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July 22, 2016

Mr. Brent J. Fields
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-9303

Re: *Incentive-Based Compensation Arrangements* (File Number S7-07-16)

Dear Mr. Fields:

The Investment Company Institute[1] appreciates the opportunity to comment on the proposed rule[2] on incentive-based compensation practices at certain financial institutions.[3] The proposed rule is designed to prohibit covered institutions, including certain investment advisers, from having incentive-based compensation arrangements that encourage inappropriate risk-taking that may jeopardize the financial institution.[4] We were disappointed to see that the proposal goes further than this in several respects, restricting compensation arrangements that do not encourage and, in some cases, even mitigate against risk. While we generally believe that the proposal goes much further than necessary to

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[1] The Investment Company Institute (ICI) is a leading global association of regulated funds, including mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI's U.S. fund members manage total assets of $17.9 trillion and serve more than 90 million U.S. shareholders.

[2] *Incentive-based Compensation Arrangements*, SEC Rel. No. 34-34-77776 (May 6, 2016), 81 Fed. Reg. 37769 (June 10, 2016), available at https://www.sec.gov/rules/proposed/2016/34-77776.pdf. The proposed rule incorporates many of the elements of an incentive-based compensation proposal issued in 2011. *Incentive-Based Compensation Arrangements*, SEC Rel. No. 34-64140 (Mar. 29, 2011), available at https://www.sec.gov/rules/proposed/2011/34-64140.pdf.

[3] Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") requires the U.S. Securities and Exchange Commission (SEC), the Office of the Comptroller of the Currency (OCC), Board of Governors of the Federal Reserve System (Federal Reserve), Federal Deposit Insurance Corporation (FDIC), Office of Thrift Supervision (OTS), National Credit Union Administration (NCUA), and Federal Housing Finance Agency (FHFA) (collectively, the "Agencies") to jointly prescribe regulations or guidelines with respect to incentive-based compensation practices at covered financial institutions.

[4] Proposed rule, at § 303.4. The proposed rule would divide covered financial institutions into three tiers, with "Level 1" institutions defined as those with assets equal to or greater than $250 billion, "Level 2" institutions with assets between $50 billion and $250 billion, and "Level 3" institutions with assets between $1 billion and $50 billion.

achieve its stated goals, we do support the proposal's risk-based approach, which avoids applying certain excessively prescriptive requirements to certain investment advisers.[5] For example, we support the SEC's decision not to mandate clawbacks as a required element of a Level 3 investment adviser's incentive-based compensation program.

The remainder of our comments primarily address the application of the proposal to investment advisers and portfolio managers of registered investment companies.

An investment adviser's business is far different from that of a bank, broker-dealer, or any of the other financial institutions that would be subject to the proposed rule. We applaud the SEC for recognizing this and taking some steps to customize the rule to investment advisers. We strongly support, for example, the proposal to include only an adviser's proprietary assets when determining if the adviser meets the proposed asset thresholds. We explain below why this is the correct approach for advisers.

We also recommend a change that is crucial to designing appropriately any final rule for investment advisers. Specifically, we urge the SEC to treat an investment adviser as a standalone institution for purposes of any final rule unless that adviser is operationally integrated with a bank holding company parent or other covered institution.[6]

We offer for the SEC's consideration additional recommendations to:

- Use discretion to treat a Level 1 or Level 2 investment adviser as a Level 3 adviser where appropriate;
- Exclude, in appropriate circumstances, chief compliance officers and heads of control functions from the definition of "senior executive officer;"
- Refine the definition of "significant risk taker" so that it does not inadvertently include portfolio managers;
- Better tailor the definition of incentive-based compensation to exclude compensation practices that do not occasion inappropriate risk;
- Revise the proposal's treatment of long-term incentive plans to avoid tacking on a second deferral period which unintentionally would encourage short-term, over long-term, incentive compensation;

[5] We recommend that the Agencies index the proposed rule's asset thresholds to inflation so that the thresholds do not become outdated and capture additional firms whose relative size has not increased.

[6] *See infra* Section II.

- Clarify that Level 3 investment advisers would not be required to adjust downward certain individuals' incentive compensation due to a downturn in company performance not related to the individual's conduct;
- Enhance investment advisers' ability to award options as deferred compensation; and
- Clarify the definition of "excessive compensation."

We explain these comments more fully below.

I. The SEC Is Right to Include Only Proprietary Assets in Calculation of an Investment Adviser's Total Consolidated Assets

The proposal defines a covered investment adviser as "an investment adviser as such term is defined in Section 202(a)(11) of the Investment Advisers Act of 1940" that has total consolidated assets of $1 billion or more.[7] We support categorizing this universe of investment advisers as covered institutions and particularly commend the SEC for clarifying in the proposed rule that investment advisers should include only proprietary assets in the calculation, excluding non-proprietary assets, such as client assets under management, regardless of whether they appear on an investment adviser's balance sheet.[8] The proposed rule is intended to prevent investment advisers from providing compensation that encourages inappropriate risk-taking with respect to the advisers' own assets, not those of their clients. The SEC rightly achieves this policy objective by excluding non-proprietary assets from the calculation of an adviser's "assets," consistent with Section 956(f) of the Dodd-Frank Act.

II. The SEC Should Credit Functional Separateness Between Investment Advisers and Affiliated Bank Holding Companies or Other Covered Institutions

The proposed rule would assign the tier of a parent bank holding company to its covered investment adviser subsidiaries.[9] The proposed rule, for example, would apply the Level 1 tier of a bank holding company parent to its Level 3 investment adviser subsidiary. This proposed treatment relies on the premise that there is often an integration of products and operations, public interest, and assessment and management of risk (including those related to incentive-based compensation) across a bank holding company and its subsidiaries. The SEC specifically expresses the belief that incentive-based compensation programs generally are designed at the holding company level and are applied throughout the consolidated organization.[10] The SEC also justifies the treatment through a concern

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[7] Proposed rule, at § 303.2(dd).

[8] *See id.*, at p. 82-83.

[9] *Id.*, at § 303.2(v)-(w).

[10] *See id.*, at p. 89.

about the potential for financial stress or the improper management of risk in one affiliate to spread rapidly to other parts of the organization.[11]

Although this may be the case for some investment advisers that are subsidiaries of bank holding companies, others do not have the type of enterprise-wide compensation system that the SEC describes. Indeed, many investment adviser affiliates or subsidiaries of banks or bank holding companies are not operationally integrated, and function as separate organizations. This lack of operational integration reduces or eliminates the risk of financial stress or the improper management of risk in one part of an organization spreading rapidly to other functionally separate affiliates. Forcing affiliated, but not operationally integrated, entities to consolidate assets therefore would inflate artificially their risk profile beyond the actual risk presented.

We recommend that the SEC allow an investment adviser to comply with the proposed rule as a standalone institution (not taking on the tier of its parent or other affiliate) where the adviser determines that it has a separate, independent existence from, or is not operationally integrated with, the bank holding company parent or other affiliated, covered institution.[12] For these purposes, the determination of whether an investment adviser operates independently of a bank holding company parent or other affiliated institution should be based on the facts and circumstances, including consideration of the following types of factors:

- The extent to which the adviser and affiliate share personnel;
- Whether the adviser makes investment decisions independently from the affiliate and without reliance on information provided by the affiliate;
- Whether the adviser keeps its investment advice confidential until communicated to its clients, including the extent to which the adviser and affiliate maintain and implement appropriate policies and procedures, including information barrier and information security policies and procedures, designed to keep the entities separate and to prevent the impermissible sharing of investment-related information between the two firms; and

[11] *Id.*, at p. 67-68.

[12] This is consistent with the SEC's approach to the broker-dealer net capital rules. The SEC applies the net capital requirements to the broker-dealer as a standalone institution. The net capital rule does not apply to the broker-dealer's holding company or unregulated subsidiaries or affiliates. *See* rule 15c3-1 under the Securities Exchange Act of 1934. *Cf. Richard Ellis, Inc.* SEC No-Action Letter (Aug. 8, 1981) (setting out a test for when two affiliated entities can be treated as separate—not operationally integrated—for purposes of registration under the Investment Advisers Act of 1940), available at https://www.sec.gov/divisions/investment/noaction/1981/richardellis031981.pdf.

- The extent to which the adviser and affiliate observe corporate formalities and conduct themselves as separate entities.

Our recommended approach would permit non-operationally integrated investment advisers to comply with the provisions of the proposed rule at a level commensurate with the adviser's actual risk profile. Otherwise, the proposed rule effectively would apply an excessively stringent, prescriptive framework to an adviser whose risk profile does not warrant this level of regulation and whose size does not support the expense and onerous nature of regulation tailored for a much larger, more complex, and integrated institution.[13]

For the same reasons, the SEC similarly should apply this operational integration principle to an investment adviser's non-bank holding company parent, where the parent is a subsidiary of a bank holding company. We recognize that, as proposed, the Federal Reserve's rules would cover the non-bank holding company parent in this corporate structure,[14] while the SEC's rules would cover the investment adviser. The better approach would be to treat the non-bank holding company the same as the entity with which its operations are integrated—the investment adviser subsidiary—provided that the non-bank holding company parent has a separate, independent existence from its bank holding company parent.

III. The SEC Should Have the Discretion to Treat a Level 1 or Level 2 Investment Adviser as a Level 3 Adviser

We recommend giving the SEC the discretion to treat a Level 1 or Level 2 investment adviser as a Level 3 adviser if it determines that the adviser's activities, complexity of operations, risk profile, or compensation practices are consistent with those of a Level 3 adviser. As drafted, the proposed rule gives the SEC the discretion to subject a Level 3 investment adviser to Level 1 or Level 2 restrictions if it determines that the adviser's activities, complexity of operations, risk profile, or compensation practices are consistent with those of a Level 1 or Level 2 adviser.[15] In our view, the converse also should apply. The proposal notes that this approach has been used in other rules for purposes of tailoring the application of requirements and providing flexibility to accommodate the variations in size, complexity, and overall risk profile of financial institutions.[16] Although the SEC likely would use this authority on

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[13] Some investment advisers already are using the Generally Accepted Accounting Principles (GAAP) tests for non-consolidation, which are even more stringent than the facts and circumstances test set out above. We therefore recommend that the SEC treat a covered investment adviser that is a subsidiary of a bank holding company as a standalone entity if the adviser is not required to be consolidated with its bank holding company parent under GAAP.

[14] *See* Federal Reserve proposed rule, at § 236.2(i) and (dd). OCC's proposed rules only would cover a subsidiary of a bank if the subsidiary has average total consolidated assets greater than or equal to $1 billion. *See* OCC proposed rule, at § 42.2(i)(2)(ii).

[15] *See* proposed rule, at § 303.6.

[16] *See id.*, at p. 191.

an infrequent basis,[17] it would provide a meaningful option for relief in cases where an investment adviser's activities, complexity of operations, risk profile, or compensation practices do not warrant an investment adviser's Level 1 or 2 designation.

IV. The SEC Must Revise the Definitions of "Senior Executive Officer" and "Significant Risk Taker"

The proposed rule would apply stringent requirements to incentive-based compensation paid to two categories of individuals—"senior executives" and "significant risk-takers"—at Level 1 and Level 2 covered institutions.[18] The SEC intends these definitions to capture individuals that may have the ability to expose a covered institution to significant risk through their positions or actions.[19]

We support the SEC's efforts to mitigate inappropriate risk-taking, but the definitions capture many individuals who simply are not positioned to expose a covered institution to significant risk. As described more fully below, we therefore recommend revising the definitions to avoid inappropriately subjecting a large number of individuals to unnecessary restrictions on their incentive compensation.

A. Exclude from Definition of "Senior Executive Officer" Those Whose Function Is to Mitigate Risk

The proposed rule defines "senior executive officer" as an individual who holds the title or performs the function of president, chief executive officer, executive chairman, chief operating officer, chief financial officer, chief investment officer, chief legal officer, chief lending officer, chief risk officer, chief compliance officer, chief audit executive, chief credit officer, chief accounting officer, or head of a major business line or control function.[20]

The SEC has requested comment on whether the types of positions identified in the proposed definition of senior executive officer are appropriate and whether any positions should be removed.[21] The SEC included CCOs and heads of control functions in the definition of senior executive officer because the SEC believes these individuals "have the ability to influence the risk measures and other information and judgments that a covered institution uses for risk management, internal control, or financial purposes."[22] In many cases, however, the incentive compensation that these individuals

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[17] *Cf. id.*

[18] *Id.*, at § 303.7.

[19] *See id.*, at p. 90.

[20] *Id.*, at § 303.2(gg). The 2011 proposed rule did not include the positions of chief compliance officer, chief audit executive, chief credit officer, chief accounting officer, and other heads of a control function. The proposed rule defines "control function" as a compliance, risk management, internal audit, legal, human resources, accounting, financial reporting, or finance role responsible for identifying, measuring, monitoring, or controlling risk-taking.

[21] *See id.*, at p. 96.

[22] *Id.*, at p. 94.

receive is not the type of compensation that would incentivize inappropriate risk-taking. Many of these individuals receive incentive compensation tied to successful mitigation of risk rather than business performance. This type of incentive compensation incentivizes the CCO or head of control function to protect the safety and soundness of an institution, and appropriately aligns those individuals' interests with the long-term health of the institution. We therefore recommend that the SEC narrow the definition of "senior executive officer" to exclude CCOs and heads of control functions where their incentive compensation is based on their successful mitigation of risk.

If the SEC follows our recommended approach, it would avoid additional, apparently unintended consequences that otherwise stem from defining risk mitigators as senior executive officers. In particular, the proposed rule would treat a control function officer of a Level 3 investment adviser subsidiary of a Level 1 bank holding company as a Level 1 senior executive officer, on par with the CEO of the Level 1 bank holding company.[23] This makes no sense whatsoever. Significant risk-takers at the Level 1 bank holding company parent would be subject to less rigorous requirements than that control function officer, even though some of those significant risk-takers may have the ability to take much greater risk than the control function officer.[24]

B. Exclude Portfolio Managers from Definition of "Significant Risk-Taker"

The proposed rule defines a covered person[25] as a "significant risk-taker" if at least one-third of the person's compensation is incentive-based, and the person meets either a "relative compensation test" or an "exposure test."[26] The SEC intends the significant risk-taker designation to capture individuals who are not senior executive officers but are in the position to put a Level 1 or Level 2 covered institution at risk of material financial loss.[27]

We support the SEC's efforts to rein in inappropriate risk-taking that can cause material financial loss to an institution. As proposed, however, the definition would capture portfolio managers who manage client (*i.e.*, third-party or agency) assets and who are not in a position to put a covered

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[23] As a senior executive officer, the control function officer would be subject to a 4 year deferral of 60 percent of his or her incentive-based compensation. *Id.*, at § 303.7(a)(1)(i).

[24] As significant risk-takers, these individuals would be subject to a 3 year deferral of 50 percent of their incentive-based compensation. *Id.*, at § 303.7(a)(1)(i).

[25] The proposed rule defines a covered person as any executive officer, employee, director, or principal shareholder who receives incentive-based compensation at a covered institution. *Id.*, at § 303.2(j).

[26] *Id.*, at § 303.2(hh). For Level 2 investment advisers, a covered person will meet the relative compensation test if the individual is in the top 2 percent of all covered persons (excluding senior executive officers) in annual compensation. For Level 1 investment advisers, a covered person must be in the top 5 percent. A covered person would meet the exposure test if the person was able to commit or expose 0.5 percent or more of the capital of the investment adviser or any of its affiliates.

[27] *See id.*, at p. 97. Most of the proposed rule's requirements relating to senior executive officers also would apply to significant risk-takers to some degree.

investment adviser at risk of material financial loss. We strongly urge the SEC to exclude these portfolio managers from the definition of significant risk-taker.

Portfolio managers generally are investment adviser employees who are highly compensated but are not positioned to take risks with the assets of the investment adviser. Portfolio managers instead engage in fully-disclosed investment strategies that may occasion investment loss or gain for funds and their shareholders. This is not the type of risk that the proposed rule aims to address.[28] In fact, the SEC excludes non-proprietary assets from the calculation of an investment adviser's assets, indicating that the SEC does not view Section 956 as applying to client assets.[29]

1. Modify Relative Compensation Test to Avoid Application Across Affiliates

We urge the SEC to modify the relative compensation test so the test does not apply across affiliates. Doing so is necessary to avoid the apparently unintended consequences explained below. Once an individual meets the initial threshold of one-third of annual compensation as incentive-based, the proposed rule would apply a relative compensation test to determine whether that individual is a significant risk-taker.[30] For a Level 1 institution, a covered person would be a significant risk-taker if the person's compensation is within the top 5 percent of compensation at that institution and across any affiliate covered institutions. For a Level 2 institution, this same concept applies, although the threshold is slightly higher—within the top 2 percent of compensation. This relative compensation test is problematic both because it assumes that high compensation correlates to ability to take inappropriate risk, and, as explained below, because application of the test across affiliates could lead to inequitable results that are inconsistent with the SEC's intent.

This recommendation is particularly critical if the SEC fails to treat portfolio managers commensurate with their actual risk-taking ability vis-à-vis the institution by not excluding them from the definition of significant risk-taker. Unfortunately, applying the relative compensation test across affiliates would create inconsistent results that disproportionately impact institutions with a higher percentage of more highly compensated individuals, such as portfolio managers. For example, an investment adviser may well have a higher proportion of highly compensated covered persons than a bank—but this is not because the investment adviser itself is at greater risk than the bank by virtue of having a higher proportion of significant risk-takers.

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[28] The significant risk-taker designation is intended to target the type of risky incentive-based compensation practices thought to have contributed to the 2007-2008 financial crisis. The release accompanying the proposed rule particularly identifies traders with large position limits, underwriters, and loan officers as three examples of non-executive personnel whose incentive-based compensation incentivized inappropriate risk-taking. The release further states that this risk-taking caused significant losses at some of the largest financial institutions during and after the financial crisis. *See id.*, at p. 21.

[29] *See id.*, at p. 83.

[30] *Id.*, at § 303.2(hh).

Geographical location also impacts relative compensation level. An institution located in a higher cost of living area would compensate its employees more than if it were located in a lower cost of living area. Geographical location, however, has nothing to do with inappropriate risk-taking.

At the same time, quite ironically, applying the relative compensation test across affiliates could result in some covered persons at the Level 1 bank avoiding designation as significant risk-takers. In fact, the application of the relative compensation test across affiliates could designate a very different set of individuals than the application of the same test on an institution-by-institution basis.[31]

2. Modify Exposure Test in Federal Reserve and OCC Proposed Rules to Exclude Portfolio Managers

Both the Federal Reserve and OCC proposed rules define "significant risk-taker" in a way that could capture portfolio managers at *non-covered* investment advisers[32] if they manage a certain amount of proprietary assets of an affiliated bank or bank holding company.[33] The Federal Reserve intended this aspect of the proposed rules "to address potential evasion of the exposure test by a Level 1 or Level 2 covered institution."[34] The exposure test appears to be designed to capture individuals such as proprietary traders with large position limits.[35] In this case, however, the affiliated adviser's portfolio manager simply is managing a discrete portion of the bank holding company's assets consistent with its investment mandate. As an employee of the adviser, the portfolio manager is investing client assets and is only committing or exposing those assets to fully disclosed investment risk. If the bank or bank holding company invested its assets with a similar, but non-affiliated, investment adviser, its assets would be subject to the same risk but the proposed rules would not reach the portfolio manager's compensation.[36] The proposed approach therefore indirectly and inappropriately penalizes portfolio managers for managing proprietary assets of an affiliated bank or bank holding company.

Further, the Federal Reserve and OCC have separately—and more directly—addressed potential concerns about risk-taking by persons investing or trading on behalf of a bank or bank holding company and compensation arrangements for those personnel. For example, the Volcker Rule

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[31] *See* Appendix A for an example of a potential scenario that could occur under the proposed rule.

[32] The SEC's proposed rule does not cover an investment adviser with less than $1 billion in total consolidated assets.

[33] *See* Federal Reserve proposed rule, at § 236.2(hh)(3); *see also* OCC proposed rule, at § 42.2(hh)(3). These proposed rules would define a portfolio manager as a significant risk-taker if the portfolio manager "may commit or expose 0.5 percent or more of common equity tier 1 capital or tentative net capital" of the Level 1 or Level 2 bank or bank holding company.

[34] *Incentive-based Compensation Arrangements*, 81 Fed. Reg. 37769 (June 10, 2016), available at https://www.federalreserve.gov/newsevents/press/bcreg/bcreg20160502a2.pdf, at p. 109.

[35] *See* Federal Reserve proposed rule, at p. 20 ("Traders with large position limits, underwriters, and loan officers are three examples of non-executive personnel who had the ability to expose an institution to material amounts of risk.").

[36] This assumes that the non-affiliated investment adviser similarly was not a covered institution under the SEC's proposed rule.

limits the ability of banks, bank holding companies, and their affiliates to take risks with their proprietary assets.[37] Moreover, the Volcker Rule specifically requires compensation arrangements of persons engaging in key permitted trading activities to be designed not to reward or incentivize prohibited proprietary trading.[38] The Rule further requires a large banking organization to take compensation arrangements into account in its written policies and procedures and management procedures to ensure compliance with the Rule.[39] Given the Volcker Rule's fulsome coverage of this area, it seems unnecessary to apply the exposure test to portfolio managers at affiliated, but non-covered institutions.

The Agencies should take steps to prevent this inappropriate and unfair application of the exposure test.

V. Definition of "Incentive-Based Compensation" Should Exclude Additional Types of Compensation that Present Little or None of the Risk Identified in the Proposal

The proposed rule would prohibit all institutions from establishing or maintaining incentive-based compensation arrangements that encourage inappropriate risk-taking by providing covered persons with excessive compensation, fees, or benefits that could lead to material financial loss to the covered institution.[40] Unfortunately, the proposed rule does not allow covered investment advisers to determine whether an incentive compensation arrangement "encourages inappropriate risk." Instead, the proposed rule simply deems incentive compensation arrangements that meet certain tests as automatically encouraging inappropriate risk-taking.

The proposed rule defines "incentive-based compensation" as "any variable compensation, fees, or benefits that serve as an incentive or reward for performance."[41] This definition is overly broad and would capture individuals receiving incentive compensation who are neither material risk-takers nor receive the type of incentive compensation that could encourage inappropriate risk-taking. We therefore recommend refining this definition to exclude types of incentive compensation plans that do not encourage inappropriate risk-taking, and incentive compensation paid to portfolio managers, who

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[37] Section 13 of the Bank Holding Company Act of 1956, 12 U.S. C. § 1851 et seq.; 12 C.F.R. § 248.1 et seq. (Federal Reserve); 12 C.F.R. § 44.1 et seq. (OCC).

[38] This is a condition for proprietary trading activity to be permitted under the underwriting, market-making, or risk-mitigating hedging exemptions. 12 C.F.R. §§ 248.4(a)(2)(iv), 248. 4(b)(2)(v), and 248.5(b)(3); 12 C.F.R. §§ 44.4(a)(2)(iv), 44. 4(b)(2)(v), and 44.5(b)(3).

[39] *See id.* at Appendix B.

[40] *See* proposed rule, at § 303.4(a).

[41] *Id.*, at § 303.2(r).

do not have the ability to cause material loss to the covered institution. We discuss these recommendations below.

A. Exclude Incentive-Based Compensation Plans that Do Not Create Inappropriate Risk

The proposed rule defines incentive-based compensation to include compensation earned under an incentive plan, annual bonuses, and discretionary awards, and it assumes that compensation of this type creates inappropriate risk-taking incentives.[42] Although the proposed rule rightly excludes compensation tied to continued employment, professional certification, or educational achievement, the definition remains broad enough to capture compensation, such as organization-wide plans and discretionary plans. Such plans, however, do not encourage inappropriate risk-taking. A firm-wide bonus plan, for example, effectively shares company profits with employees. This is exactly the type of well-structured compensation arrangement that can promote the health of a financial institution by aligning the interests of executives and employees with those of the institution's shareholders and other stakeholders.[43] We therefore urge the SEC to exclude compensation from the proposed rule where the compensation is based on 1) individual performance measures that rely on qualitative factors or 2) measures that are linked only distantly to an employee's activities, such as organization-wide plans and discretionary plans.

If the SEC decides otherwise, we are deeply concerned that an overbroad definition of incentive-based compensation would limit greatly investment advisers' ability to structure their employees' compensation, pushing investment advisers toward rewarding employees through salary rather than bonuses. For example, employees at investment advisory firms may receive a firm-wide bonus at the end of each year. This gives the investment adviser the flexibility to pay a smaller firm-wide bonus if the adviser has a less successful year, or a larger bonus if the adviser is more successful than anticipated. If the proposed rule defines incentive-based compensation to include firm-wide bonus plans, the proposed rule would result in adding significant barriers to using firm-wide bonuses for employees at investment advisers designated as Level 1 or Level 2 covered institutions.[44]

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[42] *Id.*; *see also id.*, at p. 24 (noting that "there is a public interest in curtailing the inappropriate risk-taking incentives provided by incentive-based compensation arrangements").

[43] In the release accompanying the proposed rule, the SEC specifically noted that well-structured incentive-based compensation arrangements "serve several important objectives, including attracting and retaining skilled staff and promoting better performance of the institution and individual employees." *Id.*, at p. 20.

[44] Under the proposed rule, a Level 1 or Level 2 investment adviser most likely would be a Level 3 subsidiary of a Level 1 or Level 2 bank holding company. As explained in Section IV.B., any portfolio managers who receive more than 33 percent of their salaries as incentive-based compensation would be designated as "significant risk takers," regardless of their ability to take risk with proprietary assets. The proposed rule subjects the incentive-based compensation of "significant risk takers" to very stringent deferral, forfeiture, adjustment, and clawback provisions. *See id.*, at § 303.7. Rather than penalize portfolio managers who are not in a position to take inappropriate risk with firm assets, Level 1 or Level 2 investment advisers likely

B. Exclude Compensation Based on Fund Performance

The proposed rule defines "incentive-based compensation" in part as any variable compensation "that serves as [a] reward for performance."[45] This aspect of the proposed rule seeks to regulate incentive compensation arrangements that position an employee to expose certain institutions, including investment advisers, to material risk. The SEC should clarify the proposed rule with respect to incentive compensation that portfolio managers receive in connection with fund performance for the reasons provided below.

The SEC should make it clear that the term "performance" as used in the proposed rule does not include incentive compensation received in connection with the performance of a fund that an investment adviser advises. A portfolio manager generally is an employee of the investment adviser. A portfolio manager often receives incentive compensation based on the long-term performance of the fund that he or she manages. In other words, the portfolio manager is rewarded for investing the assets of a fund in a manner that generates a positive investment return for its shareholders. In this case, the portfolio manager is not taking risks with the assets of the investment adviser. Rather, the portfolio manager is taking fully-disclosed investment risk with the separate and distinct assets of the fund.[46] This is not the type of risk that the proposed rule is meant to address.[47]

VI. The SEC Should Eliminate "Double-Deferral" that Discourages Use of Long-Term Incentive Plans

The SEC should revise deferral requirements in the proposed rule that appear to promote short-term incentive compensation and discourage other more long-term incentive compensation—a result that runs counter to the proposal's goals in deterring inappropriate risk-taking. To avoid this result, we recommend revisiting the proposal's treatment of long-term incentive plans.

The proposal defines long-term incentive plans as plans with performance periods of three years or more.[48] Only providing compensation after the passage of three years of performance is a *de facto* deferral. The proposal effectively would layer on a double-deferral—requiring an additional deferral of incentive compensation awarded upon the completion of the performance period.[49] These onerous deferral requirements likely would encourage investment advisers to increase use of short-term

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would shift to paying a higher percentage of compensation of base salary (*e.g.*, 70 percent base salary, 30 percent bonus), thereby reducing the investment adviser's flexibility to adjust compensation from year to year.

[45] *Id.*, at § 303.2(r).

[46] A portfolio manager invests fund assets as fully disclosed to fund investors in the fund's prospectus and other required disclosure documents.

[47] *See supra* note 28.

[48] Proposed rule, at § 303.2(y).

[49] *Id.*, at § 303.7(a)(2)(ii).

compensation. Long-term incentive plans, however, are an important aspect of a well-aligned incentive compensation program, and the SEC should not discourage their use. We therefore recommend eliminating the additional deferral requirements from long-term incentive plans.

VII. The SEC Should Clarify Application of Adjustment Factors

We recommend that the SEC clarify that Level 3 institutions are not required to adjust downward individual incentive compensation due to a downturn in company performance. The proposed rule could be read to require adjustment of an award "to reflect actual losses."[50] We assume, however, that the SEC intended to treat Level 3 institutions similarly to Level 1 and 2 institutions, where the proposed rule explicitly notes that downward adjustments apply to individuals "with direct responsibility, or responsibility due to the senior executive officer's or significant risk-taker's role or position in the covered institution's organizational structure," for certain triggering events.[51] We ask the SEC to confirm our understanding that the adjustment factors for Level 3 institutions would tie to behavior by the covered individual receiving the award, rather than simply a downturn in company performance.

VIII. The SEC Should Eliminate 15 Percent Limit on Use of Options as Deferred Compensation

The proposed rule would require Level 1 and Level 2 covered institutions to defer the vesting of a certain portion of all incentive-based compensation awarded to a senior executive officer or significant risk-taker for at least a specified period of time.[52] The proposed rule would limit the extent to which stock options (or similar arrangements) could be used to meet the proposed rule's minimum deferral requirements for these individuals. Under the proposed rule, options used to meet the minimum deferred amount cannot exceed 15 percent of the amount of a senior executive officer's or significant risk-taker's total incentive compensation.[53] As the SEC recognizes, however, "[o]ptions can be a significant and important part of incentive-based compensation arrangements" at an investment adviser.[54]

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[50] *Id.*, at § 303.4(d)(3); *see also id.*, at p. 177.

[51] *Id.*, at § 303.7(b)(3).

[52] The proposed rule would use various considerations to determine the minimum required deferral amount and minimum required deferral period, including the size of the covered institution, whether the covered person is a senior executive officer or significant risk-taker, and whether the incentive compensation was awarded under a long-term incentive plan or is qualifying incentive compensation. Minimum required deferral amounts would range from 40 percent to 60 percent of the total incentive compensation award, and minimum required deferral periods range from one year to four years. *See* proposed rule, at § 303.7(a).

[53] *See id.*, at § 303.7(a)(4)(ii).

[54] *See id.*, at p. 236.

The proposed rule already includes extensive forfeiture, adjustment, and clawback requirements that would aim to penalize senior executive officers and significant risk-takers for taking inappropriate risk.[55] This proposed regime is intended to make senior executive officers and significant risk-takers responsive to downside risks. The SEC does not need to impose additional draconian limits on the use of options, when options are an excellent tool for aligning the interest of senior executive officers and significant risk-takers with the long-term health of their employer. We therefore urge the SEC to eliminate the limitation on options that can count toward deferred compensation.

If the SEC continues to believe limits are necessary, however, then we recommend increasing the limit to 25 percent. A 25 percent limit would maintain a cap on the use of stock options as part of the incentive compensation arrangements for senior executive officers and significant risk-takers while still allowing investment advisers to use options as an important tool to align these individuals' interests with the long-term health of their employers.

IX. The SEC Should Clarify Use of Comparators for Determining "Excessive Compensation"

The proposed rule specifies that compensation, fees, and benefits would be considered excessive when amounts paid are unreasonable or disproportionate to the value of the services performed by a covered person, taking into account all relevant factors.[56] The proposed rule then sets forth six specific factors the SEC would take into account when determining whether a particular arrangement provides excessive compensation. These include various comparative metrics, including 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 SEC should state expressly 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.

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[55] *See id.*, at § 303.7.

[56] *Id.*, at § 303.3(b).

We appreciate the opportunity to comment on the proposed rule. If you have any questions regarding our comments or would like additional information, please contact me at (202) 326-5815 or david.blass@ici.org, or Dorothy Donohue, ICI Deputy General Counsel—Securities Regulation, at (202) 218-3563 or ddonohue@ici.org.

Sincerely,

/s/David W. Blass

David W. Blass
General Counsel

cc: Mr. Robert deV. Frierson, Secretary
Board of Governors of the Federal Reserve

Mr. Robert E. Feldman, Executive Secretary
Federal Deposit Insurance Corporation

Legislative and Regulatory Activities Division
Office of the Comptroller of the Currency

Mr. Alfred M. Pollard, General Counsel
Federal Housing Finance Agency

Mr. Gerard S. Poliquin, Secretary of the Board
National Credit Union Administration

Appendix A

Example:

- If a Level 1 bank holding company has a Level 1 bank subsidiary, a Level 3 mortgage subsidiary, and a Level 3 investment adviser subsidiary, the proposed rule would apply the relative compensation test across all of these institutions to determine the top 5% of compensated covered persons.
- If the Level 1 bank holding company, Level 1 bank subsidiary, and Level 3 mortgage subsidiary collectively employ 150,000 covered persons, and the Level 3 investment adviser employs 10,000 persons, the significant risk-taker designation will apply to the top 8,000 highest compensated covered persons across all of those institutions (who also meet the initial threshold of at least one-third of annual compensation as incentive-based compensation).
- If the Level 3 investment adviser is located in a high cost of living area, while the other institutions are in low cost of living areas, a disproportionate number of covered persons at the Level 3 investment adviser may qualify as significant risk-takers.