SUPPORTING STATEMENT
AMENDMENT OF RULE 204-2

A. JUSTIFICATION

1. Necessity for the Information Collection

Section 204 of the Investment Advisers Act of 1940 ("Advisers Act")[1] provides that investment advisers required to register with the Securities and Exchange Commission (the "Commission") must make and keep certain records for prescribed periods, and make and disseminate certain reports. Advisers Act rule 204-2[2] also sets forth mandatory requirements for maintaining and preserving specified books and records. The records that an adviser must keep in accordance with rule 204-2 must generally be retained for not less than five years.[3] These requirements constitute a mandatory "collection of information," within the meaning of the Paperwork Reduction Act. The collection has been previously approved and subsequently extended under Office of Management and Budget ("OMB") control number 3235-0278, and it is found at 17 CFR 275.204-2. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB number. The respondents are investment advisers registered with us. Responses provided to the Commission in the context of its examination and oversight program are generally kept confidential.[4]

The Commission has amended rule 204-2 in connection with its adoption of a new rule,

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1 15 U.S.C 80b-4.

2 17 CFR 275.204-2.

3 See rule 204-2(e) [17 CFR 275.204-2(e)]. The standard retention period required for books and records under rule 204-2 is five years, in an easily accessible place, the first two years in an appropriate office of the investment adviser.

4 See section 210(b) of the Advisers Act [15 U.S.C. 80b-10(b)].

206(4)-5, under section 206(4) of the Advisers Act[5] to address "pay to play" practices by investment advisers that provide, or are seeking to provide, advisory services to government clients.[6] Rule 206(4)-5 prohibits an investment adviser from providing advisory services, for compensation, to a government entity client, or to certain covered investment pools in which a government entity invests, for two years after the adviser, or certain of its executives or employees, makes a contribution to certain elected officials or candidates. The new rule also prohibits an adviser from providing or agreeing to provide, directly or indirectly, payment to any third party for a solicitation of advisory business from any government entity on behalf of such adviser, unless such third parties are "regulated persons" – registered broker-dealers or registered investment advisers, in each case themselves subject to pay to play restrictions. Additionally, the rule prevents an adviser from coordinating or soliciting from others contributions to certain elected officials or candidates or payments to certain political parties.

Amended rule 204-2 requires every investment adviser registered or required to be registered that provides advisory services to government entities to maintain certain records of contributions made by the adviser or any of its covered associates. The amendments require an adviser to make and keep the following records: (i) the names, titles and business and residence addresses of all covered associates of the investment adviser; (ii) 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

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5 15 U.S.C 80b-6(4).

6 The adopting release is attached as Appendix A. All terms used, but not defined in this Supporting Statement, are defined in Appendix A.

to the effective date of the amended rule; (iii) all direct or indirect contributions made by the investment adviser or any of its covered associates to an official of a government entity, or payments to a political party of a state or political subdivision thereof, or a political action committee; and (iv) the name and business address of each regulated person to whom the adviser provides or agrees to provide, directly or indirectly, payment to solicit a government entity for investment advisory services on its behalf. An adviser to a covered investment pool in which a government entity invests or is solicited to invest would be treated as though that investment adviser were providing or seeking to provide investment advisory services directly to the government client. The adviser's records of contributions and payments would be required to be listed in chronological order identifying each contributor and recipient, the amounts and dates of each contribution or payment and whether such contribution or payment was subject to the exception for certain returned contributions pursuant to rule 206(4)-5(b)(3). An investment adviser is only required to make and keep current the records referred to in (i) and (iii) above if it provides investment advisory services to a government entity or a government entity is an investor in any covered investment pool to which the adviser provides investment advisory services. These records would be required to be maintained in the same manner, and for the same period of time, as other books and records under rule 204-2(a).

The amendments to rule 204-2 that the Commission adopted differ from the proposed amendments in several respects. We have tailored certain of the requirements from our proposal. First, we have limited the rule to provide that only records of contributions, not payments, to government officials, including candidates, are required to be kept under the rule. Second, investment advisers to registered investment companies only have to identify—and keep

records regarding—government entities that invest in a fund as part of a plan or program of a government entity, including any government entity that selects the fund as an investment option for participants in the plan or program.[7] Third, the Commission did not adopt provisions of the proposed amendments to the recordkeeping rule that would have required advisers to maintain a list of all government entities that they have solicited. In addition, only those advisers that have government entity clients must make and keep certain required records, unlike the proposal, which would have required all registered advisers to maintain records of contributions and covered associates. We also adopted a requirement that advisers maintain records of regulated persons they pay to solicit government entities on their behalf, to reflect that rule 206(4)-5 permits advisers to compensate these solicitors.

2. Purpose of the Information Collection

The purpose of the information collection is to assist the Commission's examination and oversight program in determining compliance with the Advisers Act and rules. As noted above, respondents are investment advisers registered with the Commission. Responses provided to the Commission in the context of its examination and oversight program are generally kept confidential.[8]

3. Role of Improved Information Technology

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7 Under our proposal, investment advisers to registered investment companies would have had to identify and keep records regarding government entities that invest in the funds regardless of whether they were part of a plan or program of a government entity. For a discussion of this modification, see section II.B. of Appendix A.

8 See supra note Error: Reference source not found.

The Commission's use of computer technology in connection with this information collection, which has been previously approved by OMB, would not change. The Commission currently permits advisers to maintain records required by the rule through electronic media.[9]

4. Efforts to Identify Duplication

The collection of information requirements of the rule amendment are not duplicated elsewhere.

5. Effect on Small Entities

The requirements of the amendments to rule 204-2 are the same for all investment advisers registered with the Commission, including those that are small entities.[10] The Commission estimates that as of April 2010 approximately 708, or less than ten percent, of currently SEC-registered investment advisers are small entities.[11] Of these 708 advisers, 61 indicate on Form ADV that they have state or local government entity clients and, therefore, have to comply with the new rule 206(4)-5 and the amendments to rule 204-2.[12] To the extent small advisers tend to have fewer clients and fewer employees that would be covered associates

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9 See Electronic Recordkeeping by Investment Companies and Investment Advisers, Investment Advisers Act Release No. 1945 (May 24, 2001) [66 FR 29224 (May 30, 2001)].

10 Under Commission rules, for the purposes of the Advisers Act and the Regulatory Flexibility Act, an investment adviser generally is a small entity if it: (i) has assets under management having a total value of less than $25 million; (ii) did not have total assets of $5 million or more on the last day of its most recent fiscal year; and (iii) does not control, is not controlled by, and is not under common control with another investment adviser that has assets under management of $25 million or more, or any person (other than a natural person) that had $5 million or more on the last day of its most recent fiscal year. 17 CFR 275.0-7(a).

11 This estimate is based on registration information from IARD as of April 1, 2010. We have estimated the number of small advisers by reference to advisers' responses to Item 12.A, B and C of Part 1 of Form ADV.

12 This estimate is based on registration information from IARD as of April 1, 2010. We have estimated the number of small advisers with state or local government clients by reference to advisers' responses to Item 5.D(9) of Part 1 of Form ADV.

for purposes of rule 206(4)-5, the amendments to rule 204-2 should impose lower costs on small advisers as compared to large advisers because variable costs, such as the requirement to make and keep records relating to contributions, should be lower due to the likelihood that there would be fewer records to make and keep. Moreover, as discussed in Appendix A, rule 206(4)-5 and amended rule 204-2 were modified from what we had proposed in several ways that the Commission expects will substantially minimize burdens on small advisers.

6. Consequences of Less Frequent Collection

Less frequent information collection would be incompatible with the objectives of the rule and could hinder the Commission's oversight and examination program for investment advisers and thereby reduce the protection to investors.

7. Inconsistencies with Guidelines in 5 CFR 1320.5(d)(2)

The collection requirements under rule 204-2 generally require advisers to maintain documents for five years, and in some cases longer.[13] This retention period has not been affected by the amendments to rule 204-2. Although this period exceeds the three-year guideline for most kinds of records under 5 CFR 1320.5(d)(2)(iv), OMB has previously approved the collection with this retention period. The retention periods in rule 204-2 are warranted because the recordkeeping requirements in rule 204-2 of the Advisers Act are designed to contribute to the effectiveness of the Commission's examination and inspection program. Because the period between examinations may be as long as five years, it is important that the Commission have access to records that cover the entire period between examinations.

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[13] See rule 204-2(e) [17 CFR 275.204-2(e)]. The standard retention period required for books and records under rule 204-2 is five years, in an easily accessible place, the first two years in an appropriate office of the investment adviser.

8. Consultation Outside the Agency

In its release proposing new rule 206(4)-5 and related amendments to rule 204-2, the Commission requested public comment on the effect of information collection under these amendments. Although a few commenters expressed general concerns that the paperwork burdens associated with our proposed amendments to rule 204-2 might be understated, commenters representing advisers to registered investment companies suggested that the proposal significantly underestimated the burden attributed to these covered investment pools.[14] With respect to registered investment companies, commenters noted that the proposed recordkeeping requirements required advisers to identify government investors in registered investment companies regardless of whether the fund was part of a plan or program of a government entity, and as a result the proposed amendments to rule 204-2 would have been difficult to comply with as fund shareholder records do not necessarily identify government investors.

As a result of these comments, we recognized that we may have underestimated the recordkeeping burden for advisers to registered investment companies that would have been subject to proposed rule 206(4)-5. However, we believe that our change to the definition of "covered investment pool" from the proposal to only include those registered investment companies that are an investment option of a plan or program of a government entity addresses the recordkeeping concerns commenters expressed regarding these covered investment pools and lowers recordkeeping burdens by limiting the records relating to registered investment

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[14] See Appendix A, citing ICI Letter ("[I]n relying on the estimates for compliance with the MSRB rules, the Commission significantly underestimates the compliance and recordkeeping burdens associated with the proposed rule.").

companies that an investment adviser must keep under the rule.[15] In addition, the other changes we made to the rule amendments—other than the requirement to keep records regarding regulated persons—would lessen the recordkeeping requirements relative to our proposal and thereby diminish our burden estimates. We anticipate that commenters' general concerns that we may have underestimated the burdens we presented in our proposal, as well as the burden associated with the additional requirement to maintain a list of regulated persons that solicit on an adviser's behalf, will be offset by what we believe will be a reduction in burdens as a result of the various modifications from proposed amendments to the recordkeeping rule, as described above. Moreover, notwithstanding the fact that the amendments we are adopting reduce advisers' recordkeeping obligations relative to our proposal, we are increasing our estimates to address the additional investment advisers who have registered with us since our proposal was issued.

The Commission and the staff of the Division of Investment Management continue to participate in an ongoing dialogue with representatives of the investment adviser industry through public conferences, meetings and informal exchanges. These various forums provide the Commission and the staff with a means of ascertaining and acting upon paperwork burdens facing the industry.

9. Payment or Gift to Respondents

None.

10. Assurance of Confidentiality

Responses provided to the Commission pursuant to rule 204-2 in the context of the

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[15] See Rule 204-2(a)(18)(i)(B).

Commission's examination and oversight program are generally kept confidential.[16]

11. Sensitive Questions

None.

12. Estimate of Hour Burden

The current approved collection of information for rule 204-2, set to expire on March 31, 2011, was based on an average of 181.15 burden hours each year, per Commission-registered adviser, for a total of 1,954,109 burden hours. The total burden is based on an estimate of 10,787 registered advisers.

Commission records indicate that currently there are approximately 11,607 registered investment advisers subject to the collection of information imposed by rule 204-2.[17] As a result of the increase in the number of advisers registered with the Commission since the current total burden was approved, the total burden has increased by 148,543 hours[18] to 2,102,652 burden hours.[19]

In our Proposing Release, we estimated that approximately 1,764 Commission-registered advisers provide, or seek to provide, advisory services to government clients and to certain pooled investment vehicles in which government entities invest, and would thus be affected by the rule amendments.[20] One commenter argued that this estimate was too low because it underestimates the number of investment advisers unregistered in reliance on Section 203(b)(3)

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16 See supra note Error: Reference source not found.

17 This figure is based on registration information from IARD as of April 1, 2010. The figures we relied on in our Proposing Release were based on registration information from IARD as of July 1, 2009. See Proposing Release, at section IV.

18 11,607 – 10,787 = 820. 820 additional advisers x 181.15 hours = 148,543 hours.

19 1,954,109 + 148,543 = 2,102,652.

20 See Proposing Release, at section IV.

of the Advisers Act and estimated to be subject to the Proposed Rule.[21] Unregistered advisers are not subject to rule 204-2's recordkeeping requirements. As a result, they are not included in our estimates for purposes of this analysis. We continue to believe our estimates are appropriate, although we have revised this number for purposes of both our cost-benefit analysis, discussed in Appendix A, and our PRA analysis to reflect both an increase in the number of registered advisers since the proposal and the modification from our proposal to not require records of unsuccessful solicitations. We now estimate that approximately 1,697 registered advisers provide advisory services to government clients and to certain pooled investment vehicles in which government entities invest, and would thus be affected by the rule amendments.[22]

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[21] See Appendix A, quoting Davis Polk Letter ("The cost benefit analysis is based solely on an estimated 1,764 registered investment advisers and does not account for the costs and burdens of compliance attributable to investment advisers exempt from registration. The estimated number of investment advisers unregistered in reliance on section 203(b)(3) of the Advisers Act (2,000) and estimated to be subject to the Proposed Rule (231), appears to be low. In its comment letter, the Third Party Marketers Association notes that the number of advisory firms exempted from registration may be 'over two times the estimate of the Commission. . . .'" (citations omitted)). The Davis Polk Letter does not offer any of its own estimates for the number of unregistered advisers, and the 3PM Letter references statistics regarding the number of funds, not the number of advisers.

[22] This estimate is based on registration information from IARD as of April 1, 2010, applying the same methodology as in the Proposing Release. As previously noted, according to responses to Item 5.D(9) of Part 1 of Form ADV, 1,332 advisers have clients that are state or municipal government entities, which represents 11.48% of all advisers registered with us. 10,275 advisers have not responded that they have clients that are state or municipal government entities. Of those, however, responses to Item 5.D(6) of Part 1 of Form ADV indicate that 2,486 advisers have some clients that are other pooled investment vehicles. Estimating that the same percentage of these advisers advise pools with government entity investors as advisers that have direct government entity clients—i.e.,11.48%. 285 of these advisers would be subject to the rule (2,486 x 11.48 % = 285). Out of the 10,275 that have not responded that they have clients that are state or municipal government entities, after backing out the 2,486 which have clients that are other pooled investment vehicles, responses to Item 5.D(4) of Part 1 of Form ADV indicate that 699 advisers have some clients that are registered investment companies. Estimating that roughly the same percentage of these advisers advise pools with government entity investors as advisers that have direct government entity clients—i.e.,11.48%. 80 of these advisers would be subject to the rule (699 x 11.48% = 80). Although we limited the application of rule 206(4)-5 with respect to registered investment companies to those that are investment options of a plan or program of a government entity, we continue to estimate that 80 advisers would have to comply with the recordkeeping provisions because of the difficulty in further delineating this estimated

Under the amendments, each respondent is required to retain the records in the same manner and for the same period of time as currently required under rule 204-2. The amendments to rule 204-2 are estimated to increase the burden by approximately 2 hours per Commission-registered adviser with government clients annually for a total increase of 3,394 hours.[23] The revised annual aggregate burden for all respondents to the recordkeeping requirements under rule 204-2 thus would be 2,106,046 hours.[24] The revised average burden per Commission-registered adviser would be 181.45 hours.[25]

An adviser would likely use a combination of compliance clerks and general clerks to make and keep the information and records required under the rule, as amended. The Commission staff estimates the hourly wage for compliance clerks to be $59 per hour, including benefits, and the hourly wage for general clerks to be $52 per hour, including benefits.[26] For each adviser 181.45 hours burden hours would be required to make and keep the information

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number. Therefore, we estimate that the total number of advisers subject to the rule would be: 1,332 advisers with state or municipal clients + 285 advisers with other pooled investment vehicle clients + 80 advisers with registered investment company clients = 1,697 advisers subject to rule. We expect certain additional advisers may incur compliance costs associated with rule 206(4)-5. We anticipate some advisers may be subject to the rule because they solicit government entities on behalf of other investment advisers. In the Proposing Release, our estimates included an estimated burden attributable to advisers that do not currently have government clients but that may begin to seek them. The revision to the recordkeeping rule that eliminated the requirement to maintain records of government entities that an adviser solicits has eliminated the need for this additional burden estimate.

23 2 x 1,697 = 3,394.

24 1,954,109 (current approved burden) + 148,543 (burden for additional registrants) + 3,394 (burden for proposed amendments) = 2,106,046 hours.

25 2,106,046 (revised annual aggregate burden) divided by 11,607 (total number of registrants) = 181.45.

26 Our hourly wage rate estimate for a compliance manager and compliance clerk is based on data from the Securities Industry Financial Markets Association's Office Salaries in the Securities Industry 2009, modified by Commission staff to account for an 1800-hour work-year and multiplied by 2.93, for compliance clerks to account for bonuses, firm size, employee benefits and overhead.

and records required under the rule. We anticipate that compliance clerks would perform an estimated 31.45 hours of this work, and clerical staff also would perform the remaining 150 hours. The total cost per respondent therefore would be an estimated $9,656,[27] for a total burden cost of $112,077,192.[28]

These estimates of average burden hours and average costs of those average burden hours are made solely for the purposes of the Paperwork Reduction Act and are not derived from a comprehensive or representative survey or study.

13. Estimate of Total Annual Cost Burden

The currently approved collection of information for rule 204-2 also includes a non-labor cost estimate of $13,551,390. The non-labor costs imposed by the rule include the estimated costs of mechanisms to store information on electronic media or on paper, and building space. We estimate the annual aggregate cost burden under the collection would increase in the same proportion as the increase in the estimated hour burden for the rule, to $14,581,509,[29] as a result of the increase in the number of registered advisers since the last burden was approved.

We expect advisory firms may also incur one-time costs to establish or enhance current systems to assist in their compliance with the amendments to rule 204-2. We believe the one-time costs could vary substantially among smaller, medium, and larger firms as smaller and medium firms may be able to use non-specialized software, such as a spreadsheet, or off-the-shelf compliance software to keep track of the information required by the rule while larger firms are more likely to have proprietary systems. Based on IARD data we estimate that there

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27 [31.45 x $59] + [150 x $52] = $9,656.

28 $9,656 per adviser x 11,607 advisers = $112,077,192.

29 [2,102,652 / 1,954,109] x $13,551,390 = $14,581,509.

are approximately 1,271 smaller firms, 304 medium firms, and 122 larger firms.[30] We estimate that one half of the smaller and medium firms will not incur these one-time start up costs because they will use existing tools for compliance. We expect the other half of smaller and medium firms will incur one-time start up costs on average of $10,000, in the event they have a greater number of employees and government clients, and larger firms, that likely have the most employees and government clients, will incur one-time start up costs on average of $100,000, increasing the non-labor cost burden by $20,080,000.[31]

Due to these increases, we now estimate the revised total non-labor cost burden for rule 204-2 to be $34,661,509.[32]

14. Estimate of Cost to the Federal Government

There are no costs to the federal government directly attributable to rule 204-2.

15. Explanation of Changes in Burden

There are two reasons for the estimated increase in burden hours from the current approved total burden of 1,954,109 to 2,106,046 hours: (1) 148,543 additional hours represents an increased hours burden due to there simply being more registrants subject to the burden since the burden was last approved; (2) 3,394 additional hours represents the new burden hours associated with our amendments to rule 204-2. The revised average burden per Commission-

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30 This estimate is based on registration information from IARD as of April 1, 2010. These estimates are based on IARD data, specifically the responses to Item 5.B.(1) of Form ADV, that 997 (or 74.9%) of the 1,332 registered investment advisers that have government clients have fewer than five employees who perform investment advisory functions, 239 (or 17.9%) have five to 15 such employees, and 96 (or 7.2%) have more than 15 such employees. We then applied those percentages to the 1,697 advisers we believe will be subject to the proposed rule for a total of 1,271 smaller, 304 medium and 122 larger firms.

31 [$10,000 x 788] + [$100,000 x 122] = $7,880,000 + $12,200,000 = $20,080,000.

32 $14,581,509 + $20,080,000 = $34,661,509.

registered adviser would be 181.45 hours.[33]

Similarly, there are two reasons for the increase in the non-labor cost estimate of $13,551,390 to $34,661,509: (1) just as we estimate the hour burden will increase from 1,954,109 to 2,102,652 due to the increase in registrants subject to the burden since the burden was last approved, we also estimate there would be a proportional increase in the non-labor cost estimate from $13,551,390 to $14,581,509; and (2) in connection with the rule amendments, we expect firms will incur a one-time cost of approximately $20,080,000 to establish or enhance current systems, as we noted in the Proposing Release and reiterate above.[34]

16. Information Collection Planned for Statistical Purposes

None.

17. Approval to not Display Expiration Date

None.

18. Exceptions to Certification Statement

None.

B. COLLECTION OF INFORMATION EMPLOYING STATISTICAL METHODS

Not applicable.

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[33] See supra Item 12.

[34] See supra Item 13.