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

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

Attention: Elizabeth M. Murphy, Secretary

Re: File No. S7-12-11
Release No. 34-64140
Incentive-Based Compensation Arrangements

Ladies and Gentlemen:

This letter is submitted on behalf of the Federal Regulation of Securities Committee (the "Committee" or "we"), of the Business Law Section (the "Section") of the American Bar Association (the "ABA"). This letter is in response to the request by the Securities and Exchange Commission (the "Commission") for comments in the March 30, 2011 proposing release referenced above[1]. This letter has been prepared with the significant participation of the Committee's Subcommittee on Hedge Funds, with additional contributions from other members of the Committee and the Section.

The comments expressed in this letter represent the views of the Committee only and have not been approved by the ABA's House of Delegates or Board of Governors and therefore do not represent the official position of the ABA.

I. Introduction

On March 30, 2011, seven federal agencies, including the Commission (the Commission, together with such other federal agencies, the "Agencies") issued a joint press release seeking comment on a proposed rule implementing Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") relating to incentive-based compensation arrangements at certain financial institutions (the "Proposed Rule"). In general, the Proposed Rule prohibits covered financial institutions from awarding incentive-based compensation that encourages inappropriate risks and requires such institutions to disclose certain information regarding the structure of their incentive-based compensation to the applicable regulator.

1 Federal Register Vol. 76, No. 72 (April 14, 2011); SEC Release No. 34-64140; File No. 57-12-11 (hereinafter, the "Release").

The Agencies seek comment on virtually every aspect of the Proposed Rule. The Committee is pleased to have the opportunity to comment, but will focus on those requests for comment that are more particularly related to investment advisers (whether or not registered with the Commission), including advisers to hedge funds.[2]

II. Time Frame

The effective date of the Proposed Rule is six-months from publication of the final rule in the Federal Register.3 The annual reporting requirement is ninety (90) days after end of a covered institution's fiscal year. For covered institutions not previously subject to regulatory guidance related to incentive compensation,4 it may be unrealistic to expect that such covered institutions will be able to comply with all of the elements of the Proposed Rule in respect of all covered persons for 2011.

For example, as current compensation arrangements include contractual obligations of covered institutions (e.g., contracts with guaranteed bonuses or formulaic compensation arrangements), we respectfully suggest that such institutions should not be required to make a statement to the Commission as to why the current incentive-based compensation plan does not encourage inappropriate risks by providing excessive compensation or incentive compensation that could lead to a material financial loss5 when such compensation arrangements predate the effective date of the Proposed Rule.

Furthermore, we recommend that consideration be given to designating different compliance dates for financial institutions not previously subject to the Banking Agency Guidance6 or similar regulatory guidance related to incentive-based compensation.7 At a

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2 In the Release, the Commission estimates that there are (i) approximately five (5) covered bank and five (5) covered non-bank investment advisers with total assets of at least $50 billion, and (ii) approximately fifty (50) covered bank and ten (10) covered non-bank investment advisers with assets between $1 billion and $50 billion. Federal Register Vol. 76, No. 72 (April 14, 2011) at 21189-90, footnotes 46 and 48.

3 Federal Register Vol. 76, No. 72 (April 14, 2011) at 21174.

4 At various points, the Release refers to other incentive-based compensation guidance, and states that the Proposed Rule is to "supplement existing rules, guidance and ongoing supervisory efforts of the Agencies." Federal Register Vol. 76, No. 72 (April 14, 2011) at 21173.

5 Such statement is required by Proposed Rule 204(c)(5).

6 Guidance on Sound Incentive Compensation Policies, 75 Federal Register Vol. 75, No. 122 (June 25, 2010) at 36395 (hereinafter, the "*Guidance*").

7 The Release requests comment as to whether there should be different compliance dates for different parts of the Proposed Rule. Federal Register Vol. 76, No. 72 (April 14, 2011) at 21174.

minimum, we think the compliance date for any statements required under the Proposed Rule to be made to the Commission should post-date a covered institution's first opportunity to adjust its incentive-based compensation plan to take into account the specific requirements of the Proposed Rule.

III. Definitions

A. Definition of "Investment Adviser"

The Release at page 21174 in the Federal Register states that the Proposed Rule will apply to a "covered financial institution" and reports that, with respect to the SEC, this means an investment adviser as such term is defined in Section 202(a)(11) of the Investment Advisers Act of 1940 ("Advisers Act"). Footnote 10 explains further the definition of "investment adviser" is the operative term, regardless of whether the firm is registered as an investment adviser. Footnote 10 goes on to explain that banks and bank holding companies are generally excluded from the definition of "investment adviser." Although these very few sentences are critically important to determining which investment advisory entities are "covered financial institutions," they leave unanswered several interpretive questions that we believe should be clarified when the Proposed Rule is adopted.

First, the clause that precedes subsection (A) — and therefore subsections (B) through (H) — to Section 202(a)(11) is "does not include." In plain English, the phrase "does not include" should be read to mean "exclude," and, as the last sentence of footnote 10 correctly points out, subsection (A) thereof does exclude banks and bank holding companies from the definition of "investment adviser." And subsection (B) excludes any lawyer, accountant, engineer, or teacher, whose investment advice is solely incidental to the practice of his profession, subsection (C) excludes any broker or dealer whose investment advice is solely incidental to the practice of his profession and who receives no special compensation therefor, subsection (D) excludes the publisher of any bona fide newspaper, subsection (E) excludes any person whose advice relates to no securities other than obligations of the U.S. government, subsection (F) excludes any nationally recognized statistical rating organization, subsection (G) excludes any family office, as defined by the Commission, and subsection (H) excludes such other persons not within the intent of Section 202(a)(11) as the Commission may designate by rules and regulations or order. In short, although footnote 10 isolates just one subsection for commentary in the Release, each of the eight subsections in Section 202(a)(11) provides an identical exclusion from the definition of "investment adviser," and therefore as a matter of law any entity that may properly rely on an exclusion from the definition of "investment adviser" will not be a "covered financial institution" as that term is used in the Proposed Rule.[8]

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[8] We acknowledge that a similar interpretive scheme exists in the Investment Company Act of 1940 ("Investment Company Act"), the companion legislation to the Advisers Act. An entity that is an investment company as defined in Section 3(a) of the Investment Company Act may otherwise be excluded from the definition by a provision in Section 3(b) or Section 3(c), or by one or more of the exemptive rules that have been adopted by the Commission. See Rules 3a-1 to 3a-8. Each of those rules was adopted by the

There is no public policy reason of which we are aware that would justify distinguishing between the first six exclusions, each of which is self-executing in nature, and the last two exclusions, each of which will be available solely as a result of an action that must be taken by the Commission. More specifically, the term "family office" is not defined in the Advisers Act, and the Commission has proposed Rule 202(a)(11)(G)-1, which contains a definition of "family office."[9] The fact that the operative term "family office" in subsection (G) is the result of a rule to be adopted by the Commission does not change the fact that, whatever the term "family office" may be defined to mean, subsection (G) of Section 202(a)(11) unequivocally excludes such an entity from the definition of "investment adviser." The same argument applies equally to subsection (H). Historically, the Commission has entertained applications under subsection (H) [and its predecessors, then-subsections (F) and (G)] in which the entity filing the application seeks an order, based on the authority in subsection (H), that it is not a person within the intent of the paragraph. Again, the operative term is "not a person within the intent of this paragraph" and such a person is identified by Commission as the result of the issuance of an order; the fact that the person is identified by the issuance of an order does not change the fact that subsection (H) excludes such a person from the definition of "investment adviser."

For the reasons set forth in the two preceding paragraphs, we respectfully request that the Commission make clear in the release adopting the Proposed Rule that any person who is excluded from the definition of "investment adviser" by any one or more of the eight subsections in Section 202(a)(11) is not a "covered financial institution."

Second, Section 956(e)(2)(D) provides that the term "covered financial institution" means "an investment advis[e]r, as such term is defined in the section 202(a)(11) of the []Advisers Act []…." As the Commission knows, Section 203(a) of the Advisers Act requires that an investment adviser register with the Commission before it is permitted to make use of the mails or any means or instrumentality of interstate commerce in connection with its business as an investment adviser, except as provided in Section 203(b) and Section 203A. Section 203(b)

Commission through the exercise of its exemptive authority, and each expressly excludes an entity properly relying on that Rule from all of the provisions of the Investment Company Act. We believe that an entity that has been excluded from the definition of "investment company" is in no different position than an entity that is properly relying on an exemptive rule: in each instance, such an entity is not subject to any of the provisions of the Investment Company Act. It makes no difference as a matter of law, and thus should make no difference as a matter of public policy, that in the first instance Congress made the decision to exclude the entity and in the second instance the Commission, based on its experience in administering the Investment Company Act, used the exemptive authority given to it by Congress to adopt a rule that achieved the identical result.

9 On October 12, 2010, the SEC released proposed rules, and a request for comments, with respect to the definition of "family office" for purposes of a new exclusion from the definition of investment adviser for certain family offices. The comment period for that proposal ended November 18, 2010. "Family Offices," Investment Advisers Act Release No. 3098 (Oct. 12, 2010), available at http://sec.gov/rules/proposed/2010/ia-3098.pdf.

of the Advisers Act states that the "provisions of subsection (a) shall not apply to" a number of entities. In plain English, the phrase "shall not apply to" should be read to mean "except," and as a consequence entities that can properly rely on subsections (1) through (7) of Section 203(b) are excepted from registration with the Commission.[10] It is understood that it is the Commission's position that, notwithstanding the exception from registration, any entity relying on a subsection of Section 203(b) is still an "investment adviser" for purposes of some portions of Section 206 of the Advisers Act.[11] For example, seven of the eight rules adopted pursuant to the rulemaking authority in Section 206(4) expressly apply only to an investment adviser that is registered or required to be registered under the Advisers Act. Contrast Rule 206(4)-8 with Rule 206(4)-1 to 206(4)-7. The public policy reason for excluding certain unregistered investment advisers, *i.e.*, investment advisers that are excepted from registration, from the operation of these rules would be that (a) those investment advisers are not otherwise subject to the Commission's jurisdiction and it would be an unfair burden to keep current and comply with rules that are part of a statutory scheme as to which they are not otherwise subject, and (b) it would be unfair to hold the Commission responsible for the actions of legally unregistered investment advisers who are not otherwise subject to the Commission's jurisdiction, including its authority to conduct regular inspections or examinations.

With respect to Section 203(b), Section 203(*l*) and Section 203(m), the entities excepted from registration are:

- Subsection (1), any investment adviser, other than an investment adviser who acts as investment adviser to any private fund, all of whose clients are residents of the state within which such investment adviser maintains his or its principal office and place of business, and who does not furnish advice or issue analyses or reports with respect to securities listed or admitted to unlisted trading privileges on any national securities exchange;
- Subsection (2), any investment adviser whose only clients are insurance companies;
- Subsection (3), any investment adviser that is a foreign private adviser;
- Subsection (4), any investment adviser that is a charitable organization;
- Subsection (5), any plan described in Section 414(e) of the Internal Revenue Code of 1986;

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[10] Similarly, Section 203(l) provides an exemption from the registration provisions of the Advisers Act to an investment adviser that acts as investment adviser solely to one or more venture capital funds, while Section 203(m) directs the Commission to exempt from the registration provisions of the Advisers Act any investment adviser solely to private funds that has less than $150 million in assets under management in the United States. *See* Section 407 and Section 408, respectively, of the Dodd-Frank Act.

[11] 1 Anderson, Bagnall & Smythe, Investment Advisers: Law and Compliance § 3.04 (2009). Presumably, the Commission's view will apply equally to entities relying on Section 203(l), Section 203(m) or Section 203A.

- Subsection (6), any investment adviser that is registered with the Commodities Futures Trading Commission as a commodity trading advisor whose business does not, after July 21, 2010, become predominately the provision of securities-related advice;
- Subsection (7), any investment adviser, other than an entity that has elected to be regulated as a BDC pursuant to Section 54 of the Investment Company Act of 1940 who solely advises SBICs;
- An investment adviser solely to one or more venture capital funds, and
- An investment adviser solely to private funds that has less than $150 million in assets under management in the United States

With respect to Section 203A, certain entities registered as investment advisers in one or more states are prohibited from registering with the Commission.

To the extent that there is a common organizing principle to each of these exceptions, it is that there is no Federal interest in requiring registration under the Advisers Act because the entity is not engaging in investment activities at the national level or international level, or there is another functional regulator or regulatory framework that more appropriately governs the investment activities of the entity.

Section 956 itself does not explicitly require that the term "covered financial institution" also include entities that, although within the definition of "investment adviser," are not required to be registered under the Advisers Act. Whether an entity is excluded from the definition of "investment adviser" or excepted from registration as an investment adviser, at the end of the day such an entity is essentially not subject to the Commission's jurisdiction. By contrast, each of the other entities that is a "covered financial institution" has a Federal regulator — the Office of the Comptroller of the Currency, the Federal Reserve Board, the FDIC, the Office of Thrift Supervision, NCUA, or FHFA — and is subject to that Federal regulator's full supervisory authority. None of the other Federal regulators is seeking to apply the Proposed Rule to entities that are not fully subject to their jurisdiction and supervision. For example, the Federal Reserve Board has not sought to apply the Proposed Rule to entities, often referred to as non-bank banks, that are excluded from the definition of "bank" in the Bank Holding Company Act and thus the parent organization is not required to register as a bank holding company. There are no obvious public policy reasons for the Commission to extend the Proposed Rule to investment advisers that are excepted from registration while at the same time those entities are free to engage in investment advisory activities, well within the Commission's acknowledged area of regulatory expertise, without any oversight from the Commission. In the case of the "foreign private adviser" or a private fund adviser that is a non-U.S. adviser whose sole nexus with the United States is management of U.S. private funds from a place of business outside the United States, it would seem particularly anomalous to subject an entity that is subject to the investor protection laws of another country to the Proposed Rule. It cannot be good public policy for the Commission to take the position that entities that are otherwise excepted from registration under the Advisers Act must nonetheless be a "covered financial institution" and be subject to the requirements of the Proposed Rule, especially where that interpretation is not required by a literal reading or a fair reading of Section 956(e)(2)(D).

A pointed example of these public policy problems is the impact of the Proposed Rule on charitable organizations that are exempt under Subsection (4) of Section 203(b). Compensation practices of Section 203(b)(4) organizations are already regulated both at the federal and state level. Section 503(b) of the Internal Revenue Code of 1986, as amended, prohibits a Section 203(b)(4) organization from paying unreasonable compensation. Severe sanctions, including loss of tax-exempt status, can ensue from a violation. Short of losing its exemption, the organization (and its individual directors, officers and staff) face excise taxes ranging up to 200% for unreasonable compensation arrangements. See 26 U.S.C. 4958 and the regulations thereunder. The organization must disclose all forms of compensation, including incentive compensation, annually on Internal Revenue Service ("IRS") Form 990,[12] by which the IRS can investigate and take legal action. Compensation arrangements and other information disclosed on Form 990 is publicly available, thereby adding another layer of accountability.

The IRS's regulation of compensation practices of Section 203(b)(4) organizations operates in conjunction with oversight by state attorneys general and other state agencies. As the traditional loci of charity regulation, the states have power to regulate compensation and prosecute violations.[13] On a related point, insofar as the Proposed Rule would affect the endowment offices of one or more state universities, some states may argue that this aspect of the Proposed Rule infringes on state sovereignty. In sum, incentive compensation of Section 203(b)(4) charitable organizations is already rigorously regulated without Commission involvement. The Proposed Rule would impose an additional regulator and new compliance costs upon institutions long accustomed to oversight by the IRS and the states, and could expose the Commission to legal challenge.

For the reasons set forth in the preceding paragraphs of this section, we respectfully request that the Commission make clear in the release adopting the Proposed Rule that any person who is excepted from registration as an "investment adviser" by any one or more of the seven subsections in Section 203(b), Section 203(*l*) or Section 203(m), or not registered or required to register with the Commission by virtue of being registered in one or more states, is not a "covered financial institution." For all of the reasons set forth above, the Commission should interpret the term "an investment advis[e]r, as such term is defined in the section 202(a)(11) of the []Advisers Act []…" to mean an investment adviser that is registered or required to be registered with the Commission under the Advisers Act.

12 Part VII of IRS Form 990 requires disclosure of all compensation of directors and officers, as well as compensation the five most highly compensated employees who receive over $100,000 in annual compensation, if any. Schedule J of Form 990 requires, among other things, disclosure of specific aspects of compensation, including base compensation, bonus and incentive compensation, retirement and other deferred compensation, and nontaxable benefits.

13 Section 3(c)(1) of the Uniform Prudent Management of Institutional Funds Act, a uniform state law in effect in 48 states and the District of Columbia, restricts endowment management expenses to appropriate and reasonable costs.

B. Definition of "Total Consolidated Assets"

In respect of the definition of "total consolidated assets," we believe that a balance sheet test,[14] rather than measuring assets under management (or "AUM"), is appropriate in terms of measuring the "size" of investment advisers for purposes of Section 956 of the Dodd-Frank Act. And footnote 40 of the Release[15] makes clear that an adviser's AUM is to be distinguished from "assets" (total consolidated assets), as the Commission describes its estimate of the relatively small number of registered advisers that are expected to constitute covered financial institutions or larger covered financial institutions.[16]

However, we believe that relying solely on generally accepted accounting principles ("GAAP") will contradict the Commission's expressed distinction of AUM from "assets" in the case of a substantial number of privately-held investment advisers (and result in a substantially greater number of covered investment advisers than presently estimated in the Release). Accordingly, we believe that the balance sheet should be permitted to be adjusted in the cases of hedge fund and private equity fund advisers where strict application of GAAP would overstate

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14 The Release refers to Form ADV Part 1A for the method of calculation. While Part 1A does not set forth a method, Part 2 refers to generally accepted accounting principles ("GAAP") where a balance sheet is required. The Release's method of calculation of "assets" for investment advisers is consistent with the SEC's recent proposal (Release No. IA-3110; Rules Implementing Amendments to the Investment Advisers Act of 1940) that each investment adviser filing Form ADV Part 1A indicate whether the adviser had $1 billion or more in "assets," defined as the total assets shown on the balance sheet for the adviser's most recent fiscal year end. We do not believe that the Commission intended to include AUM in the definition of total assets for purposes of Form ADV Part 1A, as the adviser's AUM is required to be separately disclosed elsewhere in Form ADV. Accordingly, we recommend that a clarification to this effect be incorporated in respect of Form ADV as well.

15 The Release at footnote 40 states "Commission estimates that advisers with assets under management of $100 billion or more would have total consolidated assets of $1 billion or more. Based on data from the Investment Adviser Registration Depository ("IARD"), the SEC's Division of Investment Management estimates that 68 registered advisers with assets under management of at least $100 billion would have assets of $1 billion or more, and registered advisers with assets under management of at least $500 billion would have total consolidated assets of at least $50 billion." Federal Register Vol. 76, No. 72 (April 14, 2011) at 21188.

16 These estimates are consistent with the estimates expressed in terms of covered bank and non-bank advisers set forth in footnotes 46 and 48 of the Release.

an adviser's balance sheet assets and, in effect, result in using AUM as a measurement.[17] More specifically, in order to avoid such an unintended result, we urge that such definition incorporate an exclusion for any client funds that are consolidated onto an adviser's balance sheet purely as an accounting matter (*e.g.*, securitization vehicles or pooled investment funds, where such assets are, and under all circumstances will remain, the property of third-parties but are required to be consolidated under section 810 of the Accounting Standards Codification (which codified FAS 167) or other similar accounting requirements). In such instances, such assets are managed by the adviser, on an agency basis, and are not the property of or otherwise available to the adviser in respect of its general "corporate" purposes, to satisfy debts of the adviser or otherwise.

In this context, consolidation solely for accounting purposes occurs chiefly as a result of the adviser's power to direct the activities of an investment fund or vehicle, where the investors (limited partners, in the case of limited partnerships; members, in the case of hedge funds structured as limited liability companies) do not have sufficient voting or control rights so as to be able to remove the adviser, general partner or managing member, as the case may be. For many hedge funds, investors in all but very limited circumstances "vote with their feet" in electing to withdraw or redeem from the fund. For privately-held advisers, consolidation for GAAP purposes is not particularly relevant as the owners of the adviser are well aware that the GAAP balance sheet is not reflective of the adviser's "assets." For private advisers to hedge funds and private equity funds, it is more the industry norm for investors to be able to remove the adviser, general partner or managing member for cause, if at all. For publicly-held advisers, and particularly those that are subsidiaries of larger public financial institutions, the impact on information available to public shareholders must be considered and, accordingly, hedge funds advised by these advisers typically afford investors voting or control rights sufficient for a majority to remove the general partner/managing member, and thus for these advisers to avoid consolidation.

We believe that the exclusion of third-party funds that are consolidated solely for accounting purposes, and no other purpose, is consistent with the policy behind the Dodd-Frank Act and the Proposed Rule, as those assets do not constitute a risk of the "part of the capital of the covered financial institution."[18] The fluctuation in value of such assets as a result of the adviser's performance by definition should not lead to a "material financial loss" in respect of the actual (adjusted) balance sheet of the covered investment adviser.

If the adjustment to the definition of "total consolidated assets" is not incorporated in the Proposed Rule, similarly situated advisers (with the same AUM) will receive disparate treatment. In simple terms, whether the Proposed Rule applies to an adviser will be determined based on the business terms (chiefly voting and control rights) applicable to financially separate investment vehicles, and not based on the adviser's "assets." This disparity will disadvantage one group of

17 The Release requests comment as to whether the determination of total assets should be further tailored for certain types of advisers, such as advisers to hedge funds or private equity funds.

18 Federal Register Vol. 76, No. 72 (April 14, 2011) at 21181.

advisers, when, in truth, they are no more or less systemically important. In this vein, the Release cites the "principle of national treatment and equality of competitive opportunity" in expanding the definition of covered financial institution beyond those specifically identified in Section 956, and goes on to request comment as to whether there are "other types of financial institutions . . . the Agencies should treat as a covered financial institution to better promote the purpose of Section 956 and competitive equality."[19] The same principle of equality should pertain in determining whether substantially similar advisers are within or outside the definition of covered financial institution. If there is no distinction in actual systemic importance based on assets actually available to the adviser in terms of its proprietary investing, use for other corporate purposes and the like, then a divergence in regulatory treatment should not be the result.

For the foregoing reasons we respectfully request that the definition of "Total Consolidated Assets" be clarified in the Proposed Rule as finally adopted, or in the adopting release, to state that an adviser be permitted to exclude any asset from its balance sheet: (i) held by or in the name of any pooled investment vehicle, and (ii) to which the adviser would have no entitlement in the event of the dissolution of such vehicle.

IV. Policies and Procedures

The Proposed Rule requires "covered financial institutions to maintain policies and procedures appropriate to their size, complexity and use of incentive-based compensation to help ensure compliance" with the Proposed Rule.[20] At the same time, the Release recognizes that "it is necessary for covered financial institutions to take a certain amount of risk in order to operate their business"[21] and requests comment if employees might undertake "less than optimal risk."[22]

Unlike many of the other covered financial institutions, investment advisers frequently trade and invest on an agency, rather than principal, basis. In other words, they trade and invest client funds on behalf of such clients, whether in pooled investment vehicles (*e.g.*, hedge funds, commodity pools, private equity funds and the like) or separately managed accounts. As previously stated, they typically do not risk the capital of the adviser.[23] Accordingly, investment and trading activities, and the associated risk, typically do not lead to "material financial loss" in terms of the adviser's balance sheet. Rather, investment and trading activities may lead to a

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19 Federal Register Vol. 76, No. 72 (April 14, 2011) at 21174-5.

20 Federal Register Vol. 76, No. 72 (April 14, 2011) at 21173 and 21217.

21 Federal Register Vol. 76, No. 72 (April 14, 2011) at 21199.

22 Federal Register Vol. 76, No. 72 (April 14, 2011) at 21203.

23 Of course, for advisers that have substantial "skin in the game," investment and trading activities may create the risk of "material financial loss" (but those assets at direct risk in respect of trading and investment activities would be, of course, on the adviser's balance sheet).

reduction (or increase) in assets under management and, accordingly, management and performance fee income.

Typically, advisers are compensated on a flat fee basis, receive incentive compensation or profit allocations or a combination of management fees and performance compensation. In each of these cases, compensation is related to assets under management and performance. In this respect, the interests of advisers and their clients are aligned (the advisers share in the performance they generate for their clients, whether through increased management fees on appreciated asset bases or performance compensation, or both).

More specifically, in the hedge fund industry, which by and large was not implicated as a causal factor in the financial crisis or as a source of systemic risk, the typical compensation arrangements (the so-called "2/20" or 2% management fee and 20% performance compensation) create the compensation pool from which portfolio managers and owners of the business are rewarded. The investors/clients are typically sophisticated (most funds are so-called "3c7" and available only to qualified purchasers).[24] The investment and trading strategies are spelled out in offering materials provided to investors/clients, and each investment program's level of risk, based on the nature of the investments, leverage or other factors is spelled out in the documentation provided.[25]

While hedge fund advisers (unless they are publicly owned) are not required to disclose the manner in which they allocate fees to their owners and senior employees, the industry (like private equity and venture capital) is virtually unique in that the investors in funds are sophisticated investors and they agree upfront when they subscribe to a particular fund to the amounts to be paid to the fund's adviser by signing on to the 2/20 fee structure. In effect, they are making the decision that the compensation to the adviser is not unreasonable and does not encourage inappropriate risks. Indeed, investors have negotiated changes in the industry's fee structure, by requiring a "high water mark" be included, or that management fees be reduced in certain circumstances. Accordingly, there is an independent check (what the third-party investors will agree to) which exists in the industry, which makes it unlike the situation in large public companies, where "say on pay" is both a new phenomenon and is non-binding.

Such a business model would not seem inconsistent or contrary to activities permissible under the Dodd-Frank Act or the Proposed Rule for covered financial institutions, as long as institution's capital were not at risk. And, further, high-risk trading activity would and should be entirely permissible. For such businesses, subsidiaries, business units, or divisions constituting

24 The SEC recognized in the adopting release to Rule 3c7 that "qualified purchasers" were not likely to need the same level of investor protection as retail investors. Federal Register Vol. 62, No. 68 (April 9, 1997) at 17526.

25 An "inappropriate" risk under these circumstances would more likely be an investment inconsistent with or otherwise outside the parameters of the investment program, rather than any particular level of losses (there are high risk and lower risk investment programs, with investor/clients selecting investment programs based on their personal risk tolerances and investment objectives).

covered financial institutions, the prohibition on "excessive" compensation would of course pertain, but would have to be measured in the context of a business of high risk agency trading/investing.[26] In other words, we do not suggest that advisers be exempt from having in place policies which are reasonably designed to avoid unreasonable compensation, or excessive risk, but we urge that the adopting release for the Proposed Rule make clear that these policies should be evaluated within the framework of the fee structure applicable to each adviser's business.

In terms of both risk and compensation, we believe that policies and procedures will have to allow for the mission of the business and the degree to which the covered financial institution's capital is at risk (as opposed to risks that are not only accepted by but are embraced on an agency basis by clients and investors). Accordingly, we respectfully request that, for covered investment advisers, the Proposed Rule be clarified to differentiate risk taken by advisers on behalf of their client accounts based on investment programs and strategies implemented in respect of such third party accounts[27] from "inappropriate risks that could lead to material financial loss."[28]

V. <u>Competitive Forces</u>

The Release requests comment related to the competitive impact of the Proposed Rule.[29] The requirements of the Proposed Rule are likely, in our view, to put covered financial institutions that are investment advisers at some additional competitive disadvantage to advisers that are not subject to the Proposed Rule. To some degree, advisers that are part of larger institutions are already subject to management or board review of compensation policies, deferral or restricted stock programs and the like. These institutions today compete for investment and trading professionals with other parts of the hedge fund/alternative investment industry. Many of the most successful hedge fund managers began their careers employed by

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26 In the case of financial conglomerates, by extension, it may be entirely appropriate for there to be different policies in respect of an advisory subsidiary (that risks only client capital) from policies applicable to other affiliates or business lines where there is balance sheet risk. While we are not commenting on the adoption of other Agencies' approaches where they have jurisdiction over the ultimate parent where a consolidated entity is a covered investment adviser, we urge the Commission to make clear in the adopting release that in such cases it may be appropriate for elements of the policies and procedures, and compensation arrangements in general, of the covered investment adviser to differ from those applicable to other affiliates or business lines.

27 Again, in such instances, the capital of the covered financial institution is not at risk, and accordingly the policy considerations of Section 956 of the Dodd-Frank Act are not implicated.

28 Federal Register Vol. 76, No. 72 (April 14, 2011) at 21170.

29 *See, e.g.*, Federal Register Vol. 76, No. 72 (April 14, 2011) at 21200.

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commercial and investment banks. Constrained by limitations on compensation or on their investment and trading, they have struck out on their own, forming much of the hedge fund industry as it is known today. To the extent that further burdens are placed on institutional advisers, it is likely to further tempt talented investment professionals to either form their own advisory firms or join firms that offer more freedom to pursue broader investment strategies and opportunity for compensation.

To the extent that the employment market for talented professionals is efficient, as anticipated by the Release, it is not unreasonable to assume that covered investment advisers will need to increase compensation opportunities in order to "make up for" any additional deferral or look-back provisions required by the Proposed Rule (not otherwise already applicable) that would otherwise not be applicable to advisers not subject to the Proposed Rule. In other words, it should be presumed that talented employees will act in their best interests.

VI. Deferral

The Release requests comments on all aspects of specific requirements of the proposed deferral requirements.[30] We do not support the imposition of a mandatory deferral requirement for larger covered financial institutions. The Commission acknowledges in the Release that many covered investment advisers and covered broker-dealers have already adjusted their incentive-based compensation arrangements, policies and procedures to take into account the *Guidance*,[31] which imposed principles-based restrictions on such compensation (and many of these larger covered financial institutions have, we believe, deferral arrangements of one sort or another in place, either as a separate matter of governance or adopted to comply with the *Guidance*). In light of the Commission's acknowledgement, the imposition of other, arbitrary, deferral requirements (as set forth in Proposed Rule) will be in many cases duplicative of, or create inconsistencies with, other incentive-based compensation policies and controls which by the Commission's admission are already meeting the policy objectives of the Dodd-Frank Act. Instead, we believe that the Commission's approach of identifying deferral as one of the methods currently used to make compensation more sensitive to risk,[32] coupled with the annual reporting requirement and statement of compliance, addresses the necessary imperatives in respect of both larger and other covered financial institutions.

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30 Federal Register Vol. 76, No. 72 (April 14, 2011) at 21180-21181.

31 The Release acknowledges that many covered investment advisers "are already conforming to the incentive-based compensation standards reflected in the Guidance [Guidance on Sound Incentive Compensation Policies, 75 FR 36395 (June 25, 2010)] because they are affiliated with banking organizations … that have already altered their incentive-based compensation arrangements and policies and procedures following publication of the Guidance." Federal Register Vol. 76, No. 72 (April 14, 2011) at 21189.

32 Federal Register at 21179

The Release further requests comment as to whether "the required minimum deferral provisions be extended to smaller covered financial institutions?"[33] In light of the nature of the business of investment advisory firms as described herein, we do not believe that the policy considerations of the Dodd-Frank Act or articulated in the Release would be advanced by applying deferral requirements to covered financial institutions with total assets of $1 billion to $50 billion.[34] As these smaller advisers are not systemically significant, we believe that extension of the deferral requirements would be beyond the policy scope authorized by Congress in enacting the Dodd-Frank Act. Moreover, the owners of these non-systemically important, privately-held advisers (including advisers that qualify as covered financial institutions) may be distinguished from the shareholders of public companies that were impacted in the financial crisis. Because the same people responsible for managing risk own the business in the case of privately-held advisers to hedge funds, there is no policy rationale in Dodd-Frank for "protecting" these owners through imposition of deferral mechanisms.[35]

VII. Personal Hedging

The Proposed Rule should not include limits on, prohibit the use of instruments relating to, or otherwise address personal hedging activity by, covered persons. Any of the foregoing would potentially result in disadvantaging covered persons in a manner wholly-unrelated to their own personal performance, and accordingly, is inconsistent with the stated purpose of the Proposed Rule. Any covered financial institution required to implement a policy that would hold employees economically accountable for the actions of others over whom they have no influence

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33 The question is asked in the context of competitive disadvantage/impact. *See supra,* note 25.

34 Federal Register Vol. 76, No. 72 (April 14, 2011) at 21201.

35 We note that the U.K. Financial Services Authority ("FSA") took a similar approach when it published its policy statement and final rules on revising its Remuneration Code. http://www.fsa.gov.uk/pubs/policy/ps10_20.pdf. Specifically, the FSA, in considering the application of compensation principles to large financial institutions, introduced a proportionality test, applied on a tiered basis, that takes into account each institution's size and activities in determining how the Remuneration Code is to be applied. We believe that most U.K. hedge fund firms are anticipated to be classified as "Tier 4," and subject to only certain of the Remuneration Code's requirements in many respects similar to the Proposed Rule as it applies to covered financial institutions (as opposed to larger covered financial institutions), including to adopt remuneration policies (i) consistent with promotion of effective risk management and which do not expose the firm to excess risk, (ii) in line with its business strategy and long-term interests, and (iii) that create bonus pools based principally on profits, and that they be adjusted for risk and the cost of capital. In other words, principles related to remuneration in shares or other non-cash instruments, and deferral of variable remuneration are "disapplied" to most hedge fund firms in the U.K.

or control would be severely disadvantaged in terms of attracting or retaining personnel subject to such policies.[36]

Moreover, to the extent that there are deferral and "risk adjustment of awards" requirements imposed in respect of covered persons, those requirements will have the desired deterrent effect (it is the deferred compensation that is clawed back, whether or not hedged in terms of market fluctuations). After the well-publicized losses suffered by employees of Bear Stearns, Lehman Brothers and AIG,[37] to name a few, we respectfully submit that an anti-hedging provision is not only unnecessary (in light of the "risk adjustment" and "clawback" alternatives), but is bad economic and employment policy.[38]

In sum, we believe that the requirement related to board review of compensation arrangements for executive officers at covered financial institutions and deferral in respect of larger covered financial institutions, coupled with the obligation to "balance" the rewards and risks utilizing methods including "deferral of payments, risk adjustments of rewards, reduced sensitivity to short-term performance or longer performance periods" is sufficient to meet the policy objectives of Section 956 of the Dodd-Frank Act.

VIII. Other—No Private Right of Action

Section 956 mandates that the Agencies adopt standards with respect to excessive compensation, and we believe that interpretation and enforcement of the Proposed Rule (as finally adopted) should be the sole province of the Commission. We are not aware of any intention on the part of Congress to create a private right of action under Section 956 of the Dodd-Frank Act.[39] Specifically, incentive-based compensation arrangements (including, of

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[36] Moreover, in terms of unintended consequences, it is not hard to conceive of employees taking retirement in the event that an institution's stock price begins to flag, if stock vests on retirement. In such case, the institutions would be deprived of the services of such employees, and such employees would receive their previously unvested stock and be liberated from an obligation to watch helplessly as it declines.

[37] Many employees of these institutions voluntarily invested on a concentrated basis in the stock of their employers.

[38] We acknowledge that the FSA included an anti-hedging principle in its Remuneration Code as applied to Tier 4 firms. It may be possible, however, for firms to "explain" non-compliance with certain of the principles, and it remains to be seen whether the FSA would accept an explanation of non-compliance with anti-hedging in the event that deferred compensation were subject to clawback.

[39] In contrast, specific "whistle blower" provisions, including a private right of action, were incorporated into Section 21F of the Securities Exchange Act of 1934, entitled "Securities Whistleblower Incentives and Protection," adopted pursuant to Section 922 of the Dodd-Frank Act. http://www.sec.gov/rules/final/2011/34-64545.pdf.

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course, each element of such compensation, reporting obligations and policies and procedures) should not be subject to individualized challenge by shareholders, with any remedies fashioned by the judiciary. Rather, we believe that Congress clearly intended that the Agencies, and in respect of the securities laws, the Commission, evaluate and enforce compliance with any rule or regulation mandated by Section 956. We respectfully submit that, in the event that shareholders take exception to a covered financial institution's compensation arrangements or believe that a material financial loss was occasioned by actionable conduct, sufficient avenues of redress already exist, including in the courts.

We recommend that the Proposed Rule as finally adopted, or the adopting release, include an explicit statement that (i) no private right of action is, or is intended to be, created in respect of any aspect or requirement of the Proposed Rule based upon compliance or non-compliance with its provisions as finally adopted, and (ii) the authority to enforce compliance with the Proposed Rule as finally adopted is vested exclusively in the Commission.

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The Committee appreciates the opportunity to comment on the Proposed Rule and respectfully requests that the Commission consider the comments and recommendations set forth above. Members of the Committee are available to discuss these comments should the Commission or the staff so desire.

Very truly yours,

/s/ Jeffrey W. Rubin
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