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SEC Amends Disclosure Requirements for Registered Investment Advisers and Requires Electronic Filing of Part 2A of Form ADV

Registered investment advisers currently use Form ADV for reporting to regulators and disclosure to clients. Part 1 of Form ADV is filed electronically with the Securities and Exchange Commission (SEC) and/or state regulators for the purpose of registration with and reporting to those regulators. Part 2 of Form ADV is a disclosure document for clients, currently using a series of multiple choice and fill-in-the blank questions in a very structured format (advisers are allowed to use a brochure in lieu of the structured Part 2 format, but few do). On July 28, 2010, the Securities and Exchange Commission (SEC) adopted amendments to Form ADV to replace Part 2 with a mandatory narrative, plain English brochure and to require registered investment advisers to file the brochure electronically with the SEC. These changes to Form ADV take effect in 2011.

POSTED:

Aug 11, 2010

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New Format for Part 2A of Form ADV

New Part 2A of Form ADV will require a registered investment adviser to provide disclosure to clients through a brochure prepared in a narrative format and in plain English. All advisers must follow the same format, respond to each item of Part 2A in their brochures, present the information in order of the items in the form, and use the headings provided by the form. If an item is inapplicable to an adviser, the adviser still must include the heading along with an explanation that the information is inapplicable. An adviser can include a cross-reference in one part of the brochure to information in another part of the brochure where appropriate.

Part 2A contains 18 items which are largely drawn from the prior disclosure requirements of Part 2, with some changes and additions to address new concerns or developments. Below is a list of the disclosure items in the new Part 2A brochure, together with a description of some of the key requirements for each item.

- **Item 1. Cover Page**. This item will include basic information such as name, address, contact information, website, date and some required disclaimers.
- **Item 2. Material Changes**. This item will apply to amended brochures where

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an adviser must identify and briefly discuss material changes since the last brochure either in this section or in a separate document accompanying the brochure and referenced in this section.

- **Item 3. Table of Contents**.
- **Item 4. Advisory Business**. The adviser must describe its advisory business, including whether it holds itself out as specializing in a particular type of advisory service, and the amount of client assets that it manages. In computing the amount of assets under management, an adviser may use a method that differs from the method used in Part 1A to report assets under management, but an adviser opting to use a different method must keep documentation showing the method used.
- **Item 5. Fees and Compensation**. In this item, an adviser must describe how it is compensated for its advisory services, provide a fee schedule and disclose whether fees are negotiable. An adviser may omit the fee schedule and basic compensation information from any brochure provided to a client who is a "qualified purchaser."[1] This item also must describe the other types of costs that clients may pay in connection with the advisory services, such as brokerage fees, custody fees and fund expenses. Additionally, disclosure of any commissions or similar sale or transaction-based compensation and the conflict of interest it creates must be included, as well as a description of how the adviser addresses the conflict.
- **Item 6. Performance-Based Fees and Side-By-Side Management**. An adviser that charges performance-based fees or that has a supervised person who manages an account that pays such fees must disclose that fact. If such an adviser also manages accounts that are not charged a performance fee, the item requires the adviser to discuss the conflicts of interest that arise and how the adviser addresses those conflicts.
- **Item 7. Types of Clients**. This item requires general disclosure of the types of clients the firm generally has as well as the firm's requirements for opening or maintaining an account, such as minimum account size.
- **Item 8. Methods of Analysis, Investment Strategies and Risk of Loss**. Item 8 requires an adviser to describe its methods of analysis and investment strategies and disclose that investing in securities involves risk of loss which clients should be prepared to bear. Where applicable, an adviser must also disclose how specific strategies involving frequent trading can affect investment performance. Advisers must also disclose the material risks involved in each significant investment strategy or method of analysis they use.
- **Item 9. Disciplinary Information**. This item requires disclosure of the material facts about any legal or disciplinary event that is material to a client's (or

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prospective client's) evaluation of the integrity of the adviser or its management personnel. There is a list of events that are presumptively material if they occurred in the previous 10 years. An adviser may rebut this presumption, but if it does so it must document its determination in a memorandum and retain the memorandum to enable the SEC staff to monitor compliance.[2]

- **Item 10. Other Financial Industry Activities and Affiliations**. This item requires an adviser to describe in its brochure material relationships or arrangements that it (or any of its management personnel) has with related financial industry participants, any material conflicts of interest that these relationships or arrangements create, and how the adviser addresses the conflicts. In addition, if an adviser selects or recommends other advisers for clients, the adviser must disclose any compensation arrangements or other business relationships between the advisory firms, along with any conflicts created, and how the adviser addresses the conflicts.
- **Item 11. Code of Ethics, Participation or Interest in Client Transactions and Personal Trading**. This item must include (a) a brief description of an adviser's code of ethics and state that a copy is available upon request; (b) if the adviser recommends to clients, or buys or sells for client accounts, securities in which the adviser or a related person has a material financial interest, disclosure of conflicts of interest relating to this practice; and (c) whether the adviser or a related person is permitted to invest in the same securities that are recommended to clients or related securities and, if so, how the firm addresses the conflicts presented.
- **Item 12. Brokerage Practices**. This item requires an adviser to describe how it selects brokers for client transactions and determines the reasonableness of the brokers' compensation. The adviser also must disclose its soft dollar practices, whether the adviser uses client brokerage to reward brokers for client referrals and whether and under what circumstances it aggregates trades. An adviser also must state whether it permits clients to direct brokerage and explain that it may be unable to obtain the most favorable execution of client transactions in such circumstances.
- **Item 13. Review of Accounts**. This item requires an adviser to disclose whether, and how often, it reviews clients' accounts or financial plans, and who conducts the reviews.
- **Item 14. Client Referrals and Other Compensation**. This item requires a description of any arrangement under which another person is compensated for client referrals.
- **Item 15. Custody**. This item requires disclosure by an adviser with custody of client funds or securities.

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- **Item 16. Investment Discretion**. Item 16 requires any adviser with discretionary authority over client securities to disclose this fact and any limitations that clients may (or customarily do) place on this authority.
- **Item 17. Voting Client Securities**. An adviser must summarize its proxy voting practices for client securities.
- **Item 18. Financial Information**. This item requires an adviser that requires prepayment of fees of more than $1,200, six months or more in advance, to provide an audited balance sheet showing the adviser's assets and liabilities at the end of its most recent fiscal year. Also, if such prepayment of fees is required, or if an adviser has discretionary authority or custody of client funds, the adviser must disclose any financial condition that is reasonably likely to impair its ability to meet its contractual commitments to clients. An adviser that has been the subject of a bankruptcy petition at any time during the past ten years must provide disclosure about the matter.
- If an adviser sponsors a wrap fee program, a separate brochure with similar disclosure must be provided to clients of the program in lieu of the adviser's standard brochure.

Delivery and Updating of Brochures

- **Initial Delivery**. An adviser must deliver a current brochure at or before the time it enters into an advisory contract with a client. However, an adviser is not required to deliver a brochure to (1) any advisory client receiving only impersonal advice for which the adviser charges less than $500 per year, (2) clients that are investment companies registered under the Investment Company Act of 1940 or (3) certain business development companies.3
- **Annual Delivery**. An adviser must annually provide to each client to whom it must deliver a brochure either (1) a copy of an updated brochure that includes or is accompanied by the summary of material changes (see Item 2 of Part 2A described above) or (2) a summary of material changes that includes an offer to provide a complete copy of the current brochure. Each adviser must make this annual delivery no later than 120 days after the end of its fiscal year.
- **Interim Delivery**. An updated brochure must be delivered promptly whenever an adviser amends its brochure to add a disciplinary event or to change material information already disclosed pursuant to Item 9 of Part 2A. In lieu of sending an entire updated brochure, an adviser may send a separate document describing the material facts relating to the amended disciplinary event.
- **Updating Part 2A of Form ADV on File with SEC.** An adviser must keep the brochures it files with the SEC current by updating them at least annually, and

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updating them promptly when information in the brochures becomes materially inaccurate (other than the summary of material changes and the amount of assets under management, which only have to be updated annually). See "Filing Requirements" below for information regarding electronic filing of brochures with the SEC.

Part 2B: The Brochure Supplement

The revisions to Form ADV also include a new Part 2B which will consist of brochure supplements that will accompany each firm brochure. The brochure supplements will contain information about the advisory personnel on whom the particular client receiving the brochure relies for investment advice. Thus, depending on the size of an adviser and how it provides advice, the supplements delivered may vary from client to client. Like the firm brochure, the supplements must be in plain English, must follow the same format, and must contain the same headings as the items appear in the form. An adviser may prepare a separate supplement for each supervised person or may combine the information for all of the supervised persons. The supplements do not need to be filed with the SEC.

The required disclosure items for the supplements consist of the following:

- **Item 1. Cover Page**. The cover page must identify the supervised person (or persons) covered by the supplement as well as the firm.
- **Item 2. Educational Background and Business Experience**. Item 2 requires the supplement to describe the supervised person's formal education and his or her business background for the past five years. An adviser may include information about professional designations in the supplement if the adviser so chooses.
- **Item 3. Disciplinary Information**. This item requires disclosure of any legal or disciplinary event that is material to a client's evaluation of the supervised person's integrity. Like the disclosure as to events in the firm brochure, there is a list of certain events that are presumed to be material if they occurred in the last ten years. Additionally, the supplement must include disclosure if the supervised person has resigned or otherwise relinquished a professional designation in anticipation of it being suspended or revoked (other than for failure to pay membership dues) if the adviser knew or should have known of the resignation or relinquishment. Supplements delivered electronically may use a hyperlink to disciplinary information available through the FINRA BrokerCheck system as well as the IARD system.

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- **Item 4. Other Business Activities**. Item 4 requires disclosure of any other investment-related business activities of the supervised person and non-financial-related business activities if they involve a substantial amount of time or pay. Any material conflicts of interest related to the activities must be disclosed along with compensation for sales securities or other investment products. There is a presumption that other business activities that represent less than 10% of the supervised person's time and income are not substantial.
- **Item 5. Additional Compensation**. This item requires a description of any arrangements under which someone other than a client gives the supervised person an economic benefit for providing advisory services.
- **Item 6. Supervision**. This item requires the firm to describe how the firm monitors the advice provided by the supervised person, and the name, title and telephone number of the person responsible for supervising the advisory activities of the supervised person.

A client must be given a brochure supplement for each supervised person who (1) formulates investment advice for that client and has direct client contact or (2) makes discretionary investment decisions for that client's assets, even if he or she has no direct client contact. If the investment advice is provided by a team comprised of more than five supervised persons, brochure supplements need only be provided for the five supervised persons with the most significant responsibility for day-to-day advice provided to the client.

A supplement as to a supervised person initially must be given to a client at or before the time when that specific supervised person begins to provide advisory services to that specific client. An updated supplement must be provided only when there is new disclosure of a disciplinary event or a material change to the disciplinary information already disclosed. Annual updates are not required.

Filing Requirements

Firm brochures must be filed with the SEC through the IARD system. Brochure supplements and supplement amendments are not required to be filed. IARD will accept brochure filings using text-searchable Adobe PDF format. A filing of an annual updating amendment to Form ADV will not be accepted without an updated brochure, a representation by the adviser that the brochure on file does not contain any materially inaccurate information or a representation from the adviser that the adviser does not have to deliver a brochure to any of its clients.

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Compliance Dates

Each adviser applying for registration with the SEC after January 1, 2011 must file a brochure that meets the requirements of Part 2A as part of the application for registration on Form ADV.

Each adviser already registered with the SEC whose fiscal year ends on or after December 31, 2010, must include in its next annual updating amendment to its Form ADV a brochure that meets the requirements of Part 2A. Within 60 days after filing such amendment, the adviser must deliver to its existing clients a brochure and brochure supplement. Immediately after the initial filing of the brochure, an adviser must begin delivering to new clients and prospective clients a brochure and brochure supplement.

If you have any questions or concerns regarding the issues discussed in this e-alert, please contact your Reinhart attorney or an attorney with Reinhart's securities team.

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[1] A "qualified purchaser" is defined in Section 2(a)(51)(A) of the Investment Company Act of 1940 and includes natural persons who own $5 million or more of investments and persons who manage $50 million or more in investments for their account or accounts of other qualified purchasers.

[2] The disclosure requirement in Item 9 replaces Rule 206(4)-4 which is rescinded.

3There is no exception for delivery of a brochure to a hedge fund or other private fund exempt from investment company status under Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940. However, the fund rather than its investors is considered the client, so an adviser is not required to deliver its brochure to the investors in the fund.

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