May 31, 2011

Via Electronic Filing

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: Incentive-Based Compensation Arrangements, Rel. No. 34-64140; File No. S7-12-11

Dear Ms. Murphy:

The Investment Adviser Association (IAA)[1] appreciates the opportunity to comment on the Commission's proposed rules with respect to incentive compensation arrangements.[2]

Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) specifically requires the prohibition of incentive-based payment arrangements, or any feature of any such arrangement, at a covered financial institution that the federal agencies determine encourage inappropriate risks by a financial institution by providing excessive compensation or that could lead to material financial loss. The Dodd-Frank Act also requires a covered financial institution to adopt policies and procedures and to disclose to its appropriate federal regulator the structure of its incentive-based compensation arrangements.

We recognize that section 956 of the Dodd-Frank Act requires the Commission to act jointly with six other federal agencies to adopt regulations or guidelines with respect to incentive-based compensation practices at covered institutions. We, however, urge the Commission to provide investment advisers - which will be subject to these types of requirements for the first time - with flexibility to implement measures that are appropriate for advisory firms. The rules that are ultimately adopted should reflect fundamental differences between asset management firms and banking institutions.

[1] The IAA is a not-for-profit association that represents the interests of investment adviser firms that are registered with the SEC. For more information, please visit our web site: www.investmentadviser.org.

[2] Incentive-Based Compensation Arrangements, Release No. 34-64140 (Mar. 10, 2011) (Incentive-Based Compensation Release).

Background

Investment advisers engage in significantly different businesses from banking institutions for which the compensation standards were initially drafted. Investment advisers manage securities portfolios for a wide range of clients, including individuals, mutual funds, pension plans, private funds, corporations, and other institutional clients. Advisers typically carry out client mandates in accordance with the client's stated risk tolerance, objectives, and portfolio guidelines. Clients open custodial accounts with a bank or broker-dealer and authorize their investment manager to issue investment instructions to the custodian. The vast majority of advisory relationships are entered into to achieve long-term investment objectives. Investment advisers generally generate profits from receipt of management and performance fees for managing client assets rather than by taking risks with their own capital. Advisers typically act as agents on behalf of their clients rather than as principal; they do not engage in loans or other transactions with clients. Thus, investment advisory firms are not capital-intensive businesses. They have a substantially different risk profile than banks and broker-dealers, which utilize their own capital or the capital of their depositors or customers for profitmaking.

In addition to differences between advisers and other financial institutions, even within the investment advisory profession, there are a wide range of business models and structures. Further, advisory firms may have vastly different compensation practices depending on various factors, including size, structure and the nature of their services.[3]

Standards Should Reflect Differences Among Covered Institutions

Given the significant differences between depository institutions and investment advisers, as well as within the investment advisory profession, investment advisers should be permitted to comply with the standards in a manner that is appropriate for their risk profiles, their businesses, and client base.[4]

[3] In fact, many compensation arrangements may already create strong incentives to manage risk for the firm because they align the interests of the firm with those of its clients.

[4] The Financial Services Authority (FSA) in the United Kingdom took a similar approach in applying its remuneration policy to asset managers for the first time. Under the revised Remuneration Code, the FSA permits asset management firms to comply with the principles in a way and to the extent that is appropriate to their size, internal organization, and the nature, the scope, and the complexity of their activities. We appreciate that regulators in the G20 countries and the EU have been making efforts to achieve international alignment of remuneration principles to address unsound compensation systems that may have contributed to the financial crisis. Although the focus of the principles for sound compensation practices endorsed by the G20 countries has been on significant financial firms, some jurisdictions have extended application of the principles to asset managers. Given the expanded application of these principles to other global institutions, it is important that the Commission coordinate its approach internationally to promote competition and to ensure that these firms are not subject to inconsistent and potentially conflicting regulatory requirements.

For example, the proposal sets forth three standards that must be satisfied for an incentive-based compensation arrangement not to be deemed to encourage inappropriate risks by a covered financial institution that could lead to material financial loss to the covered institution. The proposal then goes on to identify four methods to make compensation more sensitive to risk, including risk adjustment of awards, deferral of payment, extending performance periods, and reducing the sensitivity to short-term performance. Although the regulators state that these methods are not exclusive, we believe it would be preferable to clearly state that these methods are examples of items that institutions could consider in determining whether incentive-based compensation arrangements encourage risk-taking rather than methods that must be used by all investment advisers.

Similarly, we support requiring covered financial institutions, including investment advisers, to maintain policies and procedures appropriate to their size, complexity, and use of incentive-based compensation. We believe this principle is particularly important for the asset management industry and should be an overarching principle that applies across all the standards and requirements. By providing flexibility to comply with these standards, the significant burden that would be imposed on investment advisers may be appropriately alleviated. We recommend that the specific factors described by the regulators in complying with the standards should not be incorporated as minimum requirements but as elements that firms should consider based on their size and complexity. As the Commission has long recognized, a one-size-fits-all approach could risk imposing standards that are not relevant or useful for asset management firms.[5] In this regard, it would be helpful for the Commission to discuss potential risks that asset managers face that pose particular issues for them in the area of incentive compensation practices.

In addition, the proposed rules state that the policies and procedures must ensure that risk-management, risk-oversight, and internal control personnel should have an appropriate role in the processes for designing incentive-based compensation arrangements and for assessing their effectiveness. The release further states that the regulators believe that these personnel should be involved in *all* phases of the process for designing incentive-based compensation arrangements. While some advisory firms may determine that risk-management personnel could provide valuable input in the design of an incentive-compensation arrangement, other advisory firms may find that the risk management and compliance personnel are not the appropriate architects of compensation arrangements and other personnel may be better suited for this task. We, therefore, believe that unique characteristics of each firm should dictate the appropriate personnel that should be involved in the design and assessment of incentive-based compensation arrangements.

[5] Investment Adviser Codes of Ethics, Investment Advisers Act Rel. No. IA-2256 (July 9, 2004) ("proposal left advisers with substantial flexibility to design individualized codes that would best fit the structure, size and nature of their advisory businesses"); Compliance Programs of Investment Companies and Investment Advisers, Investment Advisers Act Rel. No. IA-2204 (Dec. 17, 2003) ("Commenters agreed with our assessment that funds and advisers are too varied in their operations for the rules to impose of a single set of universally applicable required elements"); Proxy Voting by Investment Advisers, Investment Advisers Act Rel. No. IA-2106 (Jan. 31, 2003) ("Investment advisers registered with us are so varied that a 'one-size-fits-all' approach is unworkable").

Calculation of Threshold

The Commission proposes that the calculation of the total consolidated assets for investment advisers should be determined by the adviser's total assets shown on the balance sheet for the adviser's most recent fiscal year end, which would be consistent with the method of calculation in the proposed amendments for Form ADV Part 1A. Specifically, the Commission was of the view that the "assets" for purposes of section 956 should be defined to mean the total assets of the advisory firm rather than the "total 'assets under management,' *i.e.*, assets managed on behalf of clients."[6] We strongly agree. Section 956 was intended to apply to institutions of a certain on-balance sheet size. Neither the plain language of the statute nor any congressional intent of which we are aware calls for assets managed on behalf of clients to be counted as assets of the firm.

We understand, however, that there is currently some uncertainty with respect to requirements under US GAAP regarding the circumstances in which the assets of certain pooled vehicles managed by an investment adviser should be included in the balance sheet of the investment adviser.[7] The proposal to clarify the circumstances in which certain investment managers should consolidate the assets of these client vehicles in the balance sheets of the advisory firms has not yet been issued by the Financial Accounting Standards Board (FASB). In addition, some advisers may comply with the International Financial Reporting Standards rather than US GAAP.

We do not believe the Commission intended to make the definition of "covered financial institution" depend on accounting standards that may change over time.[8] Further, the Commission determined to exclude client assets because it has construed section 956 as specifying the total assets of the advisory firm rather than the total assets under management. Accordingly, we ask the Commission to clarify that total assets of the advisory firm do not include assets managed on behalf of clients regardless of their treatment under various accounting standards.

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[6] *See* Rules Implementing Amendments to the Investment Advisers Act of 1940, IA-3110 n. 196 and related text (Nov. 19, 2010).

[7] *See* Accounting Standards Update 2010-10, which deferred FAS 167, Amendments to FASB Interpretation No. 46R for certain investment entities that have attributes of entities subject to ASC 946 (investment company guide). The FASB deferred the guidance to develop a new model as a basis for consolidation. The proposal for the new model is expected shortly.

[8] Reliance on accounting principles also may be problematic because it can over-inflate a firm's total assets with assets that do not represent capital at risk by, for example, requiring firms to include certain intangible assets on their balance sheet (*e.g.*, goodwill). We request that the Commission clarify that such items considered assets for accounting purposes only may be excluded from the total asset calculation for purposes of the proposed regulation.

Advisory Subsidiaries of Banking Holding Companies

In the Incentive-Based Compensation Release, the Federal Reserve Board (Board) specifically states that bank holding companies are covered financial institutions and that a covered financial institution includes the subsidiaries of such institutions. We request clarification regarding the "scope of the term" as defined by the Board.

Specifically, it is unclear whether an advisory subsidiary (that itself lacks the $1 billion in assets) of a bank holding company would become a covered financial institution and be required to comply with the proposed rules independently from the holding company by, for example, submitting reports to the Commission. We are of the view that the proposed rule should apply at the level of the bank holding company and not at the level of the functionally regulated subsidiaries of a holding company. The holding company should be required to make reports to the Board, adopt policies and procedures that would apply at the holding company, and adopt incentive-based compensation arrangements that do not encourage inappropriate risks. We seek clarification that the regulated subsidiaries that would not, on their own, be subject to the proposed rules because they independently do not have assets of $1 billion would not be subject to separate obligations as a covered institution.

Moreover, for a bank holding company advisory subsidiary with $1 billion or more in assets, we believe that the holding company should have the flexibility to determine whether it would be appropriate to comply with the requirements at the level of the parent company only or also to comply at the level of the regulated subsidiaries. The parent holding company would be best situated to determine the appropriate level at which the requirements should be imposed by viewing the risks to the organization as a whole and considering the overall size, complexity, and the use of incentive-based compensation of the entire organization.

Effective Date

The federal agencies have proposed to make the rules, if adopted, effective six months after publication of the final rules, with annual reports due within 90 days of the end of each covered financial institution's fiscal year. It is unclear from the Incentive-Based Compensation Release how the rules would affect compensation contracts already in place and whether those contracts would have to be amended to comply with the new standards. We understand that the proposed rules were not intended to affect contracts signed before the effective date of the rules. We, therefore, request that the Commission clarify in the adopting release that the standards only will apply to compensation arrangements that are entered into after the effective date of the rules. If the standards were to apply retroactively to existing compensation arrangements, we believe that six months would be too short of a period to review and possibly amend existing contracts. In such a case, a minimum of a one-year compliance period from the effective date of the rules would be necessary.

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The IAA supports the Commission's efforts to implement its mandate under section 956 of the Dodd-Frank Act. We urge the Commission, however, to be mindful of the

differences between depository institutions and investment managers in adopting rules on incentive-based compensation arrangements. We believe that clarification and confirmation of the issues described above will be extremely useful to asset managers that for the first time would be subject to these new requirements. We appreciate the opportunity to provide our views on these issues and would be pleased to provide any additional information. Please contact the undersigned or Karen L. Barr, General Counsel, at (202) 293-4222 with any questions regarding these matters.

Respectfully submitted,

/s/ Jennifer S. Choi

Jennifer S. Choi
Associate General Counsel

cc: The Honorable Mary L. Schapiro, Chairman
The Honorable Kathleen L. Casey
The Honorable Elisse B. Walter
The Honorable Luis A. Aguilar
The Honorable Troy A. Paredes

Eileen Rominger, Director
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Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System