INVESTMENT COMPANY INSTITUTE

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November 22, 2021

Ms. Jill M. Peterson
Assistant Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

Re: *Reopening of Comment Period for Listing Standards for Recovery of Erroneously Awarded Compensation (File No. S7-12-15)*

Dear Ms. Peterson:

The Investment Company Institute (ICI)[1] recommends that the Securities and Exchange Commission (SEC) exclude all registered investment companies ("funds") from the scope of any final clawback rule. The SEC's 2015 proposal[2]—for which it recently reopened the comment period[3]—would direct the national securities exchanges to establish listing standards that would require each listed company to implement, and disclose, a policy providing for the recovery of erroneously awarded incentive-based compensation received by current or former executive officers.

The SEC should implement our recommendation—first articulated in our 2015 comment letter[4] and reiterated here—by explicitly excluding all funds from any final rule. Otherwise, internally managed

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[1] The Investment Company Institute (ICI) is the leading association representing regulated funds globally, including mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI's members manage total assets of $31.5 trillion in the United States, serving more than 100 million US shareholders, and $10.0 trillion in assets in other jurisdictions. ICI carries out its international work through ICI Global, with offices in Washington, DC, London, Brussels, and Hong Kong.

[2] *Listing Standards for Recovery of Erroneously Awarded Compensation*, SEC Release No. 33-9861 (July 1, 2015)(the "proposal"), available at www.sec.gov/rules/proposed/2015/33-9861.pdf.

[3] *Reopening of Comment Period for Listing Standards for Recovery of Erroneously Awarded Compensation*, SEC Release No. 33-10998 (Oct. 14, 2021)("Re-Opening Release"), available at www.sec.gov/rules/proposed/2021/33-10998.pdf.

[4] Letter from Dorothy M. Donohue, Deputy General Counsel, ICI, to Brent J. Fields, Secretary, SEC, dated Sept. 14, 2015 ("2015 ICI Letter"), available at www.sec.gov/comments/s7-12-15/s71215-25.pdf.

exchange-listed funds and certain other listed funds that provide incentive-based compensation to their chief compliance officers (CCOs) could be subject to the rule. The costs of such inclusion would outweigh any benefits.

I. The Proposal's Treatment of Funds

The proposal would exclude almost all funds on the following bases:

- Section 10D under the Securities Exchange Act of 1934 and Proposed Rule 10D-1 (the "proposed rule") do not apply to mutual funds because they do not issue listed securities.
- UITs are expressly excluded because of their structure and characteristics.[5]
- Listed registered management investment companies (which includes ETFs and many closed-end investment companies)(collectively, "listed funds")) are conditionally exempted "if such management company has not awarded incentive-based compensation to any executive officer of the company in any of the last three fiscal years… ."[6] As the proposal notes, listed funds, unlike most issuers, generally are externally managed (*i.e.*, managed by an investment adviser rather than its own employees) and therefore compensate few, if any, employees.[7] More generally, the proposal states that "the compensation structures of issuers of these securities render application of the rule and rule amendments unnecessary."[8]

Consequently, the Commission estimated that the proposal would capture an exceedingly small number of funds—approximately seven.[9]

However, we are concerned that the proposal technically—and perhaps unintentionally—may capture certain listed funds that directly compensate their CCOs, depending on the particulars of the compensation. The SEC requires each fund to designate a CCO, and for its board to approve the

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[5] Proposed Rule 10D-1(b)(2)(iii). The proposal notes that UITs do not have boards of directors, corporate officers, or investment advisers rendering investment advice; are not actively managed; and do not file shareholder reports. Proposal at 20-21.

[6] Proposed Rule 10D-1(b)(2)(iv).

[7] Proposal at 19.

[8] Proposal at 11.

[9] Proposal at 108. We believe this is a reasonable estimate of the number of internally managed listed funds. In arriving at this estimate, the SEC almost certainly excluded all externally managed listed funds, not considering how some listed funds compensate their CCOs.

CCO's designation and compensation.[10] One could construe the proposed definition of "executive officer" to cover listed fund CCOs.[11]

Unfortunately, the amount of publicly available information about fund CCO compensation practices is limited. ICI and Independent Directors Council conduct limited surveying of ICI members on this topic, and based on their most recent survey, just under half of respondents stated that their investment advisers pay all of fund CCOs' compensation.[12] Further, Management Practice, Inc.'s 2021 survey of mutual fund CCO compensation and organizational practices indicates that about 36% of respondents' investment advisers pay all of CCOs' compensation; that a large percentage of respondents (93%) indicated that they received bonuses; and that a relatively small percentage of those receiving bonuses identified "Fund Performance" as at least a partial basis for their bonuses (15%).[13]

In sum, some listed funds pay some or all of CCO compensation, although the lack of public information about these compensation packages and the fact-specific inquiry needed to determine applicability of any final rule to them make it difficult to discern the rule's potential reach to those funds. If the SEC does *not* provide a complete exclusion for funds as we recommend, then the SEC should clarify that listed fund CCOs are not included within the rule's definition of "executive officer."

II. Why All Funds Should Be Excluded

The proposal asks whether it should unconditionally exempt funds from the proposed listing standards. As we stated in 2015, this would be appropriate and consistent with the proposal's policy objectives, for the following four reasons.[14]

A. The concerns behind this Dodd-Frank Act provision do not apply to listed funds

Neither the legislative history of the Dodd-Frank Act nor commentary at the time of the legislation indicates that the purpose of this provision was to address abuses with respect to listed funds. By

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[10] Rule 38a-1(a)(4) under the Investment Company Act of 1940 ("Investment Company Act").

[11] Proposed Rule 10D-1(c)(3). The proposed definition includes "any other officer who performs a policy-making function… ." Based on the SEC's estimate of funds potentially subject to the proposal—approximately seven—we do not think that the SEC had listed fund CCOs in mind when defining this term. *See supra*, note 9 and accompanying text.

[12] This number is not much different from that reported in the 2015 ICI Letter, where just *over* half of respondents stated that their investment advisers pay all of fund CCOs' compensation.

[13] This 2021 survey's questionnaire is available at www.mpiweb.com/compensation/chief-compliance-officer-compensation-survey-2021/. By comparison, Management Practice, Inc.'s 2015 survey indicated that half of respondents' investment advisers pay all of CCOs' compensation; that 95% of respondents indicated that they received bonuses; and that 17% of those receiving bonuses identified "Fund Performance" as at least a partial basis for their bonuses.

[14] We further elaborate on these four points in the 2015 ICI Letter.

sweeping in certain listed funds, the proposal goes beyond effectuating Congressional intent. Moreover, the determination to extend the proposal to these listed funds is not based on any evidence, or even a belief, that they engage in the problematic accounting and incentive-based compensation practices that gave rise to the statutory provision.

B. The SEC excluded all funds from certain prior compensation-related rulemakings

The characteristics of listed funds, whether internally or externally managed, are similar in most salient respects. The SEC previously excluded all funds from executive compensation rules by not requiring them to disclose certain information related to executive compensation under Item 402 of Regulation S-K, as is required for operating companies.[15] The SEC predicated the 1992 executive compensation rule on fulfilling the regulatory objective of providing shareholders with additional information regarding compensation and the potential incentives that various compensation structures can create, and specifically chose to exempt *all* funds.

Since 1992, the SEC has periodically amended Item 402, and has often refrained from extending new disclosure requirements to funds. In the pay ratio disclosure amendments adopted in 2015, the SEC excluded all funds.[16] Similarly, in its 2015 pay versus performance rule proposal, the SEC opted against including funds:

> We believe that the management structure of, and the regulatory regime governing, registered investment companies differentiate them from issuers that are operating companies. Registered investment companies, unlike other issuers, are generally externally managed and often have few, if any, employees that are compensated by the registered investment company. Rather, such employees are generally compensated by the registered investment company's investment adviser.[17]

The SEC recognized the general similarities among all funds and determined not to impose new requirements on the few internally managed funds in the industry.

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[15] *Executive Compensation Disclosure*, SEC Release No. 33-6962 (Oct. 16, 1992). In the adopted rule amendments, the SEC explicitly excluded all funds from the executive compensation disclosure requirements of revised Item 402 "because the management functions of *most* such companies are performed by external managers. Instead, registered investment companies will comply with disclosure requirements prescribed by applicable Investment Company Act registration statements." (Emphasis added) Listed funds provide specified disclosure about executive compensation, to the extent applicable, in their registration statements and proxy statements.

[16] *Pay Ratio Disclosure*, SEC Release No. 33-9877 (Aug. 5, 2015), at n. 90.

[17] *Pay Versus Performance*, SEC Release No. 34-74835 (Apr. 29, 2015), at 11.

C. Listed funds' financial statements and accounting practices are less complex than those of operating companies

Under the proposal, a listed company's policy would require a clawback of erroneously awarded incentive-based compensation upon "an accounting restatement due to the material noncompliance of the issuer with any financial reporting requirement under the securities laws… ."[18] The SEC now is considering broadening this requirement to include *all* required restatements made to correct an error in previously issued financial statements.[19]

Financial statements and accounting practices of listed funds (and funds generally) are inherently less complex than those of operating companies due to the limited nature of their operations (*i.e.*, issuing shares and investing the proceeds in a portfolio of investment securities). Listed funds prepare their financial statements under the industry-specific reporting model described in FASB ASC 946. The overall objective of their financial statements is to present the investment portfolio, results of operations, changes in net assets, and financial highlights from investment activities. Listed fund financial statements also must comply with Article 6 of Regulation S-X.

Listed fund financial statements entail fewer estimates and judgments than operating company financial statements. For example, listed funds typically have no intangibles, loan loss reserves, income tax expense, inventories, or discontinued operations. Further, listed fund management has fewer choices in the application of accounting policies. For example, all securities are recognized at fair value with the change in fair value reflected in earnings (*i.e.*, no securities are classified as available for sale or held to maturity). In addition, listed funds do not utilize hedge accounting. Finally, listed funds do not have reportable segments, and they generally are not required to provide a statement of cash flows.[20] Consequently, accounting restatements are relatively rare for listed funds (and indeed, funds generally), and such restatements generally do not affect funds' net asset values (NAVs) or total return calculations (the most relevant fund metrics for purposes of this proposal).[21] Thus, even for those listed funds that could conceivably pay incentive-based compensation to their executive officers, the likelihood of them ever using their required clawback policies is highly remote.

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[18] Proposed Rule 10D-1(b)(1).

[19] Re-Opening Release at 9.

[20] *See* FASB ASC 230-10-15-4.

[21] For example, a restatement relating to characterization of an item as income versus gain, or expense versus loss, would not affect a fund's NAV or total return.

D. Costs of implementation and compliance for any potentially affected funds will outweigh any benefits

The proposal would impose tangible costs on a number of listed funds. At a minimum, they will have to evaluate the SEC's final rule and form amendments and applicable exchange rules, evaluate their current executive compensation programs in light of those final rules, and, if necessary, prepare (likely with assistance from outside counsel) a compliant clawback policy. These evaluations are not likely to be quick or easy for any listed fund, particularly for those that compensate their CCOs directly.

And if past experience is any indication, listed funds almost certainly will never use these clawback policies. Nevertheless, to the extent that the SEC or exchanges amend their rules in the future, these listed funds would need to monitor such developments and modify their policies accordingly.

Any benefits likely would be theoretical at best, and certainly not exceed the costs. There is no evidence of sub-standard accounting practices among listed funds currently, so there is little reason to believe their accounting practices will improve appreciably as a result of the any potential deterrent effect.[22] And as discussed above, listed funds' financial statements and the processes and judgments behind them are less complex than those of operating companies, so listed funds likely would not experience the same incremental improvement in their accounting practices and financial statements.

III. Responses to Fund-Related Questions in Re-Opening Release

Finally, turning to the fund-specific questions in the Re-Opening Release, we are aware of no significant changes or developments since 2015 with respect to payment of incentive-based compensation by listed funds that should affect their treatment under the proposed rule.[23] And we continue to believe that a

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[22] Listed funds' executive officers already are subject to a number of meaningful deterrents with respect to accounting. Section 304 of the Sarbanes-Oxley Act contains a clawback provision, applicable to chief executive officers and chief financial officers, which is triggered when an accounting restatement is the result of issuer misconduct. Rule 30a-2 under the Investment Company Act and Form N-CSR require principal executive officers and principal financial officers to make a number of certifications in connection with the filing of the listed funds' annual and semi-annual reports. Under Section 906 of the Sarbanes-Oxley Act, violations of certain of these certification requirements are subject to specific federal criminal penalties. Form N-CSR also requires listed funds to disclose whether, as of the end of the period covered by the report, the registrant has adopted a code of ethics that applies to the registrant's principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions, regardless of whether these individuals are employed by the registrant or a third party. Finally, a listed fund board may fire the fund's officers (or terminate the fund's investment advisory agreement) if the board deems the fund's financial statements and accounting practices to be less than satisfactory.

[23] *See supra*, notes 12 and 13 and accompanying text for updates on survey information related to CCO compensation. If the SEC does not exclude all funds or clarify that listed fund CCOs are not included within the rule's definition of "executive officer," it could inadvertently sweep in listed funds that pay their CCOs compensation that could be construed as "incentive-based." This in turn could significantly affect the rule's impact on funds and likely would mean that the proposal's aggregate cost estimate for funds was significantly understated.

fund's status as internally or externally managed should not impact its treatment. Again, for the reasons set forth above, any final rule should exclude all funds.

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If you have any questions on our comment letter, please feel free to contact me at [redacted] or Matthew Thornton at [redacted].

Sincerely,

/s/ Dorothy Donohue

Dorothy Donohue
Deputy General Counsel—Securities Regulation