

## COMMENT LETTER

July 19, 2002

# Comment Letter on NYSE Corporate Governance and Disclosure Report, July 2002

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Mr. James L. Cochrane  
Senior Vice President  
New York Stock Exchange, Inc.  
11 Wall Street  
New York, N.Y. 10005

Re: Report of the New York Stock Exchange Corporate Accountability and Listing Standards Committee

Dear Mr. Cochrane:

The Investment Company Institute [1](#) is pleased to comment on the New York Stock Exchange's Corporate Accountability and Listing Standards Committee Report ("NYSE Report" or "Report"). [2](#) We commend the Exchange and the Committee for taking the initiative to improve corporate governance and disclosure standards in the wake of failures of diligence, ethics, and controls at significant companies. The Institute's perspectives on the NYSE Report are unique in that investment companies are both investors in and issuers of securities. As investors in equity securities worth approximately 3 trillion dollars on behalf of millions of middle-income Americans, the Institute's members rely on high-quality financial reporting, audited by independent, objective professionals, to make investment decisions on a daily basis. Accordingly, the Institute supports the objectives of the NYSE Report—to enhance the accountability, integrity, and transparency of the Exchange's listed companies.

The NYSE Report's recommendations, as drafted, would apply to all listed companies, including closed-end investment companies and exchange-traded investment companies. We are pleased that the Committee recognizes that in implementing these recommendations, it may be appropriate to exclude investment companies from certain recommendations. [3](#) To assist the Committee, we have identified those recommendations that either should not apply to investment companies or where clarification with respect to investment companies is appropriate. We believe these changes are necessary in view of the differences between the structure and operations of investment companies from other listed companies and the existence of regulatory requirements that satisfy many of the

NYSE's policy goals. Our specific comments on the Committee's recommendations focus on their application to investment companies. [4](#)

Investment companies are regulated very differently from operating companies in that they are subject to detailed, substantive regulation under all four of the major federal securities laws. Most importantly, investment companies must register under the Investment Company Act. The Investment Company Act, in contrast to the other federal securities laws that take a more disclosure-oriented approach, imposes stringent requirements and prohibitions on the structure and day-to-day operations of investment companies. The core objectives of the Investment Company Act are to: (1) ensure that investors receive adequate, accurate information about the investment company; (2) protect the physical integrity of the company's assets; (3) prohibit or regulate forms of self-dealing; and (4) restrict unfair and unsound capital structures. In order to achieve these objectives, the Investment Company Act, among other things, prohibits or restricts transactions between an investment company and its affiliates.

The effectiveness of independent directors and the other important investor protections afforded under the Investment Company Act were enhanced by recent SEC rule amendments requiring that, in most instances, at least a majority of an investment company's board of directors be independent of its investment adviser and that independent directors select and nominate other independent directors. [5](#)

In addition, the structure and operations of investment companies are vastly different from the operating companies that the Report seems intended to address. Unlike operating companies, the assets of investment companies consist exclusively of investment securities, and, therefore, the accounting policies employed by investment companies are relatively straightforward (e.g., investment securities are valued at the current market value). Further, gains and losses generally are determined by reference to market prices for the fund's securities. Consequently, there is little or no opportunity to engage in potentially abusive accounting practices.

Given these operational differences and the regulatory requirements already applicable to investment companies, we believe that many of the Report's recommendations either should not apply to investment companies, or should be tailored in their application to investment companies, e.g., by permitting existing regulatory requirements or industry practices to substitute for the specific recommendations set forth in the Report.

Our specific comments on the Report are set forth below.

## **I. Definition of "Independent Director"**

The NYSE Report recommends that the NYSE tighten the definition of "independent director" so that, among other things, no director would qualify as independent unless the board of directors affirmatively determines that the director has no material relationship with the listed company. The Report points out that it is not possible to explicitly provide for all circumstances that might signal potential conflicts of interest or that might bear on the materiality of a director's relationship to a listed company. [6](#)

The Institute recommends that the NYSE's proposal on this recommendation clarify that whether a director of an investment company is independent should be determined exclusively under the provisions of Section 2(a)(19) of the Investment Company Act and the rules thereunder. These requirements are stricter in certain respects than those

recommended in the NYSE Report, and are tailored to the types of conflicts of interest faced by investment company directors. [7](#) Thus, it would be more appropriate to look to the independence standards specifically tailored for investment companies in the Investment Company Act, which would satisfy the NYSE's policy goals while avoiding the imposition of two different standards.

## **II. Nominating/Corporate Governance Committee**

The NYSE Report recommends that listed companies be required to have nominating/corporate governance committees composed entirely of independent directors that would identify individuals qualified to become board members, and to select, or to recommend that the board select, the director nominees. As a result of the Securities and Exchange Commission's investment company corporate governance rules, most investment company boards are already subject to the requirement that independent directors select and nominate other independent directors. [8](#) Therefore, we request that the NYSE clarify that if investment company independent directors select and nominate other independent directors, they do not need to also establish a nominating committee for this same purpose. [9](#) We believe SEC rules satisfy the NYSE's policy goals.

The Report also encourages companies to address in their corporate governance guidelines, among other things, "policies limiting the number of boards on which a director may sit ...". [10](#) It is common industry practice for funds within a fund complex to share common directors. [11](#) The Institute's Advisory Group on Best Practices for Fund Directors found that service on multiple boards can provide the independent directors of those boards with an opportunity to obtain better familiarity with the many aspects of fund operations that are complex-wide in nature. [12](#) It can also give the independent directors greater access to the investment company's adviser and greater influence with the adviser than they would have if there were a separate board for each fund in the complex. [13](#) Therefore, the Institute requests that the NYSE state in connection with any forthcoming related rule proposal that it is not implicit in its recommended corporate governance guidelines (or audit committee requirements, discussed in more detail, *infra*,) that multiple board service (or multiple audit committee service) by investment company directors is inappropriate.

## **III. Compensation Committee**

The NYSE Report recommends that listed companies be required to have compensation committees composed entirely of independent directors. The committee's purpose would be to discharge the board's responsibilities relating to compensation of the company's executives and to produce an annual report on executive compensation for inclusion in the company's proxy statement. We do not believe it is necessary or appropriate for this requirement to apply to investment companies.

Most investment companies are externally managed—that is, they have a contract with an investment adviser that manages the fund's securities portfolio in conformance with the fund's stated investment objectives and policies. [14](#) Investment companies structured in this way do not have executives comparable to those in other listed companies and, therefore, do not need compensation committees to oversee executive compensation. [15](#)

In addition, the Investment Company Act has requirements that are tailored to focus the attention of investment company independent directors on potential conflicts of interest

related to investment adviser compensation. Specifically, Section 15(a) of the Act makes it unlawful for any person to serve as an investment adviser except pursuant to a written contract that has been approved initially by a majority of the investment company's shareholders. Section 15(a)(2) of the Act further provides that an advisory contract can run initially for a period of no more than two years, and continue in effect thereafter only if the board annually approves it. In addition, Section 15(c) of the Act requires the advisory contract and any renewal thereof be approved by a majority of the independent directors. This action must take place at a meeting called for the purpose of voting on such approval and the votes must be cast in person. [16](#) As a practical matter, an investment company's independent directors typically meet outside the presence of management representatives to discuss the advisory contract. [17](#) Moreover, investment companies are required to disclose in their Statements of Additional Information the factors the board considered in approving and reviewing the advisory contract. [18](#) Finally, Section 36(b) of the Act imposes, as a matter of federal law, a fiduciary duty on an investment company's investment adviser with respect to the amount of compensation received from the company.

## **IV. Audit Committee**

### **A. Service on Multiple Audit Committees**

The Report provides that if an audit committee member simultaneously serves on the audit committee of more than three public companies, and the NYSE-listed 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. The NYSE's apparent concern is to assure that audit committee members have the time needed to fulfill the audit committee's responsibilities, in light of the demands of other audit committee assignments.

We believe that in applying this requirement to investment companies, the NYSE should treat a "fund complex" as one company. [19](#) It is common practice in the industry for the same group of directors to serve on the audit committee of each investment company in any given fund complex. As discussed, an investment company's financial statements are less complicated than the financial statements of operating companies and therefore audit committee oversight requires less time. In addition, typically all funds in a fund complex rely on the same accounting system and are subject to the same internal controls and policies. Accordingly, the effort associated with overseeing the financial statements of each additional fund is less than the time and effort involved in serving on the audit committee of an additional operating company. [20](#)

### **B. Duties of Audit Committee**

There are several requirements recommended in the NYSE Report relating to audit committees that should not apply to investment companies. Each of these is discussed below.

#### **Retention and Termination of Auditor**

The Institute requests that the NYSE clarify that investment companies will satisfy the requirement that the audit committee retain and terminate the company's auditor if these decisions are made by a majority of independent directors in compliance with the Investment Company Act. Section 32(a) of the Act makes it unlawful for a registered investment company to file financial statements signed or certified by an independent

public accountant unless, among other things, the accountant was selected by a vote of a majority of independent directors, cast in person, at a meeting held within thirty days before or after the beginning of the fiscal year or before the annual shareholders meeting. This requirement assures independent board oversight of independent auditors, while avoiding the imposition of two different approval requirements.

### **Review of Earnings Information**

The Institute recommends excluding investment companies from the requirement that audit committee members discuss earnings press releases as well as financial information and earnings guidance provided to analysts and rating agencies. As a preliminary matter, investment companies do not have earnings targets, nor do they provide earnings guidance to security analysts. Further, as previously discussed, because statements of an investment company's earnings and earnings press releases are more straightforward than those of operating companies, oversight by the audit committee is not necessary.

### **Separate Meeting Requirement**

The Institute recommends excluding investment companies from the requirement that audit committees meet separately, at least quarterly, with management, with internal auditors (or other personnel responsible for the internal audit function), and with independent auditors. Instead, we recommend that investment company audit committees be required to meet at least twice a year, with the committee meeting separately, at least annually, with management, personnel responsible for the internal audit function and independent auditors. Our recommendation would tailor the requirement for investment companies to be consistent with their financial statement reporting requirements. [21](#)

### **C. Audit Committee Chair**

The NYSE Report recommends that the audit committee chair of a listed company be required to have accounting or related financial management expertise. This requirement should not apply to investment companies. Instead, the audit committee chair of an investment company should be required to have experience with respect to investment company matters. We believe that providing a different, yet comparable, requirement for investment company audit committee chairs is consistent with the concept of requiring the audit committee chair to have the appropriate background to play a strong leadership role. We do not believe it is necessary to require accounting or related financial management expertise for the audit committee chair because, unlike operating companies, the assets of investment companies consist exclusively of investment securities. Further, gains and losses generally are determined by reference to market prices for the fund's securities, which are determined daily.

Consequently, the review of fund financial statements does not require professional certification in accounting or past employment experience given the relatively straightforward accounting policies employed by funds. In addition, investment companies and their investors benefit from having directors with a broad investment orientation rather than expertise in finance or accounting.

## **V. Code of Business Conduct and Ethics**

The NYSE Report recommends that listed companies adopt and disclose a code of business conduct and ethics for directors, officers, and employees. Each code also must contain compliance standards and procedures that will facilitate the effective operation of the code.

The purpose of such a code is to focus the board and management on areas of ethical risk, provide guidance to personnel to help them recognize and deal with ethical issues, provide mechanisms to report unethical conduct, and help foster a culture of honesty and accountability.

We request the NYSE to clarify that if investment companies comply with related requirements under the Investment Company Act, they would be deemed to satisfy the NYSE's recommendation. Investment companies are already subject to extensive regulation with respect to code of ethics requirements under the Investment Company Act. These requirements are tailored to the business of an investment company in that they regulate conduct associated with the investment company's business, i.e., purchasing and selling securities.

In particular, Rule 17j-1 under the Investment Company Act generally prohibits investment advisory personnel, in connection with the purchase or sale of securities for any affiliated investment company, from defrauding the investment company and from making any material misstatements or material omissions to the investment company. In addition, Rule 17j-1 generally requires every registered investment company to adopt a written code of ethics with provisions reasonably necessary to prevent investment company personnel from engaging in fraudulent personal trading activities and to institute procedures to prevent violations of the code. The investment company's board, including a majority of independent directors, must approve the investment company's code of ethics. The board's determination needs to be based partly on a certification from the investment adviser that reasonably designed procedures have been adopted to prevent violations of the code of ethics. The investment company's board must annually receive a written report reaffirming the certification and describing material violations of the code and any sanctions imposed.

In addition, the Investment Company Act prohibits or restricts transactions between an investment company and its affiliates. [22](#) These prohibitions and restrictions are designed to prevent insiders from using an investment company to benefit themselves to the detriment of the company and its shareholders. For example, the Act prohibits an affiliate of an investment company from borrowing money or other property from the investment company. [23](#) The Act also has strict requirements with respect to permissible custody arrangements for investment company assets designed to preserve the assets of investment companies and protect them from abuses by insiders. [24](#)

## **VI. Corporate Governance Guidelines**

The NYSE Report requires listed companies to adopt and disclose their corporate governance guidelines on the company's website. It is also recommended that each listed company be required to disclose on its website the charters of its most important committees, and the company's code of business conduct and ethics. Because not all investment companies have their own websites, the Institute recommends that investment companies be provided the flexibility to make the appropriate disclosures in their proxy statements, annual reports to shareholders, or websites. [25](#) This alternative would be less burdensome for investment companies while still satisfying the NYSE's goal of making this information publicly available.

\* \* \*

We appreciate the NYSE's consideration of our comments on these important and far-reaching recommendations. If you have any questions or need additional information,



please contact me at (202) 218-3563 or Amy B.R. Lancellotta at (202) 326-5824.

Sincerely,

Dorothy M. Donohue  
Associate Counsel

cc: Paul F. Roye  
Director, Division of Investment Management  
U.S. Securities and Exchange Commission

#### **ENDNOTES**

[1](#) The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,928 open-end investment companies (“mutual funds”), 499 closed-end investment companies and six sponsors of unit investment trusts. Its mutual fund members have assets of about \$6.898 trillion, accounting for approximately 95 percent of total industry assets, and over 88.6 million individual shareholders.

[2](#) [Report of the New York Stock Exchange Corporate Accountability and Listing Standards Committee](#) (June 6, 2002).

[3](#) The Report states that it is the Committee’s expectation that “technical issues, such as transition rules and exceptions for specialized securities such as exchange-traded funds (ETFs) and closed-end funds, will be addressed as appropriate.” Report at note 1.

[4](#) The Institute has commented separately on the Report from the perspective of funds as investors in corporate securities. See [Letter](#) from Craig S. Tyle, General Counsel, Investment Company Institute, to James L. Cochrane, Senior Vice President, New York Stock Exchange, dated July 19, 2002.

[5](#) Investment Company Act Release No. 24816 (January 2, 2001).

[6](#) NYSE Report at p. 7.

[7](#) Section 2(a)(19) of the Investment Company Act imposes strict standards for measuring the independence of investment company directors. For example, the Act excludes from independent director status any person affiliated with the investment adviser, principal underwriter, or the investment company as well as any person in a control relationship with any such affiliate. The term, “affiliated person” is broadly defined to include any officer, employee, or 5 percent shareholder of the investment company, its investment adviser, or principal underwriter. The Act also empowers the Commission to issue an order excluding any director from independent status who has, or within the prior two years has had, a material business or professional relationship with the investment company, its investment adviser or principal underwriter. The Commission staff recently provided guidance about the types of business and professional relationships that may be material for purposes of section 2(a)(19). See Investment Company Act Release. No. 24083 (October 14, 1999) (interpreting certain matters concerning independent directors of investment companies).

It is common industry practice to ensure that no director who appears to have, or have had, such a business or professional relationship is counted as an independent director, even in the absence of a Commission order. See [Investment Company Institute: Report of the](#)

[Advisory Group on Best Practices for Fund Directors: Enhancing a Culture of Independence and Effectiveness](#) (June 24, 1999) at 6. (“Best Practices Report”). In July 1999, the Institute’s Board of Governors unanimously approved a resolution strongly endorsing the Best Practices Report and recommending that all Institute management investment company members take appropriate actions to implement the practices recommended in the report. Although many of the recommendations in the Best Practices Report and the NYSE’s recommendation share common goals, “best practices,” by definition, go beyond what is required by law or regulation. By referencing the Institute’s Best Practices in our letter, we are not suggesting that the NYSE make these practices requirements.

[8](#) For investment companies to be able to rely on any of ten exemptive rules, independent directors must select and nominate other independent directors. Most, if not all, investment companies rely on one or more of these rules.

[9](#) If the NYSE determines to apply this requirement to investment companies, we recommend providing the nominating committee with the authority to nominate only the independent directors. We do not believe that it is necessary or appropriate for independent directors to be required to have sole authority to nominate “interested” directors. This approach is consistent with the Commission’s investment company corporate governance rules.

[10](#) Report at 19.

[11](#) A 2000 Institute survey of 201 investment company complexes revealed that approximately 92 percent shared common directors.

[12](#) These aspects include, for example, the nature and quality of compliance, administrative, transfer agency and custodial services, as well as distribution channels used by the complex.

[13](#) See Best Practices Report at 28.

[14](#) The adviser typically also provides investment research, places purchase and sale orders for the fund, and provides “back office” services, such as internal auditing and preparing reports to shareholders.

[15](#) Several closed-end investment companies are internally managed and, thus, do have executives. Because the Section 15 requirements, discussed *infra*, apply to all investment companies, including internally managed investment companies, we do not believe it is necessary for any investment company to be subject to the compensation committee requirement.

[16](#) The standards guiding the process of approving the advisory contract are complex. In cases challenging the fairness of advisory fees, courts have viewed the Act as assigning to the independent directors the primary responsibility for considering those fees. In these cases, courts consistently have found that independent directors discharged this responsibility diligently and in good faith. See, e.g., *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F. 2d 923 (2d Cir. 1982) cert. denied, 461 U.S. 906 (1983); *Schuyt v. Rowe Price Prime Reserve Fund, Inc.*, 663 F. Supp. 962 (S.D.N.Y.), aff’d, 835 F.2d 45 (2d Cir.) 1987), cert. denied, 485 U.S. 1034 (1988); *Krinsk v. Fund Asset Management, Inc.*, 715 F. Supp. 472 (S.D.N.Y. 1988), aff’d, 875 F.2d 404 (2d Cir.), cert. denied, 110 S. Ct. 281 (1989); and *Kalish v. Franklin Advisers, Inc.*, 742 F. Supp. 1222 (S.D.N.Y. 1990), aff’d, 928



F.2d 590 (2d Cir.), cert. denied, 112 S.Ct. 75 (1991).

[17](#) This practice is consistent with the Best Practices Report's recommendation for investment company independent directors to meet separately from management in connection with their consideration of the fund's advisory contract. See Best Practices Report at 24.

[18](#) Item 13(b)(10) of Form N-1A; Item 18.13 of Form N-2.

[19](#) In tailoring this requirement for investment companies, we recommend that the NYSE refer to the definition of "fund complex" in the Commission's proxy rules. See Item 22(a)(1)(vi) of Schedule 14A ("[t]he term "Fund Complex" shall mean two or more Funds that: (A) Hold themselves out to investors as related companies for purposes of investment and investor services; or (B) Have a common investment adviser or have an investment adviser that is an affiliated person of the investment adviser of any of the other Funds.")

[20](#) Under our recommended approach, audit committee membership on the audit committee of each fund in a complex would count as membership on one audit committee, which would then be added to membership on the audit committee of any operating company to determine the number of audit committees on which any one independent director serves.

[21](#) Section 30(e) and Rule 30e-1 thereunder require every registered management investment company to transmit to shareholders, at least semi-annually, reports containing, among other things, the company's financial statements. Rule 3-18 of Regulation S-X requires registered management investment companies to have their financial statements audited by independent auditors annually. In contrast, other corporate issuers are required to file financial statements quarterly with the Commission that are reviewed by their independent auditors.

[22](#) See Section 17 of the Act.

[23](#) See Section 17(a)(3) of the Act.

[24](#) See Section 17(f) of the Act.

[25](#) We also recommend that the NYSE model any such required disclosure for investment companies on that already required by the Commission with respect to codes of ethics. See Item 13(e) of Form N-1A (provide a brief statement disclosing, among other things, whether the Fund and its investment adviser have adopted codes of ethics and whether these codes permit personnel to invest in securities that may be purchased by the Fund).