

Georg Merkl
Binz, Switzerland

Via e-mail to: rule-comments@sec.gov

U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090
Attention: Elizabeth M. Murphy, Secretary

Reference: S7-12-11

April 1, 2011

Dear Ms. Murphy,

Thank you for the opportunity to provide comments on the SEC's proposed rules for incentive based compensation arrangements for financial institutions. My comments focus on the intent of Congress based on the legislative history of the Dodd-Frank Act and on the application of the rules to broker-dealers and investment advisers.

The Dodd-Frank Wall Street Consumer Protection Act only refers to "assets" without providing a definition for term or for a source from which this amount can be taken (e.g. consolidated balance sheets). In addition, the intent behind the use of an asset threshold is not clear. If Congress intended to protect creditors (including depositors) of financial institutions, it would have made more sense to refer to the amount of liabilities. However, the total assets on the consolidated balance sheet will usually have a high degree of correlation with the total liabilities on the consolidated balance sheet. In addition, if Congress intended to protect both the creditors and the shareholders of financial institutions, then using the total assets on the consolidated balance sheet of the financial institution is appropriate.

If Congress intended to protect investors (i.e. clients) that do not invest in the financial institution itself, but that use the brokerage services or the investment advisory services of the financial institutions, then referring to the assets under management would be appropriate. The investment management business of financial institutions can get very large with a high amount of assets under management from clients without requiring a high amount of total assets on the consolidated balance sheet of the investment adviser and without requiring much capital from shareholders or from creditors. Investment managers that rent their offices and maybe even rent their IT systems rather than owning them will typically not have a high amount of assets on their balance sheets. Depending on the legal structuring and the accounting treatment, securities accounts of investors may or may not be included in the total assets on the consolidated balance sheet of a broker-dealer.

The House Report 111-236 states in its performance goals and objectives section that the purpose of section 956 is to prohibit incentive-based payment arrangements that could threaten financial institutions' safety and soundness or could have serious adverse effects on economic conditions or financial stability. Although the statutory language was somewhat modified in the final version, section 956(b)(2) bans incentive-based payment arrangements that could lead to material financial loss to the covered financial institution.

Breaches of duties under contracts with clients or breaches of fiduciary duties and laws may create legal liabilities of the investment advisory or broker dealer activities that threaten the survival of a financial institution because it does not have sufficient assets to settle those legal liabilities or because the damage to the reputation would lead to an outflow of clients and assets under management.

Some activities of financial institutions, such as investment management, do not require a high amount of assets on the balance sheet of the financial institution. Other activities, such as lending, require a higher amount of assets. As a consequence, the size of a financial institution and the impact of losses on the creditors, shareholders and investment management clients (i.e. investors) may be better reflected by the sum of the total assets on the consolidated balance sheet of the financial institution and the amount of assets under management from clients that are not included in the total assets on the consolidated balance sheet. Congress probably included a measure for the size of a financial institution because it was worried about the fixed cost of compliance or because it wanted to restrict the regulations to financial institutions that have a larger importance for the financial market of the U.S.

Incentive based compensation systems that tie an employee's compensation to transaction based commissions may induce an employee of an investment adviser to engage in investment transactions that are not necessary (i.e. portfolio churning). Incentive based compensation systems that tie an employee's compensation to the performance of investments (e.g. a performance fee) without requiring the investment adviser or the employee to make substantial co-investments alongside the investors may induce an employee to make risky investments. The typical performance fee arrangement of a private equity fund enables the investment manager of the fund to receive 20% of the total investment profits of the fund while only requiring the investment manager to invest a much lower percentage (e.g. 1%) of capital in the fund. In other words the manager has a lot of upside if the investments perform well, but has very little downside if the investments make losses. Unless the investors in such funds have built limits on leverage and limits on committing more capital to investments (or underlying funds in the case of funds of funds) than is available from the investors (and thus creating the potential need for leverage to cover the shortfall) in the fund agreement, the investors may suffer losses.

The proposed definition of total consolidated assets in §248.203(i) refers to the total assets reported in the most recent year-end audited Consolidated Statement of Financial Condition of a broker or dealer registered under Section 15 of the Exchange Act or to the total assets shown on the balance sheet for the most recent fiscal year end of an investment adviser. I propose that amount of assets under management that is not reflected in the total assets on the balance sheet should be added to the total assets on the balance sheet to calculate the "assets" for purpose of section 956.

I appreciate the opportunity to comment on these matters and hope that my comments are useful in the rulemaking process.

Respectfully submitted,

Georg Merkl