SUPPORTING STATEMENT
Rule 206(4)-7

A. JUSTIFICATION

1. Necessity of the Information Collection

Rule 206(4)-7 under the Investment Advisers Act of 1940 ("Advisers Act") requires each investment adviser registered with the Securities and Exchange Commission (the "Commission") to (i) adopt and implement internal compliance policies and procedures, (ii) review those policies and procedures annually, (iii) designate a chief compliance officer, and (iv) maintain certain compliance records. The rule is designed to protect investors by fostering better compliance with the securities laws. This collection of information is found at 17 CFR 275.206(4)–7, Office of Management and Budget control number 3235-0585, and is mandatory.

The collection of information under rule 206(4)-7 is necessary to assure that investment advisers maintain comprehensive internal programs that promote the advisers' compliance with the Advisers Act. The respondents are investment advisers registered with the Commission. The Commission's examination and oversight staff may review the information collected to assess investment advisers' compliance programs.

The Commission recently adopted a new rule, 206(4)-5, under section 206(4) of the Advisers Act[1] to address "pay to play" practices by investment advisers that provide, or are seeking to provide, advisory services to government clients.[2] 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

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[1] 15 U.S.C 80b-6(4).

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

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. The Commission also adopted related amendments to Advisers Act rules 204-2 and rule 206(4)-3. As a result of the adoption of rule 206(4)-5 and related amendments, rule 206(4)-7 contains a revised collection of information requirement within the meaning of the Paperwork Reduction Act ("PRA").

2. Purpose of the Information Collection

The purpose of the information collection requirements in rule 206(4)-7 is to ensure that advisers maintain comprehensive, written internal compliance programs that promote compliance with the federal securities laws. The information collection in the rule also assists the Commission's examination staff in assessing the adequacy of advisers' compliance programs.

3. Role of Improved Information Technology

Rule 206(4)-7 does not require the reporting of any information or the filing of any documents with the Commission. The rule requires advisers to maintain written policies and procedures. Each adviser is required to maintain for at least five years copies of any records documenting the adviser's annual review of its compliance policies and procedures. The Commission permits advisers to maintain the records required under rule 204-2 through electronic media.

4. Efforts to Identify Duplication

Rule 206(4)-7 imposes a broad requirement that advisers have in place written compliance policies and procedures. Advisers currently are subject to a certain requirements elsewhere in the federal securities laws that require them to maintain written policies and procedures. Rule 206(4)-7, however, does not require advisers to maintain duplicate copies of records covered by these more targeted requirements. The staff believes, therefore, that any duplication of regulatory requirements is limited and does not impose significant additional costs on advisers.

5. Effect on Small Entities

Advisers, regardless of their size, are subject to the requirements in rule 206(4)-7. Effective internal compliance programs are essential for firms of all sizes. Rule 206(4)-7 affords advisers the flexibility to tailor their compliance program to the nature of their business. Small advisers, which generally have less complex and more limited operations, would likely need less extensive compliance programs than their larger counterparts. Thus, rule 206(4)-7 should not inappropriately burden small advisers. The Commission believes that it could not adjust the rule to lessen the burden on small entities of complying with the rule without jeopardizing the interests of clients of small advisers.

The compliance requirements related to rule 206(4)-5 and the amendments to rule 204-2 and rule 206(4)-3 are the same for all investment advisers registered with the Commission, including those that are small entities.[3] The Commission estimates that as of April 2010 approximately 708, or less than ten percent, of currently SEC-registered investment advisers are small entities.[4] 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, the amendments to rule 204-2 and the amendments to rule 206(4)-3, if that rule is applicable.[5] To the extent small advisers tend to have fewer clients and fewer employees that would be covered associates for purposes of rule 206(4)-5, the rule 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 compliance burdens on small advisers.

6. Consequences of Less Frequent Collection

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[3] 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).

[4] 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.

[5] 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.

Rule 206(4)-7 requires advisers to review their policies and procedures annually. The annual reviews required under the rule are integral to detecting and correcting any gaps in the program before irrevocable or widespread harm is inflicted upon investors, and extending the time between reviews increases the likelihood that such harm could go unchecked.

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

Rule 206(4)-7 requires advisers to maintain their internal compliance policies and procedures and documents related to the annual review of those policies and procedures for at least five years. Although this period exceeds the three-year guideline for most kinds of records under 5 CFR 1320.5(d)(2)(iv), the staff believes that this is warranted because the rule contributes 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.

8. Consultation Outside the Agency

In its release proposing new rule 206(4)-5 and related amendments, the Commission requested public comment on its estimates of the costs and burdens associated with complying with the new rule and amendments. The comments we received are discussed below in items 12 and 13 in connection with our current estimates of the hour burden and cost burden associated with rule 206(4)-7.

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

9. Payment or Gift to Respondents

Not applicable.

10. Assurance of Confidentiality

The information documented pursuant to the rule 206(4)-7 is reviewed by the Commission's examination staff, it will be accorded the same level of confidentiality accorded to other responses provided to the Commission in the context of its examination and oversight program.[6]

11. Sensitive Questions

Not applicable.

12. Estimate of Hour Burden

We expect that registered investment advisers subject to rule 206(4)-5 will modify their compliance programs to address new obligations under that rule. The current approved collection of information for rule 206(4)-7, set to expire on March 31, 2011, is based on 10,817 registered advisers that were subject to the rule at an average burden of 80 hours each year per respondent for a total of 865,360 burden hours.

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[6] Section 201(b) of the Advisers Act (15 U.S.C. 10(b)).

Commission records indicate that currently there are approximately 11,607 registered investment advisers.[7] 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 63,200 hours (790 x 80 hours). In addition, although the time needed to comply with rule 206(4)-5 will vary significantly from adviser to adviser, the Commission staff estimates that firms with government clients will spend between 8 hours and 250 hours to implement policies and procedures to comply with the rule, depending on the firm's number of covered associates.[8] We estimate that approximately 1,697 investment advisers registered with the Commission may be affected by the rule and rule amendments.[9] Of the 1,697 advisers, we estimate that approximately 1,271 advisers have fewer than five covered associates that would be subject to the rule (each, a "smaller firm"); approximately 304 advisers have between five and 15 covered

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[7] This figure is based on registration information from IARD as of April 1, 2010.

[8] *See* section IV.B.1. of Appendix A (describing the cost estimates associated with compliance with rule 206(4)-5).

[9] This estimate is based on registration information from IARD as of April 1, 2010, applying the same methodology as in the Proposing Release. 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 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.

associates (each, a "medium firm"); and approximately 122 advisers have more than 15 covered associates that would be subject to the prohibitions of the rule (each, a "larger firm").[10]

[10] 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.

These estimates are consistent with the estimates we established, and requested public comment on, in the Proposing Release. Comments we received related to these estimates pertained to costs associated with rule 206(4)-5, not costs associated with developing compliance policies and procedures pursuant to rule 206(4)-7.[11]

We anticipate that smaller firms will spend 8 hours, medium firms will spend 125 hours, and larger firms will spend 250 hours,[12] for a total of 78,668 hours,[13] to implement policies and procedures. Our estimates take into account our staff's observation that some registered advisers have established policies regarding political contributions, which can be revised to reflect the new requirements. The revised annual aggregate burden for all respondents to comply with rule 206(4)-7 thus would be 1,007,228 hours.[14]

Initial compliance procedures would likely be designed, and ongoing administration of them performed, by compliance managers and compliance clerks. We estimate that the hourly wage rate for compliance managers is $294, including benefits, and for compliance clerks, $59 per hour, including benefits.[15] To establish and implement adequate compliance procedures, we

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11 For instance, one commenter disagreed with us basing our cost estimates on an assumption that most registered advisers would have fewer than five covered associates because the commenter expects most advisers to require all or most of their employees to receive approval prior to making any political contributions in order to avoid inadvertently triggering the rule. *See* Appendix A, *citing* MFA Letter. This type of pre-screening process could be perceived by the individuals subject to them as costs imposed on their ability to express their support for certain candidates for elected office and government officials, and it would be a perceived cost associated with rule 206(4)-5, not rule 206(4)-7. *See* Appendix A, notes 476 and 477 and accompanying text for additional examples of public comments relating to compliance with rule 206(4)-5.

12 *See* Appendix A, notes 489-491.

13 (1,271 x 8 = 10,168) + (304 x 125 = 38,000) + (122 x 250 = 30,500) = 78,668.

14 865,360 (current approved burden) + 63,200 (burden for additional registrants) + 78,668 (burden attributable to rule 206(4)-5) = 1,007,228 hours.

15 Our hourly wage rate estimate for a compliance manager and compliance clerk is based on data from the *Securities Industry Financial Markets Association's Management & Professional Earnings in the Securities Industry 2009*, modified by Commission staff to account for an 1800-hour work-year and multiplied by 5.35 (in the case of compliance managers) or 2.93

estimate that the rule would impose initial compliance costs of approximately $2,352 per smaller firm,[16] approximately $29,407 per medium firm,[17] and approximately $58,813 per larger firm,[18] for a total annual aggregate cost of $19,104,306.[19]

(in the case of compliance clerks) to account for bonuses, firm size, employee benefits and overhead. The calculations discussed in this release are updated from those included in the Proposing Release to incorporate data from the most recently updated version of this publication.

[16] The per firm cost estimate is based on our estimate that development of initial compliance procedures for smaller firms would take 8 hours of compliance manager time (at $294 per hour). Accordingly, the per firm cost estimate is $2,352 (8 x $294).

[17] With respect to our estimated range of 8-250 hours, we assume a medium firm would take 125 hours to develop initial compliance procedures, and such a firm would likely have support staff. We also anticipate that a compliance manager would do approximately 75% of the work because he or she is responsible for implementing the policy for the entire firm. Accordingly, the per firm cost estimate is based on our estimate that development of initial compliance procedures for medium firms would take 93.75 hours of compliance manager time, at $294 per hour (or $27,563), and 31.25 hours of clerical time, at $59 per hour (or $1,844), for a total estimated cost of $29,407.

[18] With respect to our estimated range of 8-250 hours, we assume a larger firm would take 250 hours to develop initial compliance procedures, and such a firm would likely have support staff. We also anticipate that a compliance manager would do approximately 75% of the work because he/she is responsible for implementing the policy for the entire firm. Accordingly, the per firm cost estimate is based on our estimate that development of initial compliance procedures for larger firms would take 187.50 hours of compliance manager time, at $294 per hour (or $55,125), and 62.5 hours of clerical time, at $59 per hour (or $3,688), for a total estimated cost of $58,813.

[19] [1,271 x $2,352] + [304 x $29,407] + [122 x $58,813] = $19,104,306.

13. Estimate of Total Annual Cost Burden

In the Proposing Release, we anticipated that approximately one-third of advisers (approximately 591) that we estimated would be subject to the proposed rule and rule amendments may also incur one-time costs to engage outside legal services to assist in drafting policies and procedures, for an estimated total cost of $2,270,000 among advisers affected by the proposed rule amendments. One commenter suggested that we had underestimated both the percentage of advisers that would engage outside counsel and the number of hours that outside counsel would spend lending their assistance, but did not provide alternative estimates.[20] Based on our staff's experience administering the compliance rule program, we continue to believe that our estimates for the number of firms that will retain outside counsel for review of policies and procedures are appropriate. Based on this comment, however, we have revisited the number of hours we estimated outside counsel would spend reviewing policies and procedures and have increased these estimates. We now estimate the cost associated with such an engagement would include fees for approximately eight hours of outside legal review for a smaller firm, 16 hours for a medium firm, and 40 hours for a larger firm, at a rate of $400 per hour.[21] Consequently, for a smaller firm we estimate a total of $3,200 in outside legal fees for each of the estimated 318 advisers that would seek assistance, for a medium firm we estimate a total of $6,400 for the estimated 152 advisers that would seek assistance, and for each of the 92 larger firms we estimate a total of $16,000. Thus, we estimate that approximately 562 investment advisers will incur these one-time costs, for a total cost of $3,462,400[22] among advisers affected by the new rule and rule amendments.

[20] *See* Appendix A, *citing* Davis Polk letter.

[21] In the Proposing Release we estimated the hourly cost of outside counsel to be $400 based on our consultation with advisers and law firms who regularly assist them in compliance matters. We did not receive comment on this estimate and continue to believe that it is an accurate estimate.

The staff estimates that the rule 206(4)-7 will not impose a material ongoing cost burden on advisers, apart from the cost of the burden hours. Although the rule requires advisers to maintain certain records for five years, these records may be maintained electronically and, even if maintained in hard copy, are unlikely to be voluminous.

14. Estimate of Cost to the Federal Government

Rule 206(4)-7 does not impose any costs on the Federal government, since there is no separate filing required with the Commission. However, Commission staff may review records produced pursuant to the rule in order to assist the Commission in carrying out its examination and oversight program.

15. Explanation of Changes in Burden

We have increased the estimated annual aggregate burden from 865,360 to 1,007,228 hours based on (1) an increase in the number of SEC-registered investment advisers and (2) the burden associated with developing policies and procedures to comply with new rule 206(4)-5 and related amendments to rules 204-2 and 206(4)-3.

We also estimate that certain investment advisers will incur additional one-time costs of $3,462,400[23] to engage outside legal services to assist in drafting policies and procedures to comply with the new rule and rule amendments.

16. Information Collection Planned for Statistical Purposes

Not applicable.

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[22] [318 x $3,200 = $1,017,600] + [152 x $6,400 = $972,800] + [92 x $16,000 = $1,472,000] = $3,462,400.

[23] [318 x $3,200 = $1,017,600] + [152 x $6,400 = $972,800] + [92 x $16,000 = $1,472,000] = $3,462,400.

17. Approval to not Display Expiration Date

Not applicable.

18. Exceptions to Certification Requirement

Not applicable.

B. COLLECTION OF INFORMATION EMPLOYING STATISTICAL METHODS

Not applicable.