IDC Independent Directors Council
Promoting Excellence in Fund Governance

Comment Letter on NYSE Proposal to Improve Corporate Governance, May 2003

May 8, 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 NYSE Rules Relating to Corporate Governance (File No. SR-NYSE-2002-33)

Dear Mr. Katz:

The Investment Company Institute[1] is pleased to comment on the New York Stock Exchange's proposed corporate governance reforms.[2] We commend the Exchange for taking this initiative to improve corporate governance by enhancing the role of independent directors and strengthening the oversight responsibilities of audit committees.[3] The Institute's perspectives on the proposal are unique in that investment companies are both investors in and issuers of securities. As investors in equity securities, the Institute's members rely on high-quality financial reporting to make investment decisions. Accordingly, the Institute generally supports the proposal, which we believe will serve to enhance the interests of investors by improving the governance structure of listed companies and the integrity of financial reporting.

Our comments on the proposal focus on its application to investment companies as issuers. We are pleased that the proposal recognizes that many of the proposed requirements are "unnecessary for closed-end management companies given the pervasive federal regulation applicable to them" and that none of the proposed amendments are necessary for exchange-traded investment companies.[4] We strongly concur that with respect to closed-end investment companies, existing regulatory requirements satisfy many of the NYSE's policy goals, thereby making it unnecessary to apply the proposed

requirements with respect to: independent directors; nominating/corporate governance committees; compensation committees; corporate governance guidelines; codes of business conduct and ethics; and chief executive officer certifications regarding violations of the NYSE corporate governance listing standards.[5] Our specific comments on the proposal are set forth below.

Table of Contents

I. Audit Committee

A. Service on Multiple Audit Committees

The proposal 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 the member to effectively serve on the listed company's audit committee and to disclose such determination in its proxy statement. The NYSE's 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.[6]

The Institute strongly recommends that in applying this requirement to investment companies, the NYSE should treat a "fund complex" as one company.[7] It is common practice in the investment company industry for the same directors to serve on the audit committee of one or more funds in a complex. In addition, an investment company's financial statements are less complicated than the financial statements of operating companies and therefore audit committee oversight requires less time.[8] Moreover, 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.[9]

B. Financial Literacy of Audit Committee Members

Under the proposal, each member of the audit committee would be required 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 appointment to the audit committee. In addition, at least one member of the audit committee would be required to have accounting or related financial management expertise, as the company's board interprets such qualification in its business judgment. The proposal is identical to the NYSE's existing requirement with respect to the financial literacy of audit committee members, except that a board would be permitted to presume that a person who satisfies the definition of audit committee financial expert set out in Item 401(e) of Regulation S-K has such expertise.

The Institute recommends that the proposal be modified to require audit committee members to be financially literate at the time they join the audit committee rather than having these qualifications within a reasonable period of time after appointment to the committee. This change should enhance the effectiveness of audit committees and would make the NYSE's requirement more consistent with Nasdaq's recent corporate governance proposal.[10]

C. Internal Audit

Under the proposal, each listed company would be required to have an internal audit function. The purpose of the proposed requirement is to have a mechanism in place that would provide a company's management and audit committee with ongoing assessments of the company's risk management processes and system of internal control. The Institute recommends excluding investment companies from this requirement. We believe that such a requirement is unnecessary because of the comprehensive substantive requirements of the Investment Company Act. These include, among others, prohibitions on transactions with affiliates, fidelity bonding for officers and others that have access to fund securities, limitations on the extent to which investment companies may borrow money or leverage their portfolios, and the requirement that investment company assets be held by a bank custodian. Moreover, unlike operating companies, investment companies are subject to periodic on-site inspections by the SEC staff designed to ensure that they are operating in compliance with applicable law and their stated investment objectives and policies.

D. Review of Earnings Information

The Institute recommends excluding investment companies from the proposed requirement that audit committee members discuss earnings press releases as well as financial information and earnings guidance provided to analysts and rating agencies. Unlike operating companies, the computation of an investment company's earnings is straightforward because they are determined simply by calculating income and gains on portfolio investments less expenses. Moreover, in contrast to operating companies, the Internal Revenue Code essentially requires investment companies to distribute earnings in the calendar year in which they are received. Because of the unique nature of investment companies, they do not have earnings targets, although they often release statements announcing quarterly investment results. These statements neither provide earnings guidance to security analysts

nor contain complex detail comparable to earnings reports released by operating companies. Consequently, oversight of these earnings press releases by the audit committee is not necessary.

II. 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, [11] providing the public with only 21 days does not constitute meaningful opportunity to comment. Given the substantial resources that Congress, the SEC, and the self-regulatory organizations have devoted to improving corporate governance 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. We urge the SEC to lengthen the public comment period for any future significant self-regulatory organization rule proposals.

* * *

The Institute appreciates the opportunity to provide these comments on the NYSE's proposal. If you have any questions or need additional information, please contact me at (202) 326-5815, Dorothy M. Donohue at (202) 218-3563 or Amy B.R. Lancellotta at (202) 326-5824.

Sincerely,

Craig S. Tyle
General Counsel

cc: James L. Cochrane,
Senior Vice President
The New York Stock Exchange, Inc.

Paul F. Roye, Director
Susan Nash, Associate Director
Christopher Kaiser, Senior Counsel
Division of Investment Management

Annette Nazareth, Director
Jennifer Lewis, Attorney
Division of Market Regulation

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 8,904 open-end investment companies ("mutual funds"), 552 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. 34-47672 (April 11, 2003) [68 FR 19051 (April 17, 2003)] ("Proposing Release"). The proposal is based on the 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).

[3] We note that the NYSE's proposal is consistent with recently adopted Rule 10A-3 under the Securities Exchange Act of 1934, which directs the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that is not in compliance with the audit committee requirements mandated by Section 301 of the Sarbanes-Oxley Act of 2002. SEC Release Nos. 33-8220; 34-47654; IC-26001 (April 9, 2003) [68 FR 18788 (April 16, 2003)].

[4] Proposing Release at 19052.

[5] We previously provided the NYSE with detailed comments explaining why it is unnecessary to apply the proposed requirements to investment companies. See Letter from Dorothy M. Donohue, Associate Counsel, Investment Company Institute, to James L. Cochrane, Senior Vice President, New York Stock Exchange, dated July 19, 2002.

[6] Proposing Release at 19055.

[7] In tailoring this requirement for investment companies, we recommend that the NYSE refer to the definition of "fund complex" in the Securities and Exchange 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.").

[8] 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.

[9] The Public Company Accounting Oversight Board recently recognized that audits of investment companies are less complex than audits of operating companies due to their structure and the limited nature of their activities. See PCAOB Release No. 2003-003 (April 18, 2003) (establishing accounting

support fees to fund operations of the Board).

[10] SEC Release No. 34-47516 (March 17, 2003) [68 FR 14451 (March 25, 2003)].

[11] 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 15, 2003 (Nasdaq's Corporate Governance Proposal); 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).
