The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 25199

May 18, 2011

Draft Letter on Proposed Rules on Incentive-Based Compensation Arrangements; Comments Requested by Wednesday, May 25

[25199]

May 18, 2011

TO: CHIEF COMPLIANCE OFFICER COMMITTEE No. 9-11
CLOSED-END INVESTMENT COMPANY COMMITTEE No. 28-11
RISK MANAGEMENT COMMITTEE No. 5-11
SEC RULES COMMITTEE No. 50-11 RE: DRAFT LETTER ON PROPOSED RULES ON INCENTIVE-BASED COMPENSATION ARRANGEMENTS; COMMENTS REQUESTED BY WEDNESDAY, MAY 25

As you know, the Securities and Exchange Commission and six other federal financial regulators (collectively, the "Agencies") have proposed a rule relating to incentive-based compensation practices at certain covered financial institutions, including investment advisers. [1] The rule implements Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

ICI has prepared a draft comment letter on the proposal. The draft letter is attached and briefly summarized below. Comments on the proposed rule are due to the Agencies on May 31, 2011. If you have comments on the attached draft letter, please provide them to Bob Grohowski (rcg@ici.org or 202/371-5430) by Wednesday, May 25.

The draft letter addresses five topics:

- The need for clear standards;
- "Appropriate" versus "inappropriate" risks;
- "Excessive" compensation;
- Compatibility with effective controls and risk management; and
- The definition of "covered financial institution."

The need for clear standards. The draft letter makes the general point that these rules should be principles-based and flexible enough to allow firms to tailor their compensation practices and compete in the market for talent, while also providing firms with enough certainty that they can ensure that their compensation practices are fully legal and

compliant. The letter expresses concern in this regard that parts of the proposal, including the two main prohibitions, are vague in their use of subjective terms of art such as "inappropriate," "excessive," "unreasonable," and "disproportionate." The letter stresses that standards must be clear, particularly with respect to prohibited conduct.

"Appropriate" versus "inappropriate" risks. The letter states that, for purposes of the prohibitions, it will be crucial for firms to be able to clearly distinguish between "appropriate" and "inappropriate" risks. The letter warns the Agencies to avoid prescriptive statements about precisely what risks may be inappropriate, but also asks the Agencies to draw a distinction between taking risks with the firm's own assets and taking investment risk with client assets. More generally, the letter asks the Agencies to take care to craft a rule that appropriately distinguishes between the business models of banks, broker-dealers, and advisers.

"Excessive" compensation. In determining whether particular compensation arrangements are "excessive," the letter states that while comparators, such as size and geographic location, are clearly relevant, the Agencies should expressly state that a firm positioning itself at the top of the compensation spectrum does not, by virtue of that fact alone, provide "excessive" compensation.

Compatibility with effective controls and risk management. The draft letter takes issue with certain statements in the Release about the particular role risk management and internal control personnel should play in compensation decisions. The letter notes that, while it is unquestionably a good idea for a firm to consider the appropriate role of risk management and internal control personnel in the design and implementation of the firm's compensation arrangements, it is not appropriate for the Agencies to so expressly dictate the roles and responsibilities of specific personnel. The letter suggests that the Agencies need not, and should not, micromanage the process to the level suggested in the Release.

Definition of "covered financial institution." The letter supports the SEC's definition with respect to investment advisers as "covered financial institutions," noting that it is clear and straightforward. The letter takes issue, however, with the explicit reference to subsidiaries in the definitions proposed by the Federal Reserve Board and the OTS. The letter states that given these definitions, it is unclear how the rules apply to broker-dealers or investment advisers that are subsidiaries of banks or thrifts. In asking for clarity on this point, the letter takes the position that the rules should be structured to apply solely to those entities – whether parents or subsidiaries – that meet both of the relevant tests: the entity is an enumerated bank, broker-dealer, or investment adviser, and the entity, on its own, has the requisite assets. Any reference to subsidiaries should not inadvertently sweep in smaller firms that would not, standing on their own, be subject to the rules.

The letter also takes the position that any covered financial institution (a "parent CFI") should be permitted to comply on its own behalf and on behalf of any subsidiary that is itself a covered financial institution (a "subsidiary CFI") by adopting procedures and by making reports to the parent CFI's primary regulator that cover both the parent CFI and the subsidiary CFI. That said, the letter states that firms in that situation should be permitted the flexibility – but not required – to comply separately.

Robert C. Grohowski
Senior Counsel

Securities Regulation - Investment Companies

Attachment

endnotes

[1] See ICI Memorandum No. 25004, dated March 4, 2011. See also SEC Release No. 34-64140 (March 29, 2011), avail. at http://www.sec.gov/rules/proposed/2011/34-64140.pdf (the “Release”).
