



1401 H Street, NW, Washington, DC 20005-2148, USA  
202/326-5800 [www.ici.org](http://www.ici.org)

September 14, 2015

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

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

Dear Mr. Fields:

The Investment Company Institute (“ICI”)<sup>1</sup> appreciates the opportunity to comment on the Securities and Exchange Commission (“SEC” or “Commission”) proposal regarding recovery of erroneously awarded compensation.<sup>2</sup> The Proposal would implement Section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank Act”). This provision, which adds new Section 10D to the Securities Exchange Act of 1934 (“Exchange Act”), requires the SEC to adopt rules directing the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that is not in compliance with Section 10D’s requirements for (i) disclosure of the issuer’s policy on incentive-based compensation, and (ii) recovery of incentive-based compensation that is received in excess of what would have been received under an accounting restatement.

ICI supports the Commission’s determination to exclude most registered investment companies from the Proposal. We recommend, however, that for the reasons discussed below the Commission exclude *all* registered investment companies.

---

<sup>1</sup> The Investment Company Institute (ICI) is a leading, global association of regulated funds, 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 U.S. fund members manage total assets of \$18.2 trillion and serve more than 90 million U.S. shareholders.

<sup>2</sup> *Listing Standards for Recovery of Erroneously Awarded Compensation*, SEC Release No. 33-9861 (July 1, 2015)(the “Proposal” or the “Release”), available at [www.sec.gov/rules/proposed/2015/33-9861.pdf](http://www.sec.gov/rules/proposed/2015/33-9861.pdf).

## **I. Background and Applicability of the Proposal to Registered Investment Companies**

Proposed Rule 10D-1 under the Exchange Act (the “Proposed Rule”) first would require each national securities exchange and national securities association that lists securities to file with the SEC proposed rules that comply with finalized SEC Rule 10D-1. Then, the Proposed Rule and the applicable listing standard would require a listed issuer to adopt a written policy providing for the recovery of erroneously awarded incentive-based compensation to executive officers (“clawback policy” or “recovery policy”).<sup>3</sup>

The Proposed Rule also would subject certain registered investment companies to new disclosure requirements. In particular, amended Form N-CSR would require a registered management investment company subject to the Proposed Rule to provide annual disclosure about accounting restatements that required recovery of excess incentive-based compensation and file as an exhibit its recovery policy.<sup>4</sup> Amended Schedule 14A would require similar disclosure about accounting restatements and recoveries in proxy statements and information statements relating to the election of directors.

As an initial matter, Section 10D and the Proposed Rule do not apply to registered mutual funds because they do not issue listed securities. Moreover, in crafting the Proposed Rule, the SEC exempted the securities of most registered investment companies because “the compensation structures of issuers of these securities render application of the rule and rule amendments unnecessary.”<sup>5</sup> The Proposed Rule expressly excludes unit investment trusts (“UITs”), because of their particular structure and characteristics.<sup>6</sup> The Proposed Rule conditionally exempts listed registered management

---

<sup>3</sup> The preparation of an accounting restatement due to the issuer’s material noncompliance with any financial reporting requirement under the securities laws would trigger application of an issuer’s clawback policy. Among other things, the Proposed Rule contains detailed provisions about: what constitutes “incentive-based compensation;” who qualifies as an “executive officer;” how to determine the relevant 3-year time period for measuring the incentive-based compensation subject to recovery; what constitutes “receipt” of incentive-based compensation; how to calculate erroneously awarded compensation; and how to recover erroneously awarded compensation and determine whether recovery would be “impracticable.”

<sup>4</sup> Specifically, a fund would disclose, for each restatement, the date on which the fund was required to prepare an accounting restatement; the aggregate dollar amount of excess incentive-based compensation attributable to such accounting restatement; the estimates that were used in determining the excess incentive-based compensation, if the financial reporting measure related to a stock price or total shareholder return metric; and the aggregate dollar amount of excess incentive-based compensation outstanding. If a fund decided *not* to pursue recovery, it would describe its reason and disclose the name of the executive officer and amount forgone. A fund also would disclose, if applicable, the name of each individual from whom excess incentive-based compensation had been outstanding for 180 days or longer, along with the outstanding amount owed. A fund also would provide this disclosure as a filing exhibit in XBRL format.

<sup>5</sup> Proposal at 11.

<sup>6</sup> Proposal at 20-21. In particular, the Release 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.

investment companies (which includes exchange-traded funds (“ETFs”) and closed-end investment companies)(“Listed Funds” or “Funds”) “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... .”<sup>7</sup> As the Release 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.<sup>8</sup> The SEC estimates that the Proposed Rule would apply to an exceedingly small number of registered investment companies—approximately seven.<sup>9</sup>

## **II. Excluding All Listed Funds from the Proposal Is Appropriate**

The Commission asks in the Release whether it should unconditionally exempt Listed Funds from the proposed listing standards. For the reasons set forth below, an unconditional exemption for Listed Funds would be appropriate and consistent with the Proposal’s policy objectives.

### **A. 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. We are concerned, therefore, that the Proposal, by sweeping in certain Listed Funds, 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. Excluding Listed Funds Would be Consistent with Commission Precedent and Reflective of Their Structure and Accounting Practices**

The Commission notes in the Release that Listed Funds are, generally speaking, externally managed and do not pay incentive-based compensation to fund employees (if they have them). These are generally sound observations, and they support the Proposed Rule’s exemption for certain Listed Funds. But the Commission should go farther and exempt *all* registered investment companies. For the reasons set forth by the Commission, and those set forth below, we submit that there is virtually no justification or benefit associated with subjecting a small number of Listed Funds to the Proposal. For this purpose, Listed Funds, whether internally or externally managed, do not present the same concerns as operating companies.

---

<sup>7</sup> Proposed Rule 10D-1(b)(2)(iv).

<sup>8</sup> Proposal at 19.

<sup>9</sup> Proposal at 108. In arriving at this estimate, the Commission likely excluded all externally managed Listed Funds, not considering how some Listed Funds compensate their chief compliance officers (“CCOs”). Because some Listed Funds pay some or all of their CCOs’ compensation, this estimate might be somewhat understated. *See infra*, Section II.C.

## **1. The SEC Excluded All Registered Investment Companies From Prior Compensation-Related Rulemakings**

The characteristics of Listed Funds, whether internally or externally managed, are similar in most salient respects. The Commission previously excluded all registered investment companies 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.<sup>10</sup> The Commission 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* registered investment companies.

Since 1992, the SEC has periodically amended Item 402, and has often refrained from extending new disclosure requirements to registered investment companies. In the pay ratio disclosure amendments that the SEC recently adopted, the Commission excluded all registered investment companies.<sup>11</sup> Similarly, in its recent pay versus performance rule proposal, the SEC pointedly opted against including registered investment companies:

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.<sup>12</sup>

The SEC recognized the general similarities among all registered investment companies and determined not to impose new requirements on the few internally managed funds in the industry. We believe the SEC should take a similar tack with respect to this Proposal.

---

<sup>10</sup> *Executive Compensation Disclosure*, SEC Release No. 33-6962 (Oct. 16, 1992) ("1992 Executive Compensation Rule"). In the adopted rule amendments, the Commission explicitly excluded all registered investment companies 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.

<sup>11</sup> *Pay Ratio Disclosure*, SEC Release No. 33-9877 (Aug. 5, 2015), at n. 90.

<sup>12</sup> *Pay Versus Performance*, SEC Release No. 34-74835 (Apr. 29, 2015), at 11.

## **2. Listed Funds' Financial Statements and Accounting Practices Are Less Complex Than Those of Operating Companies**

Financial statements and accounting practices of Listed Funds (and registered investment companies 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.<sup>13</sup> Consequently, accounting restatements are relatively rare for Listed Funds (and indeed, registered investment companies 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).<sup>14</sup> Thus, even for those relatively few Listed Funds that pay incentive-based compensation to their executive officers, the likelihood of them ever using their required clawback policies is highly remote.

Because of the limited nature of Listed Fund operations, Listed Fund financial statement audits also are less complex than those of operating companies. The Public Company Accounting Oversight Board ("PCAOB") has recognized this. The PCAOB and the Financial Accounting Standards Board ("FASB") are funded through accounting support fees paid by public companies based on their market capitalization. Investment companies pay accounting support fees at a rate equal to 10% of the rate paid by operating companies. When adopting the 10% fee rate structure applicable to investment companies, the PCAOB stated, "In recognition of the structure of investment companies and the relatively less-complex nature of investment company audits (as compared to operating company audits), investment companies would be assessed at a lower rate."<sup>15</sup>

---

<sup>13</sup> See FASB ASC 230-10-15-4.

<sup>14</sup> For example, a restatement relating to characterization of an item as income versus gain, or expense versus loss, would not affect the fund's NAV or total return.

<sup>15</sup> See PCAOB Release No. 2003-003 (April 18, 2003).

Finally, Congress made a critical distinction between operating companies and registered investment companies when it mandated annual assessments of the effectiveness of internal control over financial reporting (“ICFR”). Generally, ICFR is the system of controls designed to provide reasonable assurance that the company’s financial statements are reliable and prepared in accordance with generally accepted accounting principles. In Section 404 of the Sarbanes-Oxley Act of 2002 (“Sarbanes-Oxley Act”), Congress required a public company to assess its ICFR; report the results; and engage its independent auditor to audit the effectiveness of the company’s ICFR. In contrast, Congress exempted registered investment companies from these ICFR requirements.<sup>16</sup>

### **C. Costs of Implementation and Compliance 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 the 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 clawback policy that complies with those rules.

These evaluations are not likely to be quick or easy for internally managed Listed Funds, or for other Listed Funds that technically, and perhaps unintentionally, might fall within the ambit of the Proposal. It is Listed Fund CCOs and the manner in which they receive compensation that give rise to this second category. The SEC requires each registered investment company to designate a CCO, and for its board to approve the CCO’s designation and compensation.<sup>17</sup> One could construe the proposed definition of “executive officer” to cover Listed Fund CCOs.<sup>18</sup> Unfortunately, the amount of publicly-available information about CCO compensation practices (for Listed Funds or registered funds generally) is quite limited. We are aware of two industry surveys that provide a general sense of the potential reach of the Proposal to Listed Funds because of their CCO compensation practices. ICI and Independent Directors Council conduct limited surveying of ICI members on this topic. Based on the most recent survey of registered investment companies generally, just over half of respondents stated that their investment advisers pay all of fund CCOs’ compensation; the remaining respondents stated

---

<sup>16</sup> See Section 405 of the Sarbanes-Oxley Act.

<sup>17</sup> Rule 38a-1(a)(4) under the Investment Company Act of 1940 (“Investment Company Act”).

<sup>18</sup> 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 registered investment companies 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. If the SEC did *not* intend to include Listed Fund CCOs within this definition, it should amend the definition accordingly or provide guidance to that effect.

that the funds pay some or all of their CCOs' compensation.<sup>19</sup> Further, we know from Management Practice, Inc.'s 2015 survey of mutual fund CCO compensation and organizational practices that half of respondents indicated that their investment advisers pay all of their compensation; that a large percentage of respondents (95%) 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 (17%).<sup>20</sup> In sum, Listed Funds may pay some or all of CCO compensation, although the lack of public information about these particular compensation packages and the fact-specific inquiry needed to determine applicability of the Proposed Rule to them make it difficult to discern the extent to which the Proposal could reach those Listed Funds.

If past experience is any indication, Listed Funds almost certainly will never use these clawback policies. Despite that, 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. And as the SEC points out in the Release, the Proposed Rule could result in executive officers demanding that incentive-based compensation comprise a smaller portion of their pay packages (which in turn could result in a sub-optimal alignment of interests of executive officers and Listed Fund shareholders), or receiving a greater total amount of compensation, to account for the possibility that the awarded incentive-based compensation may be reduced due to future recovery.<sup>21</sup> Listed Fund shareholders ultimately will bear these costs.

Any benefits likely would be theoretical at best, and certainly not of a magnitude exceeding the Proposal's costs.<sup>22</sup> 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 Proposal's deterrent effect.<sup>23</sup> And as discussed above, Listed Funds financial statements

---

<sup>19</sup> See also *Board Oversight of Fund Compliance*, Independent Directors Council Task Force Report, September 2009, available at [www.idc.org/pdf/idc\\_09\\_compliance.pdf](http://www.idc.org/pdf/idc_09_compliance.pdf), for a general discussion of CCO compensation practices and relevant board considerations.

<sup>20</sup> A description of this survey, a summary of its findings, and the questionnaire used are available at [www.mfgovern.com](http://www.mfgovern.com). The questionnaire does not define "Fund Performance," and solicits only a Yes or No response for this item.

<sup>21</sup> Proposal at 104.

<sup>22</sup> See, e.g., Commissioner Daniel M. Gallagher, *Dissenting Statement at an Open Meeting On Dodd-Frank Act "Clawback" Provision* (July 1, 2015), at n. 18 ("As to registered investment companies, given the limited number of them that the rule might impact, I am simply not convinced that the costs of adding this regulatory requirement to this entire segment of issuers is worth the benefit. ... However, those that do not [pay incentive-based compensation] may feel constrained from doing so in the future; and those that do so now may decide to stop. All such investment companies will at a minimum incur a cost to review the rule and determine whether the exemption applies—and then to ensure that the conditions of the exemption are met in the future.").

<sup>23</sup> 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

Mr. Brent J. Fields  
September 14, 2015  
Page 8 of 8

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 as operating companies.

\* \* \*

ICI appreciates and supports the goal of new Section 10D of the Exchange Act to provide companies with a means of recovering erroneously awarded compensation. We support the Commission's decision to exclude UITs and most other Listed Funds from the Proposal's requirements and recommend that the Commission similarly exclude *all* Listed Funds. If you have any questions on our comment letter, please feel free to contact me at (202) 218-3563 or Matthew Thornton at (202) 371-5406.

Sincerely,

/s/ Dorothy Donohue

Dorothy Donohue  
Deputy General Counsel—Securities Regulation

---

financial officers, which is triggered when an accounting restatement is the result of issuer misconduct. (The amount of required recovery is limited to compensation received in the 12-month period following the first public issuance or filing with the Commission of the improper financial statements.) 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. (Form N-Q filings also include some of these certifications.) Under Section 906 of the Sarbanes-Oxley Act, violations of certain of these certification requirements are subject to specific federal criminal penalties. 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.