

## Comment Letter on Nasdaq Proposed Code of Conduct, July 2003

July 30, 2003

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

**Re: Proposed Amendments to Nasdaq Stock Market, Inc. Rules Regarding Codes of Conduct  
(File No. SR-NASD-2002-139)**

Dear Mr. Katz:

The Investment Company Institute<sup>1</sup> is pleased to comment on Nasdaq's most recently proposed corporate governance reforms, which would place additional responsibilities on Nasdaq-listed issuers with respect to codes of conduct.<sup>2</sup> Investment companies are both shareholders of the companies in which they invest and issuers with respect to their own shareholders, directors, and officers. Accordingly, the Institute has a keen interest in this proposal

Our 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. The Institute requests that Nasdaq clarify that investment companies subject to related requirements under the Investment Company Act of 1940 would be deemed to satisfy Nasdaq's requirements regarding codes of conduct. This change would make the proposal more consistent with recent action taken by the New York Stock Exchange.<sup>3</sup> As discussed more fully below, we believe this change is appropriate in view of existing regulatory requirements for investment companies that satisfy Nasdaq's policy goals and in order to harmonize various regulatory requirements regarding codes of conduct.

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

## Codes of Conduct

Nasdaq proposed to amend Rule 4350 to require listed companies to adopt a code of conduct for their directors, officers, and employees. The code would be required to comply with the definition of “code of ethics” in Section 406(c) of the Sarbanes-Oxley Act of 2002 and related rules adopted by the Securities and Exchange Commission. In addition, the code would be required to be made publicly available and to provide for an enforcement mechanism.

In considering the appropriate scope of the proposed rules, we urge Nasdaq to take into account the fact that, unlike other issuers, investment companies already are subject to a pervasive system of substantive regulation under the Investment Company Act. These requirements are in addition to rules recently adopted by the Commission to implement the code of ethics requirement in Section 406 of the Sarbanes-Oxley Act that apply to both operating and investment companies.

In particular, Rule 17j-1 under the Investment Company Act 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. Among other things, Rule 17j-1 requires investment advisory personnel to periodically provide holdings reports listing all securities beneficially owned. It also requires that each investment company’s code of ethics be approved by the investment company’s board, including a majority of independent directors.

The Investment Company Act also prohibits or restricts various types of transactions between an investment company and its affiliates.<sup>4</sup> 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 Investment Company Act prohibits an affiliate of an investment company from borrowing money or other property from the investment company.<sup>5</sup> The Investment Company Act also prohibits an affiliate of an investment company, acting as agent, from receiving compensation from outside sources in exchange for the purchase or sale of any property to or from an investment company.<sup>6</sup> The Investment Company 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.<sup>7</sup> Furthermore, appropriate investment company officers are required to make certifications regarding the establishment and maintenance of disclosure controls and procedures and to certify investment company periodic reports.

The presence of these requirements should satisfy Nasdaq’s goal of demonstrating that the board and management of Nasdaq-listed investment companies have carefully considered: the requirement of ethical dealing, the possibility of the private interests of directors, officers, and employees conflict with the interests of the company,<sup>9</sup> and that disclosures are made fairly, accurately, and timely.

In light of the foregoing requirements and restrictions applicable to investment companies, we recommend that Nasdaq determine that investment companies that are subject to the requirements of Item 2 of Form N-CSR (or parallel requirements in Form N-SAR), Section 17 under the Investment Company Act, Rule 17j-1 thereunder, and the other requirements discussed above would be deemed to satisfy any new Nasdaq requirement regarding codes of conduct. We believe that such a determination would be consistent with Nasdaq's intentions with respect to the proposal. Moreover, such a determination would harmonize Nasdaq's code of conduct requirements with analogous requirements proposed by the NYSE.<sup>10</sup>

## Waivers

The proposed rule would require any waivers of the code for directors or executive officers to be approved by the board and to be disclosed in the issuer's next periodic report. The interpretive material accompanying the proposed rule further states that a domestic issuer must make this disclosure in its next "quarterly or annual report, whichever is sooner."<sup>11</sup> The interpretive material also states that, alternatively, an issuer would be permitted to make the required disclosure in a report on Form 8-K before its next periodic report.

If Nasdaq determines to subject investment companies to the proposed code of conduct requirements, we request that it clarify how frequently investment companies must disclose any waivers granted. Unlike operating companies, investment companies generally are not required to file quarterly reports or reports on Form 8-K.<sup>12</sup> In apparent recognition of this, the Commission recently required investment companies to disclose waivers from the new code of ethics requirements on Form N-SAR or Form N-CSR, as applicable. As an alternative, the Commission permitted an investment company to disclose this information on its Internet website within two business days after the occurrence of the waiver, in accordance with certain conditions.<sup>13</sup>

Accordingly, if the proposed code of conduct requirements are made applicable to investment companies, we request that Nasdaq clarify that an investment company may disclose waivers to its Nasdaq code of conduct on Form N-SAR or Form N-CSR, as applicable, or on its Internet website. The requested clarification takes into account the differences between the reporting obligations of operating companies and investment companies and assures consistency between Nasdaq's required code of conduct and analogous Commission requirements.<sup>14</sup>

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We appreciate your consideration of our comments on this proposal. If you have any questions or need additional information, please contact me at (202) 218-3563

Sincerely,

Dorothy M. Donohue  
Associate Counsel

cc: Mary Dunbar, Vice-President and Deputy General Counsel  
Eleni Constantine, Associate Counsel  
Officer of General Counsel

The Nasdaq Stock Market, Inc.

Paul F. Roye, Director  
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U.S. Securities and Exchange Commission

## **ENDNOTES**

<sup>1</sup> The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,678 open-end investment companies (“mutual funds”), 555 closed-end investment companies, 106 exchange-traded funds, and six sponsors of unit investment trusts. Its mutual fund members have assets of about \$6.697 trillion, accounting for approximately 95 percent of total industry assets, and 90.2 million individual shareholders.

<sup>2</sup> SEC Release No. 34-48125 (July 2, 2003) [68 FR 41194 (July 10, 2003)] (“Proposing Release”).

<sup>3</sup> See SEC Release No. 34-47672 (April 11, 2003) [68 FR 19051 (April 17, 2003)].

<sup>4</sup> See Section 17 of the Investment Company Act.

<sup>5</sup> See Section 17(a)(3) of the Investment Company Act.

<sup>6</sup> See Section 17(e) of the Investment Company Act.

<sup>7</sup> See Section 17(f) of the Investment Company Act.

<sup>8</sup> See Rule 30a-2 under the Investment Company Act.

<sup>9</sup> Because registered investment companies typically do not have employees, we note that the proposed code of conduct requirements would, in most instances, only apply to an investment company’s directors and officers. There are, however, several closed-end investment companies that

are internally managed and that, therefore, have employees.

<sup>10</sup> See Release 34-47672 at 19052, *supra* note 3, stating that the proposed code of conduct requirement as well as certain other proposed requirements are “unnecessary for closed-end management companies given the pervasive federal regulation applicable to them” and that none of the proposed requirements are necessary for exchange-traded investment companies.

<sup>11</sup> Proposing Release at 41195

<sup>12</sup> See Rule 30d-1 under the Investment Company Act (generally exempting registered investment companies from the requirement to file quarterly reports) and Rules 13a-11 and 15d-11(b) under the Securities Exchange Act of 1934 (generally exempting registered investment companies from Form 8-K filing requirements). Regulation Blackout Trading Restriction represents the only instance where the SEC has required investment companies to report on Form 8-K. In one other instance, Regulation Fair Disclosure, the SEC permitted investment companies to use Form 8-K as one of several alternative permissible methods for reporting.

<sup>13</sup> Items 2(d) and 2(e) of Form N-CSR and Instructions 102P3 (a)(4) and (a)(9) of Form N-SAR. In contrast, the SEC required operating companies to disclose waivers on Form 8-K or, alternatively, on their Internet websites. See Items 10 of Form 8-K.

<sup>14</sup> We note that there is a statement in the interpretive material accompanying proposed Rule 4350(m) suggesting that Nasdaq-listed issuers would be required to report “violators” of the law to “appropriate authorities.” See Proposing Release at 41195. We request Nasdaq to clarify that reporting violations of laws, rules, and regulations to appropriate personnel within a particular company would be sufficient for the purposes of a Nasdaq code of conduct. The recommended clarification would make the Nasdaq code of conduct more consistent with Commission rules implementing Section 406 of the Sarbanes-Oxley Act and the NYSE’s proposal regarding codes of conduct.