



## **SUBMITTED ELECTRONICALLY**

July 22, 2016

Securities and Exchange Commission  
100 F Street, NE  
Washington, D.C. 20549-1090  
Attention: Brent J. Fields

**RE: Proposed Rules on Incentive-Based Compensation Arrangements Release No. 34-77776; IA-4383; File No. S7-07-16**

Dear Mr. Fields:

### **Introduction**

The American Investment Council (the “AIC”) is submitting this letter in response to Release No. 34-77776, in which the Securities and Exchange Commission (the “Commission”) has requested comments on proposed rules (the “Proposed Rules”) implementing Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”). Section 956 of the Dodd-Frank Act requires the Commission, as well as the OCC, Board of Governors of the Federal Reserve System, FDIC, OTS, NCUA and FHFA to jointly prescribe regulations or guidelines with respect to incentive-based compensation practices at covered financial institutions. Our comments focus on the application of the Proposed Rules to investment advisers (“private equity firms”) to private equity and growth capital funds (“private equity funds”).

The AIC is an advocacy, communications and research organization established to advance access to capital, job creation, retirement security, innovation and economic growth by promoting long-term investment. In this effort, the AIC develops, analyzes and distributes information about the private equity and growth capital industry and its contributions to the U.S. and global economy. Established in 2007 and formerly known as the Private Equity Growth Capital Council, the AIC is based in Washington, D.C. The AIC’s members are the world’s leading private equity and growth capital firms united by their commitment to growing and strengthening the businesses in which they invest. For further information about the AIC and its members, please visit our website at <http://www.investmentcouncil.org>.

The AIC understands that Section 956 of the Dodd-Frank Act was adopted in large part to address perceived abuses and conflicts of interest in the area of executive compensation, including the perception that certain covered financial institutions maintain compensation practices that encourage inappropriate risk-taking by their employees. The

AIC acknowledges the importance of rules that address and prevent practices that promote inappropriate risk-taking behaviors and systemic risk that could cause failures of the financial sector, such as those experienced in the U.S. markets in 2008.

As we previously discussed in our comment letter dated May 31, 2011 regarding Release No. 34-64140; File No. S7-12-11 (the “2011 Comment Letter”), the AIC believes that the compensation practices at private equity firms do not encourage inappropriate risk-taking behaviors or pose any systemic risk concerns that would warrant the same level of regulation as may be applicable to other covered financial institutions. The AIC believes that the structure of compensation and profit participation opportunities in place at private equity firms, derived both from the nature of the private equity firm business model itself and from the typical economic provisions governing private equity funds, provides protections against the behaviors and concerns that Section 956 of the Dodd-Frank Act strives to prevent. In making these points, this letter includes first a background section, describing the business and structure of private equity firms and private equity funds and how senior managers and investment professionals at these firms participate in the profits of the private equity funds through the allocation of carried interest. The letter then proposes several modifications or clarifications to the Proposed Rules in recognition of the fact that the operation of private equity firms and the structure of carried interest allocations already protect against the risk concerns that the Proposed Rules are intended to address.

### **Background**

*Business and Structure of Private Equity Firms and Private Equity Funds.* As described in detail in our 2011 Comment Letter and its Annex (“Structure and Operations of Private Equity Firms and Funds”), the core business structures of private equity firms are significantly different from those of other covered financial institutions and do not present the kind of systemic risk concerns that the Proposed Rules intend to address because, among other reasons: (i) private equity funds typically have limited or no leverage at the fund level, and therefore are not subject to unsustainable debt or creditor margin calls; (ii) rather than relying primarily on short-term funding, private equity funds generally obtain long-term capital commitments, with that capital being locked up for the entire term of the fund (typically 10-12 years); (iii) private equity funds typically pursue “buy and hold” strategies, investing in and holding illiquid securities of operating companies, and do not generally trade or invest in liquid, publicly traded equity or intangible financial assets (such as derivatives or swaps); (iv) private equity firms and private equity funds are not deeply interconnected with other financial market participants through derivatives positions, counterparty exposures or prime brokerage relationships; and (v) private equity investments (“portfolio investments” or “portfolio companies”), firms and funds generally are not cross-collateralized, so even where a private equity fund has made an investment using equity and borrowed money, neither investors nor debtholders can force a fund to sell unrelated assets to pay a debt, and the failure of one

portfolio investment or fund will not have cascading effects on other portfolio companies or funds.

Private equity firms (or their owners) typically form and own special purpose entities to serve as their funds' general partners ("GPs") and make investment decisions for the funds. A private equity fund obtains capital commitments from sophisticated third-party investors who agree to become limited partners of the fund ("LPs") at the beginning of its term. These LPs (typically with their own experienced counsel) heavily negotiate the private equity fund terms with the GP, including the terms of management fees to the firm and the amount of carried interest to which the GP is entitled if the fund is profitable. Carried interest, in particular, is then offered to employees on the same structural terms, with the GP responsible for determining how the carry will be split up, but not generally when it will be paid. Actual realizations of carried interest by the GP (and corresponding realizations by the firm's employees) are made later in the term of a fund when its investments are sold at a profit and a hurdle rate of return to LPs has been exceeded.

*Long-Standing Practices at Private Equity Firms.* The Proposed Rules, as currently contemplated, and the incentive compensation framework therein, do not correlate with how most private equity firms operate. Indeed, operationalizing the applicable requirements may entail significant changes to private equity firms' long-established practices with little to none of the intended benefits contemplated by the Proposed Rules. These practices, as described below, have not led to inappropriate risk-taking at private equity firms and do not encourage inappropriate risk-taking or create systemic risk. Instead, by their nature, such practices already address the risk concerns underlying Section 956 of the Dodd-Frank Act.

At private equity firms, incentivization practices are structured to align the interests of senior management and investment professionals with the private equity funds sponsored by the firm and their investors. Generally, the compensation of these senior management and senior investment professionals employed by the private equity firm who source and manage investments made by the firm's funds (to whom we refer in this letter as "firm professionals") will consist of base salary and an annual cash bonus. As described in more detail below, firm professionals are also provided the opportunity to share a portion of the carried interest realized by the GP from the firm's investment funds in the form of a profits interest in the fund. For the few private equity firms that have publicly traded securities, firm professionals and other employees may also receive deferred or other awards of the firm's equity. In addition, a private equity firm's professionals and other employees generally make significant capital investments in the firm's private equity funds, which investments further align the interests and incentives of the employees with third-party investors.

*Carried Interest.* Carried interest or "carry" is a central component of profit participation in the private equity industry. Carried interest is a portion of the realized

gains generated by a private equity fund that is allocated to the fund's GP at the start of the fund, and is as an allocation of partnership profits. The carried interest participation of the GP by the private equity fund is equal to a specified percentage (typically 20%) of the cumulative net profits from the private equity fund's investments, such that (i) carried interest distributions are made to the GP only if the fund overall is sufficiently profitable above a specified threshold rate of return (*i.e.*, the "hurdle"), which is typically an 8% rate of return, and (ii) the amount of the distribution is directly proportional to the cumulative net profits achieved. Distributions of carried interest cannot lead to a material loss by the fund or the private equity firm because they are made only from realized profits received from successful investments made by the fund. As mentioned above, the carried interest percentage, and the timing and calculation of carried interest distributions, are heavily negotiated at the beginning of the term of a private equity fund between the private equity firm and the GP (and their counsel and advisers), on the one hand, and the sophisticated LPs (and their counsel and advisers), on the other.

While carry held by an employee typically vests proportionally over several years, no payment is made as the carry vests. Instead, once the GP realizes cash proceeds for its carried interest based on the arm's length negotiated terms agreed between the GP and its LPs, the GP will generally distribute those proceeds to the firm professionals and other employees in proportion to their participation percentages.<sup>1</sup> This only occurs when an investment is sold or otherwise distributes cash; no payments are made on carried interest just for "taking risk" upon making an investment, or because a particular investment has increased in value on paper. As a result, carried interest aligns the interests of the firm professionals who source and manage the investments of the private equity fund with the fund's LPs. By virtue of these allocations, the applicable carried interest recipients necessarily share in the private equity fund's success or failure. Since private equity fund carried interest distributions are calculated based on realized gains (net of any prior realized—and sometimes unrealized—losses), they correspond with actual investment realization and fund portfolio-wide performance over a period of years. Accordingly, the carried interest allocations and realizations thereof do not encourage excessive risk-taking behavior of the sort that the Proposed Rules aim to prevent because they are distributed only from profits actually realized by the private equity fund.

*Clawback.* Private equity funds also use clawback mechanisms built into their governing documents to ensure that carried interest distributions made to the GP (and the firm professionals) over the life of the fund correspond with the fund's ultimate performance. Generally, a clawback requires the GP (and the firm professionals and other employees who have been allocated carried interest) to return any over-distributions of carried interest that arise once the full investment performance of the fund has been taken

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<sup>1</sup> The GP also typically receives tax distributions to pay to the carried interest recipients to cover taxes payable on allocations of profit from the fund, and the tax distributions offset future distributions of carried interest the GP would otherwise receive.

into account. For example, if early investments of the private equity fund generate large profits and corresponding carried interest distributions but later investments are sold at a loss (or at a gain that is insufficient to cover the required hurdle rate of return to the LPs), the carried interest recipients are required to pay back prior carried interest distributions to account for such loss or insufficient gain. The clawback is typically backed by personal guarantees from each firm professional or other employee who received a portion of the carried interest distributions. As an added protection, some firms require that a portion of carried interest distributions be placed in escrow or otherwise held back pending final realization of all of a fund's investments to secure any potential clawback obligation. Clawbacks backed by personal guarantees or escrows are a unique feature of the private equity business model and ensure that private equity firm professionals and other employees have long-term alignment with the financial interests of the LPs and the financial results of the private equity funds.

*Non-U.S. Jurisdictions.* The AIC notes that laws in other non-U.S. jurisdictions have not taken a “one-size-fits-all” approach to the regulation of financial institutions and have offered greater flexibility to private equity firms in recognition of the very different risk profile of the industry. Some non-U.S. jurisdictions regulate private equity firms and private equity funds differently than other fund managers, and we believe the Commission should do the same. For example, the EU’s Alternative Investment Fund Managers Directive (the “AIFMD”) allows the applicable regulators to apply a proportionality principle to the AIFMD’s compensation rules, with the result that certain rules governing remuneration may not apply to managers of certain alternative investment funds if the size, scope and structure of the relevant alternative investment fund so warrant. Consequently, in making the modifications proposed in this letter, the Commission would be acting in accord with other regulators around the globe in recognizing the unique considerations related to practices in the private equity industry.

### **Comments on the Proposed Rules**

In light of this background, our recommended modifications and clarifications to the Proposed Rules are as follows:

1. We agree that “non-proprietary assets” should be explicitly excluded from the determination of “average total consolidated assets” for investment advisers and propose that the Commission further clarify the meaning of “non-proprietary assets”;
2. The methodology for calculating “average total consolidated assets” for investment advisers should be revised to give investment advisers more flexibility;
3. Carried interest should be specifically excluded from the definition of “incentive-based compensation”;
4. If private equity fund carried interest is included in the definition of “incentive-based compensation” notwithstanding our arguments, the final rules

- should clarify the meaning of certain terms in the Proposed Rules and omit requirements to apply additional performance measures to carried interest;
5. Certain other categories of payments should be specifically excluded from the scope of the definition of “incentive-based compensation,” including tax distributions;
  6. Private equity firms should have the discretion to weight the factors to be considered in determining whether compensation is “excessive” and tailor the assessment to their specific context, and certain factors in determining whether compensation is excessive should be clarified;
  7. We agree that covered institution status for investment advisers should be determined on an entity-by-entity basis; investment advisers that are separate legal entities should not be treated as a single investment adviser for purposes of Proposed Rules’ thresholds;
  8. The determination of whether to treat a covered institution with average total consolidated assets of at least \$10 billion as a Level 1 or Level 2 covered institution should be based on the risk-taking of the institution and systemic risk concerns;
  9. The Commission should clarify the extraterritorial reach of the Proposed Rules by excluding non-U.S. investment advisers with no U.S. operations from treatment as regulated institutions under the Proposed Rules, and excluding employees of a covered institution who are subject to non-U.S. financial institution regulation of compensation or remuneration from the definition of “covered employees”; and
  10. The Commission’s economic analysis should include an analysis of privately held institutions because the current assumption that privately held institutions employ similar compensation practices to most publicly held institutions is not valid, at least in the case of private equity investment advisers.

These clarifications and modifications are intended to make the final rules more reflective of how private equity firms function. Adoption of these modifications would not be inconsistent with the Commission’s or the other agencies’ faithful implementation of Section 956 of the Dodd-Frank Act or the legislative intent underlying such provision. Indeed, the modifications would support the adoption of final rules that are more effective and more appropriately tailored than the Proposed Rules in addressing concerns relating to incentive-based compensation arrangements. Each of these points is set forth in greater detail under the applicable heading below.

1. **The AIC agrees that “non-proprietary assets” should be explicitly excluded in the determination of average total consolidated assets of investment advisers; the Commission should clarify the meaning of “non-proprietary assets.”**

The AIC acknowledges and commends the Commission for the incorporation in the Proposed Rules of comments provided in the AIC’s 2011 Comment Letter regarding the need to exclude non-proprietary assets in calculating an investment adviser’s average total

consolidated assets for purposes of meeting the thresholds for covered financial institution status. The Proposed Rules define “average total consolidated assets” for an investment adviser as the institution’s total assets (exclusive of non-proprietary assets) shown on the balance sheet for the regulated institution for the most recent fiscal year end. Footnote 72 of the Supplementary Information to the Proposed Rules provides that the Commission “is clarifying in the proposed rule that investment advisers should include only proprietary assets in the calculation—that is, non-proprietary assets, such as client assets under management would not be included, regardless of whether they appear on an investment adviser’s balance sheet.” A definition of “non-proprietary assets” is currently not provided in the Proposed Rules.

The Commission has invited comment on whether the determination of average total consolidated assets for investment advisers should exclude non-proprietary assets that are included on a balance sheet under accounting rules, such as certain types of client assets under management required to be included on the balance sheet. The AIC strongly believes that all non-proprietary assets should be excluded from the definition of average total consolidated assets for investment advisers such as private equity firms because conflating assets that are owned by the firm with assets managed on behalf of other parties in determining total consolidated assets would obfuscate the amount of the true assets of the firm. This would lead to potentially varying treatment for otherwise similarly situated investment advisers and would subject some firms to the requirements of the Proposed Rules that would otherwise be exempt under the statutory mandate of Section 956 of the Dodd-Frank Act, which provides that these provisions will not apply to institutions with assets of less than \$1 billion. Further, including any non-proprietary assets in determining total assets, even if required on a balance sheet under accounting rules, would provide a misleading view of the size and interconnectedness of the private equity firm because a firm’s ability to acquire, hold and dispose of third-party managed assets is strictly limited by contract, regulation and other legal arrangements. Neither the private equity firm nor any creditor of the firm can use assets under management to gain access to liquidity or to settle a debt of the firm. In addition, because holdings of private equity funds that are sponsored by the same private equity firm are not cross-collateralized or cross-guaranteed, a counterparty or investor’s exposure to one private equity fund managed by a particular private equity firm does not lead to exposure to other funds managed by the same firm. The assets taken into account for purposes of meeting the Proposed Rules’ thresholds should include only those assets that are proprietary to the private equity firm.

Accordingly, in the interests of certainty and consistency of treatment, the AIC requests that the Commission further clarify the meaning of “non-proprietary assets” in the final rules to include the following kinds of non-proprietary assets: private funds with third-party and other investors and other variable interest entities (other than the covered institution’s actual proprietary interest), funds held through custody accounts or in segregated customer accounts (whether or not subject to custody rules) and funds held for the benefit of persons other than the covered institution that the covered institution is

restricted from using other than for the benefit of the other party. First, the AIC would recommend that the Commission make clear that “non-proprietary assets” include assets under management (whether in private equity funds or separate account arrangements), including specifically non-controlling interests in variable interest entities. This should be the case regardless of whether or not the relevant investment adviser is required to segregate the client assets and funds from its proprietary assets and maintain them in a separate custodian account pursuant to the Investment Advisers Act of 1940 and rules promulgated thereunder. These categories of non-proprietary assets may appear on the private equity firm’s balance sheet because the accounting rules require a firm to consolidate on its financial statements all variable interest entities in which it holds a “controlling” financial interest. These managed assets should be considered non-proprietary assets even if GAAP requires these assets to be consolidated with those of the private equity firm for the reasons discussed above. We understand the meaning of “non-proprietary assets” in the Proposed Rules to include these assets under management, including non-controlling interests in variable interest entities, but we would recommend that the final rules so clarify.

Second, the AIC further recommends that the Commission make clear that “non-proprietary assets” include investments in private funds and other vehicles or accounts that are proprietary to the firm professionals, other firm personnel and any such person’s family members or their personal investment or estate planning vehicles, or other “friends and family” (which we collectively refer to in this section as “personnel”) and other related-party managed assets, even if these assets appear on the balance sheet of the private equity firm. All of these categories of assets are properly included as non-proprietary assets, and therefore appropriately excluded from the determination of an investment adviser’s average total assets under the Proposed Rules for the reasons discussed above and because they are ultimately the property of persons other than the private equity firm.

Third, for similar reasons, the AIC recommends that the Commission make clear that non-proprietary assets include assets used to satisfy employee co-investment obligations,<sup>2</sup> carried interest, accruals of carried interest on the balance sheet in respect of unrealized investments (“carry accruals”) and management fee waivers if held by the private equity firm and not through a separate entity.<sup>3</sup> Where these types of

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<sup>2</sup> A private equity firm may opt to structure this employee co-investment commitment either directly through the private equity firm, through the fund’s GP or through a separate vehicle, which typically would result in such assets being held off the firm’s balance sheet. We believe that, in all cases, these assets are properly categorized as non-proprietary assets.

<sup>3</sup> Private equity funds may implement management fee waiver mechanics on behalf of the private equity firm’s professionals and other personnel to satisfy employee co-investment obligations of such professional or other personnel for tax purposes. Such waived management fees may, as a result, appear as an asset on the balance sheet of the firm.

non-proprietary assets may be held by the private equity firm on behalf of its personnel, it is done for administrative convenience, and the same assets could be structured in an alternative way where they would not appear on the firm's balance sheet. A private equity firm that opts to have these employee co-investment commitment, carried interest, carry accruals and waived management fees flow through itself for administrative convenience would have higher total assets on its balance sheet as compared to a firm that opts to establish separate vehicles for such purposes; yet the economic effect to the LPs would be the same in either situation.

These assets used to satisfy employee co-investment obligations, carried interest, carry accruals and management fee waivers are non-proprietary assets in that they are attributable to specific personnel or other related parties and not to the private equity firm more generally. These assets are subject to distribution to personnel in accordance with the organizational documents of the private equity firm. For example, carried interest that appears as an asset on the balance sheet of a private equity firm is attributable, and subject to distribution, to specific personnel in accordance with the firm's applicable governing documents. For contractual, regulatory, tax or similar administrative purposes, such amounts may not be distributed immediately following receipt by the private equity firm and this may result in the firm holding these assets as of the end of a fiscal year or quarter. Even so, these amounts may not be used by the private equity firm and will, when appropriate, be distributed to the firm's personnel to whom the carried interest belongs. As a result, these types of assets should be included in the definition of non-proprietary assets; the alternative would result in an incremental undue burden on investment advisers and would lead to disparate treatment for otherwise similarly situated investment advisers. Further, including any non-proprietary assets in determining an investment adviser's total assets, even if required on a balance sheet under accounting rules, would provide a deceptive view of the size of the private equity firm because the firm's ability to acquire, hold and dispose of third-party managed assets is severely limited. Neither the private equity firm nor any creditor of the firm can use these assets to gain access to liquidity or to settle a debt of the firm.

Finally, the AIC recommends that the Commission include within the meaning of "non-proprietary assets," or otherwise exclude from the calculation of a covered institution's average total consolidated assets, amounts on the balance sheet in respect of (i) assets held to pay deferred compensation, (ii) assets held to pay accrued bonuses, and (iii) any amounts held back by the firm (whether in an escrow account or otherwise) to satisfy firm professional and other employee clawback obligations. The AIC believes that they are appropriately considered non-proprietary assets because these are amounts that have already been earned or accrued by firm professionals or other employees but not yet paid and are merely being held by the private equity firm pending distribution. Inclusion of these amounts as proprietary assets would falsely overstate the private equity firm's assets. In addition, although the AIC does not believe that compensation deferrals and clawback requirements should be federally regulated and mandated by the Proposed Rules, we

acknowledge and agree that deferrals of compensation and the use of clawbacks can be sound compensation practices that reduce risk, and a private equity firm's holding of amounts to backstop its obligations to pay deferred compensation or to satisfy employee clawback requirements when they come due is a prudent risk-management practice. Inclusion of these amounts as proprietary assets for purposes of meeting the Proposed Rules' asset level thresholds would disincentivize firms from voluntarily deferring compensation or instituting clawbacks, or to holding funds to satisfy these obligations, particularly where holding funds to satisfy such obligations would cause the firm to meet a higher regulatory threshold under the Proposed Rules than would otherwise apply. The AIC believes that covered institutions should not be penalized for taking prudent risk management actions that support sound incentive compensation practices, or, in the case of Level 1 and Level 2 covered institutions, for complying with the mandatory deferral requirements of the Proposed Rules.

Accordingly, the AIC respectfully requests that the Commission clarify the meaning of "non-proprietary assets" to include all such assets discussed above as not proprietary to the investment adviser.

**2. The methodology for calculating "average total consolidated assets" for investment advisers should be revised to give investment advisers more flexibility.**

The Commission has invited comment on the definition of "average total consolidated assets." For a covered institution that is an investment adviser, the Proposed Rules currently provide that "average total consolidated assets" means the adviser's total assets (exclusive of non-proprietary assets) shown on the balance sheet for the adviser's most recent fiscal year end, which corresponds with the reporting requirement for investment advisers in Item 1.O of Part IA of Form ADV. For institutions that are not investment advisers, the Proposed Rules provide that average total consolidated assets would be determined with reference to the average of the total consolidated assets reported on regulatory reports for the four most recent consecutive quarters. The AIC respectfully requests that the formulation of "average total consolidated assets" for an investment adviser be revised such that the adviser may elect to use either (i) the method for investment advisers as proposed in the Proposed Rules or (ii) an average of the total assets (exclusive of non-proprietary assets) reported for the four most recent consecutive quarters, more in line with the definition for covered institutions that are not investment advisers. Where an investment adviser does not produce or report quarterly financial information in accordance with GAAP, which is often the case, the formulation of average total consolidated assets proposed in clause (ii) above should be determined with reference to an average reported for the two most recent consecutive fiscal years. The AIC believes that the total assets reported as of a single day at the end of the year may cause an investment adviser to be subject to the rules only because it reaches the threshold as of that day, for example, as a result of the receipt of a large end-of-year payment or accrual that results in a

temporary asset on the balance sheet. In these instances, using the average of the adviser's balance sheet for the four most recent financial quarters would be more reflective of the investment adviser's actual size relative to the financial system and more consistent with the intent of the Dodd-Frank Act. In addition, although we do not support the application of the more onerous Level 1 and Level 2 requirements to any investment advisers, we do believe that, if the Commission retains the Level 1 and Level 2 average total consolidated asset thresholds, the final rules should include a mechanism whereby these asset thresholds are adjusted annually for inflation.

**3. Carried interest should be specifically excluded from the definition of “incentive-based compensation” and “incentive-based compensation arrangements.”**

Carried interest or “carry,” as described above, is a central component of profit participation in the private equity industry and effectively aligns risk and reward for firm professionals and other employees of private equity firms. Private equity carried interest arrangements (*i*) are structured in such a way that they do not encourage excessive risk-taking behavior, (*ii*) are inherently performance and risk adjusted because they are always calculated and received based on the actual performance of the underlying investments of the private equity fund over a period of years, (*iii*) do not involve vesting conditions that could encourage excessive risk and (*iv*) cannot lead to a material loss at the private equity firm because they are distributed only from profits earned on a successful exit from an investment by a private equity fund. To provide an illustrative concept: if a mortgage broker's commission had similar features to a private equity fund carried interest, the commission on writing a mortgage would be paid only when the mortgage was repaid and the lender received all principal plus a return on the amount lent (with a clawback if loans to other borrowers failed).

The Proposed Rules do not address carried interest in the Supplementary Information or the proposed rule text. The Supplementary Information to the Proposed Rules does, however, exclude from the definition of incentive-based compensation dividends paid and appreciation realized on stock or other equity-like instruments that are owned outright by a covered person, and the AIC believes that the rationale for excluding dividends or appreciation applies equally to private equity fund carried interest, whether or not subject to time-based vesting requirements. The private equity fund carried interest is a form of equity instrument in an affiliate of the covered investment adviser, specifically a profits interest, and distributions of carry to the firm professionals and other employees are made solely based on appreciation actually realized on this instrument, notwithstanding that the underlying fund's assets are not held directly by the private equity firm's professionals and other employees. As a result, the proposed exception for amounts realized on equity and equity-like instruments should expressly include carried interest. Even if the Commission determines that this exception does not apply to private equity fund carried interest, the AIC requests that, in light of the long-term payout structure,

performance and risk-adjusted nature and payment mechanics of the private equity fund carried interest, the final rules should exclude these carried interest arrangements from the definition of “incentive-based compensation,” provided that the carry is (i) paid out of gains realized from investment and (ii) is subject to clawback on terms negotiated with the private equity fund LPs.

At the time of disposition of each private fund investment, the amount of the carry entitlement is adjusted both for the financial performance of the investment and for risk because no amount is distributed if the investment is sold at a loss (or at a gain that is insufficient to cover the required hurdle rate of return to the LPs), and distributions are based on actual gains that have been fully realized (sometimes taking into account unrealized losses). Further, to the extent the carried interest distributions at the close of a private equity fund’s existence are not reflective of cumulative fund performance (e.g., if carried interest distributions were made on a deal-by-deal basis as individual investments are sold and the last investment is sold at a loss), the private equity firm will be required to clawback any over-distributions of carry from its carry recipients, as discussed above. Accordingly, the AIC respectfully submits that the final rules explicitly exclude such carried interest arrangements from the definition of “incentive-based compensation.”

**4. If private equity fund carried interest is included in the definition of “incentive-based compensation” and “incentive-based compensation arrangements,” then the final rules should clarify the meaning of certain terms and omit requirements to apply additional performance measures to carried interest arrangements.**

The AIC strongly believes that carried interest retained by firm professionals and other personnel of a private equity firm, and distributions of the carry upon realization of profits above the specified hurdle, should fall outside the scope of incentive-based compensation for the multiple reasons discussed above. If the Commission wrongly determines that private equity fund carried interest may be a form of “incentive-based compensation,” notwithstanding that it is an equity-like instrument that is inherently performance-based and risk adjusted, the AIC requests at a minimum that the Commission’s final rules (i) confirm that a private equity firm need not apply additional performance measures to grants or distributions of carried interest and (ii) further clarify how the final rules would apply to carried interest arrangements. We discuss each of these in turn below.

First, the AIC appreciates the opportunity to comment on requirements for performance measures. The AIC believes that the requirement to apply both financial and non-financial risk-based performance measures during the performance period does not serve the purposes of the Proposed Rules in the context of private equity fund carried interest arrangements. As a result, the final rules should not mandate that additional performance measures be taken into account for carried interest arrangements either prior to, at, or after grant. Specifically, the application of both financial and non-financial

risk-based performance measures to a carried interest arrangement would impose another layer of unnecessary assessment, measurement and adjustment. Because private equity fund carried interest distributions are only made when gains are realized in respect of a portfolio investment, carried interest arrangements already expressly align performance to risk. In this case, no additional performance measures are appropriate or, indeed, necessary. In addition, the amount, terms and conditions of the carried interest arrangement (including the hurdle rate of return) are negotiated directly with the private equity fund's LPs. The interests of the private equity firm professionals and other carry recipients and the investor LPs are perfectly aligned. To repeat a concept introduced above: if a mortgage broker's commission had similar features to a private equity fund's carried interest, the commission on writing a mortgage would be paid only if and when the mortgage was fully repaid. All risks arising during the life of the mortgage (even if non-obvious or unrealized during the initial period of the mortgage) would be reflected in the ultimate payment of the commission.

In addition, as discussed above, grants of private equity fund carried interest typically are not preceded by a performance period (except to the extent award amounts are based on past performance, such as a history of successful investing). The award of the carried interest entitlement to a firm professional typically is made up front at the commencement of a private equity fund or commencement of employment, although it may also be awarded when a fund investment is made, in annual vintage or at other times. As such, there generally is limited opportunity prior to the award of the carried interest to impose additional financial and non-financial performance measures.

After the grant of a carried interest entitlement, the instrument generally does not provide for any assessment of an individual firm professional or other employee's performance or an adjustment to the entitlement percentage or payout allocated based on that individual's performance. Again, this is the case because a private equity fund carried interest arrangement is inherently risk-adjusted based on actual investment performance. To the extent the risk of any firm professional or other employee impacts the performance of the private equity fund, including through inappropriate risks taken, his or her payout under the carried interest arrangements will be impacted. In addition, the carried interest entitlements may be subject to forfeiture upon certain for-cause terminations for serious misconduct.

The AIC respectfully submits that mandating additional financial or non-financial performance measures for private equity fund carried interest arrangements, which are already inherently performance-conditioned and risk adjusted, is not justified based on the purposes of Section 956 of the Dodd-Frank Act to reduce risk-taking behavior and is inconsistent with how third-party investors want to incentivize the investment professionals who are managing their investments.

Second, the AIC believes that a standard private equity fund carried interest arrangement does not map onto the incentive compensation framework of the Proposed

Rules, particularly with respect to the interplay between award and vesting in the context of carried interest grants and vesting. The Supplementary Information to the Proposed Rules contemplates an “incentive-based compensation timeline” with an initial performance period. At or near the end of the performance period, a covered institution would “award” incentive compensation based on performance during the performance period. For Level 1 or Level 2 covered institutions under the Proposed Rules, the award is followed by “deferral” and “vesting.” With respect to carried interest, however, a carry entitlement typically is awarded (or granted) to the firm professional or other employee at the commencement of a private equity fund or the start of employment or sometimes in annual vintage or at the time investments are made. Because carried interest is typically structured as a partnership profits interest, it must be awarded at or prior to investment in a portfolio investment. The carry is typically subject to time-based vesting, which primarily serves a retentive element in that a firm professional or other employee may lose any unvested carry entitlements upon termination of employment for certain reasons. Notwithstanding the vesting schedule, cash distributions to firm professionals and personnel in respect of carried interests occur only when investments have been realized at a profit or at certain other times for the payment of taxes. Investments are not sold at a fixed time or schedule, and accordingly, distributions in respect of carried interest are similarly not made at regular intervals. Delaying the grant (or “award”) of a carried interest could have significant adverse consequences to employees, both in terms of potential loss of profits interest treatment and because, if not recognized as a profits interest, adverse consequences could result under Section 409A of the Internal Revenue Code because payments are not made at a fixed time or schedule.

The chasm between the Proposed Rules’ timeline and the private equity fund carried interest structure will render it difficult for private equity firms to interpret and apply the rules in respect of the firms’ carried interest arrangements. It is unclear whether carried interest would be considered awarded at grant, notwithstanding that there is no earlier performance period, or at the time it vests under the industry standard time-based vesting schedule. With respect to the concept of “vesting” under the Proposed Rules, it is unclear whether the time-based vesting of the carried interest arrangements or the ultimate distribution of cash upon the realization of profitable investments would more appropriately fit within the Proposed Rules’ “vesting” concept. We believe the common understanding and usage of the term “vesting” (*i.e.*, the lapse of restrictions on the interest) should instead apply. If the final rules wrongly include private equity fund carried interest in the definition of “incentive-based compensation” and “incentive-based compensation arrangements,” the AIC believes that the Commission should clarify how these terms would apply to carried interest.

**5. Certain other categories of payments should be specifically excluded from the scope of the definition of “incentive-based compensation.”**

The Commission has invited comment regarding the reported common practice for some private fund adviser personnel to receive payments in order to enable the recipients to make tax payments on unrealized income as they become due. The AIC appreciates the Commission’s request for comment and would strongly recommend that distributions received by private equity firm professionals or other employees in order to pay taxes due on undistributed income explicitly be excluded from the definition of incentive-based compensation, as well as excluded from the scope of any restrictions on payouts during deferral or vesting periods. The taxes arise because the interests held by the firm professionals and other employees typically are partnership interests. Partners are taxed when an allocation of income occurs, whether or not distributed. The AIC believes that these tax distributions are not a form of incentive-based compensation but are paid merely to cover the taxes due on undistributed income (which taxes would have been payable by the business if it were organized as a corporate entity). In any case, payment of these amounts should be permitted when the taxes come due in order to reconcile any discordance between the Commission’s incentive compensation payment rules and the Internal Revenue Code and rules thereunder governing taxation of these amounts. The AIC notes that the proposed rule released by the NCUA acknowledged a similar situation for covered persons at credit unions and permitted accelerations of deferred payments if the covered person must pay income taxes on the amount of the award, including deferred amounts, and recommends that, if carried interest is not excluded, the Commission adopt a similar provision to that in the NCUA rules permitting an exception to the general payout rules to allow covered persons to pay taxes that are due.

The AIC further recommends that the final rules explicitly clarify that, in addition to carried interest, the General Partner interests and other interests with unlimited liability are excluded from the scope of the definition of incentive-based compensation. GP interests and interests with unlimited liability for the debts of the partnership are not traditionally or appropriately considered to be a form of compensation. Although we would expect these interests to be excluded from incentive-based compensation, particularly in light of the exception for dividends paid and appreciation realized on stock or other equity-like instruments that are owned outright, the AIC requests that the final rules confirm this interpretation to avoid any doubt in this regard.

**6. Private equity firms should have the discretion to weight the factors to be considered in determining whether compensation is “excessive” and tailor the assessment to their specific context; certain factors in determining whether compensation is excessive should be clarified.**

The AIC notes that the relevance of factors to be considered in determining whether compensation is “excessive” differs widely among types of financial institutions and believes that the one-size-fits-all approach of the Proposed Rules is accordingly not

appropriate. The Supplementary Information to the Proposed Rules notes that the structure of incentive-based compensation arrangements at covered institutions would be expected to reflect these requirements of the Proposed Rules in a manner tailored to the size, complexity, risk tolerance and business model of the covered institution. Accordingly, covered private equity firms should have the discretion to weight the factors to be considered in determining whether compensation is excessive. Institutions are in the best position to assess the factors that are most relevant to their respective business models and talent pools.

The AIC also recommends that the final rules make clear a number of points regarding the factors for determining whether an incentive compensation arrangement is excessive, taking into consideration the competitive talent pool from which private equity firms hire their senior management and other investment professionals. Private equity firms face intense competition for talent, both from within the private equity industry and from other types of financial institutions, including covered institutions and other unregulated industries and global firms. Some of these businesses may not be considered “comparable covered institutions” under the Proposed Rules in analyzing whether an incentive compensation arrangement provides excessive compensation. However, a covered financial institution may appropriately design incentive compensation arrangements that differ from those of comparable covered financial institutions because it believes that such differing arrangements are necessary to attract and retain the best talent in this competitive environment. It should not be automatically presumed that these differing compensation arrangements are excessive. In this regard, the AIC recommends, first, that the final rules should clarify that, for purposes of determining appropriate compensation levels, comparable institutions should include financial and other institutions across all sectors that compete for employees from the same talent pool. Second, and relatedly, the “compensation history” of a covered person should include compensation with a prior employer because this nearly always plays a significant role in the compensation arrangement offered to a given individual.

In addition, the AIC believes that the size of the overall incentive pool, rather than how the pool is allocated among individuals, should be a significant factor in the determination of “excessiveness.” In other words, if a total pool is reasonable and not “excessive,” its distribution to and among individual employees should not be considered excessive. And finally, whether an incentive pool has been determined in consultation with institutional investors should be a factor in making a determination of “excessiveness” under the Proposed Rules. In proposing to regulate the allocation of management fees or carried interest among individual employees of an investment adviser, the Commission is proposing to substitute its judgment for an arm’s length, bargained arrangement between investors and their adviser. This is very different than the arrangements at banks and many other financial institutions, which historically have been put in place with no direct input from shareholders or other stakeholders. The AIC respectfully requests that the final rules recognize these points.

**7. We agree that covered institution status for investment advisers should be determined on an entity-by-entity basis; investment advisers that are separate legal entities should not be treated as a single investment adviser for purposes of Proposed Rules' thresholds.**

The Commission's regulatory regime with respect to broker-dealers and investment advisers generally applies on an entity-by-entity basis, and the Commission's Proposed Rules do not expressly require two or more affiliated investment advisers that are separate legal entities to be treated as a single investment adviser. However, the Supplementary Information to the Proposed Rules notes by footnote that the SEC has stated that it will, based on facts and circumstances, treat as a single investment adviser two or more affiliated investment advisers that are separate legal entities but are operationally integrated.<sup>4</sup> The Commission has invited comment regarding whether to adopt such a requirement for purposes of meeting the thresholds in the Proposed Rules. The AIC believes that the status of an investment adviser as a distinct legal entity should be respected and that consolidating the assets of affiliated investment advisers is in almost all cases inappropriate for the reasons discussed below. We respectfully recommend that the Commission confirm that affiliated investment advisers that are separate legal entities should each be treated as distinct investment advisers for purposes of meeting the Proposed Rules' thresholds unless the separate investment advisers are established as such intentionally to evade covered institution status and the requirements of these rules. In addition, the AIC requests that the Commission confirm that the mere fact that a registered investment adviser has a "participating affiliate" arrangement with an affiliate does not mean that the two firms are integrated for purposes of the Proposed Rules, just as they would not be integrated for purposes of Section 208 of the Investment Advisers Act.

The concept of "operational integration" arises in the context of attempts to evade registration under the Investment Advisers Act of 1940 (the "Act"). The so-called "*Richard Ellis* factors" are used to determine whether a separately formed advisory entity operates independently of an affiliate and should thus be treated as a single investment adviser for purpose of registration under the Act.<sup>5</sup> These factors, established by the Commission staff 35 years ago to address relatively novel issues in the development of cross border asset management, are designed to prevent investment advisers from evading registration under the Act and it is accordingly not appropriate to apply these same factors in order to determine whether two affiliated investment advisers have the kind of profile

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<sup>4</sup> The Commission cites for this proposition: Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less than \$150 Million in Assets Under Management, and Foreign Private Advisers, Investment Advisers Act Release No. 3222 (June 22, 2011) 76 FR 39,646 (July 6, 2011); In the Matter of TL Ventures, Inc., Investment Advisers Act Release No. 3859 (June 20, 2014) (settled action); and section 15 U.S.C. 80b-8.

<sup>5</sup> Richard Ellis, Inc., SEC Staff No-Action Letter (Sept. 17, 1981), cited by Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less than \$150 Million in Assets Under Management, and Foreign Private Advisers, Investment Advisers Act Release No. 3222 (June 22, 2011) 76 FR 39,646 (July 6, 2011) and In the Matter of TL Ventures, Inc., Investment Advisers Act Release No. 3859 (June 20, 2014) (settled action).

and create the kind of systemic risk that should subject their incentive compensation arrangements to the Proposed Rules. The Proposed Rules apply to all investment advisers, as the term is defined in the Act, regardless of whether the institution is registered with the Commission as an investment adviser. Where affiliated entities are structured as separate legal entities for bona fide business reasons (including tax, regulatory and limited liability reasons), each entity should be considered a separate investment adviser for purposes of meeting the Proposed Rules' thresholds.

In this connection, we note that the SEC staff has permitted affiliated investment advisers to private funds ("private fund advisers") to collectively file one Form ADV under certain circumstances ("umbrella registration"). As the Commission noted in proposing to codify this approach, this approach is premised on the notion that the affiliated entities "operate as a single business."<sup>6</sup> Many private fund advisers that rely on umbrella registration, which is designed to create a more efficient registration system for Commission examiners and registrants, would not be able to satisfy the *Richard Ellis* factors; however, we do not believe that investment advisers that rely on the umbrella registration approach (or, for that matter, separately registered investment advisers that are operationally integrated) create any systemic risk that should subject the adviser to the requirements of the Proposed Rules even if the affiliated advisers collectively have more than \$1 billion of assets.

In practice, the factors used to establish operational integration for purposes of registration under the Act are inflexible and difficult to apply.<sup>7</sup> If the Commission requires investment advisers to use the facts-and-circumstances approach of operational integration, investment advisers will not have clarity as to whether they are in fact subject to the Proposed Rules. This approach could result in certain smaller investment advisers being subject to the Commission's Proposed Rules, which is beyond the statutory mandate of Section 956 of the Dodd-Frank Act.<sup>8</sup>

Further, the Proposed Rules already prohibit a covered institution from doing indirectly, or through or by any other person, anything that would be unlawful for such institution to do directly. In order to provide certainty, we believe separate legal entities

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<sup>6</sup> [IA-4091 May 20, 2015 Amendments to Form ADV and Investment Advisers Act Rules](#), Investment Advisers Act Release No. 4091 (May 20, 2015).

<sup>7</sup> The Commission itself has recognized the inflexibility of the *Richard Ellis* factors in permitting investment advisers to take an alternative approach set forth in the so-called *Unibanco* letters. In those letters, the Commission staff provided assurances that it would not recommend enforcement action, subject to certain conditions, against a non-U.S. unregistered adviser that is affiliated with an SEC-registered adviser, despite sharing personnel and resources. See [Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less than \\$150 Million in Assets Under Management, and Foreign Private Advisers](#), Investment Advisers Act Rel. No. 3222 (June 22, 2011).

<sup>8</sup> Section 956(f) of the Dodd-Frank Act provides that "[t]he requirements of this section shall not apply to covered financial institutions with assets of less than \$1,000,000,000."

should be treated as distinct investment advisers for purposes of meeting the Proposed Rules' thresholds unless the separate investment advisers are structured as such intentionally to evade covered institution status and the requirements of these rules (*i.e.*, if the adviser does something indirectly that it could not do directly). We would specifically note that legal structures of affiliated investment advisers established prior to the release of the Proposed Rules should not be deemed to have been structured in an effort to evade application of the rules. This type of brightline rule would ensure that investment advisers are on notice of whether they are in fact covered institutions under the Proposed Rules' thresholds.

Relatedly, because the operations, services and products of private equity investment advisers typically are not effected through subsidiaries, the AIC supports the Commission's proposal not to consolidate subsidiaries of investment advisers that are not themselves subsidiaries of depository institution holding companies. The AIC would recommend that this aspect of the Proposed Rules be reflected in the final rules.

**8. The determination of whether to treat a covered institution with average total consolidated assets of at least \$10 billion as a Level 1 or Level 2 covered institution should be based on the risk taking of the institution and systemic risk concerns.**

The Proposed Rules provide that the Commission could require a covered institution with average total consolidated assets of at least \$10 billion to comply with some or all of the more stringent provisions of the Proposed Rules if the Commission determines that the activities, complexity of operations, risk profile or compensation practices of the institution are consistent with those of a Level 1 or Level 2 covered institution. While we are pleased that the Supplementary Information to the Proposed Rules notes that the Commission would only exercise this authority on an infrequent basis, the AIC believes that the Commission should exercise this discretion in extremely limited circumstances and only based on systemic risk concerns, such as whether the institution's potential failure implicates a risk for the broader economy and financial system, as is the case for the Level 1 and Level 2 covered institutions. The exercise of this authority should not be based on the complexity of operations or structure of compensation practices, which alone are not relevant to systemic risk. The Dodd-Frank Act was implemented to respond to systemic risk and as a means of identifying and regulating large, interconnected institutions whose failure could affect the entire financial system. Where practices at covered investment advisers do not encourage inappropriate risk-taking behaviors or pose any systemic risk concerns, the final rules should not permit the Commission to treat the Level 3 firm or fund as a Level 1 or Level 2 institution even if the activities or complexity of operations or compensation practices are consistent with those of larger covered financial institutions.

**9. The Commission should clarify that non-U.S. investment advisers with no U.S. operations are not regulated institutions under the Proposed Rules; the definition of “covered employees” should exclude employees of a covered institution who are subject to non-U.S. regulation of compensation or remuneration.**

The AIC believes that the extraterritorial application of the Proposed Rules should be clarified and appropriately circumscribed to conform to the Commission’s jurisdictional scope. Specifically, the AIC believes that (i) the definition of “regulated institution” in the Proposed Rules should expressly exclude investment advisers located outside of the United States which do not have U.S. operations, even where the non-U.S. investment adviser is affiliated with a U.S. investment adviser, and (ii) the definition of “covered employee” should exclude any firm professional or other employee of a covered institution who is located outside of the U.S. and already subject to non-U.S. rules governing compensation or remuneration.

The Proposed Rules apply to covered investment advisers, whether or not they are registered under the Act, and thus includes “exempt reporting advisers” and international firms, including those based outside of the United States, who may be operating under various exemptions under the Act. The AIC recommends that the Proposed Rules’ application to investment advisers based outside of the United States be limited and apply only to the extent of their U.S. operations. Non-U.S. investment advisers with no U.S. operations should be excluded from the definition of “regulated institution” under the Proposed Rules, regardless of whether the adviser is affiliated with a U.S. investment adviser. We believe this clarification is consistent with the Commission’s intent in adopting the Proposed Rules and with the scope of the Commission’s regulatory jurisdiction, but we request that the final rules so clarify.

Second, imposing the requirements of the Proposed Rules on non-U.S. firm professionals and other employees who are already subject to local regulation of their compensation or remuneration would be unjustifiable and unworkable in practice. Where the Proposed Rules and local regulations both apply, whether or not there is a conflict, the laws and regulations of the jurisdiction where the firm professional or other employee is located should govern; we believe this should be made clear in the final rules or their adopting release to provide guidance to covered institutions with an international presence. In addition, subjecting a foreign private equity firm professional or other employee to the Proposed Rules, particularly where the U.S. requirements are more stringent than the otherwise applicable local remuneration rules, will put the institution at a competitive disadvantage in terms of attracting and retaining employees. Accordingly, the definition of “covered employee” should exclude any foreign firm professional or other employee of the covered institution who is already subject to foreign laws and regulations governing compensation and remuneration.

- 10. The Commission’s Economic Analysis should include an analysis of privately held institutions because the current assumption that these institutions employ similar compensation practices to most publicly held institutions is not valid, at least in the case of private equity investment advisers.**

The Commission has requested comment on the validity of its assumption that privately held institutions employ similar compensation practices to publicly held institutions. Private equity firm compensation practices differ widely from those at most publicly held financial institutions, and where firms are subsidiaries of larger public companies, the compensation practices of these subsidiaries may differ significantly from those of the parent holding companies. In addition, publicly traded private equity firms’ compensation practices also differ significantly from other publicly traded financial institutions. As discussed in detail above, most private equity firm covered persons’ compensation is composed of base salary and annual bonus. The covered persons are also entitled to profits participation in the form of carried interest, which is an equity-like instrument owned by the covered person where distributions are only made based on realized profits, and which are subject to deferral for lengthy periods and clawbacks as negotiated with private equity fund LPs. The AIC recommends that the Commission’s economic analysis be revised to take into account the costs to private equity firms of applying the Proposed Rules given that the practices of the private equity industry differ so substantially from the practices examined in the economic analysis and conceptualized by the Proposed Rules. The Commission has requested data or analysis with respect to incentive-based compensation arrangements of covered persons at privately held covered institutions, which the AIC has attempted to provide herein.

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The AIC appreciates the opportunity to comment on the Proposed Rules and would be pleased to answer any questions you might have regarding our comments, or regarding the private equity and growth capital industry more generally.

Respectfully submitted,



Jason Mulvihill  
General Counsel

cc: The Honorable Mary Jo White, Chair  
The Honorable Kara M. Stein, Commissioner  
The Honorable Michael S. Piwowar, Commissioner