

## COMMENT LETTER

November 1, 2012

# ICI Comment Letters in Response to Proposed Rule Changes by the NYSE and Nasdaq to Modify Listing Rules for Compensation Committees (pdf)

November 1, 2012 Ms. Elizabeth M. Murphy Secretary Securities and Exchange Commission  
100 F Street, NE Washington, DC 20549 Re: Proposed Rule Change to Nasdaq Listing Standards to Comply with Rule 10C-1 (File No. SR-NASDAQ-2012-109) Dear Ms. Murphy: The Investment Company Institute (“ICI”)<sup>1</sup> is pleased to comment on the proposed rule change by The NASDAQ Stock Market LLC (“Nasdaq”)<sup>2</sup> to amend certain provisions of its listing rules relating to compensation committees and compensation advisers to comply with the requirements of Securities and Exchange Commission (“Commission” or “SEC”) Rule 10C-1.3 For all of the reasons discussed below, we urge the Commission to approve Nasdaq’s proposal. As significant investors in U.S. public companies, registered investment companies appreciate the important role that independent compensation committees play in the proper governance of operating companies, and we believe SEC Rule 10C-1 and Nasdaq’s proposal will strengthen the effectiveness of those committees. We also fully support Nasdaq’s proposal to exempt investment

<sup>1</sup> The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$13.8 trillion and serve over 90 million shareholders.

<sup>2</sup> See SEC Release No 34-68013, 77 FR 62563 (Oct. 15, 2012) (“Proposal”), available at <http://www.gpo.gov/fdsys/pkg/FR-2012-10-15/pdf/2012-25281.pdf>.

<sup>3</sup> The SEC adopted Rule 10C-1 under the Securities Exchange Act of 1934 to implement Section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank Act”). Listing Standards for Compensation Committees, Release Nos. 33-9330; 34-67220 (June 20, 2012), available at <http://www.sec.gov/rules/final/2012/33-9330.pdf>. This provision of the Dodd-Frank Act requires the SEC to adopt rules directing the national securities exchanges and national securities associations to prohibit the listing of any equity security of an issuer that is not in compliance with compensation committee and compensation adviser requirements in new Section 10C. Ms. Elizabeth Murphy November 1, 2012 Page 2 of 3

companies from these requirements because of the fundamental structural differences between investment companies and operating companies as described more fully below. In June 2012, the SEC adopted Rule 10C-1, which directs the establishment of listing standards that, among other things, require each member of a listed issuer’s compensation committee to be a member

of the board of directors and to be “independent” as defined in the listing standards. Under Rule 10C-1(b)(2), listing standards must provide that the compensation committee may, in its sole discretion, retain or obtain the advice of a compensation adviser and the compensation committee shall be directly responsible for the appointment, compensation, and oversight of the work of any compensation adviser retained by the committee. Moreover, under Rule 10C-1(b)(3), each listed issuer must provide for appropriate funding for payment of reasonable compensation, as determined by the compensation committee, to any compensation adviser retained by the committee. Under Rule 10C-1(b)(4), listing standards must require the compensation committee to take into account certain independence factors before selecting a compensation adviser. In the Proposal, Nasdaq proposes to amend its listing rules for compensation committees to comply with these requirements of Rule 10C-1. Rule 10C-1(b)(1)(iii)(A) exempts from the compensation committee member independence listing standards certain entities, including registered open-end management investment companies. The SEC’s rule did not explicitly exempt other types of investment companies registered under the Investment Company 1940 Act (“Investment Company Act”), including closed-end investment companies. The SEC did, however, expressly confirm the authority of each exchange to exempt any additional categories of issuers, as such exchange determines is appropriate.<sup>4</sup> Nasdaq proposes to retain its existing exemptions from the compensation-related listing rules. Nasdaq’s current listing rules include exemptions for management investment companies, and Nasdaq proposes that they continue to be exempt from its revised listing rules relating to compensation committees. Therefore, as proposed, closed-end and open-end funds would be exempt from the proposed requirements. We fully support Nasdaq’s proposal to exempt both open-end and closed-end funds registered under the Investment Company Act from the new compensation committee requirements. These issuers typically are externally managed and do not employ executives or by their nature have employees. We appreciate that Nasdaq recognizes that both closed-end and open-end funds registered under the Investment Company Act are subject to a “pervasive system of federal regulation in certain areas of corporate governance, and as a result, these entities have traditionally been exempt from Nasdaq’s compensation-related listing rules.”<sup>5</sup> Moreover, any potential conflicts of interest that are raised with 4 Rule 10C-1(b)(5). 5 Proposal, *supra* note 2, at 62569 at n. 60. Most investment companies enter into a contract with an investment adviser that manages the fund’s securities portfolio in conformance with the fund’s stated investment objectives and policies. As a Ms. Elizabeth Murphy November 1, 2012 Page 3 of 3 respect to compensation paid to investment advisers are adequately governed by the corporate governance standards provided in the Investment Company Act.<sup>6</sup> For these reasons, we urge the Commission to approve Nasdaq’s proposal. \* \* \* We appreciate the opportunity to submit our comments on Nasdaq’s proposed changes to its listing rules for compensation committees to comply with new Rule 10C-1. If you have any questions on our comment letter, please feel free to contact me at (202) 218-3563, Bob Grohowski at (202) 371- 5430, or Jennifer Choi at (202) 326-5876. Sincerely, /s/ Dorothy Donohue Deputy General Counsel – Securities Regulation Attachment cc: Edward S. Knight, Executive Vice President and General Counsel, Nasdaq Erika Moore, Associate General Counsel, Nasdaq result, these investment companies do not have compensated executives and thus have no need for compensation committees to oversee executive compensation. 6 See Letter from Dorothy Donohue, ICI, to Elizabeth M. Murphy, Secretary, SEC, dated April 28, 2011 for a discussion of these protections (copy attached). M April 28, 2011 Elizabeth M. Murphy Secretary U.S. Securities and Exchange Commission 100 F Street, NE Washington, DC 20549-1090 Re: Listing Standards for Compensation Committees (File No. S7-13-11) Dear Ms. Murphy: The Investment Company Institute<sup>1</sup> is pleased to comment on the Securities and Exchange Commission’s proposal regarding compensation committees of listed

companies.<sup>2</sup> The proposal would implement Section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. This provision, which added Section 10C to the Securities Exchange Act of 1934, requires the Commission to adopt rules directing the national securities exchanges to prohibit the listing of any equity security of a company that is not in compliance with Section 10C. According to the Release, in enacting Section 10C, Congress intended to require that board committees that set compensation policy consist only of independent directors and to provide shareholders of public companies with additional disclosure involving compensation practices. As significant investors in U.S. public companies, investment companies fully recognize the important role that independent compensation committees play. We believe the Commission's proposal will strengthen compensation committees at operating companies, and we fully support it in that regard. The very concept of compensation committees, however, is wholly inapplicable to the vast majority of investment companies, because they do not have compensated executives and, accordingly, do not have compensation committees. Given this fundamental structural and regulatory difference

<sup>1</sup> The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds ("ETFs"), and unit investment trusts ("UITs"). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of the ICI manage total assets of 13.0 trillion and serve over 90 million shareholders.

<sup>2</sup> SEC Release Nos. 33-9199; 34-64149, dated March 30, 2011, which is available at <http://www.sec.gov/rules/proposed/2011/33-9199.pdf> ("Release"). Elizabeth M. Murphy April 28, 2011 Page 2 of 4 from operating companies, which is described in greater detail below, the Commission should exempt registered investment companies from the entirety of Rule 10C-1. We support the Commission's decision to exclude investment companies from the proposed disclosure requirements regarding compensation consultants, recognizing that investment companies already have distinct proxy disclosure requirements tailored to their operations.

**I. Applicability of Proposal to Investment Companies**

The proposal would apply to all listed companies, including closed-end investment companies and exchange-traded funds.<sup>3</sup> We are pleased that the Commission recognized that in implementing these proposals, it may be appropriate to exclude investment companies.<sup>4</sup> We strongly recommend that the Commission exempt all registered investment companies from Rule 10C-1 in view of the fundamental differences between investment companies and other listed companies and the existence of regulatory requirements for investment companies that satisfy the policy goals underlying the proposed rule. The structure and operation of investment companies are vastly different from the operating companies that the proposal seems intended to address. 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. As a result, these investment companies do not have compensated executives and, therefore, do not need compensation committees to oversee executive compensation. 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) 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) 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) requires the advisory contract and any

<sup>3</sup> Rule 10C-1(b)(iii)(4) differentiates investment companies in one respect by carving out "open-end management investment

companies registered under the Investment Company Act of 1940” from the independence requirements that otherwise would be applicable to compensation committee members. 4 The Release states that compensation committees generally are used by operating companies and requests comment on whether the Commission should exempt registered investment companies from some or all of the requirements of Section 10C. The Release also specifically notes that registered investment companies are exempt from current exchange listing standards that require listed issuers to either have a compensation committee or to have independent directors determine, recommend, or oversee specified executive compensation matters. Elizabeth M. Murphy April 28, 2011 Page 3 of 4 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. An investment company’s independent directors typically meet outside the presence of management representatives to discuss the advisory contract.<sup>5</sup> Moreover, investment companies are required to disclose in their shareholder reports the factors the board considered in approving and reviewing the advisory contract.<sup>6</sup> 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. 7 The Commission recognized in the Release that all registered investment companies are exempt from current exchange listing standards relating to compensation committees. The New York Stock Exchange previously determined to exempt these investment companies from the compensation committee requirements, stating that they were “unnecessary for closed-end and open-end management investment companies given the pervasive federal regulation applicable to them.”<sup>8</sup> In approving the NYSE’s listing standards, the Commission agreed with the NYSE’s assessment, stating that the exemptions for investment companies from new requirements relating to the role of independent directors in compensation decisions, “is reasonable, because the Investment Company Act already assigns important duties of investment company governance, such as approval of the investment advisory contract to independent directors.”<sup>9</sup> Given this background, we strongly recommend that the Commission exempt registered investment companies from Rule 10C-1. Doing so has the dual benefits of providing regulatory certainty for investment companies regarding their need to comply with compensation committee 5 Investment Company Act Rule 0-1(a)(7)(vi) requires independent directors to meet at least quarterly in a session at which no directors who are interested persons of the investment company are present. While not specifically required, discussing the advisory contract in such a session is long-standing industry practice. See, e.g., Investment Company Institute: Report of the Advisory Group on Best Practices for Fund Directors: Enhancing a Culture of Independence and Effectiveness (June 24, 1999) (“Best Practices Report”) at 24. 6 Item 27(d)(6) of Form N-1A; Instruction 6(e) of Item 24 of Form N-2. 7 The standards guiding the process of approving the advisory contract are complex. The Supreme Court recently endorsed the well tested legal framework articulated in *Gartenberg v. Merrill Lynch Asset Management, Inc.* 694 F. 2d 923 (2d Cir. 1982) cert. denied, 461 U.S. 906 (1983). See *Jones et al. v. Harris Associates L.P.*, No. 08-586 (March 30, 2010). 8 See NYSE Listed Company Manual Section 303A.00. See also Nasdaq Rule 5615(a); NYSE Arca Rule 5.3; NYSE AMEX LLC Company Guide Section 801. 9 See SEC Release No. 34-48745 at p. 45 (November 4, 2003), available at <http://www.sec.gov/rules/sro/34-48745.htm>. Elizabeth M. Murphy April 28, 2011 Page 4 of 4 requirements and permitting the exchanges to devote their resources to reviewing their compensation committee requirements for operating companies.<sup>10</sup> II. Compensation Consultant Disclosure Section 10C(c)(2) of the Exchange Act requires that, in any proxy solicitation for an annual or special shareholder meeting, each issuer must disclose, in accordance with Commission regulations: (1) whether the compensation committee has retained or obtained the advice of a

compensation consultant; and (2) whether the work of the compensation consultant has raised any conflict of interest and, if so, the nature of the conflict and how the conflict is being addressed. Item 407 of Regulation S- K currently requires most Exchange Act registrants that are subject to the proxy rules to provide certain disclosures concerning their compensation committees and the use of compensation consultants. As the Commission pointed out in the Release, registered investment companies are subject to distinct proxy disclosure requirements, which do not include the compensation committee disclosure described in Item 407(e) of Regulation S-K. Consistent with current regulations, under the proposal, registered investment companies would not be required to provide disclosure regarding compensation advisers. We support the proposed approach and urge the Commission to incorporate it in any final rules. \* \* \* We appreciate the Commission's consideration of our comments. If you have any questions or need additional information, please contact me at (202) 218-3563. Sincerely, /s/ Dorothy M. Donohue Senior Associate Counsel cc: John Carey, Chief Counsel, NYSE Regulation, Inc. Susan Nash, Associate Director, Division of Investment Management 10 It also avoids the potential for different exchanges implementing somewhat different rules for investment companies. A piecemeal approach would impose regulatory burdens on investment companies without providing any corresponding benefit to investment company investors.

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