

MEMO# 16784

November 19, 2003

SEC PROPOSES, AND GRANTS ACCELERATED APPROVAL TO, NYSE AND NASDAQ CORPORATE GOVERNANCE RULE PROPOSALS

[16784] November 19, 2003 TO: CLOSED-END INVESTMENT COMPANY COMMITTEE No. 61-03 SEC RULES COMMITTEE No. 94-03 RE: SEC PROPOSES, AND GRANTS ACCELERATED APPROVAL TO, NYSE AND NASDAQ CORPORATE GOVERNANCE RULE PROPOSALS The Securities and Exchange Commission has solicited comments on proposed corporate governance standards and related changes to certain other rules of the New York Stock Exchange and Nasdaq Stock Market, Inc.¹ The SEC simultaneously approved the proposals, which are summarized below, on an accelerated basis. The recommended corporate governance standards that would apply to closed-end investment companies or exchange-traded investment companies are specifically noted. Comments on the proposals are due to the SEC no later than December 3rd. If you have comments that you would like the Institute to consider including in a comment letter, please provide them to me by November 25th by phone at 202.218-3563, fax at 202.326-5827, or email at ddonohue@ici.org. I. NYSE Proposal A. General Applicability to Investment Companies The NYSE determined that most of the proposed corporate governance standards discussed below should not apply to closed-end investment companies "given the pervasive federal regulation applicable to them." However, the NYSE did recommend that closed-end investment companies be required to comply with: most of the recommended enhanced audit committee provisions; the requirement that each listed company chief executive officer certify to the NYSE each year that he or she is not aware of any violation by the company of NYSE listing standards; and the requirement that each listed company chief executive officer 1 See SEC Release No. 34-48745 (November 4, 2003) [68 FR 64154 (November 12, 2003)] ("Release"). The Release can be accessed on the SEC's website at <http://www.sec.gov/rules/sro/34-48745.htm>. The principal text of the NYSE's rule filing can be accessed on the NYSE's website at <http://www.nyse.com/pdfs/finalcorpgovrules.pdf>. The Nasdaq website states that as final rules will be posted shortly, it is necessary to click on <http://www.nasdaq.com/about/RecentRuleChanges.stm> and view amendments filed with the SEC to view the text of Nasdaq's rules. 2 promptly notify the NYSE after any executive officer of the listed company becomes aware of any material noncompliance with Section 303A of the NYSE Listed Company Manual. In addition, the NYSE determined not to apply any of the recommended corporate governance standards to exchange-traded investment companies organized as open-end investment companies except for the audit committee requirements to the extent required by Rule 10A-3 under the Securities Exchange Act of 1934, and the prompt notification requirement regarding any material noncompliance with

Section 303A. Exchange-traded investment companies organized as unit investment trusts would not be subject to any of the proposed corporate governance standards. B. Proposed Corporate Governance for NYSE-Listed Companies Independent Directors – Companies generally would be required to have a majority of independent directors. In addition, the definition of “independent director” would be tightened so that no director qualifies as independent unless the board of directors affirmatively determines that the director has no material relationship with the listed company. Under the NYSE’s standards, no director who is a former employee of the listed company would be considered to be independent until three years after the employment has ended. Executive Sessions -- The non-management directors of each company would be required to meet at regularly scheduled executive sessions without management. Corporate Governance Committee –Companies would be required to have a nominating/corporate governance committee composed entirely of independent directors. This committee would be required to have a written charter that addresses the committee’s purpose and responsibilities and an annual performance evaluation. Compensation Committee – Companies would be required to have a compensation committee composed entirely of independent directors. The compensation committee would be required to have a written charter that addresses the committee’s purpose, which at a minimum, would require the production of an annual report on executive compensation. Audit Committee – Each company (including closed-end investment companies and exchange- traded investment companies organized as open-end investment companies) would be required to have an audit committee that satisfies the requirements of Rule 10A-3 under the Exchange Act. In addition, the audit committees of closed-end investment companies and exchange- traded investment companies organized as open-end investment companies would be required to establish procedures for the confidential, anonymous submission of concerns regarding questionable accounting or auditing matters by employees of the investment adviser, administrator, principal underwriter, or any other provider of accounting related services for the management company. This responsibility would be required to be addressed in the audit committee charter. The audit committee of each company (including closed-end investment companies) would be required to have at least three members and at least one member would be required to have accounting or related financial management expertise, as the board interprets in its business judgment. In the commentary accompanying this requirement, the NYSE proposes to 3 clarify that while it does not require any audit committee members to satisfy the definition of audit committee financial expert set forth In Item 401(e) of Regulation S-K, a board may presume that such person has accounting or related financial management experience. Additionally, if an audit committee member simultaneously serves on the audit committee of more than three public companies, and the company does not limit the number of audit committees on which its audit committee members serve, then in each case, the board would be required to determine that such simultaneous service would not impair the ability of such member to effectively serve on the listed company’s audit committee and to disclose such determination in its proxy statement. However, the NYSE also states that, in view of the common practice to use the same directors for boards in the same fund complex, closed-end funds would not be required to comply with the disclosure aspect of this requirement. The audit committee of each company (including closed-end investment companies) would be required to have a written charter that addresses the committee’s purpose, its duties and responsibilities, and an annual performance evaluation of the committee. The audit committee of each company (including closed-end investment companies) also would be required to discuss earnings releases and financial information provided to analysts and rating agencies. The NYSE states, in connection with this requirement, that the committee’s discussion may be general (i.e., discussion of the types of information to be disclosed and the type of

presentation to be made) and that it need not discuss in advance each earnings release or each instance in which a company may provide earnings guidance. The audit committee of each company (including closed-end investment companies) would be required to meet separately periodically with management, internal auditors, and independent auditors. The audit committee would be required to review with the independent auditor any audit problems and management's response. Internal Audit - Each company would be required to have an internal audit function, though a company would be permitted to outsource this function to a firm other than its independent auditor. (Unlike earlier proposals, closed-end investment companies are excluded from this requirement.) Corporate Governance Guidelines - Each company would be required to adopt and disclose on its website its corporate governance guidelines and the charters of its most important committees. Corporate governance guidelines would be required to address : director qualification standards, director responsibilities, director access to management, director compensation, director orientation and continuing education, management succession, and annual performance evaluation of the board. Each company's annual report would be required to state that the foregoing information is available on the company's website and in print to any shareholder who requests it. Code of Business Conduct and Ethics - Each company would be required to adopt and disclose a code of business conduct and ethics for directors, officers, and employees, and promptly disclose any waivers of the code for directors or executive officers. While each company would be permitted to determine its own policies, the Release notes that codes should address, at a minimum, among other things: conflicts of interest; corporate opportunities, including prohibiting directors, officers, or employees from taking for themselves personally opportunities that are discovered through the use of corporate information or position; confidentiality, including employees maintaining the confidentiality of information entrusted to them by the company or its customers; and fair dealing, including that no employee be permitted to take unfair advantage of anyone through misrepresentation of material facts. CEO Certifications - The Chief Executive Officer of each company (including chief executive officers of closed-end investment companies) would be required to certify to the NYSE each year that he or she is not aware of any violation by the company of NYSE corporate governance listing standards. In addition, each company (including closed-end investment companies and exchange-traded investment companies organized as open-end investment companies) would be required to promptly notify the NYSE after any executive officer of the listed company becomes aware of any material noncompliance with any applicable provisions of Section 303A. NYSE Public Reprimand Letter - The NYSE would be empowered to issue a public reprimand letter to a company that it has determined has violated an NYSE listing standard. Transition Period - Listed companies would have until the earlier of October 31, 2004 or their first annual meeting after January 15, 2004 to comply with the new standards in Section 303A. II. Nasdaq Proposal A. General Applicability to Investment Companies Under the proposal, most of the recommended corporate governance standards would not apply to closed-end investment companies or exchange-traded funds organized as open- end investment companies (hereinafter referred to as "management investment companies") because, as Nasdaq states, they are already subject to "a pervasive system of federal regulation." However, Nasdaq did recommend that management investment companies be required to comply with its proposed audit committee requirements. Exchange-traded investment companies organized as unit investment trusts would be excluded from all of the proposed requirements. B. Provisions Applicable to Nasdaq-Listed Companies Independent Directors - All companies would be required to have a majority of independent directors. In addition, Nasdaq would tighten the definition of "independent director" so that, among other things, a director who was a partner of the company's outside auditor and worked on the company's audit during the past three years, would not be considered to be independent.

With respect to investment companies, Nasdaq proposes that a director would not be considered independent if the director is an “interested person” of the company, as defined in Section 2(a)(19) of the Investment Company Act. The Release notes that this provision would be in lieu of the other tests for independence specified in Nasdaq Rule 4200.

Executive Sessions – Independent directors would be required to have regularly scheduled meetings at which only independent directors are present.

5 Compensation of Officers – Compensation of a company’s chief executive officer and certain other officers would be determined or recommended to the board for determination by either a majority of independent directors or a compensation committee comprised solely of independent directors.

Nomination of Directors – Directors would be required to be selected or recommended for the board’s selection either by a majority of independent directors or a nominations committee comprised solely of independent directors.

Audit Committee Charters – Audit committee charters (including management investment company audit committee charters) would be required to have the specific audit committee responsibilities and authority necessary to comply with Rule 10A-3 under the Exchange Act. These charters also would be required to specify the committee’s purpose of overseeing the accounting and financial reporting processes and the audits of the financial statements of the issuer. In addition, audit committees for management investment companies would be required to establish procedures for the confidential, anonymous submission of concerns regarding questionable accounting or auditing matters by employees of the investment adviser, administrator, principal underwriter, or any other provider of accounting related services for the investment company, as well as employees of the investment company.

Audit Committee Composition – All members of a company’s audit committee (including members of any management investment company audit committee) would be required to be independent under the criteria specified both in NASD Rule 4200 and Rule 10A-3(b)(1) of the Exchange Act.² In addition, all audit committee members would be required to satisfy the current requirement that they be able to read and understand fundamental financial statements. The Release states that Nasdaq will retain the requirement that at least one member of the audit committee have past employment experience in finance or accounting, requisite professional certification in accounting, or any other comparable experience or background which results in a person’s financial sophistication. It further states that Nasdaq proposes to clarify that, while it does not require any audit committee members to satisfy the definition of audit committee financial expert set forth in Item 401(e) of Regulation S-K, a board may presume that such person qualifies as a financially sophisticated audit committee member.

Issuer Certification – a company (including management investment companies) would be required to promptly notify Nasdaq after an executive officer of the company becomes aware of any material noncompliance by the company with the requirements of Nasdaq Rule 4350.

3 Code of Business Conduct and Ethics – a company would be required to adopt a code of business conduct and ethics applicable to its directors, officers, and employees. The code would be required to comply with the definition of “code of ethics” in Section 406(c) of the Sarbanes- 2 As noted above, under the proposal, Rule 4200’s definition of “independent director” is different for registered investment companies than for other companies. Rule 10A-3(b)(1) under the Exchange Act also provides different requirements for independence for investment company directors than for other directors.

3 Rule 4350 includes the requirements regarding independent directors, compensation of officers, nomination of directors, and audit committees.

6 Oxley Act of 2002 and related SEC rules. In addition, the code would be required to be made publicly available and to provide for an enforcement mechanism. Any waivers of the code for directors or executive officers would require approval by the board and would be required to be disclosed in a Form 8-K within five days.

Transition Periods – Listed companies would have until the earlier of October 31, 2004 or their first annual

meeting after January 15, 2004 to comply with the provisions regarding director independence, independent committees, and notification of noncompliance. Compliance with the code of conduct provision would be required six months after approval by the SEC.
Dorothy M. Donohue Associate Counsel

Copyright © by the Investment Company Institute. All rights reserved. Information may be abridged and therefore incomplete. Communications from the Institute do not constitute, and should not be considered a substitute for, legal advice.