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SUBMITTED ELECTRONICALLY

July 21, 2016

Brent J. Fields
Secretary
U.S. Securities and Exchange Commission
100 F Street NE
Washington, D.C. 20549

Re: Incentive-Based Compensation Arrangements, File Number S7-07-16

Ladies and Gentlemen:

National Financial Services LLC ("NFS")[1] appreciates the opportunity to comment on the rule re-proposed jointly by the Securities and Exchange Commission ("SEC"), the Board of Governors of the Federal Reserve System ("Federal Reserve"), the Office of the Comptroller of the Currency ("OCC"), the Federal Deposit Insurance Corporation ("FDIC"), the National Credit Union Administration ("NCUA") and the Federal Housing Finance Agency ("FHFA") (collectively, the "Agencies") regarding incentive-based compensation arrangements under Section 956 of the Dodd-Frank Wall Street Reform and Customer Protection Act ("Dodd-Frank").[2]

I. INTRODUCTION

Section 956 of Dodd-Frank requires the Agencies to prohibit incentive compensation that encourages "inappropriate risks" because the compensation is "excessive" or could lead to a "material financial loss" to a "covered institution." The design of the Proposed Rule is also motivated by the Agencies' concern that incentive compensation may harm shareholders or

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[1] NFS, a Fidelity Investments company, is an SEC-registered clearing and carrying broker-dealer and Financial Industry Regulatory Authority ("FINRA") member. As such, NFS acts as the custodian for cash and securities for: (i) customers of its affiliated retail introducing broker-dealer Fidelity Brokerage Services LLC ("FBS"); (ii) customers of unaffiliated introducing broker-dealers and investment advisors; and (iii) its direct institutional customers. NFS is also registered as an investment adviser with the SEC for the limited purpose of providing transition management services to funds and pension plans subject to the Employee Retirement Income Security Act of 1974, as amended, acting temporarily as an investment manager. NFS does not exercise any investment discretion in connection with this activity. Thus, although NFS is registered as an investment adviser, NFS does not provide investment advice and does not have any assets under management. Fidelity Investments is a leading provider of investment management, retirement planning, portfolio guidance, brokerage, benefits outsourcing and many other financial products and services.

[2] Incentive-Based Compensation Arrangements, Exchange Act Release No. 34-77776, 114 SEC Docket 1 (May 6, 2016), 81 Fed. Reg. 37,669 (June 10, 2016). This letter will refer to the preamble to the proposed rule ("Preamble"), the text of the SEC's proposed rule in §§ 303.1–.13 ("Proposed Rule"), and the SEC's economic analysis in Section V.I. ("SEC Economic Analysis").

impose "negative externalities" on taxpayers.[3]

Section 956 of Dodd-Frank further directs the Agencies to design any standards to be "comparable" to those established under the Federal Deposit Insurance Act.[4] It allows the Agencies the discretion, however, to differentiate among covered institutions and pursue their mandate either by prescribing regulations – or by taking a more flexible, principles-based approach and creating guidelines.

The Agencies have proposed a prescriptive rule rather than creating guidelines. The Proposed Rule would therefore apply to all "covered institutions" meeting a certain asset threshold – including banks and non-banks – rather than differentiating among them based on their actual risk profiles and the relevance of Section 956 of Dodd-Frank to their businesses. All "covered institutions" with "average total consolidated assets" of $1 billion or more (Level 3) would be subject to the Proposed Rule– with additional highly prescriptive requirements applying at the $50 billion and $250 billion thresholds (Level 2 and Level 1, respectively).[5]

We recommend a more flexible risk-based approach that would allow the Agencies to apply the requirements of Section 956 of Dodd-Frank to covered institutions in a manner that reflects both the differences among them and the relevance of Section 956 of Dodd-Frank to their businesses and balance sheets. Some assets are created or consolidated as a result of accounting rules that were designed for different purposes than the Proposed Rule. For example, certain assets that are consolidated on a covered institution's balance sheet – such as the assets required to be "locked up" by an SEC-registered broker-dealer under the Customer Protection Rule, SEC Rule 15c3-3 (defined in Section II. below) – may not be vulnerable to inappropriate risk-taking by its management or put the institution at risk of material financial loss. As set forth more fully below, we recommend that assets such as the customer reserve "lock-up" – which must be segregated by the broker-dealer and cannot be used in its proprietary business – should be excluded from a measurement of assets under the Proposed Rule because they do not give rise to the risks that Section 956 of Dodd-Frank is intended to prevent.

We also recommend that the Agencies revise the Proposed Rule to preserve discretion to assign a covered institution to a lower level based on its actual risk profile – not simply its size – because differentiation based on asset size alone can produce unintended and inequitable results. For example, a $49 billion highly leveraged institution that primarily holds high-risk assets would be categorized as a lowest risk Level 3 covered institution – whereas a $50 billion broker-dealer that has very little leverage and invests customer cash in a limited set of permissible assets for the benefit of customers as prescribed by strict SEC rules, would be treated as higher risk and subject to more stringent requirements as a Level 2 covered institution. The opposite should be true. Categorization of companies based solely on size fails to recognize fundamental differences in their business models, ownership structures and other

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[3] Preamble, 81 Fed. Reg. at 37,673–75; SEC Economic Analysis, 81 Fed. Reg. at 37,758 and 37,763. Note, however, that no language in Section 956 of Dodd-Frank gives the Agencies a mandate to attempt to reduce "negative externalities."
[4] Preamble, 81 Fed. Reg. at 37,673; *see* 12 U.S.C. § 5641.
[5] Proposed Rule § 303.2(i) and §§ 303.2(v)-(x), 81 Fed. Reg. at 37,832-33.

factors the Agencies should consider in a risk analysis.

A comparison of broker-dealers and investment advisers, in particular, to other types of institutions covered by the Proposed Rule illustrates the importance of differentiating among businesses. In its economic analysis, the SEC recognizes that broker-dealers and investment advisers "differ from other financial services firms with respect to business models, nature of the risks posed by the institutions, and the nature and identity of the persons affected by those risks."[6] The case for treating them the same as those other firms is further undermined by the fact that the "academic literature does not provide clear evidence that [they] have produced negative externalities for taxpayers."[7] Nothing in Section 956 of Dodd-Frank requires the Agencies to disregard those differences and apply rules that were designed for banks to fundamentally different companies like broker-dealers and investment advisers.

Similarly, where stakeholder interests and managerial interests are well aligned, such as in a closely-held company (i) there is no discernible benefit to applying the Proposed Rule; and (ii) as the SEC acknowledges, it may do more harm than good to apply the Proposed Rule's prescriptive requirements, which were designed based on the attributes of public companies.[8] In such circumstances, the Agencies should maintain discretion to tailor the treatment of a covered institution and assign it to an appropriate level under the Proposed Rule based on its risk profile, regardless of its asset size.

Specifically, we recommend that the Agencies:

- **Exclude assets custodied by a carrying broker-dealer that are required to be "locked up" in the Customer Reserve Account from the calculation of "average total consolidated assets" for purposes of the Proposed Rule;**

- **Reserve the discretion to treat a company as a lower level covered institution based on risk profile, regardless of asset size; and**

- **Index the asset thresholds for inflation for all covered institutions to maintain the intended scope of the Proposed Rule.**

In support of our recommendations, we provide examples of how they would apply to our firm in the discussion below. We note, however, that the principles we suggest are broadly applicable and are by no means limited to NFS.

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[6] SEC Economic Analysis, 81 Fed. Reg. at 37,758, n.316; *id.* at 37,787.
[7] SEC Economic Analysis, 81 Fed. Reg. at 37,758.
[8] SEC Economic Analysis, 81 Fed. Reg. at 37,758-59.

II. ASSETS THAT ARE REQUIRED TO BE "LOCKED UP" IN THE CUSTOMER RESERVE ACCOUNT SHOULD BE EXCLUDED FROM THE CALCULATION OF "AVERAGE TOTAL CONSOLIDATED ASSETS" FOR PURPOSES OF THE PROPOSED RULE.

The Agencies have invited comment on the definition of "average total consolidated assets."[9] A broker-dealer or an investment adviser will be subject to the Proposed Rule if the covered institution has average total consolidated assets greater than or equal to $1 billion (Level 3).[10] Mandatory deferral and clawback requirements would also apply to a broker-dealer or investment adviser with total consolidated assets greater than or equal to $50 billion (Level 2) or $250 billion (Level 1).[11] Under § 303.2(b) of the Proposed Rule, "average total consolidated assets" means the average of a regulated institution's total consolidated assets, as reported on the regulated institution's regulatory reports, for the four most recent consecutive quarters. For a FINRA member broker-dealer, the applicable regulatory report is the FOCUS Report.[12]

Congress drafted Section 956 of Dodd-Frank based primarily on the concern that management could be incentivized to expose balance sheet assets to more risk in pursuit of greater compensation. For many financial institutions covered by the Proposed Rule, the bulk of balance sheet assets are owned by the covered institution and are available for management to deploy, and thereby expose to risk, however they see fit. The Proposed Rule should be revised to allow the Agencies to recognize that not all of the "assets" included on the balance sheet for purposes of Generally Accepted Accounting Principles (GAAP) may be put at risk by a covered entity.[13]

Our focus is on certain balance sheet assets of a carrying broker-dealer that are already effectively protected from the type of risk-taking that is the stated concern of the Proposed Rule — *i.e.,* the aggregate net balance owed to customers that is required to be "locked up" and deposited in a separate bank account and held exclusively for the benefit of those customers (the "Customer Reserve Account") pursuant to Rule 15c3-3 of the Securities Exchange Act of 1934 (the "Exchange Act") (hereinafter referred to as the "Customer Protection Rule").[14] The Customer Protection Rule requires a carrying broker-dealer to maintain a "reserve" of funds and/or "qualified securities" in the Customer Reserve Account

[9] Preamble, 81 Fed. Reg. at 37,690, Request for Comment 2.4.
[10] Proposed Rule § 303.2(i), 81 Fed. Reg. at 37,832.
[11] Proposed Rule, § 303.7, 81 Fed. Reg. at 37,835-37; Preamble, 81 Fed. Reg. at 37,680-81.
[12] Proposed Rule § 303.2(ee), 81 Fed. Reg. at 37,833. FINRA member carrying firms are required by SEC Rule 17a-5 to file with FINRA a monthly Financial and Operational Combined Uniform Single Report (FOCUS Report). *See* SEC Rule 17a-5(a)(2)(i), 17 C.F.R. § 240.17a-5(a)(2)(i); NYSE Information Memo 92-42 (December 23, 1992).
[13] For example, assets such as capitalized goodwill and intangible assets that appear on a balance sheet may make entities, and their risk-taking capabilities, appear larger than they actually are.
[14] SEC Customer Protection Rule, 17 C.F.R. § 240.15c3-3. *See* Exchange Act Release No. 9856 (Nov. 10, 1972), 37 Fed. Reg. 25,224 (Nov. 29, 1972); Fin. Resp. Rules for Broker-Dealers, Exchange Act Release No. 34-70072 (July 30, 2013), 78 Fed. Reg. 51,824 (Aug. 21, 2013).

that is at least equal in value to the net cash it owes to customers.[15]

As further set forth below, the assets "locked up" in the Customer Reserve Account should be excluded from the calculation of the carrying broker-dealer's "average total consolidated assets" for purposes of the Proposed Rule because the Customer Protection Rule (1) prohibits the carrying broker-dealer from using the "locked up" customer assets to finance any part of its proprietary business; and (2) requires the carrying broker-dealer to invest the Customer Reserve Account deposit only in cash or "qualified securities"–thereby providing protection in case of insolvency. The employees of the carrying broker-dealer have no ability to take "inappropriate risks" with respect to the assets in the Customer Reserve Account – and their decision-making authority is so limited that these assets are already shielded from the behavior that Section 956 of Dodd-Frank is intended to prevent. Further, treating the "locked up" assets as if they may be vulnerable to inappropriate risk-taking would be inconsistent with the SEC's long-standing policy and public statements regarding the inviolable manner in which carrying broker-dealers are required to safeguard those assets.

A. The SEC's Customer Protection Rule Already Effectively Safeguards the Customer Reserve Account.

The SEC has long recognized that the purpose of the Customer Protection Rule for carrying broker-dealers is "to give more specific protection to customer funds and securities, in effect forbidding brokers and dealers from using customer assets to finance any part of their businesses unrelated to servicing securities customers; *e.g.*, a firm is virtually precluded from using customer funds to buy securities for its own account."[16] As a result, unlike a bank, which can freely use customer cash deposits for its proprietary lending activities, a carrying broker-dealer like NFS is prohibited by the Customer Protection Rule from using customer funds to finance its proprietary business activities.[17] Indeed, the SEC has repeatedly recognized that the Customer Protection Rule is an effective prohibition against a broker-dealer's use of customer funds and securities to finance activities for its own account.[18] When the Customer Protection Rule was amended in 2013, SEC Chair Mary Jo White said: "[i]nvestors need to feel confident that their money is safe when it's being held by their broker-dealers… [t]hese measures will significantly bolster the protections that our rules already

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[15] 17 C.F.R. § 240.15c3-3(e); *see also infra* note 34 (defining "qualified securities"). The vast majority of the "assets" disclosed on NFS's balance sheet for GAAP purposes come not from its own proprietary assets – but from the amounts "locked up" in the Customer Reserve Account. The amount "locked up" in the Customer Reserve Account is reflected as a line item on the Statement of Financial Condition required to be filed annually by broker-dealers under Rule 17a-5 of the Exchange Act ("Cash and Securities Segregated under Federal Regulations"). 17 C.F.R. § 240.17a-5(d). Similarly, the amount "locked up" in the Customer Reserve Account is also referenced in various line items on the FOCUS Report.
[16] Fin. Resp. Rules for Broker-Dealers, 78 Fed. Reg. at 51,826. *See also* Exchange Act Release No. 21,651 (Jan. 11, 1985), 50 Fed. Reg. 2690 (Jan. 18, 1985).
[17] Fin. Resp. Rules for Broker-Dealers, 78 Fed. Reg. at 51,832; Exchange Act Release No. 21,651, 50 Fed. Reg. at 2690. *See* Michael P. Jamroz, *The Customer Protection Rule,* 57 BUS. LAW. 1069, 1070 (May 2002) (hereinafter, "Jamroz").
[18] Fin. Resp. Rules for Broker-Dealers, 78 Fed. Reg. at 51,826; Exchange Act Release No. 21,651, 50 Fed. Reg. at 2690.

offer."[19] Similarly, in discussing the SEC's recent imposition of a $415 million fine against a major broker-dealer, Andrew Ceresney, director of the SEC's Division of Enforcement, stated that "[t]he rules concerning the safety of customer cash and securities are fundamental protections for investors and impose lines that simply can never be crossed."[20]

1. The Two Primary Steps of the Customer Protection Rule Effectively Segregate Assets for the Benefit of Customers.

The SEC adopted the Customer Protection Rule in November 1972 "in response to a Congressional directive to strengthen the financial responsibility requirements for broker-dealers that hold securities and cash for customers."[21] The Customer Protection Rule "can be loosely described as a 'segregation' rule, [which] divides the customer and proprietary activities" of a carrying firm.[22] The Customer Protection Rule is designed to protect customers by segregating their cash and securities from the broker-dealer's own business activities. If the broker-dealer fails financially, then the customer cash and securities should be isolated and readily identifiable as customer property which is available to be distributed to customers ahead of other creditors.[23] The Customer Protection rule therefore requires the carrying broker-dealer to safeguard these assets through two primary steps:

> ***Step 1: Possession or Control of Fully Paid and Excess Margin Customer Securities***. In addition to contractual obligations that make the broker-dealer the custodian of its customer's property, the Customer Protection Rule requires that a carrying broker-dealer promptly obtain possession, and thereafter maintain physical possession or "control" of all "fully-paid" and "excess margin" securities held by the firm for customers.[24] For this purpose, securities are deemed to be in the firm's "control" when held in the firm's name at a clearing corporation or other approved "control location" and allocated to the firm's customers on its books and records – a form of "bookkeeping segregation."[25] Most importantly, the firm cannot use such securities to finance its own business.

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[19] U.S. Sec. Exch. Comm'n, SEC Adopts Amend. to Fin. Resp. Rules for Broker-Dealers, Press Release No. 2013-140 (July 31, 2013), https://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539739257.

[20] U.S. Sec. Exch. Comm'n, *"Merrill Lynch to pay $415 Million for Misusing Customer Cash and Putting Customer Securities at Risk"*, Press Release No. 2016-128 (June 23, 2016). "Merrill Lynch violated these rules, including during the heart of the financial crisis, and the significant relief imposed today reflects the severity of its failures." *Id.*

[21] Exchange Act Release No. 9856, 37 Fed. Reg. at 25,224; Fin. Resp. Rules for Broker-Dealers, 78 Fed. Reg. at 51,826.

[22] *See* Jamroz, *supra* note 17, at 1070.

[23] Merrill Lynch, Pierce, Fenner & Smith, Inc., Exchange Act Release No. 78,141 at 4 (June 23, 2016), https://www.sec.gov/litigation/admin/2016/34-78141.pdf.

[24] 17 C.F.R. § 240.15c3-3(b)–(d).

[25] 17 C.F.R. § 240.15c3-3(c)(1); *see also* Michael E. Don & Josephine Wang, *Stockbroker Liquidations Under the Securities Investor Protection Act and Their Impact on Securities Transfers*, 12 CARDOZO L. REV. 508, 529-31 (1990). All fully-paid and excess margin securities of an end customer carried by the broker-dealer are not considered to be "assets" of the carrying firm reflected on its balance sheet. Rather, the carrying broker-dealer holds them in a custodial capacity, and the "possession or control" requirement is designed to ensure that the carrying broker-dealer treats them in a manner that allows for their prompt return. Fin. Resp. Rules for Broker-Dealers, 78 Fed. Reg. at 51,826, n.12.

Step 2: Customer Reserve Account Deposit Process for Net Customer Cash (the "Lock-Up").

The Customer Protection Rule treats customer funds differently. Under the rules, and pursuant to a formula specified in Rule 15c3-3a, a carrying broker-dealer must make a not less than weekly calculation of an amount designed to reflect its net cash obligations to customers.[26] Under the reserve formula, the carrying broker-dealer adds customer credit items that it owes to customers (for example, cash in securities accounts) and then subtracts from that amount customer debit items that customers owe to it (for example, margin loans). The reserve formula permits the carrying broker-dealer to offset customer credit items only with customer debit items.[27] If the customer credit items exceed the customer debit items, that net amount must be "locked up" and deposited (or already be on deposit) in the Customer Reserve Account in the form of cash and/or "qualified securities."[28] Although the reserve formula itself may seem complex, "it embodies a simple concept for the responsible stewardship of customer cash: if a broker-dealer owes more to its customers than its customers owe to it, the broker-dealer must set aside at least an amount equal to that difference so that it is readily available to repay customers."[29]

The carrying broker-dealer at all times must keep this reserve account "separate from any other bank account of the broker or dealer."[30] The carrying broker-dealer must also have a written contract with the bank which provides that "the cash and/or qualified securities will at no time be used directly or indirectly for a loan to the broker or dealer by the bank and will not be subject to any right, charge, security interest, lien, or claim of any kind in favor of the bank or any person claiming through the bank."[31] The purpose of the reserve account requirement is to ensure that funds a broker-dealer holds as a result of its customer business are used only to finance customer liabilities, and not to finance the broker's proprietary positions.[32]

As noted above, under the customer reserve formula, the deposit in the Customer Reserve Account must not be less than the excess of the total credits over total debits.[33] NFS and other broker-dealers add proprietary capital to the Customer Reserve Account as a conservative buffer. Once those amounts are deposited into the Customer Reserve

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[26] 17 C.F.R. §§ 240.15c3-3(e)(1), 240.15c3-3a; Jamroz, *supra* note 17, at 1095-96. For most firms subject to the Customer Protection Rule, this computation must be done weekly, as of the close of business on Friday, and any required deposit into the Customer Reserve Account must be made by 10am on the following Tuesday.

[27] 17 C.F.R. § 240.15c3-3a.

[28] 17 C.F.R. § 240.15c3-3(e). *See also infra* note 34 (defining "qualified securities"). Unlike customer securities (*see supra* note 25), customer cash is a balance sheet item of the carrying broker-dealer (i.e., the amount of cash received from a customer increases the amount of the carrying broker-dealer's assets and creates a corresponding liability to the customer). Merrill Lynch, Pierce, Fenner & Smith, Inc., Exchange Act Release No. 78,141 at 4 n.2.

[29] Merrill Lynch, Pierce, Fenner & Smith, Inc., Exchange Act Release No. 78,141 at 5.

[30] 17 C.F.R. § 240.15c3-3(e); Jamroz*, supra* note 17, at 1095-96.

[31] 17 C.F.R. § 240.15c3-3(f).

[32] Fin. Resp. Rules for Broker-Dealers, 78 Fed. Reg. at 51,827, n.18.

[33] In arriving at total debits, Rule 15c3-3 requires firms to reduce debits in cash and margin accounts by one percent. 17 C.F.R. § 240.15c3-3a (Exhibit A, Note E (3)). For firms electing the "alternative" method of computing their minimum required net capital, that reduction is three percent. 17 C.F.R. § 240.15c3-1(a)(1)(ii)(A).

Account, the amounts become subject to its restrictions and generally cannot be withdrawn without a new reserve formula calculation showing that a smaller amount is required to be maintained in the Customer Reserve Account. The deposit in the Customer Reserve Account, therefore, is effectively a complete, dollar-for-dollar segregation of the net amount the broker-dealer owes to customers, plus a cushion amount of proprietary capital.

2. A Carrying Broker-Dealer Has Limited Control over the Investment and Size of the Customer Reserve Account.

The Customer Protection Rule further protects the "lock-up" deposit from inappropriate risk because it limits the investment of the Customer Reserve Account deposit by the carrying broker-dealer to one of two choices: (i) cash or (ii) "qualified securities."[34] Qualified securities (*e.g.*, Treasury securities) are all by definition of high credit quality — and they generally tend to be liquid and of short duration. By law, the broker-dealer cannot incur more than *de minimis* market or credit risk in connection with the Customer Reserve Account.

Further, a carrying broker-dealer like NFS has no control over the timing of customer investment decisions that drive the weekly balances in the Customer Reserve Account. If a customer has $1 million and uses it to buy Apple stock, that $1 million of stock has not historically been required by GAAP to be included on the broker-dealer's balance sheet. Those securities are subject to the possession or control provisions of the rule and typically are custodied elsewhere at good "control locations."[35] However, if the customer sells that same Apple stock and now has $1 million of un-invested cash in a brokerage account, that cash is required to be "locked up" in the Customer Reserve Account (if it is not being used to facilitate other customer activity in that customer credits may only be offset by customer debits). The decision to buy or sell belongs only to the customer – not to the carrying broker-dealer or its individual employees. The carrying broker-dealer therefore has limited ability to reduce the size of the Customer Reserve Account.[36] Additional restrictions on banks holding the Customer Reserve Account deposit add to its protection for the exclusive benefit of customers.[37]

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[34] The term "qualified security" means a security issued by the United States or a security in respect of which the principal and interest are guaranteed by the United States. 17 C.F.R. § 240.15c3-3(a)(6). Published SEC interpretations also permit money market deposit accounts, time deposits and reverse repurchase agreements collateralized by instruments guaranteed by the United States. *See* FINRA Customer Protection Interpretations, Rule 15c3-3(e)/010, /011, /012, and /05, http://www.finra.org/sites/default/files/sea-rule-15c3-3-interpretations.pdf.
[35] Permissible locations include a bank, as defined in section 3(a)(6) of the Exchange Act, and a clearing agency. Fin. Resp. Rules for Broker-Dealers, 78 Fed. Reg. at 51,826.
[36] Some carrying broker-dealers are able to sweep customer cash to customer bank accounts at banking affiliates. For those broker-dealers that are not affiliated with a bank, the ability to do so may be limited by restrictions on the ability to contract for these services with unaffiliated banks, the capacity limitations of such banks, and customers' desire to limit their exposure to banks.
[37] In 2013, the SEC, recognizing that "cash deposits at a bank are fungible and may be used by the bank in its lending and investment activities," further amended the Customer Protection Rule by, among other things (i) excluding the amount of any cash on deposit in an affiliated bank of the broker-dealer in determining whether the broker-dealer had met its reserve account requirements; and (ii) similarly limiting potential counterparty exposure to the bank by capping the total amount of reserves deposited by a single broker-dealer to no more than 15% of the

3. The Customer Reserve Account is Protected in the Event of Insolvency of the Broker-Dealer.

Together, the combination of the possession or control requirement and the Customer Reserve Account "lock-up" deposit requirement are designed to "require the broker-dealer to hold customer assets in a manner that enables their prompt return in the event of an insolvency, which in turn increases the ability of the firm to wind down in an orderly self-liquidation and thereby avoid the need for a proceeding under the Securities Investor Protection Act of 1970 ("SIPA")."[38] Thus, if a broker-dealer were to fail financially, the segregated securities and net cash owed to customers would be readily available to be returned to its customers. In addition, if it ultimately were necessary to liquidate the failed broker-dealer in a formal proceeding under SIPA, the securities and net cash are isolated and would be distributed to customers ahead of other creditors. Because financial assistance from the Securities Investor Protection Corporation ("SIPC") is only required if customer cash or securities are missing or lost in the custody of an insolvent broker-dealer, as long as the insolvent broker-dealer has followed the two-step segregation process of the Customer Protection Rule and has maintained accurate books and records, SIPC financial assistance is simply not necessary.[39]

In fact, during SIPC's 45-year history, cash and securities distributed to customers have totaled $138.2 billion. Of that amount, $137.2 billion came from the broker-dealer's estates − and only $1 billion has been paid out of the SIPC Fund. In other words, less than 1% of total recovery from insolvent broker-dealers in the past 45 years required payment from the SIPC Fund – thereby illustrating just how effective the Customer Protection Rule has been in safeguarding assets segregated for the benefit of customers.[40] History demonstrates the effectiveness of the Customer Protection Rule in protecting the "locked up" assets from risk. The Agencies should similarly recognize this existing regulatory safeguard in determining which assets should be considered subject to potentially "inappropriate risk" under the Proposed Rule.[41]

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bank's equity capital. 17 C.F.R. § 240.15c3-3(e)(5); *see* Fin. Resp. Rules for Broker-Dealers, 78 Fed. Reg. at 51,832-51,835.

[38] Exchange Act Release No. 55,434 (Mar. 9, 2007), 72 Fed. Reg. 12,862 (Mar. 19, 2007).

[39] Fin. Resp. Rules for Broker-Dealers, 78 Fed. Reg. at 51,869.

[40] SIPA proceedings have been relatively rare and the majority of SIPA liquidations have not required access to SIPC insurance coverage because the customer funds were properly segregated and reserved for under the Customer Protection Rule. Since SIPA's inception in 1970, only 328 proceedings have been commenced under SIPA. Over the last 10 years, the annual average number of new SIPA cases was 1.4. In 2013, only 3 new SIPA cases were commenced. In 2014 and 2015, no new cases were commenced. SEC. INV'R PROT. CORP., 2015 Annual Report 8 (2015). Only one SIPA case has been filed in the first 6 months of 2016—Global Arena Capital Corp (January 28, 2016). SIPC is the Trustee, and the time period for submitting claims has not yet expired. SEC. INV'R PROT. CORP., http://www.sipc.org/cases-and-claims/open-cases. SIPA liquidation proceedings therefore represent less than 1% of the approximately 39,400 broker-dealers who have been SIPC members over the past 45 years.

[41] *See Bellsouth Telecom Inc., v. FCC*, 469 F.3d 1052, 1060 (D.C. Cir. 2006) (agencies have "no license to ignore the past when the past relates directly to the question at issue."). Even in the midst of Lehman Brothers Holdings Inc.'s sudden collapse and bankruptcy during the 2008 financial crisis, its U.S. broker-dealer subsidiary, Lehman Brothers Inc., was able to satisfy 100% of customer claims in full (approximately $38 billion) and no advance from the SIPC fund was necessary. *See* SEC. INV'R PROT. CORP., *"SIPC Applauds Lehman Trustee on Milestone 100 Percent Return of Securities Customers' Property"*, SIPC News Release (June 7, 2013), http://sipc.org/news-and-

B. The Customer Reserve Account is Similar to Assets Under Management That May Appear on the Balance Sheet of an Investment Adviser.

Under the Proposed Rule, for an investment adviser, "average total consolidated assets" is defined as total assets (exclusive of non-proprietary assets) shown on the balance sheet for the most recent fiscal year end.[42] The SEC has further clarified that "investment advisers should include only proprietary assets in the calculation—that is, non-proprietary assets, such as client assets under management, would not be included, regardless of whether they appear on an investment adviser's balance sheet."[43]

The Agencies have requested comments under the Proposed Rule on whether the determination of average total consolidated assets for investment advisers should exclude non-proprietary assets that are included on a balance sheet under accounting rules, such as certain types of client assets under management required to be included on an investment adviser's balance sheet.[44] Commenters to the 2011 proposal stated that where assets under management are included on an investment adviser's balance sheet solely for accounting principles, those assets should be excluded from the calculation.[45] In Item 1.O. of Part 1A of Form ADV, assets under management are generally excluded from the question asking whether the investment adviser has assets of $1 billion.[46] The SEC appropriately noted that this method is drawn directly from the statute itself − Section 956 of Dodd-Frank.[47]

We agree with the statutory approach and with the SEC's interpretation regarding investment advisers. Any customer assets under management that may be included on an adviser's balance sheet for accounting reasons are different than other balance sheet assets and should be treated differently because they are held explicitly for a different purpose – to benefit customers, not the company – and because the company's ability to invest them is strictly limited by regulation and by contract. Fund assets under management must be invested in compliance with SEC regulations, the fund's investment objectives and policies and the other restrictions in its organizational and offering documents.

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media/news-releases/20130607; SEC. INV'R PROT. CORP., *"Lehman Agreement Paves Way for 100 Percent Return of Customer Property"*, SIPC News Release (October 5, 2012), http://sipc.org/news-and-media/news-releases/20121005.

[42] Proposed Rule § 303.2(b), 81 Fed. Reg. at 37,832.

[43] Preamble, 81 Fed. Reg. at 37,689, n.72.

[44] Preamble, 81 Fed. Reg. at 37,690, Request for Comment 2.11.

[45] *See, e.g.,* Comment Letter of the Federal Regulation of Securities Committee of the American Bar Association, June 1 , 2011 ("the exclusion of third-party funds that are consolidated solely for accounting purposes, and no other purpose, is consistent with the policy behind the Dodd-Frank Act and the Proposed Rule, as those assets do not constitute a risk of the 'part of the capital of the covered financial institution"); *See also*, Comment Letter from BlackRock, Inc., May 23, 2011 ("BlackRock believes that separate accounts, and the portion of assets of consolidated investment funds to which the company has no economic exposure, should be excluded from the definition of 'total consolidated assets' for purposes of the Incentive-Based Compensation Rule.").

[46] Preamble, 81 Fed. Reg. at 37,689, n.72. On page 14, the instructions to the Form ADV state: "Item 1.O.: Assets. For purposes of Item 1.O. only, "assets" refers to your total assets, rather than the assets you manage on behalf of clients. Determine your total assets using the total assets shown on the balance sheet for your most recent fiscal year end." https://www.sec.gov/about/forms/formadv-instructions.pdf.

[47] Preamble, 81 Fed. Reg. at 37,689, n.72, citing Section 956(f) of Dodd-Frank (referencing "assets" only).

Similarly, a carrying broker-dealer must calculate the assets required to be "locked up" on deposit in the Customer Reserve Account and invest the "lock-up" assets in compliance with the Customer Protection Rule. A carrying broker-dealer's management is not allowed to decide to keep assets out of the Customer Reserve Account, invest them in anything other than cash or "qualified securities" or deploy them for its own activities. Failure to comply with these SEC requirements results in serious penalties.[48]

In the Proposed Rule, the Agencies have properly recognized that broker-dealers and investment advisers are fundamentally different from other financial firms[49] and that certain assets that may be on a firm's balance sheet are not vulnerable to the sort of risks that Section 956 of Dodd-Frank is intended to prevent. The regulations and contractual obligations governing the broker-dealer "lock-up" in the Customer Reserve Account and investment adviser assets under management insulate them from "inappropriate risk" and eliminate the need for Section 956 of Dodd-Frank to apply to them. Both types of assets should therefore be excluded from the calculation of a covered institution's average total consolidated assets for purposes of the Proposed Rule.

III. THE AGENCIES SHOULD RESERVE THE DISCRETION TO TREAT A COMPANY AS A LOWER LEVEL COVERED INSTITUTION BASED ON RISK PROFILE, REGARDLESS OF ASSET SIZE.

As noted above, the Proposed Rule applies increasingly prescriptive requirements to covered institutions based solely on asset size. For example, the mandatory deferral and clawback provisions would apply only to Level 1 and Level 2 covered institutions.[50] Any proposal that imposes compensation restrictions based on arbitrary asset thresholds is likely to create unintended and inequitable results.

The concept of imposing additional restrictions on financial institutions under the Proposed Rule simply because they are "large" – without regard to the risk profile of the entity – would fail to consider the purported problems Section 956 of Dodd-Frank was meant to address. Contrary to the Proposed Rule, the 2010 Federal Banking Agency Guidance recognized that asset size alone cannot be the sole determining factor of risk. Rather, "the analysis and methods for ensuring that incentive compensation arrangements take appropriate account of risk should be tailored to the size, complexity, business strategy, and risk tolerance of each organization."[51] The SEC itself has similarly recognized that the broker-dealers registered with it "vary significantly in terms of their size, business activities and the complexities of their operations," and has imposed greater or lesser capital and other requirements on broker-dealers based on the level of market and credit risk assumed by the broker-dealers, and whether the broker-dealers

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[48] U.S. Sec. Exch. Comm'n, *"Merrill Lynch to pay $415 Million for Misusing Customer Cash and Putting Customer Securities at Risk"*, Press Release No. 2016-128 (June 23, 2016).
[49] SEC Economic Analysis, 81 Fed. Reg. at 37,758, n.316; *id.* at 37,787.
[50] Proposed Rule §§ 303.2(v)-(x), 81 Fed. Reg. at 37,833; Proposed Rule § 303.7, 81 Fed. Reg. at 37,835-37.
[51] Guidance on Sound Incentive Comp. Policies, 75 Fed. Reg. 36,395, 36,406 (June 25, 2010).

have responsibility for the custody of customer funds and securities.[52]

Because the scope of the Proposed Rule was expanded from the 2011 proposal, the incentive compensation of many employees who cannot subject the covered institution to material risk of loss would nevertheless be subject to the Proposed Rule.[53] Further, prescriptive definitions and mandatory design provisions may result in uniform compensation arrangements across certain types of firms, which may result in market-wide liquidity dampening,[54] credit market tightening,[55] over-emphasis on fixed compensation, talent drain from covered entities to less regulated competitors, and a stifling of innovation, among other industry-wide risks.[56] To minimize these unintended consequences, the Proposed Rule should preserve discretion for the Agencies to differentiate among covered institutions and emphasize the importance of a program that is tailored to a company's business model and risk profile – not based solely on its size.

Under the Proposed Rule, the Agencies are permitted to subject a Level 3 covered institution with at least $10 billion but less than $50 billion in "average total consolidated assets" to Level 1 or Level 2 restrictions if it is determined that the institution's activities, complexity of operations, risk profile or compensation practices are consistent with those of a Level 1 or Level 2 covered institution.[57] In our view, the converse should also apply. We propose that the Agencies should have the discretion to treat a covered entity with more than $50 billion in assets as a Level 3 covered institution, for example, when its risk profile is low, or where incentive compensation could not lead to a material loss at the institution. Retaining the authority to apply the Proposed Rule in a manner that is proportional to the risks presented by the business would also reflect the position taken under European rules on remuneration in the financial services sector which have to date permitted the disapplication of certain remuneration structuring requirements for institutions which are deemed to be lower risk.[58]

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[52] Fin. Resp. Rules for Broker-Dealers, 78 Fed. Reg. at 51,868. The SEC's financial responsibility rules include the net capital rule (Rule 15c3-1 under the Exchange Act) and the Customer Protection Rule. SEC Net Capital Requirements for Brokers or Dealers Rule, 17 C.F.R. § 240.15c3-1; SEC Customer Protection Rule, 17 C.F.R. § 240.15c3-3.

[53] Based on initial projections and subject to the terms of the rule when finalized, Fidelity Investments estimates that approximately 20,000 of its personnel (employed by NFS or FBS) could be impacted by the Proposed Rule – almost half of its current employee population.

[54] Robert DeYoung and Minjie Huang, *External Effects of Bank Executive Pay: Systemic Risk and Liquidity Creation*, Univ. of Louisville, Mar. 23, 2016 (finding that pay-performance incentives reduce system-wide liquidity).

[55] Peter J. Wallison, *They're Coming For Your Bonus: New Limits on Incentive Pay – Such As Seven-Year Clawback – Will Dampen Risk-Taking and Growth*, Wall Street Journal, May 1, 2016.

[56] Anya Kleymenova and A. Irem Tuna, *Regulation of Compensation*, Univ. of Chicago Booth Business School and London Business School, March 2016 (finding that the after-effects of the UK Remuneration Code include unintended consequences of greater CEO turnover, compensation contracts that are more complex, decreases in pay-for-performance sensitivity, and decreases in measures of firm risk).

[57] Proposed Rule § 303.6, 81 Fed. Reg. at 37,835.

[58] In the European Union, although the original rules issued by the Committee of European Banking Supervisors in 2010 clearly envisaged the ability of smaller and less significant institutions to disapply certain remuneration-structuring requirements (and such rules were subsequently reflected in the regulatory rules of many EU member states by local country regulators which rules continue to apply currently), the European Banking Authority ("EBA"), when issuing draft revised guidance in 2015, took the position that the relevant legislation did not in fact

A. Clearing and Carrying Broker-Dealers and Investment Advisers Have Lower Risk Profiles Than Banks.

Banks and companies taking bank-like risks were the motivation for Section 956 of Dodd-Frank and banking rules were the models for the Proposed Rule. As the Agencies have acknowledged, Section 956 of Dodd-Frank requires them to ensure that standards adopted in the Proposed Rule are "comparable to the compensation-related safety and soundness standards applicable to insured depository institutions under section 39 of the [Federal Deposit Insurance Act]."[59] However, "comparability" of rules does not require uniformity of design or application, and that should not be the objective of the Agencies in the Proposed Rule.

In their proprietary lending businesses, banks can take financial risks to benefit themselves and thereby put shareholder capital and customer deposits at risk – borrowing on a short-term basis from depositors while making long-term illiquid loans – all while under the federal safety net, including FDIC insurance and access to the Federal Reserve discount borrowing window.[60] In fact, taking proprietary risk with a maturity mismatch between liabilities and assets is the essence of the banking business model. Standards adopted to govern bank compensation may be appropriate for non-banks that take bank-like risks. We believe they are inappropriate, however, and will do much more harm than good if they are applied to non-banks and assets that are not subject to such risks. This is particularly true when the covered institution does not engage in activities identified by the Agencies as creating greater risk, including having significant levels of off-balance sheet activities (*e.g.*, derivatives) and maintaining high-risk business lines (*e.g.*, lending to distressed borrowers or investing or trading in illiquid assets).[61]

Clearing and carrying broker-dealers like NFS provide back office clearing, settlement and custody services to other introducing broker-dealers (and registered investment advisers) and their end customers. NFS is not a bank and does not have bank subsidiaries, nor is it

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permit such disapplication. The EBA has more recently confirmed (when issuing the final revised guidance in December 2015) that it is recommending that the relevant legislation should be amended to explicitly permit disapplication of certain remuneration-structuring requirements as it recognised that such disapplication of such requirements may be appropriate for smaller and less significant institutions. (Opinion of the European Banking Authority of the application of the principle of proportionality to the remuneration provisions in Directive 2013/36/EU (December 21, 2015), available at: https://www.eba.europa.eu/documents/10180/983359/EBA-Op-2015-25+Opinion+on+the+Application+of+Proportionality.pdf.)

[59] *See* Preamble, 81 Fed. Reg. at 37,673.

[60] Although this government support helps protect banks and their depositors, it also creates a well-known moral hazard. *See, e.g.,* Thomas M. Hoenig, *Banking Safety Net Makes Wall Street Dangerous*, AM. BANKER (January 17, 2013) ("The safety net [deposit insurance and Federal Reserve credit] was designed to safeguard the retail consumer and to assist solvent commercial banks in meeting the liquidity demands so essential to the functioning of our national payments and clearing system. While the safety net meets these goals, it also creates the well-recognized moral hazard problem in banking: creditors worry less about getting their money back, so they pay less attention to a financial firm's condition and capital levels and they have less to lose should it fail. This results in a subsidy for insured banks in the form of reduced capital cost and funding advantages.").

[61] *See* Preamble, 81 Fed. Reg. at 37,715.

affiliated with a deposit-taking, investment-banking or commercial-lending bank. NFS does not make markets in equity securities, and it does not publish research. NFS does not engage in proprietary equity trading to make a profit—its trading desk executes trades for others acting as agent. NFS does not engage in derivatives or futures trading. NFS maintains a *de minimis* inventory of fixed income securities primarily to provide trading liquidity to customers. NFS' margin lending book is sufficiently collateralized. NFS does not make investment recommendations and does not give investment advice as those terms are defined by federal securities laws.

Similarly, investment advisers are equally distinguishable from banks and most other financial firms because they act as advisers or agents on behalf of clients. In this regard, investment advisers operate as fiduciaries and client assets typically are held by independent custodians (typically banks) under contractual obligations to the clients. Unlike a commercial or an investment bank that acts as principal and uses its own balance sheet, investment advisers generally do not risk their own capital or act as principal.[62]

As noted above, in its economic analysis, the SEC acknowledges that broker-dealers and investment advisers "differ from other financial services firms with respect to business models, nature of risks posed by the institutions, and the nature and identity of the persons affected by those risks."[63] The analysis also concedes that size is a poor indicator of risk and comparability to banks: "in the case of [broker-dealers] and [investment advisers], which may have a much narrower scope of activities than a comparably sized commercial bank, the narrower range of activities could limit their impact on the overall financial system."[64]

The Administrative Procedure Act requires that the costs of the Proposed Rule be balanced against the benefit because "[n]o regulation is 'appropriate' if it does significantly more harm than good."[65] Here, the SEC's economic analysis recognizes that there are some broker-dealers and investment advisers that have large balance sheet assets that do not pose potentially negative externalities on taxpayers − and some that do.[66] For those that do not, the SEC observed that the Proposed Rule, which fails to differentiate among them, may negatively distort incentive compensation practices.[67]

Clearing and carrying broker-dealers and investment advisers are, in our view, precisely the types of institutions that do not impose negative externalities on shareholders or taxpayers − notwithstanding that these institutions may facially appear to have large amounts of balance sheet assets due to accounting rules and regulatory reporting requirements. As a result, the SEC should reserve the discretion to treat them as lower level covered institutions, regardless of asset size.

[62] *See, e.g., supra* note 45 (Comment Letter from BlackRock, Inc., May 23, 2011).
[63] SEC Economic Analysis, 81 Fed. Reg. 37,758, n. 316; *id.* at 37,787.
[64] SEC Economic Analysis, 81 Fed. Reg.at 37,778.
[65] *Michigan v. EPA*, 135 S. Ct. 2699, 2707 (2015).
[66] SEC Economic Analysis, 81 Fed. Reg. at 37,778.
[67] *Id.*

B. Closely-Held Companies May Have a Lower Risk Profile than other Covered Institutions.

Similar to a broker-dealer or investment adviser with a low risk-profile, a closely-held company does not raise the same concerns with respect to inappropriate risk taking that may occur with public companies whose shareholders and other stakeholders may have interests that are not as closely aligned with management's interests. In discussing the importance of aligning managerial compensation with the interests of the taxpayers and in the interest of avoiding negative externalities, the Proposed Rule focuses on companies with diffuse ownership rather than closely-held companies.[68] The Agencies recognize that shareholders of a covered institution have an incentive to align the interests of executives, managers and other employees with the institution's long-term health. However, the Agencies also note that shareholders may not always be able to protect the safety and soundness of an institution, deter excessive compensation, or deter behavior or inappropriate risk-taking that could lead to a material financial loss at the institution, because executive officers and employees of a covered institution may be willing to tolerate a degree of risk that is inconsistent with the interests of shareholders, as well as broader public policy.[69]

To the contrary, in a closely-held company, shareholders frequently serve as directors and executive officers. Therefore, there is no distinction between those shareholders and management. Shareholders of a closely-held company do not have the "agency problem" that public company shareholders have, in which company employees may have different incentives, and directors that are independent of management are hired to oversee the company's employees and protect shareholders' interests. Shareholders of a closely-held company invest the capital to start and grow the business. Thus, they have an overarching interest in – and the ability to protect – the long-term safety and prosperity of the institution, and to ensure that incentive structures do not run afoul of these long-term objectives. Further, the rationale for deferring employees' incentive compensation so that it is exposed to potential future losses and they have sufficient "skin in the game" to influence their behavior is inapplicable to employees who already own part of the business and have invested the capital to run it. The Agencies implicitly recognize these points, noting that regulation is particularly necessary at larger institutions where "shareholders and other stakeholders may have difficulty effectively monitoring and controlling the impact of incentive-based compensation arrangements."[70]

In addition to not producing the intended benefits, the SEC importantly recognizes that the Proposed Rule may have unnecessary adverse consequences if it is applied to institutions that are able to contract efficiently for compensation arrangements.[71] In particular, unintended consequences may include curbing risk-taking incentives to a sub-optimal level, with consequent negative effects on efficiency and shareholder value. Further, applying the

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[68] The SEC's economic analysis relies on information that is available from the reports filed by public companies. SEC Economic Analysis, 81 Fed. Reg. at 37,766.
[69] Preamble, 81 Fed. Reg. at 37,674.
[70] Preamble, 81 Fed. Reg. at 37,675.
[71] SEC Economic Analysis, 81 Fed. Reg. at 37,763.

Proposed Rule in this scenario may result in losses of managerial talent that may migrate from covered institutions to firms in different industries or foreign jurisdictions.[72] Applying the Proposed Rule to closely-held companies, which by virtue of their ownership structures are unlikely to have incentive-based compensation arrangements that result in excessive compensation or inappropriate risk-taking, will undermine the ability of shareholders to establish incentives that motivate employees to take appropriate risks without producing offsetting benefits.

No company is in the business of taking "inappropriate risks" or providing "excessive compensation" to its employees. Although those dynamics can arise in a public company with a diffuse shareholder base, they are much less likely to arise in a closely-held company given alignment of the pecuniary interests and access of its shareholders. Shareholders of closely held companies are already exposed, via ownership interests, to the consequences of their decisions. As with clearing and carrying broker-dealers and registered investment advisers, the Agencies should consider application of Level 3 requirements to a closely-held company, regardless of asset size.

IV. THE ASSET THRESHOLDS TO DETERMINE THE LEVEL OF A COVERED INSTITUTION SHOULD BE INDEXED FOR INFLATION.

Finally, we believe that the $1 billion (Level 3), $50 billion (Level 2) and $250 billion (Level 1) asset thresholds should be indexed for inflation so that, in the future, only those institutions whose assets are equivalent to $1 billion, $50 billion and $250 billion today will be subject to these rules. This would help ensure that the asset thresholds remain constant in real terms in the future and that smaller institutions currently intended to be outside the scope of this rule are not unintentionally brought within its scope simply by the passage of time.

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[72] *Id*.

NFS appreciates the opportunity to comment on the Proposed Rule. We would be pleased to provide further information or respond to any questions that the SEC staff or other Agencies may have.

Sincerely,

Karen M. Crupi
Senior Vice President & Deputy General Counsel
Chief Legal Officer, National Financial Services LLC

cc: The Honorable Mary Jo White, Chair, SEC
The Honorable Kara M. Stein, Commissioner, SEC
The Honorable Michael S. Piwowar, Commissioner, SEC

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