Setting the global standard for investment professionals

17 June 2011

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Incentive-based Compensation Arrangements File No. S7-12-11

Dear Ms. Murphy:

CFA Institute[1] appreciates the opportunity to comment on this joint proposal that addresses incentive-based compensation arrangements. CFA Institute represents the views of investment professionals before standard setters, regulatory authorities, and legislative bodies worldwide on issues that affect the practice of financial analysis and investment management, education and licensing requirements for investment professionals, and on issues that affect the efficiency, integrity and accountability of global financial markets.

As requested in the proposal, our comments are specifically directed in this case to the SEC.

Executive Summary

We are concerned about the proposed approach of formally regulating incentive-based compensation arrangements. We do not believe that the SEC staff currently has the expertise or other resources to make the determinations about quality and nature of compensation schemes required in this proposal, nor do we think regulators/government are in the best position for making those determinations. What continues to fuel innovation in our increasingly-complex financial markets includes risk-taking and the appropriate rewards that accompany innovative foresight. Instead of adopting <u>regulations</u>, we urge the SEC to meet the Dodd-Frank requirements of section 956 by electing to propose <u>guidelines</u>, to address issues raised by incentive-based compensation arrangements.

[1] CFA Institute is a global, not-for-profit professional association of over 105,000 investment analysts, advisers, portfolio managers, and other investment professionals in 139 countries, of whom over 94,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 137 member societies in 58 countries and territories.

Charlottesville Hong Kong London
560 Ray C. Hunt Drive
PO Box 3668
Charlottesville, VA
22903-0668 USA
434 951 5499 tel
434 951 5262 fax
info@cfainstitute.org
www.cfainstitute.org

Discussion

In its attempt to implement section 956 of the Dodd-Frank Act ("Act"), the SEC has joined other agencies in proposing rules to establish requirements for certain companies that offer incentive-based compensation arrangements. The proposed regulations would prohibit companies from maintaining incentive-based compensation arrangements that encourage inappropriate risk-taking that could lead to material loss to the firm. For larger companies, the proposed regulations would require additional measures, including deferral of compensation, and board action with respect to compensation arrangements for certain personnel. Boards also would assume responsibility for monitoring compliance with company policies and procedures relating to their incentive-based compensation arrangements.

Regulation vs. Guidance

As a threshold issue, we disagree with the approach taken to address this area through explicit regulation. While the Act allows the agencies to jointly prescribe regulations or guidelines, the SEC has elected to propose regulations. We believe a much more reasonable approach would be to enhance the existing *principles* contained in Banking Agency Guidance, from which the proposed regulations draw.

We appreciate much of the concern and tone underlying this proposal that seeks to rein in pay practices that encourage executives and others to engage in high-risk activities to boost short-term returns while benefiting from an implied or expressed taxpayer guarantee. The events of the last several years have raised questions about decisions made by some and have spotlighted the numbers of executives who made substantial amounts of money while the companies they led suffered great losses. All of this has understandably called into question the roles of executives and the boards, and the influence of incentives in executive compensation arrangements. We believe that these arrangements deserve attention and that companies could benefit from detailed guidelines, as well as increased corporate governance measures.

We do not, however, believe that this is an area in which the use of explicit regulations is appropriate. In fact, we believe that trying to actually regulate executive compensation overreaches appropriate boundaries and may actually be detrimental to the forces that underlie our free market economy and on which competition in the private sector is built.

Instead of implementing the proposed regulations, we believe a different approach as follows is needed:

1. We encourage the SEC and other agencies to provide meaningful guidance along the lines discussed in the release.

2. We encourage the SEC to consider requiring additional pay disclosures that will highlight for shareowners and the investing public compensation packages that may raise questions.

3. We encourage the SEC to promulgate proxy access rules. We believe the ability of investors to nominate board members on company proxy statements in certain limited circumstances will enable investors to hold board members and senior executives more accountable for their decisions and their actions.

We believe these steps will help achieve the goals sought by these regulations, but in a manner that provides greater flexibility for companies, and lower cost for regulators.

Adequacy of Resources

Regardless of its best efforts, we do not believe that the SEC has the expertise or is otherwise in a position to consistently and accurately assess what pay practices lead to inappropriate risk-taking or excessive pay. This is due, in part, to the complexity of operations involved in the firms that would be covered by this regulation. While the release sets forth three standards for making this assessment[2], we question the degree to which SEC resources (both in terms of staff numbers and expertise) are adequate to perform the analysis this assessment would require. In fact, we believe that few regulators—even those who oversee a relatively homogenous set of institutions—are well-equipped to conduct the type of research that would result in more than a superficial/perfunctory conclusion.

Ambiguity of Standards

We also believe that the prohibitions in the regulations lack measurable criteria that will allow a realistic assessment. By its terms, the proposed regulations would prohibit incentive-based compensation arrangements that "encourage inappropriate risks" by the firms that "could lead to material financial loss." On its face, this may appear reasonable. However, in many companies, and depending on market movements and unforeseen developments, what will be seen as "inappropriate" in terms of risk that a firm undertakes is often only apparent with hindsight. In many situations, risk is not static, but must be evaluated against an ever-shifting stream of market and financial developments.

Moreover, a regulation that pivots even in part on what "could" lead to material financial loss has the potential to make the regulation almost meaningless. A company laboring under a regulation that may penalize it for actions that *could* lead to loss may be forced to decrease or otherwise limit even reasonable risk-taking for fear that its actions will be second-guessed. Given

[2] The three standards focus on the balance of risk and financial rewards (including risk adjustment of awards, deferral of payment, longer performance periods, and reduced sensitivity to short-term performance); compatibility with effective controls and risk management; and strong corporate governance.

that some risk is not only inherent, but desirable, in companies that seek to be profitable, this outcome would be unfortunate.

Effects on Competition

Our financial markets traditionally have operated with a combination of competition and market forces that includes compensation packages aimed at hiring the most qualified people for a particular position. By proposing to regulate compensation, the SEC is taking the free-market element out of the equation and replacing it with a formula against which it will now judge the reasonableness of that package. We are concerned that this approach places the covered institutions—in this case, brokers and advisers—in a weakened position to compete for the most talented and qualified staff. We do not believe that this potential outcome is in the best interests of our markets.

Conclusion

While we share the concern that unreasonable risk-taking may correlate with excessive compensation, we do not believe that direct government regulation is the key. Instead, we favor use of the proxy process and the issuance of guidelines as a means to more appropriately address this area.

Should you have any questions about our positions, please do not hesitate to contact Kurt N. Schacht, CFA at kurt.schacht@cfainstitute.org or 212.756.7728; or Linda L. Rittenhouse at linda.rittenhouse@cfainstitute.org or 434.951.5333.

Sincerely,

/s/ Kurt N. Schacht

Kurt N. Schacht
Managing Director, Standards and
Financial Market Integrity
CFA Institute

/s/ Linda L. Rittenhouse

Linda L. Rittenhouse
Director, Capital Markets Policy
CFA Institute