THE REGULATORY FUNDAMENTALS GROUP LLC

July 21, 2016

Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street, NE.
Washington, DC 20549

Via E-mail: rule-comments@sec.gov

Re: Proposed Rule – Incentive-based Compensation Arrangements (File Number S7-07-16)

Dear Mr. Fields:

The Regulatory Fundamentals Group ("RFG") submits this letter in response to the Securities and Exchange Commission (the "SEC") request for comment on proposed rules pertaining to incentive-based compensation arrangements (the "Proposed Rule"), pursuant to Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").

RFG is a consulting company that represents a consortium of leading U.S. charitable organizations, advising them on regulatory and operational issues that arise as a result of their investment activities. RFG's clients typically have endowment assets in the $1 billion and above range. Our clients operate within a framework of laws and regulations that has been designed both to facilitate the operation of charitable institutions and to recognize the unique trust that is placed in them by the communities they serve.

A key part of this framework, the Internal Revenue Code relieves charities, and their donors, of unnecessary tax burdens, while imposing special disclosure requirements and conflicts policies. The SEC early-on showed an appreciation for these considerations and crafted a series of "no-action" letters that allowed charitable organizations to pool funds with other charitable organizations and to advise other charitable organizations, without registration under the Investment Company Act of 1940 or the Investment Advisers Act of 1940.

Further, in 1995, during the passage of the Philanthropy Protection Act (P.L. 104-62), Congress articulated its rationale for excluding charitable organizations from federal financial oversight. These reasons included:

- The lack of a rationale for imposing such regulation: "a longstanding congressional intent that such organizations should not be asked to comply with the comprehensive scheme of investor protection regulations designed to protect investors in the securities of for-profit corporations;"[1] and

- The undesirability of having charities spend resources on legal fees as opposed to the services they offer: "…[E]nactment of this bill would free charities to do what they do best: serve the people of America."[2]

Also, then as now, the investment and compensation practices of charitable organizations were already regulated by state attorneys general, the dictates of the Internal Revenue Code, and by the boundaries of uniform state laws that govern endowment management, usage and expenses[3].

These special rules reflect the fact that charitable organizations, even those that advise third-parties on investments, are different from other types of investment advisers regulated by the SEC. Typically, the stakeholders advised by charitable organizations share an underlying charitable goal that is more important than any investment objective, and the investment objective is usually aimed at enhancing the funding of such charitable goal. Charitable organizations exist for the public good in areas such as education and healthcare, not to carry out investment activities independent of their charitable purpose. Accordingly, the resources and staff devoted to investments typically represent only a small part of an organization's operations.

Against this backdrop, we note that the Proposed Rule may encompass many charitable organizations whose activities and compensation arrangements are outside the intended scope of the Dodd-Frank Act. This occurs because the Proposed Rule's foundational definition, "covered institution," could potentially capture charitable organizations that (1) are investment advisers for purposes of Section 202(a)(11) of the Investment Advisers Act of 1940 (the "Advisers Act"), even if they are exempt from registration pursuant to Section 203(b)(4) of the Advisers Act ("Charitable Advisers"), and (2) have assets that equal or exceed $1 billion, even if such assets are only in the form of property, buildings, and endowment funds used to support the organization's charitable mission.

In order to prevent the unnecessary application of the Proposed Rule to a large number of charitable organizations, RFG encourages the SEC to clarify that the Proposed Rule does not apply to Charitable Advisers exempt from registration pursuant to Section 203(b)(4) of the Advisers Act. Although the

[1] Congressman Markey's testimony, 141 Cong. Rec. H. 13670. November 28, 1995.
[2] Congressman Gephardt's testimony discussing the PPA and the Charitable Gift Annuity Relief Act, 141 Cong. Rec. E 2240 (November 29, 1995). See also his statements, "Without this legislation, these nonprofit organizations are vulnerable to lawsuits based on a perceived violation of Federal antitrust and securities laws…" and "I am concerned with cuts in Federal spending that threaten the ability of our Nation's nonprofit organizations to continue their philanthropic programs. We should not compound their situation by failing to respond to the legal vulnerability they face under laws intended to regulate commercial securities. This legislation, supported by the Securities and Exchange Commission, will protect charities from securities and antitrust-based lawsuits, and allow them to raise funds in the years to come."
[3] The Uniform Prudent Management of Institutional Funds Act (UPMIFA) addresses the manner in which endowments may make investments and has been adopted by every state, except Pennsylvania (which maintains an earlier uniform state law on its books). In addition, many state laws specify particular governance provisions, including requirements about how a non-profit organization must address conflicts of interest.

definition used in Section 956 of the Dodd-Frank Act is broad enough, *as a technical matter,* to cover Charitable Advisers, charities are not typically thought of as "financial" institutions; their compensation and other practices did not play a role in creating the financial crisis for which the Dodd-Frank Act was the legislative response; and the legislative history shows that, reflecting its focus on the financial crisis, Congress sought in Section 956 to bring accountability to the banking and financial services industry, *not charities*.

This is reflected in the structure of Subtitle E of Dodd-Frank, entitled "Accountability and Executive Compensation," of which Section 956 constitutes only a part. Every other section of Subtitle E clearly is focused on the compensation practices of traditional financial services firms or organizations which issue publicly-traded securities. [4] Although Section 956 does apply to "covered financial institutions" (which is defined by listing organizations typically considered to be financial institutions), the mere fact that the list might encompass Charitable Advisers otherwise exempt from SEC registration does not preclude the SEC from excluding Charitable Advisers from the coverage of the Proposed Rule. At the very least, the SEC clearly has the power to define an "inappropriate risk." In this regard it should be guided by the statements of the bill sponsor, Representative Barney Frank, who discussed the purpose of Section 956 during a House-Senate Conference Committee on June 16, 2010.[5] The comments start at page 45 and continue to page 50. We highlight several of his key statements below.

First, Frank was clearly focused on government financial assistance and not on the private sector. On page 45 he notes that "…we have to make some distinctions…. What a private company not receiving significant government assistance pays its employees … is not a matter of Federal jurisdiction…"

Second, his concern focused on bonuses given by bank-like firms that might be subject to a federal bailout. "The Federal reserve has concluded this that a compensation system in the financial area, which gives people an incentive to take risk by compensating them with the risk payoff, and denying them any penalty of the risk on payoffs, incentivize them to take too much risk…. So we have mandated in the House bill all regulators of financial institutions to adopt rules…. [These rules are not to set pay, but for public companies there is] a requirement that the shareholders get to vote on the top officials pay, and for others that the financial companies, only financial companies, make sure that the rules do not provide for gross incentives." His comments also indicate a focus on financial institutions which sold financial instruments that should not have been sold.

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[4] Section 951 requires shareholders to approve executive compensation arrangements (charitable organizations have no shareholders); Section 952 also is keyed off of the existence of shareholders who purchased securities listed on an exchange (and requires these to have independent compensation committees and to meet certain other standards); Section 953 again keys off of proxy and consent materials for the annual meeting of shareholders of an issuer and requires a description of compensation to be paid; Section 954 instructs the SEC to direct "the national securities exchanges and national securities associations to prohibit the listing of any security of any issuer" that does not meet certain requirements; Section 955 again focuses on proxy and consent solicitation materials for an annual meeting of shareholders of any issuer and requires certain disclosures about hedging by employees and directors; Section 957 addresses voting by brokers when they are not the beneficial owners of publicly traded securities.

[5] The transcript is available on Lexis and is entitled "House-Senate Conference Committee Holds a Meeting on the Wall Street Reform and Consumer Protection Act" (June 16, 2010).

Third, Frank expected regulators to provide a reasonable interpretation to Section 956. Responding to a proposal to limit Section 956, he called the expansive interpretations put forward by the section's opponents "an effort to caricature beyond what is reasonable." (at page 47.) He continues (at pages 47-49) to highlight the focus on "Wall Street firms;" his concern with the "sub-prime mortgage situation;" and his expectation that the regulators would interpret the powers granted by Section 956 in a reasonable manner, and not for example regulate bank tellers or eliminate Christmas bonuses.

In short, his focus—and those of the others participating in the meeting-- was on financial firms subject to federal bailouts. There is no mention of Charitable Advisers being encompassed in the legislation, because that result was not even within the contemplation of Congress. However, there was a great deal of discussion of the fear that financial services regulators might extend the scope of the regulation to unintended areas of the economy; such as a concern that automotive retailers could be found to be financial companies (see statement of Representative Hensarling on page 49). Frank responds to this concern by calling attention to "what caused the problem"—essentially mortgages and those who packaged mortgages loans and the need to limit risk taking by employees "who take risk that could threaten safety and soundness."[6]

In light of the structure of Subtitle E and the clarity of the legislative history as to the reasons for its passage, we believe the SEC has ample authority to conclude that Charitable Advisers cannot create inappropriate risks and thus should be exempted from the Proposed Rule.

Should the SEC determine not to provide exemptive relief of the sort we suggest, RFG submits two further recommendations. First, that the calculation of "average total consolidated assets" for a Charitable Adviser only include those assets that are dedicated to the provision of investment advice, not the total assets of the legal entity (which include many assets focused on a charitable purpose). Second, that the Proposed Rule only apply to incentive-based compensation paid to those Charitable Advisers' staff members who are directly responsible for the provision of investment advice, not to all staff members of the organization.

Calculation of Consolidated Assets.

Under the Proposed Rule, "average total consolidated assets" for an investment adviser means the regulated institution's total assets*, exclusive of non-proprietary assets*, shown on the balance sheet for the most recent fiscal year (Section 303.2(b)). This clearly reflects an intent that the Proposed Rule only apply to investment advisers of significant size as measured by their proprietary assets, such that a smaller-sized adviser would not fall under the Proposed Rule regardless of the size and importance of its advised clients or the amount of the adviser's total assets under management. However, although Charitable Advisers are not financial services companies (the activities of which could have implications for the financial stability of

[6] Id. at page 50. Indeed, House Report No. 111-517 (June 29, 2010), at 647 explains that Section 956 "requires federal financial regulators to monitor incentive-based payment arrangements of federally regulated financial institutions larger than $1 billion and prohibit incentive-based payment arrangements that the regulators determine jointly could threaten financial institutions' safety and soundness or could have serious adverse effects on economic conditions or financial stability."

the broader economy) and although, for many charities, investment management operations are a very small part of their overall operations and focus, many Charitable Advisers may satisfy the "average total consolidated assets" test and fall under the Proposed Rule. In large part this is a direct result of how "average total consolidated assets" is calculated under the Proposed Rule. The proprietary balance sheet of Charitable Advisers would include assets (such as the charitable entity's property, buildings, and operational and endowment funds) that can quickly take a Charitable Adviser above the $1 billion threshold, even if it is advising only a de minimis amount of third-party funds.

By way of illustration, imagine a university that agreed as an accommodation to manage the assets of a school-affiliated publication which typically do not exceed a few thousand dollars. Assume further that the university owns buildings and an endowment that exceeds $ 1 billion. In this situation the Proposed Rule creates bizarre results. First, the charity with one small client would be regulated but an Investment Adviser managing significant third party assets may not be regulated at all (assuming its proprietary assets are less than $1 billion). Second, since the rule and its requirements are based on proprietary assets, a large university might be subject to the same level of regulation as would apply to the wealthiest investment advisers managing billions, if not trillions, of third-party dollars. To avoid these bizarre results, we suggest that the definition of "average total consolidated assets" be amended to provide that when an investment adviser is exempt from registration due to the operation of Section 203(b)(4) of the Advisers Act only those assets dedicated to the provision of investment advice to third-parties would be included in the calculation.

Compensation Arrangements.

Similarly, due to the definition of "covered person", the Proposed Rule as applied to a Charitable Adviser would sweep in the compensation arrangements of all personnel of the Charitable Adviser. This result is incongruous with the intent of the Proposed Rule because, in many cases, the vast majority of the personnel of a Charitable Adviser play no part in investment management operations or financial services activities of any sort. Rather, they serve administrative, research, pedagogical or other functions that support the charitable mission of the organization. Simply put, the provision of investment advice is not the raison d'être for the existence of the vast majority of charitable organizations -- and their staffing arrangements reflect this. Charitable organizations have staff, payroll and compensation arrangements which focus on the personnel needed to support their primary, charitable functions -- whether these be professors, researchers, doctors or others. Such staff needs to be compensated in accordance with industry norms, which may include incentive-based compensation; however, these payments in no way implicate the financial market stability issues Congress intended to address in the Dodd-Frank Act and are already governed by state and federal tax laws that reign in excessive compensation.

With this in mind, we suggest that, when an investment adviser is exempt from registration due to the operation of Section 203(b)(4) of the Advisers Act, the term "covered person" refers only to persons directly responsible for the provision of investment advice to third-parties.

Thank you for your consideration of our comments. We would appreciate the opportunity to discuss these issues with you at your convenience. I can be reached at [redacted] or [redacted].

Sincerely,

/s/Deborah Prutzman

Deborah S. Prutzman
Chief Executive Officer
The Regulatory Fundamentals Group LLC