IDC Independent Directors Council
Promoting Excellence in Fund Governance

Comment Letter on NASD Proposal to Enhance Independent Directors' Role, April 2003

April 15, 2003

Mr. Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549-0609

Re: Proposed Amendments to NASD Rules Regarding Board Independence and Independent Committees (File No. SR-NASD-2002-141)

Dear Mr. Katz:

The Investment Company Institute[1] is pleased to comment on Nasdaq's proposed corporate governance reforms.[2] We commend the National Association of Securities Dealers, Inc. and its subsidiary, The Nasdaq Stock Market, Inc., for taking steps to improve corporate governance standards by enhancing the role of independent directors on board committees. The Institute's perspectives on the proposal are unique in that investment companies are both investors in and issuers of securities. As investors, the Institute strongly supports the objectives of the proposal—to enhance investor confidence in the companies that list on Nasdaq, to empower independent directors to more effectively carry out their responsibilities, and to enhance the effectiveness of audit committees. Our specific comments on the proposal focus on its application to investment companies as issuers.

The proposal would apply to all listed companies, including closed-end investment companies and exchange-traded investment companies. We strongly recommend that the proposal be modified so as not to apply to investment companies in some instances and clarified with respect to investment companies in certain other respects. These changes would make the proposal more consistent with recent actions by the New York Stock Exchange and the SEC regarding corporate governance.[3] We

believe these changes are necessary in view of existing regulatory requirements for investment companies that satisfy many of Nasdaq's policy goals and in order to harmonize various regulatory requirements regarding audit committees.

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 of 1940. 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 help achieve these objectives and to further ensure that investment companies are being operated in the interests of shareholders, the Act requires investment company boards to be comprised of a minimum percentage of independent directors.

The requirements under the Investment Company Act pertaining to fund directors were enhanced by SEC rule amendments adopted in 2001 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.[4]

Given the regulatory requirements already applicable to investment companies, we believe that much of Nasdaq's proposal either should not apply to investment companies or should be tailored in its application to investment companies, e.g., by permitting existing regulatory requirements or industry practices to substitute for the proposed listing requirements.

Our specific comments on Nasdaq's proposal are set forth below.

I. Definition of "Independent Director"

II. Nomination of Directors

III. Compensation of Officers

IV. Audit Committee

A. Duties of Audit Committee

1. Harmonization with Rule 10A-3

2. Procedures for Handling Complaints

3. Audit Committee Authority to Engage and Fund Outside Advisers

I. Definition of “Independent Director”

Proposed interpretive material accompanying with respect to the definition of “independent director” NASD Rule 4200 would state that a board of directors has a responsibility to make an affirmative determination that in order to be considered “independent” a director does not have a relationship with the listed company that would impair his independence. In addition, certain relationships identified in Rule 4200 would preclude a board finding of independence.[5] The Proposing Release states that it is important for investors to have confidence that individuals serving as independent directors do not have a relationship with the listed company that would impair their independence.[6]

The Institute recommends that the proposal be modified to 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, which imposes strict standards for measuring the independence of investment company directors. These requirements are stricter in certain respects than those identified in the proposal, and are tailored to the types of conflicts of interest faced by investment company directors.[7] Using the Investment Company Act definition would satisfy Nasdaq’s policy goals while avoiding the imposition of two different standards.

II. Nomination of Directors

Under the proposal, listed companies would be required to have a majority of their independent directors, or a nominations committee comprised solely of independent directors, nominate directors. According to the Proposing Release, independent director oversight of nominations would enhance investor confidence in the selection of well-qualified director nominees.[8] We note that as a result of the SEC’s investment company corporate governance rule amendments, most investment company boards already are subject to the requirement that independent directors select and nominate other independent directors. Therefore, we request that the proposal be clarified so that this requirement would not apply to investment companies if their independent directors nominate other independent directors. We do not believe that it is necessary or appropriate for investment company independent directors to be required to have sole authority to nominate “interested” directors. Our recommended approach is consistent with the Commission’s investment company corporate governance rules. It would also be consistent with the NYSE’s most recent recommendations regarding director nominations.[9]

III. Compensation of Officers

The proposal would require listed companies to have either a majority of independent directors or a compensation committee comprised solely of independent directors meeting in executive session determine the compensation of the chief executive officer and certain other officers.[10] According to the Proposing Release, independent director oversight of compensation would help assure that appropriate incentives are in place, consistent with the board's responsibility to maximize shareholder value.[11] 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.[12] Investment companies structured in this way do not have executives comparable to those in other listed companies and, therefore, do not need the proposed oversight of executive compensation.[13]

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. Moreover, Section 15(c) of the Act requires that 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.[14] As a practical matter, an investment company's independent directors typically meet outside the presence of management representatives to discuss the advisory contract.[15] 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.[16] 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. Duties of Audit Committee

1. Harmonization with Rule 10A-3

The proposal would expand the items that must be specified in a company's audit committee charter. Specifically, the following audit committee responsibilities would be required: (i) the pre-approval of all audit services and permissible non-audit services as set forth in Section 10A(i) of the Exchange Act; (ii) the sole authority to appoint, determine funding for, and oversee the outside auditors, as set forth in

Section 10A(m)(2) of the Exchange Act; (iii) the responsibility to establish procedures for complaints as set forth in Section 10A(m)(4) of the Exchange Act; and (iv) the authority to engage and determine funding for independent counsel and other advisors as set forth in Section 10A(m)(5) of the Exchange Act.[17] Nasdaq explains that these requirements should enhance the effectiveness of audit committees in carrying out their responsibilities.

The Institute strongly suggests modifying the proposal so as to harmonize any new audit committee responsibilities required by Nasdaq with recently adopted Rule 10A-3.[18] We believe that such an approach is appropriate because it will ease administration of the new requirements for listed companies and be more appropriately tailored for investment companies,[19] while affording important investor protections. We specifically recommend that the proposal be modified so that Rule 4350(d)(1)(D) references Rule 10A-3 (rather than Section 10A(m)).[20]

2. Procedures for Handling Complaints

Under the proposal, audit committees would be required to establish procedures for: (i) the receipt, retention, and treatment of complaints received by the listed issuer regarding accounting, internal accounting controls or auditing matters; and (ii) the confidential, anonymous submission by employees of the listed issuer of concerns regarding questionable accounting or auditing matters. The Institute supports the proposed requirements, particularly Nasdaq's decision to refrain from prescribing specific procedures. Given the variety of issuers and organizational structures, we believe companies should be afforded the flexibility to develop procedures appropriate for their particular circumstances. In addition, we note that this aspect of the proposal has the benefit of being consistent with Rule 10A-3.

3. Audit Committee Authority to Engage and Fund Outside Advisers

Under the proposal, an audit committee would have the authority to engage independent counsel and other advisers, as it determines necessary to carry out its duties. The Institute supports this aspect of the proposal because it will permit audit committees to perform more effectively by being able to seek advice, as appropriate, on accounting and legal matters. Moreover, we do not believe it would be appropriate for an audit committee to be dependent on management's willingness to pay for advisers that the audit committee has determined to be necessary to more effectively carry out its functions.[21] Therefore, we recommend that the proposal be revised to make clear that Nasdaq-listed issuers would be required to provide appropriate funding, as determined by the audit committee, for payment of compensation to any advisers employed by the audit committee.[22]

B. Audit Committee Composition

1. Committee Member Independence

Under the proposal, a member of any investment company's audit committee must be independent as defined in Rule 4200, meet the criteria for independence set forth in Section 10A(m)(3) of the Exchange Act, and not own or control 20 percent or more of the company's voting securities (or such

lower measurement as may be established by the SEC in rulemaking under Section 10A(m)). The proposal does not distinguish investment companies from other listed companies.

In contrast to the proposal, under Rule 10A-3, a member of an investment company's audit committee may not be an "interested person" of the investment company, as defined under Section 2(a)(19) of the Investment Company Act. The SEC explained in the Rule 10A-3 Adopting Release that it had substituted the Section 2(a)(19) test for the affiliation test applied to operating companies because the Section 2(a)(19) test is tailored to capture the broad range of affiliations with investment advisers, principal underwriters, and others that are relevant in the case of investment companies.[23] The Institute recommends that the proposal be modified to make the same adjustment for investment companies that was made in Rule 10A-3. We believe that this is the more appropriate standard to use because it is tailored to the types of conflicts of interest faced by investment company directors.

2. Committee Member Financial Background

Under the proposal, audit committee members would be required to be able to read and understand fundamental financial statements, including a company's balance sheet, income statement, and cash flow statement, and listed companies would be required to certify that they have, and will continue to have, at least one member of the audit committee who has past employment experience in finance or accounting, requisite professional certification in accounting, or any other comparable experience or background that results in the individual's financial sophistication, including being or having been a chief executive officer, chief financial officer or other senior officer with financial oversight responsibilities. This is identical to Nasdaq's existing requirement with respect to audit committee members except that the proposal would tighten the current requirements by providing that audit committee members would be required to be able to read and understand fundamental financial statements at the time they join the board rather than having these qualifications within a reasonable period of time of joining the board.

We do not object to the proposed change and believe that it should enhance the effectiveness of audit committees if committee members are required to read and understand financial statements at the time that they join the committee (rather than within a reasonable period of time thereafter). We strongly recommend, however, that Nasdaq defer action on this aspect of the proposal so that it can harmonize its requirements with analogous NYSE requirements.[24]

V. Public Comment Period

The SEC provided the bare minimum, 21-day period for interested persons to comment on this significant rule proposal. As the Institute has noted several times in the past,[25] such a short comment period is extremely inadequate to develop comments before the close of the comment period on such a significant rule proposal. Given the substantial resources that Congress, the SEC, and the self-regulatory organizations have devoted to improving the corporate governance structure of American

companies and foreign companies listed in the United States, it seems that the SEC would wish to seek to provide “interested persons” with a bona fide “opportunity to submit … views and arguments” concerning these proposed rule changes. Providing the public with only 21 days to comment on such a significant proposal does not constitute meaningful opportunity to comment. We urge the SEC to lengthen the public comment period for any future significant self-regulatory rule proposals.

* * *

We appreciate your consideration of our comments on this important proposal. If you have any questions or need additional information, please contact me at (202) 326-5815, Dorothy Donohue at (202) 218-3563, or Amy B.R. Lancellotta at (202) 326-5824.

Sincerely,

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ENDNOTES

[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,912 open-end investment companies ("mutual funds"), 554 closed-end investment companies, and six sponsors of unit investment trusts. Its mutual fund members have assets of about $6.254 trillion, accounting for approximately 95 percent of total industry assets, and over 90.2 million individual shareholders.

[2] SEC Release No. 34-47516 (March 17, 2003); 68 FR 14451 (March 25, 2003) ("Proposing Release").

[3] See Corporate Governance Rule Proposals Reflecting Recommendations from the NYSE Corporate Accountability and Listing Standards Committee As Approved by the NYSE Board of Directors August 1, 2002 ("NYSE August Report"), SEC Release Nos. 33-8220; 34-47654; IC-26001 (April 9, 2003) (adopting Rule 10A-3 under the Securities Exchange Act of 1934 to implement Section 301 of the Sarbanes-Oxley Act of 2002) ("Rule 10A-3 Adopting Release"). See also Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, dated February 19, 2003 (Institute comments on proposed Rule 10A-3).

[4] SEC Release No. IC-24816 (January 2, 2001). For investment companies to be able to rely on any of ten key exemptive rules under the Investment Company Act, a majority of a company's board must be independent and those directors must select and nominate any other independent directors of the company. Most, if not all, investment companies rely on one or more of these rules.

[5] See proposed Rule 4200(a)(14) and (15). Under the proposal and as discussed in more detail below, audit committee members would be subject to heightened standards of independence.

[6] See Proposing Release at 14452.

[7] For example, Section 2(a)(19) 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. Section 2(a)(19) 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 has provided guidance about the types of business and professional relationships that may be material for purposes of Section 2(a)(19). See SEC Release No. IC-24083 (October 14, 1999) (interpreting certain matters concerning independent directors of investment companies).

[8] See Proposing Release at 14455.

[9] See NYSE August Report, supra note 3, at text following note 2, which states that "[t]he Exchange considers the significantly expanded standards and requirements provided for in Section 303A to be unnecessary for closed-end management investment companies given the pervasive federal regulation applicable to them. However, closed-end management investment companies will be required to continue to comply with audit committee requirements, as they are enhanced and expanded in subsections 6 and 7 of Section 303A." In other words, the NYSE has recommended excluding closed-end investment companies from contemplated enhanced requirements regarding compensation

committees, nominating committees, and the independence of directors and subjecting them to the audit committee requirements. The Report also notes that the NYSE does not apply corporate governance standards to passive business organizations in the forms of trusts and special purpose securities like exchange-traded investment companies.

[10] See Proposing Release at 14455. The proposed requirement specifically would apply to officers, as that term is defined in Section 16 of the Exchange Act and Rule 16a-1 thereunder. Rule 16a-1 defines "officer" as, among others, a company's president, principal financial officer, principal accounting officer, vice-presidents in charge of a principal business unit, and any other officer who performs a policy-making function. With respect to deliberations regarding the compensation of these officers, the chief executive officer would be permitted to be present but not to vote.

[11] The NYSE has recommended a similar requirement whereby a nominating committee composed entirely of independent directors would be required 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. The NYSE has recommended excluding investment companies from this requirement.

[12] The adviser typically also provides investment research, places purchase and sale orders for the fund, and provides services, such as internal auditing and preparing reports to shareholders.

[13] 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 proposed requirements regarding oversight of officer compensation.

[14] The standards guiding the process of approving the advisory contract are complex. In cases challenging the fairness of advisory fees, courts have viewed the Investment Company 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).

[15] This practice is consistent with the Institute's 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 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.

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

[17] The proposed interpretive material to NASD Rule 4350, Nasdaq’s rule regarding audit committees, states that while an audit committee would be empowered to retain outside consultants, they would not be expected to do so routinely. Rather, Nasdaq expects that such authority would be exercised in response to specific circumstances giving rise to an audit committee determination that such action was in the best interests of the company and its shareholders.

[18] Rule 10A-3 under the Exchange Act directs the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer whose audit committee does not meet certain requirements. These requirements relate to: the independence of audit committee members; an audit committee’s responsibility to select and oversee the issuer’s independent accountant; the procedures for handling complaints regarding the issuer’s accounting practices; the authority of an audit committee to engage advisers; and the funding for the independent auditor and any other advisers engaged by an audit committee.

[19] For example, under our recommended approach, exchange-traded funds organized as unit investment trusts would be exempted from the audit committee requirements. In addition to being consistent with Rule 10A-3, we believe that this is appropriate because, as a passive investment vehicle, a UIT has no board of directors. For that same reason, we recommend that UITs be excluded from the entire proposal.

[20] Our recommended approach would be consistent with SEC statements in the Rule 10A-3 Adopting Release. There, the SEC stated that to the extent that national securities associations listing standards do not comply with the proposed Rule 10A-3, these associations “will be required to issue or modify their rules, subject to Commission review, to conform their listing standards. An SRO that wished to do so could satisfy the requirements of the rule by requiring that a listed issuer must comply with the requirements set forth in Exchange Act Rule 10A-3. The SROs are not precluded from adopting additional listing standards regarding audit committees, as long as they are consistent with Exchange Act Rule 10A-3.” See Rule 10A-3 Adopting Release at 22.

[21] We note that these aspects of the proposal are consistent with the Institute’s Best Practices Report, which recommends that a fund’s independent directors have qualified counsel, have express authority to consult with the fund’s independent auditors or other experts, and have the authority to use fund assets to retain experts when they deem it necessary to further shareholder interests. See Best Practices Report at 19-20.

[22] While Section 10A(m)(6) of the Exchange Act sets forth this requirement, unlike the other provisions in Section 10A(m), it is not referenced in the proposal. However, the accompanying explanation states

that the charter "must specify all audit committee responsibilities set forth in Section 10A of the Act," which presumably includes Section 10A(m)(6). See Proposing Release at 14454. Accordingly, we believe that this aspect of the proposal should be clarified. The requested clarification is consistent with Rule 10A-3. See Rule 10A-3 Adopting Release at 21.

[23] Rule 10A-3 Adopting Release at 12-13.

[24] The NYSE currently requires each audit committee member to be "financially literate," as such qualification is interpreted by the company's board in its business judgment, or to become financially literate within a reasonable period of time after his appointment to the committee. In addition, at least one member of the audit committee must have accounting or related financial management expertise, as the board interprets such qualification in its business judgment. In a report issued in June, the NYSE Corporate Accountability and Listing Standards Committee recommended requiring the audit committee's chair to have the requisite accounting or related financial management expertise See Report of the NewYork Stock Exchange Corporate Accountability and Listing Standards Committee (June 6, 2002) at 12. Subsequently, the NYSE Board of Directors determined to wait to act on this recommendation until the SEC issued the final definition of financial expert. (See NYSE August Report at note 3).

[25] See e.g., Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, dated April 6, 2001 (File No. S7-03-01) (Proposed Rule Changes of Self-Regulatory Organizations), and Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, dated January 9, 2001 (File No. SR-NASD-00-59) (Nasdaq Mutual Fund Quotation Service).
