

MEMO# 24871

January 12, 2011

Draft ICI Letter on Proposed Changes to Form ADV and Amendments to "Pay-to-Play" Rule

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TO: CHIEF COMPLIANCE OFFICER COMMITTEE No. 3-11
INVESTMENT ADVISERS COMMITTEE No. 1-11
SEC RULES COMMITTEE No. 5-11
SMALL FUNDS COMMITTEE No. 4-11 RE: DRAFT ICI LETTER ON PROPOSED CHANGES TO FORM ADV AND AMENDMENTS TO "PAY-TO-PLAY" RULE

As you know, the Securities and Exchange Commission recently proposed changes to Form ADV and amendments to the pay-to-play rules. [1] A draft Institute comment letter on the proposal is attached and briefly summarized below.

Comments on the proposal are due to the SEC on January 24. Please provide comments on the draft letter to us by Wednesday, January 19. If you have comments on the portions of the draft letter relating to Form ADV or proposed Rule 203A-5, please provide them to Bob Grohowski (rcg@ici.org or 202/371-5430). If you have comments on the portion of the letter relating to the pay-to-play rules, please provide them to Heather Traeger (htraeger@ici.org or 202/326-5920).

The draft letter has three main sections: 1) proposed amendments to Form ADV; 2) proposed amendment to the pay-to-play rules; and 5) proposed new rule 203A-5. [2]

Proposed Amendments to Form ADV

Soft dollar disclosure. Item 8 of Form ADV currently requires advisers to state whether they, or any related persons, receive soft dollar benefits in connection with client securities transactions. The SEC proposes to add a follow-up question asking whether all such soft dollar benefits qualify for the safe harbor under Section 28(e) of the Securities Exchange Act of 1934. The draft letter supports that part of the proposal.

The Release asks whether, in addition to that follow-up question, Form ADV should solicit information about advisers' receipt of soft dollar benefits, such as requiring advisers to quantify the benefits they receive. The draft letter explains that it will be difficult to

quantify soft dollar benefits with the consistency and specificity necessary to make this disclosure meaningful. Accordingly, it recommends against such a requirement.

Reporting of over \$1 billion in assets. The Commission proposes, among other things, to add a question to Item 1 of Form ADV requiring advisers to indicate whether they had \$1 billion or more in total assets as determined on the adviser's balance sheet for the most recent fiscal year. This information is necessary to enable the SEC to identify advisers that are subject to Section 956 of the Dodd-Frank Act, which mandates executive compensation rules or guidance for advisers and certain other financial institutions with over \$1 billion in assets. The draft letter strongly supports the way the SEC chose to interpret Section 956 as applying to advisers with over \$1 billion in balance sheet assets, rather than \$1 billion in assets under management.

Timing of annual updates to Form ADV. Advisers currently have 90 days from their fiscal year ends to provide an annual update to Form ADV. Although not part of the proposal, the Commission asks in the Release whether it should consider accelerating this deadline to 60 days or some other shorter time period. The draft letter cautions against doing so, particularly in the next few years as advisers are digesting the impact of these and other significant changes to Form ADV.

Proposed Amendments to the Pay-to-Play Rules

Amendments to the Solicitation Provisions. The draft letter takes issue with the Commission's proposal to amend its pay-to-play rule to permit an adviser to pay only a "regulated municipal advisor" to solicit government entities on its behalf. It explains that the pay-to-play concerns that have led the Commission to effectively prohibit an affiliate from soliciting government business for compensation on behalf of its affiliated investment adviser could be satisfactorily addressed through less restrictive means. Specifically, the letter recommends that any employee of an affiliate be permitted to solicit government business for compensation on behalf of an adviser that controls, is controlled by, or is under common control with the affiliate as long as the employee is treated as the adviser's "covered associate." It further states that affiliates should not be required to register as municipal advisors to solicit for compensation on behalf of affiliated advisers because it does not serve any public interest if the affiliate's solicitation activities are subject to the same regulatory regime governing the adviser's solicitation activities.

The draft letter outlines some of the costs and burdens of the proposal and of municipal registration. These include the imposition on affiliates of significant regulatory obligations and potential unintended consequences that could negatively affect the municipal securities markets if affiliates choose to avoid the additional regulatory obligations associated with municipal advisor registration and regulation. The draft letter concludes that the Commission could narrowly tailor the regulation to an affiliate's solicitation activity without losing any protections afforded to the public. [\[3\]](#)

Additional Clarification Regarding the Definition of "Covered Associate." The draft letter seeks additional guidance from the Commission with respect to the term "covered associate" and the use of the term "solicit" within that definition. The letter notes that, consistent with the pay-to-play rule, it is appropriate that advisers classify as a "covered associate," all employees who communicate with or solicit a government entity for the principal purpose of obtaining and retaining government investment advisory business. It explains, however, that many Institute members are struggling with how to classify

employees who do not meet with clients for the principal purpose of obtaining and retaining business, but who either are involved in the preparation and/or dissemination of communications to government entities or provide information about the adviser's operations or policies, procedures, or controls. Citing an MSRB Interpretive Notice, the draft letter requests that the Commission confirm our understanding that the term "solicit" would not include communications that are incidental to the services provided by the adviser (i.e., communications that are not made with the principal purpose of obtaining, retaining, or referring a government entity).

Need for Regulatory Obligations for Intermediaries. The proposed amendments present the opportunity to comment on pay-to-play issues more generally, and the draft letter does so by recommending that the Commission provide regulatory assistance to advisers in obtaining information from intermediaries in order to comply with their recordkeeping and reporting requirements under the pay-to-play rule. The draft letter explains that advisers are subject to detailed reporting and recordkeeping requirements under the pay-to-play rule, but they do not own, control, or possess all information they are required by the rule to maintain. It states that much of this information is with financial intermediaries, many of which are subject to the Commission's jurisdiction. Accordingly, the draft letter recommends that the Commission require broker-dealers and other persons subject to its jurisdiction to provide advisers and funds with the account information the adviser is required by law to have in order to comply with the Commission's pay-to-play rule. The letter concludes that the Commission's failure to do so will result in advisers' inability to comply fully with the new pay-to-play rule's recordkeeping requirements through no fault of their own.

Proposed New Rule 203A-5

This new rule would require each adviser to file an amendment to its Form ADV no later than August 20, 2011 to report the market value of its AUM. The filing is intended to facilitate compliance with the new AUM thresholds for federal adviser registration. The draft letter points out that advisers to registered investment companies are required to register with the SEC, regardless of AUM. Accordingly, with respect to these advisers, the filing serves no meaningful purpose and should not be required.

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Securities Regulation - Investment Companies

Heather L. Traeger
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[Attachment](#)

endnotes

[1] See Memorandum No. [24746](#), dated Nov. 30, 2010.

[2] Much of the SEC's proposal would give effect to provisions of Title IV of the Dodd-Frank Act that, among other things, increase the statutory threshold for registration by

investment advisers with the Commission, require advisers to hedge funds and other private funds to register with the Commission, and require reporting by certain investment advisers that are exempt from registration. The draft comment letter does not address these topics.

[\[3\]](#) The draft letter also questions whether the proposed amendments are consistent with Congressional intent in Section 975 of the Dodd-Frank Act.

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