July 22, 2016

Via Electronic Submission (www.sec.gov)

Mr. Brent J. Fields, Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Incentive-based Compensation Arrangements
File No. S7-07-16

Dear Mr. Fields:

The Investment Adviser Association appreciates the opportunity to comment on the recently proposed rules relating to incentive-based compensation arrangements utilized by certain large banks, broker-dealers, investment advisers, and other financial institutions.[1] The IAA exclusively represents the interests of SEC-registered investment adviser firms, with a membership that consists of approximately 600 firms that collectively manage nearly $20 trillion for a wide variety of individual and institutional investors, including pension plans, trusts, investment companies, private funds, endowments, foundations, and corporations.[2] We are submitting this letter to provide specific comments on the application of the rules to those firms.

We generally support the way the SEC proposes to implement these rules, although we recognize that it gives rise to a number of practical implementation questions. In particular, we address below the proposed definition of "covered financial institution" as it applies to investment advisers, the potential need for further guidance on the treatment of parent-subsidiary structures, what constitutes "non-proprietary assets," and "operational integration," and the need to ensure consistency between the registration form used by advisers (Form ADV) and this rule's definition of covered financial institution.

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[1] *Incentive-based Compensation Arrangements*, Release No. 34-77776; IA-4383 (May 6, 2016), available at https://www.sec.gov/rules/proposed/2016/34-77776.pdf (the "Release"). The proposal was jointly proposed by the Office of the Comptroller of the Currency, Treasury (OCC); the Board of Governors of the Federal Reserve System (Board); the Federal Deposit Insurance Corporation (FDIC); the Federal Housing Finance Agency (FHFA); the National Credit Union Administration (NCUA); and the SEC (collectively, the "Agencies").

[2] For more information, please visit www.investmentadviser.org.

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Definition of "Covered Financial Institution"

As proposed, the rules would apply to an investment adviser, as such term is defined in section 202(a)(11) of the Investment Advisers Act, with average total consolidated assets greater than or equal to $1 billion. "Average total consolidated assets" is further defined to mean an adviser's "total assets (exclusive of non-proprietary assets) shown on the balance sheet for the regulated institution for the most recent fiscal year end."[3]

We strongly support this definition, and we appreciate that the SEC clarified in the proposed rule 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.[4] In enacting Section 956 of the Dodd-Frank Act, Congress was primarily concerned with the types of behavior that could threaten the safety and soundness of the financial institution itself, or ultimately threaten financial stability.[5] In essence, Section 956 was intended to address the types of behaviors that could put an institution's own balance sheet at risk. Focusing on an entity's balance sheet—and more particularly on those proprietary items on the balance sheet that could be put at risk by someone at the firm—is therefore appropriate and consistent with the intent and purposes of Section 956.

More generally, we support the approach of determining an adviser's status by looking first at the proprietary assets on *its* balance sheet, and then—only if the adviser is at that point a covered financial institution—to affiliations with other covered financial institutions to determine which level under the rule applies.

Potential Need for Further Guidance

While we support the proposed approach, we recognize that there are wide ranges of business models, structures, specialties, and compensation practices within the investment advisory profession. These variations may give rise to interpretive questions in three areas in particular: the treatment of subsidiaries, consolidation, and the meaning of "non-proprietary" assets. Each of these are discussed below.

For the most part, the SEC staff is well-suited to resolving these types of questions through interpretive guidance, such as responses to FAQs, that would help the industry apply the

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[3] Section 303.2(b).

[4] Release, at n.72.

[5] As Congress explained, "This subtitle also requires federal financial regulators to monitor incentive-based payment arrangements of federally regulated financial institutions larger than $1 billion and prohibit incentive-based payment arrangements that the regulators determine jointly could threaten financial institutions' safety and soundness or could have serious adverse effects on economic conditions or financial stability." *See* the Joint Explanatory Statement of the Committee of Conference, at 873, available at http://www.llsdc.org/assets/DoddFrankdocs/dodd-frank-act-jt-expl-statement.pdf.

principles in the rule to advisers. The Agencies could consider, however, whether additional clarification in an adopting release may be necessary or desirable. The Agencies might also consider incorporating some sort of mechanism to provide flexibility where the rule may produce anomalous results, such as where significant intangible assets such as goodwill inflate a firm's balance sheet with assets that do not represent capital at risk.[6] Embedding a process within the rule that would permit firms to seek relief under unique circumstances would allow the Agencies to avoid situations where two otherwise similarly situated firms were subject to disparate treatment.

Subsidiaries. We strongly support the proposed rule's treatment of subsidiaries. The definition of "covered financial institution" in each of the proposed rules includes an exception for subsidiaries that are depository institutions, broker-dealers or investment advisers.[7] The Release explains that "[i]n general, the operations, services, and products of broker-dealers and investments advisers are not typically effected through subsidiaries and it is expected that their incentive-based compensation arrangements are typically derived from the activities of the broker-dealers and investment advisers themselves."[8]

While we agree, it is not entirely uncommon for advisers to be either subsidiaries or parent companies of other entities. The SEC might therefore consider further clarifying examples illustrating the rule's treatment of subsidiaries, along the lines of the example provided in the Release of a hypothetical bank holding company with a Level 1 subsidiary national bank, a Level 3 mortgage subsidiary, and an adviser with $100 million in average total consolidated assets that is not a covered financial institution under the rule.[9] In this regard, the SEC might consider examples that include an adviser that is a subsidiary of a non-bank holding company, which is a common structure for publicly traded advisers, and an adviser parent to an adviser subsidiary where only one is a covered financial institution and the two are not operationally integrated.

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[6] A number of commenters, including the IAA, raised issues in 2011 relating to the inclusion of intangible assets in the calculation of total assets. *See* Letter from Jennifer S. Choi, Associate General Counsel, Investment Adviser Association to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission (May 31, 2011), at 4, available at https://www.sec.gov/comments/s7-12-11/s71211-627.pdf. ("IAA's 2011 Comment Letter"). *See also* letters from Blackrock, Federated, and ICI.

[7] Each Agency has set forth text for its Agency-specific definition of the term "covered institution" that specifies the entities to which that Agency's rule applies. For example, in the case of the OCC, the term includes "A national bank, Federal savings association, or Federal branch or agency of a foreign bank with average total consolidated assets greater than or equal to $1 billion; and a subsidiary of a national bank, Federal savings association, or Federal branch or agency of a foreign bank, ***if the subsidiary (A) is not a broker, dealer, person providing insurance, investment company, or investment adviser***; and (B) has average total consolidated assets greater than or equal to $1 billion." OCC rule section 42.2(i) [emphasis added], available at http://www.occ.gov/news-issuances/news-releases/2016/nr-occ-2016-49a.pdf. Each Agency's definition includes the same exception for advisers.

[8] Release, at 71. We understand that there is an exception for covered financial institutions that are subsidiaries of other covered financial institutions, in which case the subsidiary would be subject to the same rules as the parent. As a result, to the extent that an adviser is itself a covered financial institution, it may be subject to treatment at a different level based on its affiliations.

[9] Release, at n.90 and accompanying text.

Consolidation. The proposed rule includes a provision making it unlawful to do indirectly anything that would be unlawful to do directly. The Release suggests, in a footnote, that this prohibition may be used by the SEC to consolidate the balance sheets of two or more affiliated investment advisers for purposes of determining status as a covered financial institution, with reference to the concept of operational integration.[10]

It is not clear when and to what extent the SEC will exercise this power to consolidate two or more affiliated advisers, but we would expect that it should be relatively rare. It is common for larger firms to maintain multiple advisers for legitimate business, accounting, and other reasons. A given firm may, for example, have separate advisers for its registered investment company clients, private fund clients, and institutional separate account business. It also may have separate advisers for different jurisdictions or regions. Given the context of this rule, consolidation should be used only when the advisers appear to have chosen a legal structure that has no apparent business purpose other than to evade status as a covered financial institution—in other words, to do indirectly something that they could not do directly. Accordingly, as in essentially all other contexts under the Investment Advisers Act,[11] we would expect that the separate legal status of the advisers would be respected unless there is sufficient reason to disregard it.

The existing guidance on operational integration may be useful as a starting point for the consolidation analysis, but we caution that it was developed in the context of SEC registration and may be too rigid to be appropriate in this particular context.[12] An analysis in the context of this particular rule should look at a variety of factors as to how each investment adviser conducts its business, without any one factor being dispositive or constituting a bright-line test. And the analysis may involve factors that have not been used for purposes of SEC registration. For example, the SEC could take into account the fact that the "significant risk taker" provisions in the rule would extend across legal entity lines, such that individuals that are employed by one entity might be considered "significant risk takers" of another entity. This would appear to make it less likely that a particular corporate structure would be designed to evade covered financial institution status, and thus less likely that the two entities would need to be consolidated for

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[10] Release, at n.64.

[11] Id. at n.63 (noting that the SEC's "regulatory regime with respect to…investment advisers generally applies on an entity-by-entity basis").

[12] In the context of determining which entities need to register with the SEC, the staff has indicated that a subsidiary entity may be regarded as having a separate, independent existence and to be functioning independently of its parent if it (1) is adequately capitalized, (2) has a buffer, such as a board of directors a majority of whose members are independent of the parent, between the subsidiary's personnel and the parent, (3) has employees, officers, and directors, who if engaged in providing advice in the day-to-day business of the subsidiary entity, are not otherwise engaged in an investment advisory business of the parent, (4) itself makes the decisions as to what investment advice is to be communicated to, or is to be used on behalf of, its clients and has and uses sources of investment information not limited to its parent, and (5) keeps its investment advice confidential until communicated to its clients. *See* Letter to Richard Ellis, Inc. (March 18, 1981), available at http://www.sec.gov/divisions/investment/noaction/1981/richardellis031981.pdf.

purposes of the rule. In any case, we strongly recommend that the SEC develop a flexible, facts and circumstances framework for operational integration that is specific to this rule and context.

Non-Proprietary Assets. As noted above, we appreciate and strongly support the exclusion of non-proprietary assets from the definition of "average total consolidated assets" for purposes of determining status as a covered financial institution.[13] We recognize, however, that the lack of a definition for "non-proprietary assets" may give rise to interpretive questions as to which assets on a balance sheet should be counted towards the thresholds.

As with questions on consolidation, these questions likely are best addressed by the SEC staff through FAQs or other interpretive guidance. In resolving these questions, the SEC staff should be guided by the basic purpose of this rule, which, as noted above, was to address the types of behaviors that could put an institution's own balance sheet at risk. Consistent with this purpose, we would expect advisers to include those "proprietary" assets where the adviser is acting as principal and gains and losses directly affect the assets on its balance sheet for which the adviser is the beneficial owner, and to exclude those "non-proprietary" assets where it is acting as an agent in the management of assets for clients, including clients that are employed by or affiliated with the adviser. For example, an adviser would include assets of a pooled vehicle or special purpose entity, such as a collateralized loan obligation where the adviser serves as collateral manager, only to the extent of the adviser's beneficial ownership interest in that pool, even where accounting rules may require the entire pooled vehicle's assets to be included on the adviser's balance sheet. We would also expect that items that might be on the balance sheet purely for accounting purposes, but that do not represent assets that can be placed at risk, could be excluded from an adviser's total consolidated assets.[14]

If the Agencies adopt this rule, we look forward to working with the SEC staff on guidance on these types of interpretive questions.

Need for Clarification and Amendment of Form ADV Item 1.O

Item 1.O of Form ADV asks advisers "Did you have $1 billion or more in assets on the last day of your most recent fiscal year?"[15] Instructions to Form ADV explain that "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."[16]

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[13] Section 303.2(b).

[14] For example, new accounting rules for leases were issued earlier this year that require companies to recognize a lease as a "right of use" asset on its balance sheet, offset with the accompanying lease obligations. The effect is to increase both a firm's assets and liabilities in the same amount, which could lead to anomalous results for purposes of this rule. See ASU 2016-02 Leases (Topic 842), available at http://www.fasb.org/jsp/FASB/FASBContent_C/CompletedProjectPage&cid=1176167904031.

[15] *See* Form ADV, available at https://www.sec.gov/about/forms/formadv-part1a.pdf, at page 4.

[16] *See* Instruction 1(b), available at https://www.sec.gov/about/forms/formadv-instructions.pdf.

As the SEC recognizes in the Release, Item 1.O was added to Form ADV in 2011 specifically to help identify advisers that might be subject to this particular rulemaking.[17] As the SEC explained in the 2011 adopting release, "we will use [Item 1.O] to identify those advisers that could be subject to rules regarding certain excessive incentive-based compensation arrangements required by section 956 of the Dodd-Frank Act."[18]

Based in part on responses to Item 1.O, the SEC estimates that approximately 669 investment advisers will be covered institutions under the proposed rules. Based on our experience and discussions with members about Form ADV, our sense is that a number of advisers may have answered affirmatively based on a misunderstanding of the question or the consolidation of non-proprietary assets. Accordingly, we strongly recommend that if the Agencies adopt this rulemaking, the SEC also should adopt a technical clarifying amendment to Item 1.O to ensure consistency of that response with this rule's definition of covered financial institution and treatment of non-proprietary assets. Given the common use by advisers of the term "assets" to describe assets under management, we strongly encourage the SEC to make the question itself as clear as possible, relying less upon the instructions to highlight the difference between balance sheet assets and assets under management. For example, the SEC might consider rephrasing the question to read: "Did you have $1 billion or more in balance sheet assets (not assets that you manage on behalf of clients) on the last day of your most recent fiscal year?"

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We appreciate your consideration of our comments on this proposal. Please contact me at [redacted] with any questions regarding these matters.

Respectfully,

/s/

Robert C. Grohowski
General Counsel

[17] *See Rules Implementing Amendments to the Investment Advisers Act of 1940*, Advisers Act Release No. IA-3221 (September 19, 2011), available at https://www.sec.gov/rules/final/2011/ia-3221.pdf, at nn.322, 323.

[18] *Id.* at n.323.