

MEMO# 11440

December 1, 1999

INSTITUTE COMMENT LETTERS ON AUDIT COMMITTEE PROPOSALS

1 Securities Exchange Act Release No. 41987 (October 7, 1999), 64 FR 55648 (October 14, 1999). 2 Securities Exchange Act Release Nos. 41980 (October 6, 1999) and 41981 (October 6, 1999). The National Association of Securities Dealers also filed similar proposed rule changes with the SEC. Securities Exchange Act Release No. 41982 (October 6, 1999). Because the NASD's proposal is virtually identical to the Amex's proposal, the Institute's comments on the Amex's proposal also apply to the NASD's proposal. 3 See Memorandum to Accounting/Treasurers Committee No. 36-99, Closed-End Investment Company Committee No. 36-99, and SEC Rules Committee No. 81-99, dated October 30, 1999. 4 The SEC Proposal and Exchange Proposals would apply to closed-end investment companies. The SEC Proposal, however, requests comment on whether any or all of the SEC Proposal should apply to open-end investment companies. 5 See Role of Independent Directors of Investment Companies, Investment Company Act Release No. 24082 (October 14, 1999). [11440] December 1, 1999 TO: ACCOUNTING/TREASURERS COMMITTEE No. 47-99 CLOSED-END INVESTMENT COMPANY COMMITTEE No. 47-99 SEC RULES COMMITTEE No. 101-99 RE: INSTITUTE COMMENT LETTERS ON AUDIT COMMITTEE PROPOSALS

The Institute has filed comment letters (attached) with the Securities and Exchange Commission ("SEC") in connection with the SEC's proposed new rules and rule amendments related to the functioning of corporate audit committees¹ ("SEC Proposal") and proposed rule changes filed by the New York Stock Exchange ("NYSE") and the American Stock Exchange ("Amex") relating to their audit committee requirements for listed companies² ("Exchange Proposals") (collectively, the "Proposals")³. In general, the Institute's letters state that while the Institute supports the overall objective of the Proposals - to promote quality financial reporting and investor confidence in the integrity of the financial reporting process - we strongly oppose their application to investment companies.⁴ Investment companies are structured and regulated very differently from public operating companies. As a consequence, the potential financial reporting abuses the Proposals are intended to address do not exist in the context of investment companies and the proposed disclosure requirements would not provide meaningful information to fund shareholders. In addition, the Institute's letter noted that the SEC's recently issued Fund Governance Proposals,⁵ which are designed to enhance the effectiveness of independent directors of investment companies, include a proposal specifically focusing on audit committees. The Institute's letters also had several specific comments on the Proposals. SEC Proposal The SEC Proposal requested comment on whether a closed-end fund's semi-annual financial statements should be reviewed by independent auditors before being sent to shareholders. The Institute letter states that even if the SEC determines not to exclude closed-end investment companies from the SEC Proposal generally, it should not adopt such a

requirement. The comment letter notes that while closed-end funds do not issue and redeem shares on a daily basis like open-end funds, they do typically calculate daily the mark-to-market value of their holdings and distribute a net asset value to the media and others. The dissemination of mark-to-market net asset values and the availability of related total return performance information substantially decreases the impact that the release of closed-end fund financial statements would otherwise have in the marketplace. Closed-end fund semi-annual financial reports therefore have much less significance than quarterly earnings releases by operating companies. The letter states that the Institute believes, therefore, that the value to fund shareholders of requiring closed-end funds' semi-annual financial statements to be reviewed by independent auditors before being sent to shareholders would be insignificant. The SEC Proposal also would require that the audit committee provide a report in the company's proxy statement that would disclose, among other things, whether anything came to the attention of the members of the audit committee that caused them to believe that the audited financial statements included in the company's annual report on Form 10-K contain an untrue statement of material fact, or omit to state a material fact necessary to make the statements therein not misleading. The Institute's letter notes that investment companies are not required to file Form 10-K and it is unclear from the proposing release whether the SEC intended to exclude them from this requirement. Nevertheless, the comment letter states that the Institute opposes the proposed requirement as it would be superfluous, for operating companies as well as investment companies. Auditors are already under an obligation to disclose in their reports any policies related to an issuer's financial statements. Thus, the proposed disclosure would, in substance, simply duplicate this information.

Exchange Proposals The Institute's comment letter states that as part of the SEC's Fund Governance Proposals, the SEC has proposed a new rule under the Investment Company Act, Rule 32a-4, to exempt funds from the requirement that shareholders ratify the board's selection of the fund's independent auditors. Proposed Rule 32a-4 is tailored specifically for investment companies, including closed-end funds. In contrast, the Exchange Proposals include certain requirements that may not be necessary for investment companies. For example, the Amex's proposal would require that at least one member of the audit committee have past employment experience in finance or accounting, professional certification in accounting, or other comparable experience or background. The Institute's letter states that financial reporting and the application of appropriate accounting policies in the public operating company context is a complex process that requires oversight by board members who possess financial management expertise. In contrast, the accounting policies employed by investment companies are relatively straight-forward (e.g., investment securities are valued at the current market-value) and audit committee oversight does not require the same degree of accounting expertise. The comment letter states that based on the foregoing, the Institute recommends that closed-end funds be excluded from the Exchange Proposals. If it is determined that listed closed-end funds should be subject to enhanced audit committee requirements, the Institute recommends that they be subject only to the conditions set forth in Rule 32a-4, in the form it is adopted. This would avoid closed-end funds being subject to inappropriate, duplicative, and potentially conflicting regulatory requirements. In addition, in the event the SEC determines that there is a need to proceed with the Exchange Proposals as they relate to closed-end funds, the Institute urges that there be a single standard for closed-end funds to follow and that it be the NYSE standard. One of the significant distinctions between the NYSE's and the Amex's proposals relates to the financial literacy requirements for audit committee members. The NYSE would permit directors to exercise their business judgment to determine the ability of board members to satisfy the financial management expertise requirement, while the Amex proposal would require past employment in the financial arena to qualify. The letter states that the NYSE's

standard is more consistent with the manner in which closed-end fund boards conduct their business. Ari Burstein Assistant Counsel Attachments

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