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A legal update from Dechert's Financial Services Group

SEC Staff Issues Relief from Pay-to-Play Recordkeeping Requirements for Investment Advisers to Registered Investment Companies

The staff of the U.S. Securities and Exchange Commission's ("SEC") Division of Investment Management ("Staff") on September 12, 2011 issued a no-action letter that provides relief from the "pay-to-play" recordkeeping requirements for investment advisers to registered investment companies.[1] As discussed more fully below, the no-action letter was issued after months of discussion with the fund industry regarding the inability of many advisers to fully comply with the recordkeeping requirements, which became effective on September 13, 2011. The no-action letter permits advisers to maintain an "alternative" set of records that will be deemed to comply with the recordkeeping requirements. As a result, advisers will no longer be required to rely on fund third-party distributors and other intermediaries to collect information necessary to comply with the recordkeeping requirements.

Background

On July 1, 2010, the SEC adopted Rule 206(4)-5 ("Rule") under the Investment Advisers Act of 1940 ("Advisers Act").[2] The Rule was designed to prohibit "pay-to-play" practices and prohibits, among other things, an adviser from providing advisory services for compensation, either directly or through a "covered investment pool,"[3] to a government entity for a two-year period after the adviser or certain of its employees make a political contribution to certain elected officials or candidates. The Rule thus limits the ability of advisers and their "covered associates" to make political contributions to elected officials and candidates that may influence the selection of an adviser by a public pension plan or other government entity. The penalties for violating the Rule are significant.

The SEC also amended the recordkeeping rule under the Advisers Act to require investment advisers to keep records of all government entities to which the adviser provides, or has provided, investment advisory services, or which are or were investors in any covered investment pool managed by the adviser, in the past five years but not prior to

1 *See Investment Company Institute*, SEC No-Action Letter (pub. avail. Sept. 12, 2011), available at http://www.sec.gov/divisions/investment/noaction/2011/ici091211-204.htm.

2 *See Political Contributions by Certain Investment Advisers*, SEC Investment Advisers Act Release No. 3043 (Jul. 1, 2010), available at http://www.sec.gov/rules/final/2010/ia-3043.pdf.

3 The Rule defines "covered investment pool" as any investment company registered under the Investment Company Act of 1940 that is an investment option of a "plan or program of a government entity," or any company that would be an investment company under Section 3(a) but for the exclusions provided by Sections 3(c)(1), 3(c)(7) or 3(c)(11). A "plan or program of a government entity" is generally defined as any participant-directed investment program or plan sponsored or established by a state (*e.g.*, a "qualified tuition plan" authorized by Section 529, or a retirement plan authorized by Section 403(b) or 457, of the Internal Revenue Code).

September 13, 2010.[4] However, investment advisers to registered investment companies that are covered investment pools must keep and maintain these records only as of September 13, 2011. [5]

Application of the Rule to Covered Investment Pools and Special Look Through Considerations

While the Rule and recordkeeping requirements apply to a broad range of services provided by advisers to public entities, the Rule and the recordkeeping requirements apply to advisers of registered investment companies in that capacity only if the investment companies are an investment option of a participant-directed retirement plan or an education savings program sponsored by a state (*e.g.*, a 403(b), 457 or 529 plan).

For most types of advisory services provided to public entities, the Rule and related recordkeeping requirements became effective on March 14, 2011. However, because of concerns expressed during the comment process on the Rule regarding the impracticability of the requirements for advisers to registered investment companies, the SEC delayed the compliance date for these advisers until September 13, 2011. In the release adopting the Rule and related recordkeeping requirements, the SEC acknowledged "the compliance challenges relat[ed] to identifying government investors in registered investment companies." However, the SEC stated that, "[w]hen an adviser's investment company is an investment option in a participant-directed government plan or program, [the SEC] believe[s] it is reasonable to expect the adviser will know (or can reasonably be expected to acquire information about) the identity of the government plan."

Many advisers to registered investment companies have expressed concerns to the SEC and the Investment Company Institute that, despite good faith efforts, such advisers are unable to fully comply with the record-keeping requirements. For example, under the amended recordkeeping rule, investment advisers are required to maintain a list of *all* government entities that have invested in any registered investment company that is an investment option of a participant-directed retirement plan or an education savings program sponsored by a state. However, 403(b) and 457 plans are not used exclusively by government entities, and contributions by 403(b) and 457 plans may be commingled into an omnibus position that is forwarded to a fund (*i.e.*, government entities may purchase fund shares through another entity that has a fund account, such as a broker-dealer, a bank or trust department, a third-party administrator/recordkeeper for retirement plans or an insurance company). In these circumstances, it may be difficult for an adviser to a registered investment company that is a covered investment pool to distinguish government entity investors from other investors—which makes the recordkeeping requirement discussed above particularly challenging.[6]

To further complicate matters, third-party distributors and other intermediaries through which government entity investors purchase fund shares generally had refused, despite requests from investment advisers, to provide the information that satisfies the recordkeeping requirement discussed above. Among other things, these intermediaries were under no legal obligation to provide the relevant information to fund advisers; were concerned about protecting customer lists; and may have been prohibited from disclosing this information under banking or state laws. In addition, these intermediaries may not have coded their accounts to easily identify government entity investors, and there may have been multiple "layers" of intermediaries which could have complicated efforts to obtain the relevant information.

SEC Staff No-Action Letter

In response to these industry concerns, the Staff issued a no-action letter in which it agreed not to recommend enforcement against an adviser to a registered investment company that is a covered investment pool, if the adviser maintains an "alternative" set of records

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4 *See* Rule 204-2(a)(18)(i)(B).

5 *See* Staff Responses to Questions About the Pay to Play Rule (last updated Apr. 28, 2011), at Question I.2, *available at* http://www.sec.gov/divisions/investment/pay-to-play-faq.htm.

6 Investment advisers to other covered investment pools, such as private equity and hedge funds, generally negotiate directly with government entity investors and can therefore readily distinguish government entity investors from other investors.

under the recordkeeping rule.[7] The records the adviser must maintain to rely on this no-action letter must include a list or other record of:

- Each government entity that invests in a covered investment pool, where the account of such government entity can *reasonably* be identified as being held in the name of or for the benefit of the government entity *on the records of the covered investment pool or its transfer agent*;[8]
- Each government entity, the account of which was identified as that of a government entity—at or around the time of the initial investment—to the adviser or one of its client servicing employees,[9] regulated persons or covered associates;
- Each government entity that sponsors or establishes a 529 plan and has selected a specific covered investment pool as an option to be offered by such 529 plan; and
- Each government entity that has been solicited to invest in a covered investment pool either (i) by a covered associate or regulated person of the adviser; or (ii) by an intermediary or affiliate of the covered investment pool if a covered associate, regulated person, or client servicing employee of the adviser participated in or was involved in such solicitation, regardless of whether such government entity invested in the covered investment pool.

While the no-action letter provides relief from the recordkeeping requirements relating to government entities that own shares in registered investment companies that are covered investment pools (including through intermediaries), it is important to note that other provisions of the Rule remain in effect. For example, investment advisers should understand that they will continue to be subject to the prohibition on the receipt of compensation from a government entity following certain contributions to elected officials or candidates, including in situations where, at the time of the "triggering" contribution, the government entity was not known to the adviser or listed on the covered investment pool's books and records as an investor. However, in such circumstances, investment advisers may be able to obtain exemptive relief under the Rule.

Although the last minute relief provided by the Staff in the no-action letter was welcomed by the fund industry, there are certain ambiguities in the letter that advisers need to consider. For example, the no-action letter does not provide any guidance on how often (*e.g.*, monthly, quarterly, etc.)—or how—an investment adviser should update the records described above. In addition, since there is no grace period provided in the letter, advisers intending to rely on it should begin to develop policies and procedures reasonably designed to capture the relevant information as soon as possible.[10]

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7 The relief is limited to advisers to *registered investment companies* that are covered investment pools. Furthermore, the relief applies only to the requirement to maintain a list of all government entities that are or have invested in any registered investment company that is a covered investment pool (and thus advisers will continue to be required to maintain a list of all government entities to which the adviser directly provides or has directly provided investment advisory services).

8 The Investment Company Institute represented that new account opening documents would be amended to capture relevant information to determine whether a shareholder is a government entity. A task force of the Investment Company Institute has developed search terms and standard codes that may be used by transfer agents and others to identify and code accounts for purposes of identifying government entity investors in order to comply with the recordkeeping rule.

9 For purposes of the no-action letter, a "client servicing employee" is any person who provides, on behalf of an investment adviser or covered investment pool, specialized client services to a government entity that invests in the covered investment pool. Employees of a covered investment pool or adviser who have incidental contact with a variety of shareholders or who service a variety of clients as part of their normal course of business without being assigned specific responsibility to service a particular accountholder (*e.g.*, call center representatives) will not be considered "client servicing employees" for purposes of the no-action letter. If client servicing responsibilities are subcontracted to any other person, an adviser must obtain this information from this person.

10 Subadvisers to registered investment companies that intend to rely on the no-action letter will also be expected to keep and maintain the records described above. These subadvisers should request the relevant information from the fund's primary adviser.

Practice group contacts

For more information, please contact the authors, one of the attorneys listed or any Dechert attorney with whom you regularly work. Visit us at www.dechert.com/financial_services.

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