MANAGED FUNDS ASSOCIATION

aima
Alternative Investment Management Association

July 22, 2016

Via Electronic Filing:
Brent J. Fields
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: MFA and AIMA Comments on Incentive-Based Compensation Arrangements; File No. S7-07-16

Dear Mr. Fields:

Managed Funds Association ("MFA")[1] and the Alternative Investment Management Association ("AIMA")[2] are grateful for the opportunity to comment on the proposed rules, "Incentive-based Compensation Arrangements" (the "Proposed Rules") issued by the Securities Exchange Commission (the "SEC") and other federal regulatory agencies (together the "Joint Agencies"). We acknowledge that Congress in enacting Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") directed the Joint Agencies to issue rules or guidelines to limit incentive-based compensation arrangements that could pose systemic risks or that could threaten the safety and soundness of covered financial institutions. We appreciate that the Commission has made improvements to this proposal as compared with

[1] The Managed Funds Association (MFA) represents the global alternative investment industry and its investors by advocating for sound industry practices and public policies that foster efficient, transparent, and fair capital markets. MFA, based in Washington, DC, is an advocacy, education, and communications organization established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry's contributions to the global economy. MFA members help pension plans, university endowments, charitable organizations, qualified individuals and other institutional investors to diversify their investments, manage risk, and generate attractive returns. MFA has cultivated a global membership and actively engages with regulators and policy makers in Asia, Europe, North and South America, and many other regions where MFA members are market participants.

[2] Founded in 1990, the Alternative Investment Management Association (AIMA) represents the global hedge fund industry. Our membership is corporate and comprises over 1,600 firms (with over 10,000 individual contacts) in more than 50 countries. Members include hedge fund managers, fund of hedge funds managers, prime brokers, legal and accounting firms, investors, fund administrators and independent fund directors. AIMA's manager members collectively manage more than $1.5 trillion in assets. See www.aima.org.

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the original proposal.[3] Nonetheless, we believe that the Proposed Rules in certain respects impose restraints on incentive-based compensation arrangements that exceed the intent of Section 956, as set out below.

Calculation of Adviser Assets

Exclusion of non-proprietary assets

We strongly support the SEC's proposal to exclude non-proprietary assets for purposes of determining whether an adviser exceeds one of the asset thresholds. As noted in the preamble to the Proposed Rules, this clarification is important to ensure that only an adviser's assets, and not its client assets under management, are counted toward the adviser's assets for purposes of determining whether an adviser exceeds the asset thresholds. As such, we strongly encourage the SEC to explicitly exclude non-proprietary assets in the final rule. We believe that this approach is fully consistent with the statutory language and purpose of Section 956.

Assets set aside for deferred compensation or that remain in an adviser's funds

In addition, we believe that the SEC should exclude certain assets that may appear on an adviser's balance sheet from the calculation of an adviser's assets for purposes of the asset thresholds in the Proposed Rules, to the extent those assets promote the policy objectives underlying Section 956 and the Proposed Rules. In particular, we encourage the SEC to exclude assets that are: (i) invested or otherwise remain in a fund managed by an adviser; or (ii) held in or set aside for deferred compensation arrangements for employees from an adviser's assets for purposes of the asset thresholds, which we believe further the policy objectives of Section 956 and the Proposed Rules. For this purpose, we believe that deferred compensation arrangements should include compensation arrangements that defer income for U.S. tax purposes, as well as other compensation arrangements that contain features such as vesting periods or contractual lock-up terms that require such compensation to be invested side-by-side with investors in a fund managed by the adviser.

Assets invested or that otherwise remain in funds managed by the adviser serve to align the interests of the adviser and investors, which encourages advisers to seek prudent long-term, risk-adjusted gains and avoid inappropriate short-term risk taking. Further, deferred compensation, whether it is tied to the performance of the adviser or to a pooled investment fund managed by the adviser, can be a valuable risk management tool for advisers. Including assets that are invested or otherwise remain in an adviser's funds and assets held in or set aside for deferred compensation arrangements when determining whether an investment adviser is subject to the incentive-based compensation rules creates a disincentive for an adviser to use these mechanisms. For example, an adviser that is close to exceeding or just exceeds one of the asset thresholds in the rule would be incentivized to reduce the amounts it sets aside for deferred compensation (or the amount it holds in its funds) so as not to exceed the asset threshold. To avoid creating incentives that are contrary to the policy objectives of the rules, we encourage the SEC to exclude assets that are

[3] Release No. 34–64140; 76 FR 21170, April 11, 2011.

invested or otherwise remain in a fund managed by the adviser and assets held in or set aside for deferred compensation arrangements from an adviser's assets for purposes of determining whether an adviser exceeds one of the thresholds set out in the rules.

If the SEC does not amend the Proposed Rules to exclude assets invested or otherwise remain in a fund managed by the investment adviser, we encourage the SEC to provide that the investment adviser should calculate those assets based on the net assets of the fund and not the fund's gross assets. Because of accounting rules in the United States,[4] assets held in an investment fund managed by the adviser may appear on the adviser's balance sheet as gross assets, whereas assets an adviser may hold in other investments are more likely to appear as net assets. We believe that an adviser should not be penalized with a higher balance sheet number simply because it chooses to hold assets in funds it managers, rather than other types of assets.

Assets related to non-advisory businesses

Some investment advisers may be, directly or indirectly, engaged in businesses or activities other than just the investment advisory business, including businesses that are outside the scope of the institutions covered by Section 956. For tax or other business reasons, it may be advantageous for the adviser to conduct such business or activity itself or through a subsidiary, and the assets of such other business or activities would be reflected in the consolidated balance sheet of the adviser. We believe an unintended consequence of the Proposed Rules would be to include such assets in the calculation of the adviser's assets for purposes of the asset thresholds, even when those assets are not related to the investment advisory business. Accordingly, we believe that the SEC should make clear that only assets that are part of an adviser's investment advisory business should be included in the calculation of the adviser's assets for purposes of the asset thresholds in the Proposed Rules.

Investment fund assets held at a related broker-dealer

Investment advisers and/or the investment funds they advise may own one or more broker-dealer entities whose primary purpose is to hold assets of the investment funds to facilitate portfolio management, to facilitate clearing and settlement functions, or financing related thereto. To the extent that the assets such a broker-dealer entity holds would be treated as non-proprietary assets that are excluded from the determination of whether an investment adviser meets the relevant total consolidated asset thresholds for being deemed a covered institution, we believe that either: (i) such assets also should be exempted from the determination of whether such a broker-dealer meets the relevant total consolidated asset threshold for being deemed a covered institution; or (ii) broker-dealers that are owned by investment advisers and/or investment funds and whose primary purpose is to hold assets of the investment funds to facilitate portfolio management, facilitate clearing and settlement

[4] Financial Accounting Standards No. 167, Amendments to FASB Interpretation No. 46(R), (June 12, 2009), available at
http://www.gasb.org/cs/ContentServer?c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176156246786.

functions, or financing related thereto should be exempt from the definition of covered institution.

Foreign Private Advisers and 203(m)-1 Exempt Reporting Advisers

Although Section 956 includes investment advisers as defined in Section 202(a)(11) of the Investment Advisers Act of 1940 (the "Advisers Act") as covered financial institutions for purposes of that Section, we believe that certain non-U.S. advisers that meet that definition nonetheless should be excluded from the scope of the incentive-based compensation rules because those advisers generally do not present a level of U.S. regulatory interest that would justify including them within the scope of the rules. We encourage the SEC to exclude advisers relying on the foreign private adviser exemption in Section 202(a)(30) of the Advisers Act and Rule 202(a)(30)-1 under the Advisers Act from the scope of the incentive-based compensation rules.

We further encourage the SEC to provide guidance that an adviser relying on the private fund adviser exemption in Section 203(m) of the Advisers Act and Rule 203(m)-1 under the Advisers Act may determine its assets for purposes of the incentive-based compensation rules by reference to the adviser's place of business in the U.S., similar to the determination of the adviser's assets under management in the U.S. Similar to Rule 203(m)-1, this approach would exclude a non-U.S. adviser's assets and non-U.S.'s businesses from the scope of the rule.[5]

Other Types of Advisers Excluded from Registration by Advisers Act Section 203(b)

We also believe that the SEC should amend the Proposed Rules to exclude, or at least minimize the impact of the rules on, investment advisers excluded from registration under Advisers Act Section 203(b)(4) and (5), *i.e.*, advisers that are charitable organizations or advisers to church plans ("charitable organization advisers"). While we recognize that Section 956 of Dodd-Frank applies to investment advisers as defined in the Advisers Act, we do not believe that Congress intended to apply incentive compensation rules designed for banks and other large financial institutions to charitable organizations or church plans simply because they meet the technical definition of "investment adviser" in the Advisers Act. Accordingly, we encourage the SEC to consider the following suggestions to limit the impact on this group of entities.

We encourage the SEC to provide guidance that a charitable organization's or church plan's assets being managed by the charitable organization adviser will be deemed non-proprietary assets under management for purposes of calculating the adviser entity's assets for purposes of the rules. We believe that assets managed for the charitable organization would be more appropriately viewed as client assets under management, rather than adviser assets. We further encourage the SEC to exclude assets owned by the charitable organization that are used to fulfill the charitable organization's purpose from the adviser's assets for purposes of the rules. Including those assets would effectively treat a charitable

[5] In addition to being consistent with SEC policy determinations in other contexts, we also believe this approach is consistent with the treatment of U.S. branches of non-U.S. banking organizations.

organization as if it were a covered financial institution, which we believe is beyond the intended scope of Section 956 and the Proposed Rules.

We note that, with respect to advisers that are themselves charitable organizations (or certain persons associated with or employed by such organizations), which could also include certain advisers to church plans that are themselves charitable organizations, Section 4958 of the Internal Revenue Code of 1986, as amended (the "Tax Code") already restricts the amount of compensation such persons can charge. This provision provides that, if any person who has or has had substantial influence over the affairs of a charitable organization (a "disqualified person") engages in an "excess benefit" transaction (that is, a transaction where such a person receives disproportionate consideration for his or her activities for the organization), the Board and officers of the organization and the disqualified person are subject to a substantial excise tax. In addition, in the case of private foundations, the self-dealing rules of Section 4941 of the Tax Code also impose significant limits on compensation paid to foundation managers. Further, state corporation law also imposes fiduciary standards on the Boards of these charitable organizations that require the Boards to exercise the duties of due care and loyalty in approving the compensation paid to foundation managers. Comparable rules under state law apply to state pension funds. Therefore, we further encourage the SEC to include in any final rules, or interpretive guidance, that a charitable organization adviser will be deemed to comply with the incentive-based compensation rules to the extent its compensation arrangements comply with applicable tax and state law rules regarding the compensation of persons associated with charitable organizations, foundations, and church plans.

With respect to investment advisers exempt from registration under Section 203(b)(6), *i.e.*, commodity trading advisors ("CTAs") registered with the Commodity Futures Trading Commission ("CFTC"), we note that CTAs and other CFTC regulated entities are not explicitly defined as covered financial institutions by Section 956. As such, it seems counterintuitive to cover a CTA, which, by definition, is not principally engaged in the business of being an investment adviser, within the scope of the incentive-based compensation rules when it is exempt from registration as investment advisers because of the limited nature of that part of the CTAs business. Accordingly, we encourage the SEC to permit a registered CTA to count only the *pro rata* portion of its assets in a ratio based on the portion of its investment adviser business, as compared to its CTA business, for purposes of the asset thresholds in the rules.

Alternatively, we encourage the SEC to consider using its rule making authority in Advisers Act Section 202(a)(11)(H) to exclude advisers exempt from registration under Section 203(b)(4), (5), or (6) from the incentive-based compensation rules. Advisers Act Section 202(a)(11)(H) allows the SEC to exclude from the definition of investment adviser "by rules and regulations or order" "such other persons" as the SEC determines "are not within the intent of this paragraph." While we are unaware of the SEC using its authority under this provision to exclude advisers from the application of specific provisions in the Advisers Act, in reviewing the legislative history of that Section, we do not believe there is anything that indicates the SEC could not use its authority to provide a limited exclusion from the definition of "investment adviser" for purposes of the incentive-based compensation rules. As such, we encourage the SEC to carefully consider its authority under Section 202(a)(11)(H) to provide a limited exclusion from the definition of investment adviser, solely for purposes of the incentive-based compensation rules for advisers exempt from SEC registration under Section 203(b)(4), (5), or (6) of the Advisers Act.

Payments Tied to Ownership Interests

We believe that payments received by a person on account of his or her ownership stake in a covered financial institution should not be deemed incentive-based compensation under the Proposed Rules. Treatment of these types of payments as compensation would unfairly subject the owners of a covered financial institution to restrictions on their ownership interests that are not imposed on others, without any supporting evidence that such ownership involves the type of risks sought to be addressed by Section 956. We encourage the SEC to provide a clear provision in the final rules that such payments will not be deemed incentive-based compensation under the rules.

Timing of Asset Calculation

We note that under the Proposed Rules, investment advisers are required to calculate their assets for purposes of the thresholds as of the end of the year, while other covered financial institutions are permitted to calculate their assets based on an average of multiple dates during the year. This could result in an investment adviser that only exceeds the asset threshold on that particular day to be subject to the rules, which we believe would be an unfair result, particularly given the Congressional determination to exclude smaller financial institutions from the scope of the rules. For example, an investment adviser that receives all, or a substantial portion of, its fees or performance allocations at the end of the year may exceed one of the asset thresholds on that day, but at no other time during the course of the year. We encourage the SEC to amend the Proposed Rules to permit an investment adviser to determine its assets based on an average of multiple dates in a calendar year thereby avoiding this anomalous result, provided the adviser uses a reasonable methodology to calculate its average assets and explains its methodology to the SEC. The SEC could amend Item 1.O. on Form ADV to provide an alternative checkbox for advisers that choose to use an average of quarterly assets so that the SEC knows which method an adviser is choosing to calculate its assets.

Threshold Adjustments for Inflation

We believe it is important that each of the asset thresholds be adjusted over time to account for the effects of inflation and the growth of capital markets. Section 956(f), which excludes institutions with assets of less than $1 billion from the scope of the requirements of that section, evidences a clear Congressional intent to exclude smaller financial institutions from the incentive-based compensation rules. Without appropriate adjustments over time, however, the thresholds set out in the Proposed Rules will become outdated and capture additional firms whose size relative to the size of capital markets has not increased. Accordingly, we encourage the SEC to amend the Proposed Rules to include a requirement that the asset threshold be periodically adjusted for inflation and the growth of capital markets.

<u>Coordination with Tax Code</u>

In determining the structure of compensation paid to employees, we believe it is important to permit covered financial institutions to consider tax consequences for those employees as well as for the financial institutions. Without consideration of the tax consequences, covered persons could face current tax obligations in excess of the cash compensation they are permitted to receive in a given year, while other alternatives may cause the financial institutions to be subject to current income taxation on the amount of compensation that is required to be deferred. To help avoid unintended tax consequences resulting from the Proposed Rules, we encourage the SEC to coordinate with the Internal Revenue Service regarding the relationship between the Proposed Rules and the tax consequences of those rules for covered institutions and covered persons under Sections 83, 409A and 457A of the Tax Code.

Section 83 of the Tax Code requires taxpayers to include as income (subject to tax) vested equity, even if the employee is not permitted to immediately sell or redeem that equity. Sections 409A and 457A of the Tax Code set out the requirements that companies and employees must meet for tax obligations on amounts set aside for deferred compensation also to be deferred. While many companies seek to structure their deferred compensation arrangements in a manner consistent with these provisions of the Tax Code to minimize timing differences in when the compensation is actually paid and when tax obligations arise, not all deferred compensation arrangements meet the requirements of these sections of the Tax Code. To the extent deferred compensation, either in the form of cash payments or equity, do not meet the requirements of the Tax Code, an employee would owe taxes in the current year, even if that employee is not entitled to receive the compensation until a future year.

We note that the National Credit Union Administration's ("NCUA") proposal would permit credit unions to accelerate payments to covered persons to the extent of any tax liabilities owed, for example, to pay for current tax liabilities on deferred compensation amounts. We believe the SEC rules should permit covered financial institutions to consider: (i) a covered person's tax situation in setting his or her incentive-based compensation, including the ability to accelerate cash payments to a covered person to allow that person to meet his or her tax obligations; and (ii) the after-tax resources of the financial institution in implementing the deferred compensation arrangement.

Conclusion

MFA and AIMA are grateful for the opportunity to comment on the Proposed Rules. If you have any questions regarding any of these comments, or if we can provide further information with respect to these or other regulatory issues, please do not hesitate to contact Benjamin Allensworth or Stuart Kaswell at [redacted] or Jennifer Wood or Jiří Król at +[redacted].

Respectfully submitted,

/s/	/s/
Stuart J. Kaswell	Jiří Król
Executive Vice-President and Managing Director, General Counsel MFA	Deputy CEO Global Head of Government Affairs AIMA