INVESTMENT COMPANY INSTITUTE

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July 29, 2010

Implications On Transfer Agents Of The SEC's Newly Adopted Pay-To-Play Restrictions For Investment Advisers

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TO: TRANSFER AGENT ADVISORY COMMITTEE No. 44-10 RE: IMPLICATIONS ON TRANSFER AGENTS OF THE SEC’S NEWLY ADOPTED PAY-TO-PLAY RESTRICTIONS FOR INVESTMENT ADVISERS

The Securities and Exchange Commission has adopted a new rule designed to inhibit pay-to-play practices by investment advisers through restrictions on political contributions to government officials who are in a position to influence the award of advisory business. [1] The rule applies to advisers to certain registered pooled investment vehicles, including mutual funds, if the registered pools are an investment option of a participant-directed plan or program of a government entity.

Implications of the Rule on Transfer Agents’ Recordkeeping Obligations

While the new rule is discussed in detail below, transfer agents and other mutual fund record keepers should be aware of provisions in it that may impact their recordkeeping obligations. In particular, the new rule requires, among other things, that advisers that provide advisory services to a pooled investment vehicle that is a funding vehicle or investment option in a government-sponsored plan, such as a retirement plan or a 529 plan (e.g., a mutual fund that is offered on a government’s retirement plan or 529 plan platform), [2] maintain a list or other record of:

> All government entities to which the investment adviser provides or has provided investment advisory services, or which are or were investors in any covered investment pool to which the investment adviser provides or has

provided investment advisory services, as applicable, in the past five years, but not prior to September 13, 2010. [3]

The Release recognizes that, when the government holds its shares in such plan through an intermediary, "an adviser may have to take additional steps to identify a government entity." Examples of instances in which it would be "more challenging for an adviser to distinguish government entity investors from others" when compiling this list of government entities are when funds in a 403(b) or 457 plan are comingled with non-government funds or when the government funds are comingled with other funds in an omnibus position that is forwarded to the fund. [4] For existing accounts, funds may need to reach out to their shareholders in omnibus or 403(b) or 457 accounts to determine if any shareholders are government plans. Prospectively, funds may be able to revise their account opening documents to elicit this information. To provide sufficient time to accomplish this, the Commission has delayed the compliance date for these requirements until September 13, 2011.

Summary of the New Rule's Requirements

Modeled after the Municipal Securities Rulemaking Board ("MSRB") rules G-37 and G-38 governing municipal security dealers, [5] the new rule includes four primary provisions. First, the rule imposes a two-year "time out" on conducting compensated advisory business with a government client after a contribution is made. Second, it prohibits advisers from paying third parties to solicit government entities for advisory business, unless the third parties are registered broker-dealers or registered investment advisers, in each case themselves subject to pay-to-play restrictions. Third, the rule makes it unlawful for an adviser to solicit or coordinate (1) contributions for a government official to which the adviser is seeking to provide advisory services or (2) payments to a political party of a state or locality where the adviser is providing or seeking to provide advisory services to a government entity. Fourth, the rule includes a provision prohibiting an adviser from doing anything indirectly that, if done directly, violates the rule.

Advisers and Services Subject to the Proposal

The rule applies to any adviser registered with the Commission or unregistered in reliance on the exemption available under Section 203(b)(3) of the Investment Advisers Act of 1940. It does not apply to most small advisers that are registered with the state securities authorities and certain other advisers that are exempt from registration with the Commission, such as intrastate investment advisers. The rule does apply to subadvisers. An adviser to underlying funds in a fund of funds arrangement is not required, however, to look through the investing fund to determine whether a government entity is an investor in the investing fund unless the investment was made as a means for the adviser to do indirectly what it could not do directly under the rule. [6]

Under the rule, advisory services include directly managing or advising government-run funds, or managing or advising a private investment pool. Government funds include, among others, all public pension plans and other collective government funds, including participant-directed plans such as 403(b), 457, and 529 plans.

Two-Year "Time Out" for Contributions

The rule prohibits an adviser, or its covered associates, from providing advice for compensation to a government entity within two years after making a contribution to an official of the government entity in a position to influence the selection of the adviser. [7] An adviser is not required under the new rule to provide uncompensated advice indefinitely if it triggers the prohibition. Rather, the adviser may need to continue to provide advice, pursuant to its fiduciary obligations, for only a reasonable period of time. The primary consideration of the length of a reasonable period of time would be the amount of time a client might need in good faith to find and engage a successor to the adviser, which may depend in part on such matters as applicable law, the client's customary process of finding and engaging advisers, and the types of assets managed by the adviser that is subject to the time out.

The new rule applies to political incumbents as well as candidates. [8] Under the rule, contributions include any gift, subscription, loan, advance, deposit of money, or anything of value made for the purpose of influencing an election for a federal, state, or local office, including any payments for debts incurred in such an election. [9] It also includes transition or inaugural expenses incurred by a successful candidate for state or local office.

Covered associates include the adviser's general partners, managing members, executive officers, or other individuals with a similar status or function. In a change from the proposal, the rule clarifies that "other executive officers" – those other than the president and vice presidents in charge of principal business units or functions – include only those officers or other persons who perform a policy-making function for the investment adviser. [10] Moreover, whether a person is an executive officer depends on his or her function, not title. In addition, a covered associate includes any employee of the adviser who solicits government entity clients for the adviser, and any person who supervises such employee, as well as any political action committee ("PAC") controlled by the adviser or any of the adviser's covered associates. [11]

The rule includes a "look back" provision in which the two-year time out would continue in effect after the covered associate who made the triggering contribution left the advisory firm. Further, a contribution made by a covered associate would be attributed to any other adviser that employs or engages the person who made the contribution within two years after the date the contribution was made. [12] The rule includes an exception to the look back provision that provides that the time out is not triggered by a contribution made by a natural person more than six months prior to becoming a covered associate, unless he or she, after becoming a covered associate, solicits clients. The Commission determined not to exclude from the look back provision contributions made before a merger or acquisition. [13]

The new rule includes two exceptions to the two-year time out provision. The exceptions have been modified from the proposed rule. First, it includes a de minimis provision allowing a covered associate to make contributions of up to $350 per election per candidate if the contributor is entitled to vote for the candidate and contributions of up to $150 per election per candidate if the contributor is not entitled to vote for the candidate. Second, it includes a limited exception for inadvertent contributions by a covered associate to officials other than those for whom the associate was entitled to vote at the time of the contribution and that do not exceed the $350 per election per candidate restriction. To claim this exception, the adviser must have discovered the contribution within four months of the date of such contribution and, within sixty days upon discovery, must cause the contribution to be returned to the contributor. The exception is available to an adviser twice in a twelve-month period for advisers with fifty or fewer employees, and three times for advisers with more than fifty employees, and only once with respect to the same covered associate, regardless of the time period.

Ban on Using Third Parties to Solicit Government Business

The rule prohibits an adviser from paying a third party, such as a solicitor, finder, pension consultant, or placement agent, to obtain government clients, unless the third party is a registered broker-dealer [14] or investment adviser subject to pay-to-play restrictions. The prohibition does not apply to any of the adviser's employees, general partners, managing members, or executive officers. These persons would instead trigger the rule's two-year time out provision. The Release clarifies that a non-affiliated person providing legal, accounting, or other professional services in connection with specific investment advisory business would not be subject to the prohibition so long as the non-affiliated person was not being paid directly or indirectly by an adviser for communicating with a government entity for the purpose of obtaining or retaining investment advisory business for the adviser.

Restriction on Soliciting and Coordinating Contributions and Payments

The rule prohibits an adviser, its covered associates, or its PAC from soliciting or coordinating (1) contributions on behalf of a covered elected official or (2) payments to a political party of the state or locality where the adviser is providing or seeking to provide advisory services to the government. The rule prohibits bundling contributions or payments as well as coordinating contributions or payments through a third party, like a gatekeeper. A direct contribution to a political party by an adviser or its covered associates does not violate the rule, unless the contribution was earmarked or known to be provided for the benefit of a particular government official.

Indirect Contributions and Solicitations

The rule prohibits an adviser from doing indirectly what it is prohibited from doing directly, such as by directing or funding contributions through third parties such as spouses, lawyers or companies affiliated with the adviser.

Pooled Investment Vehicles

Covered investment pools subject to the rule include mutual funds, [15] hedge funds, private equity funds, venture capital funds, and other collective investment pools. Mutual funds, however, are only subject to the rule to the extent that the funds are an investment option of a participant-directed plan or program of a government entity. [16] A mutual fund is an investment option of a plan or program of a government entity where the participant selects a model fund or portfolio (such as an age-based investment option of a 529 plan) and the government entity selects the specific underlying mutual fund or funds in which the portfolio's assets are invested. If an adviser is selected by a government entity to advise a government-sponsored plan, regardless of whether the plan selects one of the pools the adviser offers or manages as an option available under its plan, the prohibitions of the rule directly apply to the adviser.

Exemptions

The rule includes a provision under which an adviser may apply to the Commission for an order exempting it from the two-year compensation ban. Applying a facts and circumstances analysis, the Commission will consider situations in which an adviser discovers contributions that trigger the ban only after they have been made or when imposition of the prohibitions is unnecessary to achieve the rule's intended purpose.

Recordkeeping Requirements

The rule requires an adviser that seeks government clients or provides advisory services to a covered investment pool in which a government entity investor invests to make and keep certain records of contributions. Such records are required to be listed in chronological order identifying each contributor and recipient, the amounts and dates of each contribution, and whether such contribution was subject to the exception for certain returned contributions. They would include:

- the names, titles and business and residence addresses of all covered associates of the investment adviser;
- all government entities for which the investment adviser provides or has provided investment advisory services, or which are or were investors in any covered investment pool to which the investment adviser provides or has provided investment advisory services, in the past five years; [17]
- all direct or indirect contributions made by the investment adviser or any of its covered associates to an official of a government entity, a political party of a state or political subdivision thereof, or a PAC; and
- the name and business address of each regulated person to whom the investment adviser agrees to provide payment to solicit a government entity for investment advisory services on its behalf.

The rule does not require an adviser to a covered investment pool that is an option of a government plan or program to make and keep records of all participants in the plan or program, only the government entity. In addition, the prohibition and recordkeeping requirements only apply to contributions made on or after the effective date of the rule. [18]

Effective and Compliance Dates

The rule becomes effective sixty days after publication in the Federal Register. The rule's compliance date varies for the rule's various provisions, as follows:

- two-year time out for contributions and prohibition on solicitations – six months after the effective date;
- ban on third-party solicitors – one year after the effective date;
- recordkeeping requirements – six months after the effective date, except records related to regulated third-party solicitors have one year after the effective date;
- requirements for advisers to mutual funds (registered investment companies) that are covered investment pools – one year after the effective date; and
- amendment to cash solicitation rule – one year after the effective date.

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endnotes

[1] See Securities and Exchange Commission Release No. IA-3043 (July 1, 2010)

("Release"), available at http://www.sec.gov/rules/final/2010/ia-3043.pdf. See also, Memorandum to SEC Rules Members No. 104-09, 529 Plan Members No. 9-09, and Investment Adviser Members No. 17-09 [23851], dated October 6, 2009.

[2] See discussion on pp. 102-108 of the Release.

[3] See Rule 204-2(18)(i)(B) under the Investment Advisers Act of 1940.

[4] See Release at fn. 375.

[5] In the Release, the Commission stated that its decision to adopt the rule based on the MSRB model was influenced primarily by the Commission's judgment that the MSRB rules have significantly curbed pay-to-play practices in the municipal securities markets. The Commission also stated that the use of codes of ethics or compliance procedures alone, as suggested by the Institute and other commenters, would be inadequate to stop pay-to-play practices, particularly when the adviser or senior officers of the adviser are involved either directly or indirectly.

[6] In addition, if an adviser or subadviser makes a contribution that triggers the two-year time out, the adviser or subadviser that did not make the triggering contribution could continue to receive compensation from the government entity, unless the arrangement was a means to do indirectly what the adviser or subadviser could not do directly under the rule.

[7] The two-year period runs from when the contribution is made. According to the Release, a mutual fund could implement the rule's compensation prohibition by either: (1) waiving its advisory fee for the fund as a whole in an amount approximately equal to the fees attributable to the government entity; or (2) permitting the government entity to continue to pay its portion of the advisory fee and having the adviser rebate that portion of the fee to the fund as a whole.

[8] A candidate for federal office may be an official under the proposed rule because of the office he or she currently holds.

[9] The Release explains that a donation of an individual's time is not considered a contribution provided the adviser has not solicited the individual's efforts and the adviser's resources, such as office space, are not used.

[10] The final rule does not include a limitation that the officer, as part of his or her regular duties, performs or supervises any person who performs advisory services for the adviser, or solicits or supervises any person who solicits for the adviser.

[11] A PAC would include separate segregated funds or non-connected committees within the meaning of the Federal Election campaign Act, or any state or local law equivalent.

[12] In the Release, the Commission clarified that an adviser is subject to the time out regardless of whether it is "aware" of the political contributions. Thus, statements by prospective employees regarding whether they have made relevant contributions are insufficient to inoculate the adviser.

[13] An adviser could, however, seek an exemption from the Commission in the case of a merger or acquisition.

[14] FINRA is preparing rules for consideration that would prohibit its members from

soliciting advisory business from a government entity on behalf of an adviser unless they comply with requirements prohibiting pay-to-play activities.

[15] This is the case regardless of whether the shares of the registered investment company are registered under the Securities Act of 1933.

[16] In a change from the proposed rule, all three of the prohibitions in the final rule would apply to a covered mutual fund.

[17] According to the Release, the Commission recognized that an adviser may have to take additional steps to identify a government entity when shares are held through an intermediary. To accommodate this, the Commission provided advisers to mutual funds with additional time to modify current systems and processes.

[18] Similarly, the five-year look back period in the recordkeeping requirement will not apply to activities predating the rule's effectiveness.
