IM Guidance Update

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FUND ADVISERS SERVING "AT COST" OR FOR NO COMPENSATION

A registered investment company's (fund's) advisory relationship is at the core of the Investment Company Act of 1940 (Company Act). The protections and safeguards that the Company Act affords to a fund in its relationship with its investment adviser are vital to investor protection and capital formation. Among the many issues that the Commission has considered in this regard over the years is whether a person or company that temporarily serves a fund "at cost" or for no compensation is an investment adviser under the Company Act.

Section 2(a)(20) of the Company Act defines an investment adviser of an investment company to include, in relevant part, any person "who pursuant to contract with such company regularly furnishes advice to such company with respect to the desirability of investing in, purchasing or selling securities or other property, or is empowered to determine what securities or other property shall be purchased or sold by such company." Section 2(a)(20)(iii), however, excludes from this definition "a company furnishing such services at cost to one or more investment companies, insurance companies, or other financial institutions." The Commission has made clear that "[t]his exclusion refers to a company which is in the business of providing such services at cost—such as a company which is owned by, and provides services exclusively to, such financial institutions."[1] The Commission also has emphasized that Section 2(a)(20)(iii) "was not intended to provide an exclusion for investment advisers who provide services temporarily at cost to particular clients only."[2] The Commission therefore "did not interpret such persons not to be investment advisers as defined in Section 2(a)(20). Any such interpretation would be inconsistent with the investor protections mandated by the [Company] Act."[3]

One particular context in which an investment adviser may be temporarily providing advisory services to a fund at cost or for no compensation involves an "assignment" of an investment advisory contract. Under Section 15(a)(4) of the Company Act, it is unlawful for a person to act as investment adviser for a fund except pursuant to a written contract which, in relevant part, must be approved by the vote of a majority of the fund's outstanding voting securities and must provide for the contract's automatic termination in the event of its assignment. Section 2(a)(4) of the Company Act broadly defines

assignment to include, in relevant part, any direct or indirect transfer or hypothecation of a contract by the assignor or of a controlling block of the assignor's outstanding voting securities. Recognizing the difficulties a fund might experience in getting timely shareholder approval of a new advisory contract in the event of an assignment and automatic termination of the old advisory contract, the Commission adopted Rule 15a-4 under the Company Act.

Rule 15a-4 provides a temporary 150-day period during which a person may act as investment adviser for a fund under an interim contract without shareholder approval, subject to specified conditions. Under Rule 15a-4, in the event of a failure to obtain shareholder approval as provided for in the rule, the investment adviser may be paid its costs incurred in performing the interim contract. Although Rule 15a-4 provides relief for substantially all circumstances in which a fund might need additional time to obtain shareholder approval of an advisory contract in the case of an assignment, Division staff occasionally has provided similar relief in no-action letters in particular circumstances. Consistent with the Commission's approach in Rule 15a-4, certain of these no-action letters were premised, among other things, on the investment adviser being paid only its costs incurred during the relevant interim period,[4] whereas other no-action letters relied, in part, on a representation that the investment adviser would receive no compensation and no reimbursement of its costs.[5]

Service at cost or for no compensation has been a factor underlying Commission and staff relief for a person to act temporarily as an investment adviser to a fund without shareholder approval. As the Commission has stated, however, "[w]hile the Commission has . . . granted certain temporary exemptions from the provisions of [S]ection 15(a) conditioned on such person's serving during the interim period on a cost basis, it did not interpret such persons not to be investment advisers as defined in [S]ection 2(a)(20)."[6]

Endnotes

1 *Exemption for Certain Investment Advisers and Principal Underwriters of Investment Companies*, Investment Company Act Release No. 10809 (Aug. 6, 1979) at footnote 1.

2 *Id*.

3 *Exemptions for Certain Investment Advisers and Principal Underwriters of Investment Companies*, Investment Company Act Release No. 11005 (Jan. 2, 1980) ("Adopting Release") at footnote 2.

4 *See, e.g.*, *Gartmore Global Partners* (SEC Staff No-Action Letter, pub. avail. July 31, 2000).

5 *See, e.g.*, *Claymore Advisors, LLC* (SEC Staff No-Action Letter, pub. avail. Apr. 27, 2010) and *Mellon Equity Associates, LLP* (SEC Staff No-Action Letter, pub. avail. Apr. 1, 2005).

6 Adopting Release at footnote 2.

This IM Guidance Update summarizes the views of the Division of Investment Management regarding various requirements of the federal securities laws. Future changes in laws or regulations may supersede some of the discussion or issues raised herein. This IM Guidance Update is not a rule, regulation or statement of the Commission, and the Commission has neither approved nor disapproved of this IM Guidance Update.

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- promote informed investment decisions and
- facilitate appropriate innovation in investment products and services

through regulating the asset management industry.

If you have any questions about this IM Guidance Update, please contact:
Chief Counsel's Office/Public Inquiry
Phone: 202.551.6825
Email: IMOCC@sec.gov