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Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: Proposed Rule – Incentive-based Compensation Arrangements (File No. S7-12-11) (the "Release")

Ladies and Gentlemen,

The National Association of College and University Business Officers ("NACUBO")[1] is pleased to have the 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"). NACUBO respectfully requests 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 NACUBO members, as well as to many other charitable institutions in the nonprofit sector.

The reasons in support of the requested clarification are several and strong.

First, it should be recognized that the universe of Charitable Advisers is a tightly circumscribed group of "investment advisers" that is subject to a specialized set of legal and organizational considerations. In order to qualify as Charitable Adviser, an organization must itself be a charity that is a federally tax-exempt organization described in paragraphs (1) through (5) of Section 170(c) or in Section 501(c)(3) of the Internal Revenue Code of 1986, as

[1] NACUBO, founded in 1962, is a nonprofit professional organization representing chief administrative and financial officers at more than 2,100 colleges and universities across the country. NACUBO's mission is to promote sound management and financial practices at colleges and universities.

amended (the “Code”).[2] Commercial concerns cannot therefore qualify as Charitable Advisers.

Furthermore, in order to qualify for the Charitable Adviser Exemption, Charitable Advisers can only advise the narrow list of charitable funds and similar entities provided by that exemption and in incorporated provisions from Section 3(c)(10)(B) of the Company Act (the companion exclusion from the definition of “investment company” for pooled charitable fund arrangements). This list is a recognition of the reality that Charitable Advisers generally do not solicit third-party business but instead primarily manage money for their own accounts.[3] As will be shown below, the fact that Charitable Advisers manage proprietary funds and are not participating in the commercial marketplace puts their compensation policies at a distance from the intent of the Proposed Rule and Section 956 of the Dodd-Frank Act and would create special problems in any attempt to apply the Proposed Rule to Charitable Advisers.

Second, in light of the context, history and text of Section 956 of the Dodd-Frank Act, it seems clear that a Charitable Adviser was not intended to be a “covered financial institution,” as defined in subsection 956(e)(2). As noted above, Charitable Advisers are not commercial concerns soliciting business, dealing with the public or providing services to other participants in financial markets. Charitable Advisers did not create systemic risk in the financial crisis of 2008 and they do not do so today. In giving effect to Congress’ use of “financial” in the term “covered financial institution” in subsection 956(e)(2), one cannot help but notice that Charitable Advisers stand out on the list of investment advisers that are exempt from registration under Section 203(b) of the Advisers Act as the only advisers that are not engaged in a commercial business or what is commonly understood to be a “financial” business. The Commission is not in any significant way a “regulator” of Charitable Advisers, certainly not in the way that the Internal Revenue Service or state attorneys general are.[4]

The legislative history of the Dodd-Frank Act reflects Congress’ intention that Subtitle E of Title IX (“Accountability and Executive Compensation”), including Section 956, apply to commercial interests. The conference report accompanying the Dodd-Frank Act, as adopted

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[2] Section 3(c)(10)(D)(iii) of the Investment Company Act of 1940, as amended (the “Company Act”), as incorporated in Section 203(b)(4) of the Advisers Act. Section 170(c) of the Code sets forth a list of organizations and governmental bodies to which tax-deductible charitable contributions can be made, while Section 501(c)(3) sets forth a list of charitable organizations that qualify as exempt organizations under the Code. As a practical matter, many Charitable Advisers are described in both Section 170(c) and Section 501(c)(3).

[3] That is not to say that related and unrelated charities do not on occasion pool their investment assets in order to lower management costs and increase investment opportunities. Indeed, federal legislative policy as reflected in both the federal securities laws and the Code has encouraged various forms of pooling. *See* Section 3(c)(10)(B) of the Company Act and Section 501(f) of the Code. However, both the tax and securities laws operate to restrict significantly third-party activities and maintain the focus of Charitable Advisers on their own funds.

[4] The existing system of federal and state oversight of employee compensation paid by Charitable Advisers is considered in greater detail below. To be sure, any Charitable Adviser which is in fact an “investment adviser” (as defined in Section 202(a)(11) of the Advisers Act) remains subject to the general antifraud provisions of Section 206 of the Advisers Act. As will also be shown below, adherence to the Advisers Act’s antifraud provisions follows naturally from state statutory and fiduciary law specifically governing the management of endowment and other institutional funds, and does not, in and of itself, suggest that Charitable Advisers are federally-regulated entities in the same way that registered investment advisers are.

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 a serious adverse effects on economic conditions or financial stability" (emphasis added).[5]

Floor testimony from members of the House of Representatives further illustrates how far Charitable Advisers were away from the contemplation of the Congress in adopting Section 956. Thus, one finds references to "executives at banks [taking] on more risk,"[6] the "risky compensation practices" of such banks,[7] the need to bring "accountability to big banks" and to "rein in Wall Street excess,"[8] "profits and compensation in the banking industry,"[9] 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."[10] 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, Charitable Advisers cannot in any way be seen as fitting within even the broadest colloquial interpretation of "banks" or "megabanks."

Perhaps most importantly, the incentive-based compensation practices of Charitable Advisers are far removed from the concerns underlying Section 956. Many Charitable Advisers simply do not pay incentive compensation, except possibly annual bonuses that are a relatively small percentage of total compensation.[11] Sales-based incentives are rare, if not non-existent. As charities and tax-exempt organizations, Charitable Advisers cannot provide equity-based incentives. In order for a Charitable Adviser to provide significant amounts of deferred compensation, such compensation must be conditioned upon the future performance of substantial services by the prospective recipient and subject to a "substantial risk of forfeiture."[12] Indeed, as a result of the significant legal constraints relating to compensation paid by Charitable Advisers, any incentive compensation paid by such Advisers tends to avoid the major problems of misalignment between the interests of employer and employee that are sometimes found in the commercial sector. Moreover, as Charitable Advisers act primarily for their own account, unlike in the case of a relationship between, for example, a retail investment adviser and its unrelated client, the even more difficult problems of misalignment of interests between the client, on one hand, and the employer and employees of the investment adviser, on the other, are also avoided. This alignment is illustrated by the fact that the "client" of the Charitable Adviser often sets the Charitable Adviser's compensation,

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[5] 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.
[6] 155 Cong. Rec. E2982 (daily ed. Dec. 11, 2009) (statement of Rep. John Conyers, Jr.).
[7] *Id.*
[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).
[10] *Id.*
[11] Our understanding of the Proposed Rule is that a "covered financial institution" that does not provide incentive compensation would still be required to report on its compensation. *See* Release at 21196 ("[I]nstitutions with no incentive-based compensation arrangements or arrangements that affect only a few covered persons, would need to submit only limited information.").
[12] *See* Section 457(f) of the Code.

as well as the compensation of employees of the Adviser. In contrast, in the case of a more traditional adviser-client relationship, the client usually has little or no control over the adviser's compensation of its own employees.

To be sure, a plain reading of Section 956 shows that Congress intended to cast a wider net by defining "covered financial institution" to include "an investment advisor [sic], as that term is defined in section 202(a)(11) of the [Advisers Act]" than it would have cast by referring simply to advisers required to be registered under the Advisers Act. That Congress' intent was broader seems natural in the context of the Dodd-Frank Act, as Congress was also entirely rewriting the scheme of exemptions from registration under the Advisers Act and meanwhile applying new forms of regulation to certain categories of previously-exempted advisers, such as the new private fund adviser systemic risk reporting rules.[13] However, in all of the rewriting of the rules applicable to, and categories of, regulated investment advisers, Congress left fully in place and did not otherwise question the propriety of the Charitable Adviser Exemption – a strong indication that this unique category was not within the scope of those entities whose practices brought about the need for the Dodd-Frank Act.[14]

Third, it has never been clear whether Charitable Advisers are in fact "investment advisers" within the meaning of Section 202(a)(11) of the Advisers Act. Do they in fact "advise others," as required by that Section? As noted above, Charitable Advisers primarily manage money for their own account, but their management sometimes extends to charitable gift trust or fund arrangements in which donors and other beneficiaries hold a lifetime or a residuary interest, or to other organizations which are affiliated supporting organizations for federal income tax purposes,[15] or sometimes a step further to unrelated charities with common investment objectives. Do Charitable Advisers receive "compensation" for their efforts – another requirement of Section 202(a)(11)? Frequently, the costs of management are recovered by Charitable Advisers from the managed assets themselves, but this is not necessarily "compensation," particularly where the assets belong primarily to the Charitable Advisers in the first place.[16] Does it matter whether the Charitable Adviser is the college or university or other charity itself or is instead a separate charitable organization (most frequently organized for purposes of federal tax exemption as a supporting organization of the principal charity)?

It seems highly unlikely that Congress, through Section 956, was seeking to reopen these basic definitional questions that have long remained dormant. Prior to the adoption of the Philanthropy Protection Act of 1995 (the "PPA"), which provides a comprehensive set of exemptions from the federal securities laws to charitable organizations acting within their charitable boundaries, these questions were dealt with as matters of policy by the Commission

[13] *See* Form PF: Reporting Form for Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors.

[14] The only other untouched category of advisers exempt from registration under Section 203(b) of the Advisers Act is certain advisers to insurance companies. *See* Section 203(b)(2) of the Advisers Act.

[15] *See* Section 509(a)(3) of the Code.

[16] State law contemplates that the recovery of management costs can be folded into the investment return on endowment funds. *See* Comment to Subsection 4(d) of the Uniform Prudent Management of Institutional Funds Act, a uniform state law in effect in forty-eight states and the District of Columbia ("UPMIFA"). A version of UPMIFA has been introduced into law in the two remaining states (Florida and Mississippi).

and its staff. Without resolving the questions, the Commission provided conditional no-action assurances to charities. It is notable that, in the discussions of how the federal securities laws might be seen as applying to such arrangements as charitable pooled income funds, questions relating to the Advisers Act usually took back seat to the more pressing issues of whether the funds required registration under the Company Act or whether interests in the funds were subject to registration under the Securities Act of 1933, as amended.[17] The staff's statements of enforcement policy proved insufficient when the status of charitable funding arrangements under the federal securities laws was challenged in a national civil class action.[18] Congress reacted swiftly by adopting the PPA, which inserted the Charitable Adviser Exemption into the Advisers Act, to resolve the lingering status questions. It can fairly be said that the effect, if not the original purpose, of the Charitable Adviser Exemption has been to eliminate the inquiries as to "advising others" and "for compensation" under Section 2(a)(11) of the Advisers Act that are unique to investment advisers within the charitable realm.

Fourth, as both evidence that Congress could not have intended Section 956 to apply to Charitable Advisers and a reason why application of that provision to such Advisers would be misplaced, it should be noted that compensation paid by Charitable Advisers is already subject to an extensive scheme of federal and state regulation. At the core of this scheme is the notion that a federally tax-exempt organization must pay appropriate compensation in order to maintain tax exemption.[19] Also at work are a set of "intermediate sanctions" applicable to compensation paid by a tax-exempt organization, which impose excise taxes of up to 200% on disqualified persons receiving unreasonable compensation.[20] Moreover, through the public availability of the annual IRS Forms 990 filed by tax-exempt organizations, there is already extensive public disclosure of all aspects of compensation paid to officers, key employees and other highly-compensated persons at Charitable Advisers.[21]

The extensive scheme of regulation of compensation under the Code is supplemented in most states by the potential review of compensation and related business practices by state attorneys general, pursuant to their enforcement authority with respect to public charities. Again, in marked contrast to the commercial/financial sector, Charitable Advisers are generally subject to a provision of UPMIFA, the uniform state law governing endowment management and usage, that restricts endowment management expenses to "appropriate and reasonable" costs.[22]

Fifth, we note that several state universities or their investment management affiliates rely on the Charitable Adviser Exemption from registration under the Advisers Act. It must be presumed that, in the absence of a more clearly-expressed and constitutionally-justified intent

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[17] *See, e.g.*, Investment Company Act Release No. 11016 (Jan. 10, 1980); *see also* American Council on Education, SEC No-Action Letter (Dec. 14, 1972).
[18] Ozee v. American Council on Gift Annuities, 888 F. Supp. 1318 (N.D. Tex. 1995).
[19] *See* Section 503 of the Code.
[20] *See* Section 4958 of the Code and the regulations thereunder.
[21] The disclosure requirements apply to Charitable Advisers who file Form 990 but do not apply *per se* to investment management personnel where the Charitable Adviser is the college or university itself. However, at major universities with significant endowment funds, it is typical for there to be considerable coverage of investment management personnel in the Form 990 disclosures.
[22] *See* Section 3(c)(1) of UPMIFA.

to regulate employee compensation paid in the context of state government, Congress did not mean to do so. This in turn is further evidence that Congress did not intend to place Charitable Advisers within the sweep of Section 956 of the Dodd-Frank Act.

Sixth, as further evidence of Congressional intent and demonstration of the difficulty in applying the Proposed Rule to Charitable Advisers, we focus on that aspect of the Proposed Rule that provides that covered financial institutions with assets of less than $1 billion shall not be subject to the requirements of Section 956.[23] The Commission has appropriately proposed this threshold as a balance sheet test, as opposed to a test based on assets under management, in view of the clear Congressional intent that the incentive-based compensation rules apply only to investment advisers of significant size. Indeed, it is customary in the commercial investment adviser industry for assets under management to be very large relative to proprietary balance sheet assets. But this pattern does not hold true in the context of Charitable Advisers, where most often their proprietary balance sheet assets include substantially all of the Charitable Adviser's assets under management. In other words, if interpreted to apply to Charitable Advisers, the Proposed Rule would tend to apply to much smaller-scale investment management operations than Congress and the Commission presumably have in mind – an ironic twist given the limited intersection between the business of Charitable Advisers and the concerns underlying Section 956, and the Dodd-Frank Act more generally. This perverse application is made still worse in the case of Charitable Advisers that are colleges and universities by the possibility that those institutions may exceed the $1 billion threshold by carrying on their books not only proprietary investment assets (say, $250 million) but also unrelated instructional property, plant and equipment (say, $800 million).[24]

Seventh, if the Proposed Rule is revised to exclude Charitable Advisers, charitable investment assets would continue to receive the protections afforded by the Proposed Rule. That is because much of the investment management activity carried on by Charitable Advisers consists of selecting third-party investment managers and investing in other funds to carry out the charity's actual securities investment activities. In other words, Charitable Advisers rely on many of the commercial investment managers that will be subject to the Proposed Rule. The task of creating proper financial incentives is best addressed at the level of actual securities investment.

Finally, the costs of subjecting Charitable Advisers to the Proposed Rule greatly outweigh the related benefits, in view of the absence of systemic risk posed by Charitable Advisers, the relatively narrow compensation structures used by most Charitable Advisers, and the extensive regulation already applicable to compensation paid by Charitable Advisers. In the Release, the Commission has estimated the average cost of annual compliance for the smaller

[23] *See* Proposed Rule §§ 248.202 and 248.203(c), implementing the exemption provided by Section 956(f) of the Dodd-Frank Act.

[24] The perverse application of the $1 billion threshold does not stop here in the specialized context of colleges and universities. Within the higher education sector, there are institutions that include their instructional property, plant and equipment on their balance sheets, whereas other institutions rely on a time-honored exception to generally accepted accounting principles to exclude these amounts. As a result, the application of the $1 billion threshold likely would produce inconsistent results within the education sector.

investment advisers that would be subject to the Proposed Rule at $3 million.[25] Obviously, this estimate would be unlikely to hold for any "covered financial institution" that pays little or no incentive compensation. However, the estimate is a good indication that the Proposed Rule will in all events be an expensive scheme of regulation – as is perfectly natural in addressing a key concern of Congress as to the causes of the 2008 financial crisis. The PPA, however, stands as a Congressional judgment that the costs of federal securities regulation should not be visited on the charitable sector in the course of its philanthropic endeavors. We respectfully submit that the same judgment applies in the context of the Proposed Rule. Given the broad sweep of the Dodd-Frank Act, some unintended consequences are to be expected. The application of the Proposed Rule to Charitable Advisers would be one of these and should be averted in the rulemaking process.

We appreciate the Commission's attention to our comments.

Sincerely yours,

Matthew W. Hamill
Senior Vice President

[25] *See* Release at 21197. The estimate is well in excess of the total annual investment management-related employee compensation paid by many colleges and universities with total consolidated assets in excess of $1 billion.