SIDLEY AUSTIN LLP
ONE SOUTH DEARBORN
CHICAGO, IL 60603
(312) 853 7000
(312) 853 7036 FAX

BEIJING
BRUSSELS
CHICAGO
DALLAS
FRANKFURT
GENEVA
HONG KONG
LONDON
LOS ANGELES
NEW YORK
PALO ALTO
SAN FRANCISCO
SHANGHAI
SINGAPORE
SYDNEY
TOKYO
WASHINGTON, D.C.

FOUNDED 1866

May 31, 2011

Ms. Elizabeth M. Murphy, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: File Number S7–12–11: Proposed Rule relating to Incentive-Based Compensation Arrangements

Dear Ms. Murphy:

We appreciate the opportunity to respond to the SEC's Proposed Rules relating to Incentive-Based Compensation Arrangements, published April 14, 2011, in the Federal Register.[1] Our comments focus on the proposed method of determining the asset size for investment advisers subject to the Proposed Rule in connection with the definition of "covered institution" therein.

The Proposed Rules are designed to implement Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"), which provides that the SEC and other agencies shall prescribe regulations or guidelines to require each covered financial institution to make certain disclosures about incentive-based compensation arrangements, and to prohibit any such institutions from having incentive-based payment arrangements that the regulators determine encourage inappropriate risks by covered financial institutions. The rationale for the Proposed Rules is that incentive-based compensation arrangements encouraged risk-taking that was a significant cause of the recent financial crisis.

The Act defines "covered financial institution" to include any of the following types of institutions that have $1 billion or more in assets: (A) a depository institution or depository institution holding company, as such terms are defined in section 3 of the Federal Deposit Insurance Act ("FDIA") (12 U.S.C. 1813); (B) a broker-dealer registered under section 15 of the Securities Exchange Act of 1934 (15 U.S.C. 78o); (C) a credit union, as described in section 19(b)(1)(A)(iv) of the Federal Reserve Act; (D) an investment adviser, as such term is defined in section 202(a)(11) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-2(a)(11)); (E) the Federal National Mortgage Association (Fannie Mae); (F) the Federal Home Loan Mortgage Corporation (Freddie Mac); and (G) any other financial institution that the appropriate Federal

[1] Federal Register Vol. 76, No. 72 (April 14, 2011); SEC Release No. 34-64140; File No. S7-12-11.

regulators, jointly, by rule, determine should be treated as a covered financial institution for these purposes.

Definition of Total Consolidated Assets

The Proposed Rule's method of calculation of "assets" for investment advisers is consistent with the SEC's recent proposal (Release No. IA-3110; Rules Implementing Amendments to the Investment Advisers Act of 1940) that each investment adviser filing Form ADV Part 1A indicate whether the adviser had $1 billion or more in "assets," defined as the total assets shown on the balance sheet for the adviser's most recent fiscal year end. The proposed Rules Implementing Amendments to the Investment Advisers Act of 1940 makes a clear distinction between the adviser's assets, and its assets under management (known as "AUM"). However, using assets shown on the balance sheet is inherently misleading to an investor in connection with the Form ADV Part 1A, for reasons described below, and is similarly inappropriate for determining status as a covered institution under the Proposed Rule.

Generally accepted accounting principles ("GAAP") concerning balance sheet consolidation of hedge funds and their advisers creates the potential for a misleading result with respect to the application of the total consolidated assets test of the Proposed Rule. Pursuant to Accounting Standards Codification 810, consolidation of a private hedge fund's assets onto the books of its general partner (which is typically the investment adviser or an affiliate of the investment adviser) is contingent on whether the limited partners of such hedge fund have the substantive ability to dissolve or liquidate the limited partnership or otherwise remove the general partner without cause (often referred to as "kick-out rights"). Thus, if the limited partners have kick-out rights, the private fund's AUM is not included on the adviser's consolidated financial statements. Conversely, if the limited partners do not have kick-out rights, the fund's AUM will be included on the adviser's consolidated financial statements. Similar rules may be applied in the case of advisers of offshore funds. (The rules addressing consolidation in these situations are being reexamined by the FASB.) There may be other circumstances where relatively minor differences in fund terms may have large differences in accounting treatment.

It is our experience that many hedge funds do not provide kick-out rights, and therefore the balance sheet assets of many advisers include the assets of their affiliated funds under GAAP. The advisers are generally not concerned with this accounting treatment (there are few consequences of having a balance sheet that includes a significant contribution from noncontrolling interests in consolidated entities) and when necessary and after disclosure these advisers may provide a modified balance sheet presentation to remove such assets and present a more accurate picture of their financial condition.

However, the Proposed Rules and the Rules Implementing Amendments to the Investment Advisers Act of 1940 do create consequences, most certainly unanticipated, to this GAAP accounting consolidation rule. As currently drafted, the proposed definition of total

assets for purposes of an investment adviser's Form ADV would often include the adviser's AUM (which is already called for separately in the Form ADV). So whether an adviser is a "covered financial institution" would be dependant upon applicable GAAP rules (which may change) regarding the treatment of affiliated funds. This is bad policy, and we suggest that including assets that are not really owned by the adviser in total assets for the Proposed Rule can present a misleading picture.

Since we believe that the Commission clearly did not intend for this to be the result under the Proposed Rule,[2] the Proposed Rule should be revised to make explicit that the assets of an investment adviser's managed hedge funds (which might be characterized on a GAAP balance sheet as "noncontrolling interests in consolidated entities") should not be included in the definition of "total consolidated assets."

Retaining the Proposed Rule's asset definition in determining status as a "covered financial institution" would result in investment advisers with similar balance sheets (under a more appropriate calculation) and similar assets under management being treated differently under the Proposed Rule because of relatively minor differences in the governing documents of the funds managed by them (i.e., based on whether or not a "kick-out" right is included in those documents). Additionally, it could even result in certain "small entities," as defined by Commission rules in connection with the Investment Advisers Act of 1940 and the Regulatory Flexibility Act, becoming subject to the Proposed Rule.

Based on what the Commission may believe to be a distinction between AUM and total consolidated assets, in the release accompanying the Proposed Rules the Commission estimated that 68 registered investment advisers would have assets of $1 billion or more.[3] We believe that, based on data provided by the Investment Adviser Association, approximately 1320 investment advisers who manage private funds have AUMs in excess of $1 billion (this number is likely smaller than the actual number as not all advisers are known to the Association). If no more than 50% of these advisers do not provide limited partners with kick out rights (an estimate we believe conservative) or other attributes necessary to avoid consolidation, 660 advisers would qualify as "covered institutions" under the Proposed Rules, almost 10 times more than the number estimated by the SEC.

---

[2] See the "Estimated Burden" section of the release accompanying the Proposed Rule: The Commission's misunderstanding of the Proposed Rules was evident in its belief that investment advisers "with assets under management of $100 billion or more would have total consolidated assets of $1 billion or more." Federal Register Vol. 76, No. 72 (April 14, 2011), page 21188, footnote 40, implying that only the largest advisers in terms of AUM would be affected.

[3] "Based on date from the Investment Adviser Registration Depository… the SEC's Division of Investment Management estimates that 68 registered advisers with assets under management of at least $100 billion would have assets of $1 billion or more." Federal Register Vol. 76, No. 72 (April 14, 2011), page 21188, footnote 40. Federal Register Vol. 76, No. 72 (April 14, 2011), page 21188, footnote 40.

In our experience many of these 660 advisers will have assets on their (unconsolidated) balance sheets of well under $1 billion, and defining them as covered institutions would result in a significantly greater regulatory reach and burden than contemplated by the drafters of the Proposed Rules. Few if any of these smaller advisers are likely to be systemically important or in any way threaten the stability of the financial system. But many of these smaller investment advisers would be required to bear significantly greater record-keeping and compliance costs, at no benefit to the financial system.

In sum, the Proposed Rules contain a defect in the definitions of "covered financial entities" and "total consolidated assets" that would, if uncorrected, result in an excessive and unanticipated regulatory burden on small and mid-sized investment advisers in the hedge fund industry. Thus we strongly urge the Commission to reevaluate and revise the proposed definitions in light of the specific issues of the hedge fund industry to avoid such a result by excluding from the definition of "total consolidated assets" the assets of the advisers' managed funds.

Exclusion of Certain Assets in the Definition of Total Consolidated Assets

We believe that Congressional intent behind Section 956 of the Act was to help prevent a future financial crisis by correcting one of the perceived causes of the recent financial crisis, the misalignment of incentives between persons engaged in the financial services industry and investors. For example, the Financial Crisis Inquiry Commission concluded that "[c]ompensation systems ... too often rewarded the quick deal, the short-term gain—without proper consideration of long-term consequences. Often, those systems encouraged the big bet—where the payoff on the upside could be huge and the downside limited.[4]" Accordingly, the Proposed Rule attempts to safeguard the financial system against large-scale collapse by discouraging any compensation arrangements that encourage inappropriate risks by a financial institution by providing excessive compensation schemes that reward short term gain without corresponding consequences for failure.

In general, however, the interests of hedge fund advisers are generally aligned with those of their clients, and risks are borne in parallel. Investment advisers to hedge funds typically receive as compensation a profit allocation in the advised fund. When realized, this interest is reflected as an asset on the balance sheet of the adviser and as an investment in the managed fund. Rather than immediately withdrawing such interests in their sponsored hedge funds and distributing the resulting cash to its owners, many investment advisers leave such interests invested in the funds on the same basis as their investors, giving the adviser real "skin in the game" and precisely aligning the interests of the adviser and the investors, one of the goals of the

[4] The Financial Crisis Inquiry Report, Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States, January 2011, *Conclusions of the Financial Crisis Inquiry Commission,* page xix.

"skin in the game" provisions of the Act. Such investments create a strong disincentive to taking excessive risk on the part of the investment adviser's principals.

Because those investment advisers with total consolidated assets of $1 billion or less are exempted from the requirements of the Proposed Rule, investment advisers near such threshold will be incentivized to monitor their balance sheets at all times and, when approaching $1 billion in assets, be compelled to redeem the interests held by them in their affiliated hedge funds. If they distribute the interests in cash to their owners, they will reduce the total consolidated assets on their balance sheets allowing the adviser to stay below the asset threshold for covered institutions. Such a result would be perverse, as it would undermine the purposes of the Dodd-Frank Act and the Proposed Rules by incentivizing short term profit-withdrawal and discouraging investment advisers from maintaining large stakes in their affiliated hedge funds.

Furthermore, in the context of investment advisers engaged in the hedge fund industry, the Proposed Rule would discourage certain types of compensation that have the effect of closely aligning the incentives of covered persons (other than the owners who are already incentivized to act prudently) with the long term health of the investment adviser and the financial system. Hedge fund managers, to encourage alignment of interests of employees and investors, often grant to employees an interest in the adviser's retained interests in its managed funds as a form of deferred compensation. Until these assets are paid out to the employees they are reflected on the balance sheet of the investment adviser, even if earmarked for the employees. For investment advisers near the $1 billion threshold for covered institutions, retaining assets in the fund to allow this type of deferred compensation planning would become problematic as it could serve to push the investment adviser into the category of covered institution.

To avoid creating the incentive on the part of investment advisers to reduce the size of their balance sheets by distributing investments out of their funds and to their owners, we strongly urge the Commission to further revise the definition of "total consolidated assets" as it applies to investment advisers by excluding from the definition of "assets" interests held by investment advisers and their affiliates in their managed hedge funds. Such an exemption would be strongly supported by the underlying goals of the Dodd-Frank Act and would serve to encourage investment advisers to continue to closely align the incentives of covered persons with the long-term success of the investment adviser and its clients.

Sidley Austin LLP