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July 22, 2016

VIA ELECTRONIC SUBMISSION

Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: Proposed Rule – Incentive-based Compensation Arrangements (File No. S7-07-16) (the "Release")

Ladies and Gentlemen,

We appreciate this opportunity to comment on rules proposed by the Securities and Exchange Commission (the "Commission") concerning incentive-based compensation arrangements at certain financial institutions (the "Proposed Rule") pursuant to Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").

Firstly, we respectfully request that the Commission clarify that the Proposed Rule does not apply to any "investment adviser" within the meaning of Section 201(a)(11) of the Investment Advisers Act of 1940, as amended (the "Advisers Act"), that is nevertheless exempt from registration by reason of Section 203(b)(4) of the Advisers Act (the "Charitable Adviser Exemption") (a "Charitable Adviser"). Without such clarification, there is potential for costly, uncertain and unintended application of the Proposed Rule to a significant number of charitable institutions in the nonprofit sector. In this regard, we would once again direct the Commission's attention to the points previously made in the comment letter submitted by the National Association of College and University Business Officers in connection with the Commission's prior proposed rules governing incentive compensation.[1] Without repeating all of them here, we support those points and have sought to elaborate on them herein by illustrating the disproportionate and clearly unintended effect

[1] Letter of the National Association of College and University Business Officers to the Commission (May 31, 2011) (the "NACUBO Letter"), available at https://www.sec.gov/comments/s7-12-11/s71211-634.pdf.

of treating Charitable Advisers in the same manner as the large commercial investment advisers that are the concern of Section 956 of the Dodd-Frank Act.

Secondly, and in the alternative, in response to the Commission's request for comments in the Release,[2] we propose that the Commission define the "average total consolidated assets" of Charitable Advisers so as to account for their unique nature and structure, in contrast to the large commercial investment advisers that are the concern of Section 956. In this regard, we note that a Charitable Adviser is often the "charity in chief" (*i.e.*, the Charitable Adviser is not a separate legal entity from the charitable organization it advises), and thus its proprietary balance sheet assets include all of the charity's assets under management ("AUM"), and in many cases all of its assets used in pursuit of its charitable mission, including properties, equipment, supplies, publications and other non-financial assets. In many cases, a charity's balance sheet assets that represent mission-critical operations will dwarf the assets that are dedicated to investment management activities. This characteristic of Charitable Advisers is distinguishable from a typical commercial investment adviser, where the investment adviser is a separate legal entity distinct from the clients whose assets the investment adviser manages. In the case of a typical commercial investment advisor, its proprietary balance sheet assets are primarily attributable to its provision of advisory services. Indeed, where proprietary assets are distributed to equity owners and staff, even the most lucrative commercial investment advisors with significant client AUM may not have significant balance sheet assets to report. Consequently, we recommend that the Commission tailor the definition of "average total consolidated assets" as applied to Charitable Advisers to cover only the Charitable Adviser's proprietary assets dedicated to the activity of investment management (*i.e.*, the property, equipment and other assets used in investment management operations), as opposed to the Charitable Adviser's AUM and any other assets of the Charitable Adviser. Without such a rule, we believe that the "jurisdictional test" of average total consolidated assets of at least $1 billion would effectively become an AUM test for many Charitable Advisers, contrary to the Commission's stated focus on proprietary assets as the intended test.[3] The further effect would be to apply compensation regulation to charities with sizeable assets overall, but relatively small and incidental investment management operations, while failing to regulate compensation at commercial investment advisers with much larger operations and much larger AUM that happen to be more thinly capitalized. It is doubtful that Congress intended compensation regulation of Charitable Advisers under any circumstances. It is doubly doubtful that Congress intended this perverse result.

Before developing our two comments further, a note on Charitable Advisers is likely in order. The Charitable Adviser Exemption is highly constraining. In order to achieve it, an investment adviser must itself be a "charitable organization," which is defined by reference to Section 3(c)(10)(D)(iii) of the Investment Company Act of 1940, as amended, as "an organization described in paragraphs (1) through (5) of Section 170(c) or Section 501(c)(3) of the Internal Revenue Code of 1986." A

[2] *See* Release at 37690 ("Should the determination of average total consolidated assets be further tailored for certain types of investment advisers, such as charitable advisers . . . and, if so, why and in what manner?").
[3] *See* Release at 37689, n. 72.

commercial purveyor of financial services is not able to achieve either of these federal tax law statuses, as neither the federal tax law nor the Internal Revenue Service recognizes investment management as an inherently charitable activity. In order to achieve tax-favored treatment, investment management must be included within, or otherwise linked to, an otherwise charitable entity. Moreover, the Charitable Adviser Exemption requires that the investment adviser serve exclusively accounts that are charitable in nature, including the charity itself, other charities, charitable supporting organizations, charitable pooled income funds, irrevocable charitable remainder unitrusts and annuity trusts, and charitable lead trusts. The emphasis in all of the enumerated arrangements, which are creatures of the federal tax law, is on charitable donation as opposed to private assets. As a matter of existing federal law, Charitable Advisers, while practicing investment disciplines, exist in a world separate from the commercial financial service purveyors that are the focus of the Dodd-Frank Act and, as discussed herein, are already subject to extensive regulation that is tailored to that separate world.

The legal parameters of the Charitable Adviser Exemption are only half of the story. The fundamental non-profit nature of Charitable Advisers, and the clear expression of Congressional intent as to their regulatory treatment that is reflected in the Charitable Adviser Exemption, are also relevant in this context. Charities only become or form Charitable Advisers in pursuit of a charitable mission. Indeed, a charity managing its own assets is like any other person managing assets for its own account insofar as it is not an "investment adviser" under Section 202(a)(11) of the Advisers Act at all. No "advice," "others," "compensation" or "business" is involved. Where the charity also manages assets relating to certain donative instruments recognized by the tax law, such as a charitable remainder trusts, there may be a question as to whether the elements of the Section 202(a)(11) definition are present. The question also arises where the charity manages the assets of a closely related charity (a common arrangement) or an unrelated charity in the effort to achieve economies of scale and share expertise (a less common arrangement). Since the passage of the Philanthropy Protection Act of 1995[4] (the "Philanthropy Protection Act") and its introduction of the Charitable Adviser Exemption into the Advisers Act, Congress has determined that charities can be relieved from worrying about the abstract definitional issues posed by Section 202(a)(11), provided that they follow the narrow constraints of the Charitable Adviser Exemption. In performing whatever extent of investment management activity, whether solely for its own account or also the account of donative arrangements or other charities as referenced in the Charitable Adviser Exemption, a charity's investment management activities must necessarily remain within the scope and in pursuit of the charity's charitable mission. Thus, Charitable Advisers are not for-profit businesses seeking to grow AUM by commercial client attraction. Their investment management is by definition incidental to a charitable mission.[5] As such, Charitable Advisers have not been, nor are they likely to be, a potential source of spreading mayhem on our financial system.

[4] Philanthropy Protection Act of 1995, Pub. L. No. 104-62 (codified as amended in scattered sections of 15 U.S.C).
[5] In discussing so-called "consolidation" rules in the Release, the Commission has noted important differences in the regulatory regime for investment advisers as opposed to those for depository institutions. *See* Release at 37685-37686. One of the key differences is that status as a depository institution is all-defining due to strict banking law restrictions

With this background in mind, we turn to an analysis of whether and how the Proposed Rule should apply to Charitable Advisers.

I. The Proposed Rule Should Not Apply to Charitable Advisers

A. Congress did not intend to include Charitable Advisers within the scope of Section 956.

The legislative history of the Dodd-Frank Act reflects Congress's intention that Subtitle E of Title IX ("Accountability and Executive Compensation"), including Section 956, apply to commercial financial interests. The conference report accompanying the Dodd-Frank Act, as adopted by the House of Representatives and Senate, states that the relevant provisions of the Act "require . . . 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" (emphasis added).[6]

Floor testimony from members of the House of Representatives further demonstrates that Congress was focused on Wall Street's largest, federally regulated financial institutions – and not charitable organizations. This floor testimony includes references to "executives at banks [taking] on more risk," the "risky compensation practices" of such banks,[7] the need to bring "accountability to big banks" and to "reign[] in Wall Street excess,"[8] and "megabanks and a flawed system leading to megaprofits of a tiny percentage of the American people, even a small percentage of the business community."[9] While Section 956 by its terms clearly extends to federally-regulated financial entities that are not technically "banks" for purposes of the federal banking laws, it is clear that Charitable Advisers have very little, if anything, in common with the "banks" and "megabanks" that Congress clearly contemplated when it enacted Section 956. Ironically, in their role as institutional investors, Charitable Advisers have often been in the forefront of questioning the incentives, structures and compensation practices at work in commercial investment management firms and other financial intermediaries, dating from well before the perceived need for Section 956 of the Dodd-Frank Act.

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on other activities. There are no comparable restrictions for investment advisers, with the result that investment adviser status can be incidental to overall financial or nonfinancial activities of the investment adviser status, and registered investment adviser status can be in the nature of a license. Charitable Advisers are the prime example of entities conducting investment management activities on an incidental basis.

[6] H.R. Rep. No. 111-517, at 873 (2010), http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_reports&docid=f:hr517.111.pdf.

[7] 155 Cong. Rec. E2982 (daily ed. Dec. 11, 2009) (statement of Rep. John Conyers, Jr.).

[8] 155 Cong. Rec. E3053 (daily ed. Dec. 17, 2009) (statement of Rep. Betty McCollum).

[9] 156 Cong. Rec. S3125 (daily ed. May 5, 2010) (statement of Sen. Robert P. Casey).

Section 956 defines "covered financial institution" to include "an investment advisor [sic], as that term is defined in section 202(a)(11) of the [Advisers Act]." As the Commission notes in the Release, Congress did not expressly limit the application of Section 956 to *registered* investment advisers. Nonetheless, while it is plausible that Congress intended to include within the scope of Section 956 certain unregistered advisors that could pose systemic risks to our financial system, we believe for the reasons noted above that Congress did not intend to include unregistered Charitable Advisers within such scope, and that accordingly, the best reading of Section 956 is one that gives effect to the Philanthropy Protection Act, which provides a sound and comprehensive set of exemptions from the federal securities laws to charitable organizations acting within their charitable boundaries. Without a clear expression of Congressional intent to the contrary, it is a perverse result to apply the Commission's incentive compensation rules to charitable organizations when Congress has expressly put such charitable organizations largely outside the scope of the vast majority of other federal securities laws. Moreover, as noted above, Section 203(b)(4) of the Advisers Act, which takes Charitable Advisers outside the scope of the regulation of registered investment advisers, is a clear manifestation of the Philanthropy Protection Act's intent to give Charitable Advisers special status within the federal securities law framework.

B. Congress did not intend regulation that cannot be enforced, strays from the boundaries of financial regulation, and carries with it costs that do not outweigh the related benefits.

It must be presumed that in the call for rulemaking under Section 956 of the Dodd-Frank Act, Congress sought to provide for enforceable rules. Thus, each of the agencies enumerated in that section was tasked with making rules with respect to the entities that they already regulate and certain affiliates of those entities. This is by no means the case with respect to Charitable Advisers, as to which the Philanthropy Protection Act provides protection from the application of federal securities laws and regulations. The Commission has no inherent power to inspect or direct the practices of Charitable Advisers except pursuant to authority such as that conferred by Section 206 of the Advisers Act,[10] which, despite its breadth, cannot fairly be read to speak to compensation practices. Compensation practices are woven into the internal affairs of an investment adviser, and, insofar as the SEC would otherwise have no authority to look into and regulate those internal affairs, the effort to regulate compensation from afar would suffer if not fail entirely.

The ways in which the Proposed Rule would apply to Charitable Advisers further support the point that Congress was likely not seeking to impose compensation regulation on them. For instance, under the Proposed Rule, a college president (or even a dean or faculty member) would be a "covered person" in the event that she received some form of incentive compensation, regardless of whether the incentives had nothing to do with investment performance, asset collection or investment management profitability. It makes no policy or practical sense to subject Charitable

[10] *See* Advisers Act § 206 (prohibiting, among other things, investment advisers from engaging in fraudulent practices or transactions).

Advisers to a scheme of regulation where the effect of doing so is to create the need to back them out of all of the commonly applicable provisions. Again, the Philanthropy Protection Act attempted to ensure that this did not happen.

Finally, as investment managers whose investment management activities are merely incidental to a non-profit core mission, Charitable Advisers do not engage in the same types of risky compensation practices or pose the same systemic risks contemplated by Congress when it enacted Section 956. In addition, Charitable Advisers are already subject to an extensive scheme of federal and state regulation and disclosure requirements, including requirements under the Internal Revenue Code relating to compensation and general supervision by state attorneys general.[11] As noted above, Charitable Advisers are further constrained by the parameters of the Charitable Adviser Exemption. Thus, in view of the absence of systemic risk posed by Charitable Advisers, the statutorily constrained compensation structures used by most Charitable Advisers, and the extensive regulation already applicable to Charitable Advisers, the costs of subjecting Charitable Advisers to the Proposed Rule greatly outweigh any perceived benefits.

II. <u>In the Alternative, the Commission Should Tailor the Definition of "Average Total Consolidated Assets" as Applied to Charitable Advisers</u>

For the reasons described above, we believe that the Commission should give effect to Congress's judgment, as expressed in the Philanthropy Protection Act, to exclude Charitable Advisers from the significant costs of federal securities regulation in connection with their philanthropic endeavors. If the Commission chooses to apply the Proposed Rules to Charitable Advisers, we respectfully urge the Commission to tailor the definition of "average total consolidated assets" as applied to Charitable Advisers to include only certain balance sheet assets associated with the Charitable Adviser's investment management activities, as described in more detail below. This clarification is necessary to ensure that Charitable Advisers are treated consistently with commercial investment advisers for purposes of determining whether an adviser's average total consolidated assets are significant enough to warrant regulation under the Proposed Rules.

The Proposed Rule provides, in accordance with Section 956, that covered financial institutions with assets of less than $1 billion shall not be subject to the requirements of Section 956. As applied to investment advisers, the Commission has appropriately proposed this threshold as a proprietary balance sheet test, as opposed to a test based on non-proprietary client AUM, in view of clear Congressional intent that the incentive-based compensation rules should apply only to large

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[11] *See, e.g.*, Internal Revenue Code § 503 (requiring a 501(c)(3) entity to pay reasonable compensation in order to maintain its federal tax exemption), Internal Revenue Code § 4958 (imposing an excise tax on disqualified persons receiving unreasonable compensation). *See also* the Uniform Prudent Management of Institutional Funds Act, a uniform state law in effect in forty-nine states, the District of Columbia and the U.S. Virgin Islands ("UPMIFA") (providing rules for the investment of funds held by charitable institutions and the expenditure of funds donated as "endowments" to those institutions).

financial institutions. The Commission notes in the Release that its interpretation is based on the text of Section 956, which refers to the (proprietary) "assets" of the financial institution.

In the case of Charitable Advisers, however, proprietary balance sheet assets typically include all or substantially all of the Charitable Adviser's AUM and other assets. This means that if the same balance sheet test is applied to Charitable Advisers, the Proposed Rule could apply to much smaller-scale investment management operations than Congress and the Commission presumably have in mind (assuming, of course, that Congress intended to cover Charitable Advisers in the first place, which we do not believe to be the case for the reasons set forth in Section I of this letter). For example, in the case of Charitable Advisers associated with colleges and universities, an institution may exceed the $1 billion threshold by carrying on its balance sheet not only proprietary investment assets, but also instructional property, plant and equipment, the latter of which almost certainly will be orders of magnitude larger than the institution's assets devoted to investment management activities. Even assuming for the moment that it somehow made sense to include such other assets for purposes of the $1 billion threshold, it should be recognized that there are substantial differences in accounting practices within the nonprofit world, leading to disparate and conceivably unfair results. For example, not all educational charities carry all of their properties and buildings on their balance sheets or even necessarily at fair value (*e.g.*, special collections).

Perhaps more relevant from a fairness perspective are the different regulatory results that might flow from differences in structures of Charitable Advisers. In a distinct minority of cases, a Charitable Adviser has been set up as a separate charitable supporting organization of the charity in chief, which continues to hold the investment assets managed by the Charitable Adviser. In these cases, the Charitable Adviser's investment management assets sit by themselves on the Charitable Adviser's books, and in all likelihood will never exceed the $1 billion threshold. Such a Charitable Adviser would, therefore, not be subject to the Proposed Rule. Charitable Advisers that are the charity in chief or otherwise have mixed their investment management operating assets with AUM or other assets could conceivably respond to attempted SEC regulation of compensation by segregating the relevant investment management operating assets in a newly formed Charitable Adviser (thereby putting such Charitable Advisers on equal footing with commercial investment advisers for purposes of calculating average total consolidated assets) to achieve the same result. It would be unfortunate were Charitable Advisers to be put to the significant expense of such a reorganization (including the expense of obtaining tax exemption for a new entity) simply to demonstrate that their investment management activities do not have sufficient scale to be included within the SEC's scheme of investment management compensation regulation.

For the reasons described above, we recommend that the Commission tailor the definition of "average total consolidated assets" as applied to Charitable Advisers to provide that the definition includes only the institution's proprietary assets dedicated to the activity of investment management (*i.e.*, the property and equipment dedicated to investment management activities) and not the institution's proprietary investment assets or other unrelated assets.

We believe that the special rule for Charitable Advisers can easily be included within the text that has been proposed for §303.2(b) of Title 17, Chapter II of the Code of Federal Regulations or in conclusive guidance from the Commission to the same end (proposed new language **bolded**):

> "(b) Average total consolidated assets means the average of a regulated institution's total consolidated assets, as reported on the regulated institution's regulatory reports, for the four most recent consecutive quarters. If a regulated institution has not filed a regulatory report for each of the four most recent consecutive quarters, the regulated institution's average total consolidated assets means the average of its total consolidated assets, as reported on its regulatory reports, for the most recent quarter or consecutive quarters, as applicable. Average total consolidated assets are measured on the as-of date of the most recent regulatory report used in the calculation of the average. Average total consolidated assets for a regulated institution that is an investment adviser **(other than any entity described in Section 203(b)(4) of the Investment Advisers Act of 1940, as amended)** means the regulated institution's total assets (exclusive of nonproprietary assets) shown on the balance sheet for the regulated institution for the most recent fiscal year end. **With respect to any institution described in Section 203(b)(4) of the Investment Advisers Act of 1940, as amended, average total consolidated assets means the institution's property, plant, equipment and other assets primarily used in the activity of serving as investment adviser as of the most recent fiscal year end."**

We appreciate the Commission's attention to our comments.

Sincerely,

/s/ Christopher A. Klem
Christopher A. Klem

/s/ Molly S. Moore
Molly S. Moore