INVESTMENT COMPANY INSTITUTE

1401 H Street, NW, Washington, DC 20005-2148, USA
202/326-5800 www.ici.org

May 31, 2011

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

Re: Incentive-Based Compensation Arrangements (File Number S7-12-11)

Dear Ms. Murphy:

The Investment Company Institute[1] appreciates the opportunity to comment on the Securities and Exchange Commission's proposed rules on incentive-based compensation.[2] These rules were mandated by Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank").[3]

This rulemaking presents the Agencies with a distinct challenge. As the Release notes, compensation arrangements are "critical tools in the successful management of financial institutions." The Agencies must take great care to craft rules that take two, sometimes opposing, approaches: the rules should be principles-based and flexible enough to allow firms to tailor their compensation practices and compete in the market for talent, but must also provide covered firms with enough clarity

[1] The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $13.1 trillion and serve over 90 million shareholders.

[2] *Incentive-based Compensation Arrangements*, Release No. 34-64140 (March 29, 2011), 76 Fed. Reg. 21170 (April 14, 2011) (the "Release"), available at http://www.sec.gov/rules/proposed/2011/34-64140.pdf.

[3] Section 956 requires the SEC, as well as the OCC, Board of Governors of the Federal Reserve System, FDIC, OTS, NCUA, and FHFA (together "the Agencies") to jointly prescribe regulations or guidelines with respect to incentive-based compensation practices at covered financial institutions. Specifically, Section 956 requires that the Agencies prohibit incentive-based payment arrangements, or any feature of any such arrangement, at a covered financial institution that the Agencies determine encourages inappropriate risks by a financial institution by providing excessive compensation or that could lead to material financial loss. Section 956 also requires covered financial institutions to submit reports to the appropriate Agency describing the structure of their incentive-based compensation arrangements sufficient to allow the Agency to determine whether the arrangements provide "excessive compensation, fees, or benefits" or "could lead to material financial loss" to the institution.

that they can design compensation practices that are fully legal and compliant.

We appreciate the Agencies' efforts to strike the right balance between flexibility and certainty in the proposed rules, and we support the principles-based approach generally taken by the Agencies. Overly prescriptive rules would stifle competition and ultimately fail. As Commissioner Paredes stated, "simply put, the Commission is not well-equipped to prescribe rules that dictate the specifics of how individuals must be paid."[4]

Nevertheless, we have several concerns with the proposal:

- ***The standards for prohibited conduct are not clear.*** To improve that clarity without taking an overly prescriptive approach, we recommend including a rebuttable presumption in the final rules that compensation arrangements approved in good faith by a covered financial institution's board are permissible. We also recommend that the Commission's staff, separately from the other Agencies, provide supplementary FAQs that illustrate the types of arrangements or practices that it has identified as "inappropriate," "excessive," "unreasonable," or "disproportionate."

- ***There is very little, if any, meaningful discussion in the Release about the distinction between "appropriate" risks and "inappropriate" risks.*** While we believe that the Agencies should avoid prescriptive statements about precisely what risks may be inappropriate, the Agencies should make it very clear that there is a distinction between taking risks with the firm's own assets and taking fully disclosed investment risk with client assets. The latter is quite simply not the behavior that this rule is meant to address.

- ***An overemphasis on comparators in determining the "excessiveness" of compensation could quell legitimate competition for talent.*** Although comparators are clearly relevant, the Agencies should expressly state that a firm positioning itself at the top of the compensation spectrum does not, by virtue of that fact alone, provide "excessive" compensation. Some firms choose to hold themselves out as providing better compensation packages than their competitors, and nothing in Section 956 or this rulemaking should prohibit them from competing for talent in the marketplace on that basis.

- ***Statements in the Release about the Agencies' expectations for risk management and***

[4] *Statement at Open Meeting to Propose Rules Regarding Incentive-Based Compensation Arrangements*, Commissioner Troy A. Paredes (March 2, 2011), avail. at http://www.sec.gov/news/speech/2011/spch030211tap-icomp.htm.

internal control personnel are overly prescriptive. While many firms may use risk management and internal control personnel in much the way suggested by the Release, others may not. The Agencies need not, and should not, micromanage the process to the level suggested in the Release. Rather, each firm should be afforded the flexibility to determine the best way to utilize its staff to achieve the Agencies' goals on compensation.

- ***While we strongly support the use of a balance-sheet assets test for determining status as a "covered financial institution," the definition could be improved in several respects.*** The final rules should clarify the status of bank and thrift subsidiaries and impart some flexibility for firms that temporarily may cross the $1 billion or $50 billion thresholds.

- ***Separate standards for "larger" firms are not warranted at this time.*** Nothing in Section 956 suggests a different standard for larger firms, and nothing requires the Agencies to propose explicit requirements on the deferral of executive compensation. We recommend that the Agencies reconsider the proposed requirements for larger covered financial institutions, and adopt them only after experience with the rule demonstrates that the general requirements are not sufficient to deal with incentive compensation practices at those firms.

These concerns and recommendations are explained more fully below.

1. Standards for Prohibited Conduct

Despite our strong support for a flexible, principles-based approach, we are concerned that parts of the proposal, including the two main prohibitions, are so vague as to provide no practical guidance to regulated entities and reserve virtually unfettered discretion to regulators.[5] Standards must be clear, particularly with respect to prohibited conduct. Normative terms such as "inappropriate," "excessive," "unreasonable," and "disproportionate" erect inherently subjective standards that are easy for regulators to apply *post hoc* to facts and circumstances, but are far harder for regulated entities to use *ex ante* in crafting compliance policies and procedures. We recognize that it may be difficult to craft rules defining these terms without becoming overly prescriptive, but the Agencies must also recognize that such vagueness will not promote the purposes of the law or facilitate compliance. If the Agencies themselves cannot better articulate the parameters of their rules, how then can the regulated community?

[5] Moreover, it is not clear that Congress intended the Agencies to adopt these prohibitions by merely incorporating the statutory text. Section 956 instructs the Agencies to prohibit practices "*that the regulators determine* encourages inappropriate risks." By merely parroting the statutory text, the Agencies have made no such determination.

We have two recommendations to more clearly define the parameters of prohibited conduct while maintaining the rules' principles-based approach. First, the rules should create a rebuttable presumption that compensation arrangements approved in good faith by a covered financial institution's board are permissible. The proposed rule specifically requires incentive-based compensation arrangements to be "supported by strong corporate governance, including active and effective oversight by the covered financial institution's board of directors or a committee thereof." Regulators should not be permitted to second guess compensation decisions and find that compensation is excessive or encourages inappropriate risk unless there is clear and compelling evidence that the board has not fulfilled this mandate, and has acted in bad faith or with a lack of due care in approving the compensation.

Second, we recommend that the Commission staff, separately from the other Agencies, provide supplementary guidance through informal FAQs that illustrates the types of arrangements or practices that it has identified as "inappropriate," "excessive," "unreasonable," or "disproportionate." The Release specifically contemplates this type of approach, as it states that "[e]ach Agency may issue supplemental guidance specific to their regulated entities, including guidance as necessary to clarify the regulatory requirements proposed in this rulemaking."[6] While we understand that the staff may be hesitant to provide examples out of concern that they be viewed as the exclusive circumstances in which the prohibitions are violated, it could make clear that any examples provided are illustrative only and not meant to constitute an exhaustive list of practices that may violate the rules.

2. Appropriate vs. Inappropriate Risks

The proposed rule would prohibit a covered financial institution from establishing or maintaining any incentive-based compensation arrangement that "encourages inappropriate risks by the covered financial institution" either by providing a covered person with excessive compensation or by providing incentive-based compensation to covered persons that could lead to material financial loss to the covered financial institution.

There is very little, if any, meaningful discussion in the Release about the distinction between "appropriate" risks and "inappropriate" risks. All financial institutions take risks, including some that may expose the firm to a material financial loss. And some financial institutions, like investment advisers, are engaged specifically to take disclosed investment risks with their clients' assets. Accordingly, it will be crucial for these firms to be able to clearly distinguish between "appropriate" and "inappropriate" risks.

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[6] Release, 76 Fed. Reg. at 21173-74.

While we believe that the Agencies should avoid prescriptive statements about precisely what risks may be inappropriate, the Agencies should make it very clear that there is a distinction between taking risks with the firm's own assets and taking fully disclosed investment risk with client assets. The latter is quite simply not the behavior that this rule is meant to address. Rather, it is behavior that is fully disclosed, heavily regulated, and both expected and demanded by the client.

The UK's Financial Services Agency (FSA) recently recognized this point in crafting its remuneration rules, applying different minimum expectations for compliance to firms based on their "tier." The highest tiers applied to credit institutions and broker-dealers that engage in significant proprietary trading and/or investment banking activities. The lowest tier, tier four, contains firms, like asset managers, that generate income from agency business without putting their balance sheets at risk.[7] The FSA's rules recognize that an investment advisory business is quite different than a bank's or broker-dealer's business, and involves a lower enterprise risk that should be reflected in a remuneration rule. The Agencies should follow suit and craft a rule that takes full account of the very different risk characteristics of the affected businesses. A "joint rulemaking" does not justify an across-the-board approach.

3. The Standards for "Excessive" Compensation

The proposed rule sets forth seven considerations the Agencies will take into account when determining whether a particular arrangement provides "excessive" compensation. These include various comparative metrics, like the compensation history of other individuals with comparable expertise at the covered financial institution, and comparable compensation practices at firms with comparable size, geographic location, and complexity.

Although such comparators are clearly relevant, the Agencies should expressly state that a firm positioning itself at the top of the compensation spectrum does not, by virtue of that fact alone, provide "excessive" compensation. Some firms choose to hold themselves out as providing better compensation packages than their competitors, and nothing in Section 956 or this rulemaking should prohibit them from competing for talent in the marketplace on that basis. An overemphasis on comparators in determining the "excessiveness" of compensation could quell legitimate competition for talent.

4. Compatibility with Effective Controls and Risk Management

As noted above, the proposed rule would prohibit a covered financial institution from establishing or maintaining any incentive-based compensation arrangement that encourages inappropriate risks that could lead to material financial loss to the covered financial institution.

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[7] *See Revising the Remuneration Code*, FSA Policy Statement 10/20 (Dec. 2010), at pages 32-37.

In order to avoid violating this prohibition, the proposed rule expressly states that the compensation arrangement must be balanced, "compatible with effective controls and risk management," and supported by strong corporate governance. The proposed rules also require policies and procedures to "ensure that risk management, risk-oversight, and internal control personnel have an appropriate role in the covered financial institution's processes for designing incentive-based compensation arrangements and for assessing their effectiveness in restraining inappropriate risk-taking."

In explaining what is meant by those provisions, the Agencies lay out their expectations for risk management and internal control personnel:

> [T]he Agencies believe that risk-management, risk-oversight, and internal-control personnel should be involved in all phases of the process for designing incentive-based compensation arrangements. Risk-management and risk-oversight personnel also should have responsibility for ongoing assessment of incentive-based compensation policies to help to ensure that the covered financial institution's processes remain up-to-date and effective relative to its incentive compensation practices.[8]

While it may be a good idea for a firm to consider the appropriate role of risk management and internal control personnel in the design and implementation of the firm's compensation arrangements, it is not appropriate for the Agencies to so expressly dictate the roles and responsibilities of specific personnel. While many firms may use risk management and internal control personnel in much the way suggested by the Release, others may not. Some advisers may have risk management personnel focus solely on investment risk, and the design of compensation arrangements may be well outside their area of expertise. Some firms may use internal control personnel tactically, rather than strategically. There may not be a role for them to play in designing a compensation plan. Moreover, compliance and control personnel are most effective when the rules are clear, which, as noted above, is not the case here.

For all of these reasons, we believe that each firm should be afforded the flexibility to determine the best way to utilize its staff to achieve the Agencies' goals on compensation. The Agencies need not, and should not, micromanage the process to the level suggested in the Release.

[8] Release, 76 Fed. Reg. at 21182.

5. Definition of "Covered Financial Institution"

In General. Each of the Agencies define "covered financial institution" for purposes of the application of their rules. The Commission's definition with respect to investment advisers is clear and straightforward – the term includes "an investment adviser as such term is defined in section 202(a)(11) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-2(a)(11)) that has total consolidated assets of $1 billion or more." We support that definition.[9]

Status of Subsidiaries. The definitions proposed by two of the Agencies – the Board and the OTS – are not as clear as the Commission's definition, in that they explicitly reference subsidiaries. As proposed, the Board's definition expressly states that "a covered financial institution includes the subsidiaries of the institution." Similarly, the Release suggests that in the case of the OTS, a covered financial institution "also includes an operating subsidiary," although the OTS' rule does not include an express reference to subsidiaries.

Given these definitions, it is unclear how the rules apply to broker-dealers or investment advisers subject to the Commission's jurisdiction that are subsidiaries of banks or thrifts. Consider, for example, a bank holding company subject to the Board's jurisdiction with greater than $50 billion in assets and an investment adviser subsidiary. Although the Board's definition clearly states that the bank's status "includes" the adviser, does that mean that the adviser is separately considered a covered financial institution (and therefore must submit a separate report to its primary regulator, the SEC)? If so, would the investment adviser be considered a "larger covered financial institution" because it is owned by a bank that qualifies as such? Does any part of this analysis turn on whether the adviser has over $1 billion in total consolidated assets on its balance sheet?

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[9] While a firm's balance sheet assets calculated under generally accepted accounting principles provide an objective, readily-available measure of a firm's size, we are concerned that total consolidated assets may, in certain circumstances, overstate the size of the firm and the amount of systemic risk it presents to the financial system. For example, an investment adviser that has acquired another adviser will typically recognize "goodwill" as an intangible asset. Goodwill represents the excess of the consideration paid by the acquirer over the fair value of the acquired adviser's identifiable assets. Where an investment adviser's total consolidated assets exceed the $1 billion threshold due to intangible assets such as goodwill, we are uncertain that the purposes of Section 956 are achieved by deeming the adviser to be a covered financial institution. To provide flexibility in that context, and in other situations where the application of the total consolidated assets test produces odd results, we recommend that the Agencies incorporate a mechanism into the final rules that would permit firms in such situations to seek relief.

We also have concerns with an ongoing project at the Financial Accounting Standards Board that may require an investment adviser to consolidate any investment company it advises. See Financial Accounting Standards Board, *Consolidation Policy and Procedures*. In particular, if the FASB requires investment advisers to consolidate the funds they advise, advisers' total consolidated assets may increase by a factor of ten, or a hundred, or more, significantly increasing the population of covered financial institutions. In such case, the Agencies will need to revisit the total consolidated assets test to ensure that it is working as intended.

We believe that the rules should be structured to apply solely to those entities – whether parents or subsidiaries – that meet both of the relevant tests: the entity is an enumerated bank, broker-dealer, or investment adviser, and the entity, on its own, has the requisite assets. Any reference to subsidiaries should not inadvertently sweep in smaller firms that would not, standing on their own, be subject to the rules.

We further believe that any covered financial institution (a "parent CFI") should be permitted to comply on its own behalf and on behalf of any subsidiary that is itself a covered financial institution (a "subsidiary CFI") by adopting procedures and by making reports to the parent CFI's primary regulator that cover both the parent CFI and the subsidiary CFI. Firms in this situation should be permitted the flexibility – but not required – to comply separately. Some firms may decide that it would be more appropriate to treat subsidiary CFIs as separate and distinct covered financial institutions, with separate policies and procedures and separate reporting obligations to a different regulator. Others may prefer to take a more holistic approach with respect to their policies and reports.

Timing of Threshold Determinations. A financial institution's status under the rule would be determined by reference to a single data point – the balance sheet as of its most recent fiscal year-end. While this provides objective certainty, it also may be problematic for some firms that might cross a relevant threshold in some years but not others. The Agencies may wish to consider creating a more flexible process, like the one employed for the federal registration of advisers. SEC-registered advisers that become ineligible for federal registration because of a decrease in assets under management have a 180-day grace period before they have to deregister.[10] Similarly, the Agencies could permit firms a grace period after crossing the $1 billion or $50 billion thresholds. If the firm's total consolidated assets fell below the threshold during the grace period, it would not meet the definition of covered financial institution (or larger covered financial institution).

6. Separate Requirements for "Larger" Covered Financial Institutions

The proposed rule would impose two additional requirements on certain covered financial institutions with $50 billion or more in total consolidated assets: (1) the mandatory deferral of a portion of executive officers' incentive compensation, and (2) board approval of the incentive-based compensation for any non-executive officers who have the ability to expose the firm to substantial losses.

We share the concerns expressed by Commissioners Casey and Paredes that these requirements

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[10] *See Rules Implementing Amendments to the Investment Advisers Act of 1940*, Release No. IA-3110 (Nov. 19, 2010), at footnote 68 and accompanying text, available at http://www.sec.gov/rules/proposed/2010/ia-3110.pdf.

go beyond what is necessary to fulfill the mandate under Dodd-Frank. Nothing in Section 956 suggests a different standard for larger firms, and nothing requires the Agencies to propose explicit requirements on the deferral of executive compensation. These requirements could impede the ability of larger firms to attract executive officers, placing them at a competitive disadvantage compared to their somewhat smaller peers.

We recommend that the Agencies reconsider these requirements for larger covered financial institutions, and adopt them only after experience with the rule demonstrates that the general requirements are not sufficient to deal with incentive compensation practices at larger covered financial institutions.

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We appreciate your consideration of our views on this important topic. If you have any questions or need additional information, please contact Bob Grohowski at (202) 371-5430 or me at (202) 326-5815.

Sincerely,

/s/ Karrie McMillan

Karrie McMillan
General Counsel

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

Eileen P. Rominger, Director
Division of Investment Management