,” exempting advisers from liability for breach of fiduciary duty under the Adviser’s Act as long as certain soft-dollar fee-setting and disclosure requirements are met.

Soft Dollar Practices: Generally, a soft dollar arrangement is one where an adviser pays a broker a commission or fee for one or a bundle of brokerage services, such as research, execution, etc. Directing client transactions to brokers in exchange for these soft dollar benefits creates incentives (and thus conflicts) for RIAs to direct brokerage transactions to that broker. Thus, RIAs must specifically describe these arrangements in Item 12.A.1.⁷³

Congress created a “safe-harbor,” exempting advisers from liability for breach of fiduciary duty under the Adviser’s Act as long as certain soft-dollar fee-setting and disclosure requirements are met.⁷⁴ RIAs must make more detailed disclosures for products or services that do not qualify for safe harbor than for those that do.⁷⁵

Client Referrals: “If an adviser uses client brokerage to compensate or otherwise reward brokers for client referrals, it must disclose this practice, the conflicts 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).”⁷⁶

Directed Brokerage: If an RIA permits clients to direct brokerage in their own accounts, Item 12.A.3 requires the RIA to disclose that it may not be able to obtain best execution or the best prices for the customer. But the RIA need not make this disclosure if directed brokerage arrangements “are only conducted subject to the adviser’s ability to obtain best execution.”⁷⁷

Trade Aggregation: Item 12.B requires an adviser to describe when and how it “aggregates trades to obtain volume discounts on execution costs.” The adviser must also disclose when it does not aggregate trades when it has the opportunity to do so, and that this practice may cause clients to pay higher brokerage costs.⁷⁸

Review of Accounts

“Item 13 requires that an adviser disclose whether, and how often, it reviews clients’ accounts or financial plans, and identify who conducts the review. An adviser that reviews accounts other than regularly must explain what circumstances trigger an account review.”⁷⁹

Client Referrals and Other Compensation

An adviser must disclose all arrangements where it or a related person compensates a third party (lawyer, accountant, etc.) for client referrals. Rule 206(4)-3 (“solicitation rule”) only requires disclosure of referral fees (as opposed to non-cash benefits), and only

requires disclosure by the solicitor and not the adviser. So Item 14 goes a step beyond Rule 206(4)-3.⁸⁰

RIAs must also disclose any economic benefit they receive (fees, sales awards, prizes) for providing advisory services to clients from “a person who is not a client.”⁸¹

Custody

An adviser with custody of client funds or securities is required to explain that the client will receive monthly or quarterly account statements from the custodian bank, broker dealer, etc., and that the client should carefully review these statements. If the RIA provides its own account statements to the customer, the RIA must include a statement “urging” clients to compare the account statements from the custodian with those from the adviser to determine whether account transactions, fees, or deductions are proper.⁸²

The SEC has issued detailed rules addressing an adviser’s duties regarding custody of client funds, whether the adviser or another entity acts as custodian over those funds.⁸³ The Madoff debacle has put pressure on the SEC to ensure advisers are closely monitoring the custodians of customer funds. Thus, SEC examiners are focusing on reviewing an adviser’s controls over custody. “The ultimate goal is to attain a high level of confidence that the transactions and portfolio positions reported to clients by the adviser fully and fairly reflect the actual investments and transactions made by the adviser.”⁸⁴

The SEC Director of Compliance Inspections and Examinations has outlined suggested steps advisers can take to ensure compliance with the SEC’s custody rules:

- Obtain custodian statements from the custodian.
- Compare custodian statements to advisory records.
- Review the adviser’s reconciliation process—comparing the transactions and portfolio positions on the custodian statements with the adviser’s books and records for consistency.
- Periodically review client account statements sent by the adviser to ensure the transactions and positions reported and the names and addresses of the clients are consistent with the reports of the custodian.⁸⁵

Investment Discretion

An adviser must disclose if it has discretionary authority over client accounts, and any limitations clients may place on the adviser’s discretionary authority. If the RIA discloses

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this information in Item 4's description of the advisory business, the RIA in Item 16 may simply refer to its response in Item 4.⁸⁶

Voting Client Securities

This item parallels Rule 206(4)-6.⁸⁷ The RIA must disclose whether it accepts authority to vote client securities and, if so, describe the voting policies and conflicts attendant to the adviser's proxy authority. If the RIA does not accept a client's proxy authority, the RIA must disclose this and disclose how clients can receive their proxies and other solicitations.⁸⁸

Financial Information

Under Item 18.A, if an RIA requires clients to prepay more than \$1,200 in fees six months or more in advance, the RIA must provide clients with an audited balance sheet, in accordance with GAAP, that shows "the adviser's assets and liabilities at the end of its most recent fiscal year."⁸⁹

Under Item 18.B, if an RIA has discretionary authority or custody of client funds or securities, or the RIA requires clients to prepay more than \$1,200 in fees six months or more in advance, the RIA must disclose "any financial condition that is reasonably likely to impair your ability to meet contractual commitments to clients." As an example, the SEC indicates that disclosure may be required of any arbitration award "sufficiently large that payment of it would create such a financial condition."⁹⁰

Item 18.C requires disclosure of any bankruptcy petition by the RIA during the past ten years.⁹¹

The SEC ends with a cautionary statement to advisers that "their 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."⁹²

Part 2A, Appx. 1: The Wrap Fee Program Brochure

A "wrap fee program" is an instance when an RIA provides a suite of services for a specific fee that is "not based directly upon transactions in a client's account for investment advisory services...and execution of client transactions."⁹³ The services provided in wrap fee programs include, among others, "portfolio management or advice concerning the selection of other investment advisers."⁹⁴

RIAs that sponsor wrap fee programs will continue to be required to prepare and deliver to wrap fee clients a separate "wrap fee program brochure" in lieu of the RIA's standard brochure. Although the required

disclosures in the wrap fee brochure are substantially similar to the previous disclosures required by Schedule H in the previous Part 2, the requirements of Schedule H have been modified to incorporate many of the amendments contained in the new Form ADV Part 2. So, the wrap fee brochure, similar to the standard brochure, contains the following required disclose items:

- Cover Page
- Material Changes
- Table of Contents
- Services, Fees and Compensation
- Account Requirements and Types of Clients
- Portfolio Manager Selection and Evaluation
- Client Information Provided to Portfolio Managers
- Client Contacts with Portfolio Managers
- Additional Information⁹⁵

But the SEC is including one additional disclosure requirement for RIAs offering wrap fee programs that "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."⁹⁶ The SEC says RIAs have incentives to select one of their related persons to serve as the portfolio manager for the wrap fee program because of that person's affiliation with the RIA "rather than based on expertise or performance." So the new rule requires RIAs 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."⁹⁷

The SEC will permit a wrap fee program sponsor to deliver the RIA's wrap fee brochures to customers and maintain those records provided the sponsor is able to "promptly" produce the wrap fee records to the SEC staff at the office of either the sponsor or the RIA. Moreover, the SEC is clear that the legal obligation to deliver the wrap fee brochure remains with the RIA, and thus the RIA should confirm that the delivery task has been delegated appropriately.⁹⁸

Part 2B: Brochure Supplement Items

The brochure supplement will provide information on all supervisory persons who provide advisory services to the client, as opposed to only listing senior management or executives.⁹⁹

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The brochure supplement disclosure must be provided for each supervised person who:

- “formulates investment advice for a client and has direct client contact,” or
- “has discretionary authority over a client’s assets, even if the supervised person has no direct client contact.”¹⁰⁰

A supplement is not required if a supervised person has no direct client contact “and has discretionary authority over a client’s assets *only* as part of a team.”¹⁰¹ And if the team providing discretionary advice to clients is comprised of more than five supervised persons, the supplement need only provide information about “the five supervised persons with *the most significant responsibility* for the *day-to-day discretionary advice* provided to the client.”¹⁰²

The brochure supplement must include information in six categories about each supervised person covered by the Rule:

1. *Cover Page*. The cover page must include “information identifying the supervised person (or persons) covered by the supplement as well as the advisory firm.”¹⁰³

2. *Educational Background and Business Experience*. Item 2 requires the following information on each supervised person:

- Formal education
- Business background for the last five years, which must include specific positions at prior employers and not simply a list of prior employers
- A disclosure that the supervised person does *not* have either: 1) a high school education; 2) no formal education after high school; or 3) no business background.¹⁰⁴

The SEC does not require a supervised person to list any professional designations because the SEC does not want to be seen as endorsing them. But if a supervised person does list his or her professional designations, the supplement must also include “a sufficient explanation of the minimum qualifications required for the designation to allow clients and potential clients to understand the value of the designation.”¹⁰⁵

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.”¹⁰⁶ This item lists certain legal or disciplinary events that are presumed material, which parallel the list contained in Item 9 of Part 2A of the brochure. Supervised persons may include in the supplement brochure a hyperlink to a disciplinary disclosure contained on either

FINRA’s BrokerCheck¹⁰⁷ or the SEC’s Investment Adviser Public Disclosure (“IAPD”)¹⁰⁸ Web site. If the link is provided, the brochure must note that the supervised person does have a disciplinary history that can be found at the site and a hyperlink with an explanation of how the client can access the disciplinary history.¹⁰⁹

4. *Other Business Activities*. The supervised person must disclose the following activities:

- Any investment related business and “any material conflicts of interest such participation may create;”¹¹⁰
- Any cash and non-cash compensation the supervised person receives for selling any investment or securities product, and an explanation of the investives this compensation scheme creates to sell these products;
- Any business activity or occupation that involves a “substantial amount of time or pay.” The SEC does not define substantial because it is subject to the specific facts and circumstances of the supervised person and the RIA. But the SEC does note that an activity or compensation is presumed not substantial if its represents “less than 10 percent of the supervised person’s time and income.”¹¹¹

5. *Additional Compensation*. “This item requires that the supplement describe arrangements in which someone other than the client gives the supervised person an economic benefit (such as a sales award or other prize) for providing advisory services.”¹¹²

6. *Supervision*. An adviser must describe in the supplement how it “monitors the advice provided by the supervised person addressed in the brochure supplement.” Item 6 also requires that the RIA provide customers with “the name, title, and telephone number of the person responsible for supervising the advisory activities of the supervised person.”¹¹³

Delivery and Updating Requirements

Delivery to Clients

In General

The SEC has amended Rule 204-3¹¹⁴ to require an RIA to deliver a current brochure “before or at the time it enters into an advisory contract with the client.”¹¹⁵ RIAs are *not* required to deliver a brochure to clients receiving only “impersonal advisory services” as defined under Rule 204-3(g)(1), clients who are invest-

The SEC has amended Rule 204-3 to require an RIA to deliver a current brochure “before or at the time it enters into an advisory contract with the client.”

ment companies registered under the Investment Company Act of 1940, or clients who are business development companies subject to section 15(c) of the Investment Company Act.¹¹⁶ OFIR “strongly encourages” Michigan advisers to follow the “amended requirements for preparing, delivering, and offering the new Form ADV Part 2” as set forth in the SEC instructions for the new form, including electronic filing using FINRA’s Investment Adviser Registration Depository (“IARD”).¹¹⁷

Annual Delivery

Each year, within 120 days after the end of the RIA’s fiscal year, the RIA must deliver to each client either: 1) a current and updated copy of the brochure and a summary of material changes; or 2) a summary of material changes “that includes an offer to provide a copy of the current brochure.”¹¹⁸ An adviser may offer to provide its brochure or summary of material changes electronically pursuant to the SEC’s electronic delivery guidelines.¹¹⁹ This delivery requirement seeks to avoid clients relying on “stale” brochures.¹²⁰

Interim Delivery

Whenever an RIA amends its brochure to add a disciplinary event, or changes material information previously disclosed, RIAs must “promptly” deliver to clients an updated brochure or a document “describing the material facts relating to the amended disciplinary event.”¹²¹

Updating Part 2A Brochure

Consistent with current rules, RIAs must update their Form ADV Part 2A at least annually, and promptly, if any information becomes materially inaccurate. But material changes to assets under management and the summary of material changes need only be filed annually, even if they become materially inaccurate in the interim, *unless* the RIA is amending Part 2A for a separate reason between annual amendments *and* the RIA’s assets under management has become materially inaccurate.¹²²

RIAs need not file or deliver an annual amendment or a summary of material changes if it has not filed any interim amendment since the brochure’s last annual update, and “the brochure continues to be accurate in all material respects.”¹²³

RIAs will make annual and interim updates to their brochures on their own computer systems and then submit the revised brochure through the SEC’s IARD. Only the most recent version of the RIA’s brochure will be available to the public through the

IARD system, although previously filed versions of the RIA’s brochure will remain on the IARD system.

Updating Part 2B Supplement

Updated supplements are not required to be delivered annually. Instead, RIAs must “promptly” deliver an amended supplement to clients “only when there is a new disclosure of a disciplinary event, or a material change to the disciplinary information already disclosed in response to Item 3 of Part 2B.”¹²⁴ Like brochures, supplements can be delivered electronically.¹²⁵

Special Problems for Fund Managers Under the New Form ADV Rule

Dodd-Frank requires various hedge and private equity fund managers to register as investment advisers and file the new Form ADV Part 2. Fund managers have as clients the investment funds into which investors invest, not the investors themselves. Commentators argue that the Form ADV is geared toward advisers that contract directly with client investors, and thus its requirements are not well-suited to the fund business model.¹²⁶

One example of this incongruity is the disclosure requirements related to client referrals. Sometimes a fund adviser compensates someone for referring investors to the investment fund. But because the fund investors are not “clients” of the adviser (the fund is), it is unclear whether the fund adviser must disclose these referrals as “client referrals” called for by Item 14 of Part 2A.¹²⁷

Another example of the incongruity of the brochure rules as applied to fund advisers are the custody rules. Commentators argue that the custody rules and disclosures in Part 2A and under the Advisers Act do not directly address certain fund custody arrangements, such as where the fund adviser relies on third-party audits of its fund customers to address asset custody issues.¹²⁸

Conclusion

The Form ADV Part 2 is arguably the most critical disclosure document for investment advisers; and it may soon be for broker-dealers. It will be interesting to watch the disclosure rules and issues develop as advisers begin complying with the new brochure and brochure supplement rules, and brokers navigate into the advisory sphere.

NOTES

1. Generally, advisers with assets under management of over \$100 million are exempt from registration with the State of Michigan under Michigan Uniform Securities Act and must file with the SEC. *See* Dodd-Frank Act, §410(2)(B)(i)-(ii); MCL 451.2402(f); 451.2102a(e)(v). Investment Companies, Venture Capital Funds, and Family Office advisers have their own SEC registration requirements and exemptions. *See, e.g.*, Dodd-Frank, §§407-409.
2. *See* Matthew P. Allen, *A Lesson From History, Roosevelt to Obama — The Evolution of Broker-Dealer Regulation: From Self-Regulation, Arbitration, and Suitability to Federal Regulation, Litigation, and Fiduciary Duty*, Moritz College of Law, Ohio State University, *Entrepreneurial Bus LJ*, Vol 5. No. 1 (2010), at 20-21.
3. *Id.*
4. *Id.* at 24.
5. *See* Allen, *supra* note 2, at 21 (quoting 15 USC 78c(a)(4)-(5)).
6. *See id.* at 21-22.
7. Allen, *supra* note 2, at 36 (citing U.S. Treasury, Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation (2009), at 71 (“Obama Whitepaper”).
8. SEC Release No. IA-3060, *Amendments to Form ADV* (Final Rule, Aug. 12, 2010), 75 FR 49234, 49287.
9. *See* SEC Director of Compliance Inspections and Examinations, Mar 12, 2009 speech.
10. The SEC Director of Compliance Inspections and Examinations described the adviser’s fiduciary duty as encompassing five major responsibilities: 1) put the clients’ interests first; 2) act with utmost good faith; 3) provide full and fair disclosure of all material facts; 4) don’t mislead clients; and 5) expose all conflicts of interest to clients. *See* SEC Director of Compliance Inspections and Examinations, Feb 27, 2006 speech; *SEC v Capital Gains*, 375 US 180 (1963).
11. *See* 17 CFR 275.204-3.
12. *See* SEC Director of Compliance Inspections and Examinations, Feb 27, 2006 speech
13. *See* 15 USC 80b-3; 17 CFR 275.204-3.
14. *See* 17 CFR 275.204-3(a).
15. Dodd-Frank, §913.
16. Dodd-Frank, §914.
17. SEC Staff Study on Investment Advisers and Broker-Dealers (“Section 913 Study”), at 165 (Jan. 2011).
18. *Id.* at 116.
19. FINRA Notice 10-54 (Oct. 2010).
20. *Id.*
21. Letter from FINRA Chairman and CEO Richard Ketchum to SEC, *Commission Study on Enhancing Investment Adviser Examinations Mandated by Section 914 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd Frank”)*, at 1-2 (Nov. 2, 2010).
22. *See id.*; Suzanne Barlyn, *Self-Regulator Ready to Step Up On Investment Advisers*, *Wall St. J*, C7 (Nov. 8, 2010).
23. Barlyn, *supra* note 22; *see also* Mark Schoeff Jr., *Who Should Oversee Advisers? FINRA, IAA Square Off*, *Investment News* (Oct 27, 2010).
24. *See* Barlyn, *supra* note 22; Schoeff, *supra* note 21.
25. SEC Staff Study on Enhancing Investment Adviser Examinations (“Section 914 Study”), at 39 (Jan. 2011).
26. *See* MCL 451.2605; 451.2701.
27. *See In re Transition Order Administering the Michigan Uniform Securities Act*, OFIR Order No. 09-049-M (Sept. 1, 2009).
28. Third Transition Order Administering [MUSA], OFIR Order No. 09-070-M (Dec. 18, 2009), ¶10 (citing MCL 451.2411(7)).
29. Letter from OFIR Investment Adviser Specialist (Oct 7, 2010).
30. *Id.*
31. *See* 75 FR 49234, 49287 (general instructions for new Form ADV Part II).
32. SEC Release No. IA-3129, *Amendments to Form ADV; Extension of Compliance Date* (Dec. 28, 2010).
33. *See* 75 FR 49234, 49254.
34. *See* Letter from OFIR Investment Adviser Specialist (Oct 7, 2010).
35. 75 FR 49234, 49235.
36. *Id.*
37. *See id.* at 49249-51.
38. *Id.* at 49307.
39. *Id.* at 49234.
40. *Id.* at 49287. The SEC’s Office of Investor Education and Advocacy has published *A Plain English Handbook*.
41. www.sec.gov/news/extra/handbook.htm. OFIR references the SEC Plain English Handbook and this website in its October 7, 2010 letter adopting the new SEC Form ADV rule. *See supra* note 29.
42. 75 FR 49234, 49240 (Item 9).
43. *Id.* at 49236 (Item 1).
44. *Id.*
45. *See id.* at 49237 & n35.
46. *Id.* at 49237.
47. *Id.* at 49236-37 (Item 2).
48. *Id.* at 49237 (Item 3).
49. *Id.* at 49237 (Item 4).
50. *See* SEC Release No. IA-3110, *Rules Implementing Amendments to Investment Advisers Act of 1940* (Nov. 19, 2010) (discussing changes to calculations and methodologies for determining “assets under management,” now referred to by the SEC as “regulatory assets under management.”).
51. *See* 75 FR 49234, 49237.
52. *See id.* at 49238 (Item 5).
53. *Id.* at 49238 n59 (citing 15 USC 80a-2(a)(51)(A)).
54. *Id.* at 49238.
55. *See id.* at 49238-39 & n67 (Item 6).
56. *Id.* at 49239 (Item 7).
57. *See id.* at 49239 (Item 8).
58. *Id.* at 49239-40.
59. *Id.* at 49239.
60. *See* 17 CFR 275.206(4)-4; *see also* 75 FR 49234, 49241 (Item 9) (expressly rescinding Rule 206(4)-4 effective on the date RIAs must deliver their new Form ADV Part 2 to clients and prospective clients).
61. 75 FR 49234, 49240 (Item 9).
62. *Id.*
63. *Id.*
64. *Id.*
65. 75 FR 49234, 49245 (Item 18) (Financial Information).
66. *See id.* at 49300-01 (Item 19) (Requirements for State-Registered Advisers).
67. *See id.* at 49241, 49296 (Item 10).
68. *See* SEC Director of Compliance Inspections and Examinations, June 17, 2009 speech
69. SEC Director of Compliance Inspections and Examinations, June 17, 2009 speech (emphasis added).
70. *See* 75 FR 49234, 49241-42 (Item 11).
71. *See id.* at 49242.

72. *See* 49241-42.
 73. *See id.* at 49242-43; 49297-98 (Item 12).
 74. 15 USC 78bb(e); SEC Release 34-45194, Interpretive Guidance on the Scope of Section 28(e) [safe harbor provision] of the Exchange Act (Dec 27, 2001); SEC Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds (Sept 22, 1998).
 75. *See* 75 FR 49234, 49242-43 (Item 12) (Soft Dollar Practices).
 76. *Id.* at 49243 (Item 12) (Client Referrals); 49298 (Item 12.A.2).
 77. *Id.* at 49243 (Item 12) (Directed Brokerage).
 78. *See id.* at 49244 (Item 12) (Trade Aggregation).
 79. *Id.* at 49244 (Item 13).
 80. *See id.* at 49244 & n161 (Item 14).
 81. *Id.* at 49244 (Item 14).
 82. *See id.* at 49244 (Item 15).
 83. *See* 17 CFR 275.206(4)-2.
 84. SEC Director of Compliance Inspections and Examinations, Mar 12, 2009 speech.
 85. *Id.*
 86. *See* 75 FR 49234, 49244-45 (Item 16).
 87. 17 CFR 275.206(4)-6.
 88. *See* 75 FR 49234, 49245 (Item 17).
 89. *Id.* at 49245; 49300 (Item 18).
 90. *Id.* at 49245.
 91. *See id.*
 92. *Id.* at 49245 (Item 18); *see also id.* at 49300 (Item 18).
 93. 17 CFR 275.204-3(g)(4); 75 FR 49234, 49246 & n182.
 94. *Id.*
 95. *Id.* at 49304-06.
 96. *Id.* at 49246.
 97. *Id.*
 98. *See id.*
 99. *See id.* at 49248.
 100. *Id.* at 49307.
 101. *Id.*
 102. *Id.* (emphasis added).
 103. *Id.* at 49249 (Item 1).
 104. *See id.* (Item 2).
 105. *Id.*
 106. *Id.* (Item 3).
 107. BrokerCheck is an online database that customers can use to search for background information on broker-dealers and their registered representatives. The information on the broker dealers and their representatives is obtained from Central Registration Depository ("CRD"), the securities industry registration and licensing database.
 108. The SEC's IAPD Web site allows customers to search advisers or RIA representatives that are either registered with the SEC or a state securities regulator(s). The Investment Adviser Registration Depository ("IARD"), is an electronic filing database for advisers that is operated by FINRA. *See* www.iard.com & n117. The IARD "facilitates investment adviser registration, regulatory review, and the public disclosure information of investment adviser firms." *See* www.iard.com.
 109. *See* 75 FR 49234, 49250 (Item 3).
 110. *Id.* at 49250 (Item 4).
 111. *Id.*
 112. *Id.* (Item 5).
 113. *Id.* (Item 6).
 114. 17 CFR 275.204-3.
 115. 75 FR 49234, 49246.
 116. *See id.* (citing 17 CFR 275.204-3).

117. Letter from OFIR Investment Adviser Specialist (Oct 7, 2010). *But see* OFIR Order No. 09-070-M, ¶10 (Dec 18, 2009) (setting forth delivery rules for the previous Form ADV Part II for Michigan advisers). The IARD is an electronic filing system for advisers, developed and operated by FINRA in accord with SEC rules, that "facilitates investment adviser registration, regulatory review, and the public disclosure information of investment adviser firms." *See* www.iard.com.

118. 75 FR 49234 at 49246.

119. *See id.* at 49247 & n196 (referring to the SEC IA Release No. 1562, entitled *Use of Electronic Media by Broker-Dealers, Transfer Agents, and Investment Advisers for Delivery of Information* (May 9, 1996) (61 FR 24644) ("Electronic Media Release")).

120. *See* 75 FR 49234, 49247.

121. *Id.*

122. *See id.* & n209.

123. *Id.* at 49247.

124. *Id.* at 49252.

125. *See id.*

126. *See* Nathan Greene, *With Eye on New Applicants, SEC Overhauls Registration Form For Investment Advisers...And Misses an Opportunity*, Sec. Reg. & Law Rep. (BNA), No. 38, Sept. 27, 2010, at 1814.

127. *See id.* at 1815.

128. *See id.*



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