Client Advisory

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Financial Services

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Alternative Pay to Play Recordkeeping Requirements Approved for Advisers to Registered Funds

On September 12, the staff of the SEC's Division of Investment Management (Staff) issued a no-action letter to the Investment Company Institute (ICI) approving alternative recordkeeping requirements for investment advisers to registered investment companies under the "pay to play" rules. The no-action relief, which is available only to investment advisers with respect to advisory services rendered to certain registered investment companies, should facilitate compliance with the rules by advisers to exchange-traded funds, mutual funds whose shares are held in omnibus accounts and funds that are otherwise offered through financial intermediaries.

"Pay to Play" Recordkeeping Requirements

In July 2010, the SEC adopted Rule 206(4)-5 (the Pay to Play Rule) under the Investment Advisers Act of 1940, as amended (the Advisers Act) to prohibit certain "pay to play" activities by investment advisers. The Pay to Play Rule generally prohibits advisers from (i) receiving compensation from a government client for two years after the adviser, certain of its employees or its third-party solicitors make contributions to candidates or elected officials of the government client and (ii) soliciting contributions or payments to officials or political parties of a government client or prospective government client and, subject to certain exceptions, paying third parties to solicit government entities.

To help detect such pay to play activity, the SEC adopted amendments to Rule 204-2(a) (the Recordkeeping Rule) under the Advisers Act that require advisers to maintain, among other things, a list or record of all government entities that are or were investors in any registered investment company (Covered Investment Pool) that is an investment option of a plan or program of a government entity to which the adviser provides or has provided investment advisory services in the past five years, but not prior to September 10, 2010. advisers were required to begin keeping such records on September 13, 2011.

Alternative Recordkeeping Requirements

In adopting the Recordkeeping Rule, the SEC concluded that "it is reasonable to expect advisers to know the identity of the government entity when a registered fund they advise is part of a plan or program." The ICI acknowledged that, ordinarily, an adviser will know the identities of large government entities that invest directly in a Covered Investment Pool, government entities that the adviser targets in marketing and government entities that sponsor tuition programs (e.g., 529 Plans) offering the Covered Investment Pool as an investment option, due to the nature of such programs.

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However, the ICI noted that there often is a lack of transparency with respect to the identities of government entities that invest in a Covered Investment Pool through one or more intermediaries and in such cases advisers may be unable to comply with the Recordkeeping Rule. The ICI therefore requested that the Staff permit advisers to make and maintain a set of records different than those required under the Recordkeeping Rule. The SEC agreed and has granted no-action relief to all Covered Investment Pool advisers if an alternate set of records is kept. Specifically, the alternate set of records consists of a list or 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;
- 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 servicing employees, 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 a 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.

The SEC acknowledged that the alternate set of records will be broader in some respects than required under the Recordkeeping Rule, and narrower in others. The SEC also expects advisers relying on the September 12 no-action relief to alter mutual fund account opening documents so that an investor can state whether or not it is a government entity covered by the Pay to Play Rule.

In granting the requested no-action relief, the Staff approved without modification the alternate set of records proposed by the ICI. The Staff noted, however, that the relief does not extend to other recordkeeping requirements related to the Pay to Play Rule, such as the requirement that advisers make and keep a list of all government entities to which the adviser provides or has provided investment advisory services.

The ICI's no-action request letter and the Staff's response letter are available here. Advisers may also refer to the Staff's FAQs on the Pay to Play Rule.

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