



INVESTMENT COMPANY INSTITUTE

CRAIG S. TYLE
GENERAL COUNSEL

February 19, 2003

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

Re: Standards Relating to Listed Company Audit Committees (File No. S7-02-03)

Dear Mr. Katz:

The Investment Company Institute¹ appreciates the opportunity to express its views on proposed Rule 10A-3 under the Securities Exchange Act of 1934, which is intended to implement Section 301 of the Sarbanes-Oxley Act of 2002.² Proposed Rule 10A-3 would direct the national securities exchanges 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; the 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 the audit committee to engage advisers; and the funding for the independent auditor and any other advisers engaged by the audit committee.

The Institute strongly supports the Commission's proposal. 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'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 proposed Rule 10A-3 – to enhance, and

¹ The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,935 open-end investment companies ("mutual funds"), 559 closed-end investment companies and 6 sponsors of unit investment trusts. Its mutual fund members have assets of about \$6.382 trillion, accounting for approximately 95% of total industry assets, and 90.2 million individual shareholders.

² SEC Release Nos. 33-8173; 34-47137; IC-25885 (January 8, 2003); 68 Fed. Reg. 2637 (January 17, 2003) (the "Proposing Release").

make more effective, the oversight of the financial reporting process. Such oversight will assist in ensuring the accuracy and reliability of financial reporting.

Our specific comments on the Commission's proposal focus on its application to investment companies as issuers.³ We are pleased that the Commission has recognized that it is appropriate to tailor certain aspects of the proposed rule for investment companies. We believe that this approach is necessary in view of the differences between the structure and operations of investment companies from that of other listed issuers and the existence of certain regulatory requirements for investment companies. For example, we support the Commission's decision to exempt listed UITs from the requirements of the proposed rule, recognizing that as a passive investment vehicle, a UIT has no board of directors.⁴ Other specific comments on the proposed rule are set forth below.

A. Audit Committee Member Independence

Under the proposed rule, 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 of 1940. The Proposing Release explains that the Commission has 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.⁵ The Institute supports using Section 2(a)(19)'s definition of interested person to determine whether a member of an investment company's audit committee is independent. We agree that this is the most appropriate standard to use because it is tailored to the types of conflicts of interest faced by investment company directors.

In addition to requiring that a member of an investment company's audit committee not be an "interested person" under Section 2(a)(19) of the Investment Company Act, proposed Rule 10A-3 would prohibit audit committee members of any listed issuer, including investment companies, from accepting any consulting, advisory or other compensatory fee from the issuer or an affiliate of the issuer, other than in the member's capacity as a member of the board of directors. Indirect payments, including payments to a law firm in which an audit committee member is a partner and which provides legal services to the issuer, would be prohibited.

We request that the Commission provide an exemption from Rule 10A-3 that would permit a director on an investment company's audit committee to: (i) provide legal services to an investment company's independent directors; and/or (ii) be a partner of a law firm that provides legal services to an investment company's independent directors. We do not believe

³ The proposed rule would apply to closed-end investment companies and exchange-traded funds that are listed on a national securities exchange. Listed unit investment trusts ("UITs") and open-end investment companies (other than listed ETFs) would not be subject to the proposal.

⁴ Proposing Release at 2650.

⁵ Proposing Release at 2641.

that payments from an investment company in either circumstance should disqualify that director from serving on the investment company's audit committee, provided that the payment is consideration for legal services provided to the investment company's independent directors. The recommended exemption is consistent with a recent Commission staff letter on this point.⁶

B. Responsibilities Relating to Registered Public Accounting Firms

Under proposed Rule 10A-3(b)(2)(i), the audit committee would be responsible for the "appointment, compensation, retention and oversight" of the independent accountant engaged for the purpose of preparing an audit report. The Commission has proposed exempting investment companies that fall within the scope of the proposed rule from the requirement that the audit committee be responsible for the selection of the independent accountant, recognizing that Section 32(a) of the Investment Company Act requires a majority of disinterested directors to have annually "selected" the independent accountant.

The Institute supports this approach because it would avoid imposing an inconsistent and unnecessary selection requirement on the audit committee while assuring independent director oversight of the auditor selection process. We have a technical comment, however, to ensure that the proposed rule does not conflict with Section 32(a) of the Investment Company Act. Specifically, we recommend that the Commission clarify that "selection" as used in proposed Rule 10A-3(b)(2)(ii) includes the terms "appointment" and "retention" as used in proposed Rule 10A-3(b)(2)(i). We believe our recommendation is consistent with the Commission's intent, as stated in the Proposing Release, that investment companies would "remain subject to the proposed requirements regarding audit committee responsibility in all other areas, including *compensation and oversight* of the auditors" (emphasis added).⁷

C. Procedures for Handling Complaints

The Commission has proposed that each audit committee establish procedures for: (1) the receipt, retention, and treatment of complaints received by the listed issuer regarding accounting, internal accounting controls and auditing matters; and (2) the confidential, anonymous submission by employees of the listed issuer of concerns regarding questionable accounting or auditing matters. The Institute supports the proposed rule, including the Commission'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.

⁶ See Ballard Spahr Andrews & Ingersoll, LLP (pub. avail. April 3, 2002) (where the staff stated that a person who serves as counsel or is a partner of a law firm that provides legal services to the independent directors of an investment company is not an interested person of that company under Section 2(a)(19)(A)(iv) even if the investment company pays the legal expenses of the independent directors).

⁷ Proposing Release at 2644.

D. Engagement and Funding of Advisers to the Audit Committee

Under the Commission's proposal, an audit committee must have the authority to engage independent counsel and other advisers, as it determines necessary to carry out its duties. Issuers would be required to provide appropriate funding, as determined by the audit committee, for payment of compensation to any public accounting firm performing audit services and to any advisers employed by the audit committee. The Institute supports these aspects of the Commission's 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 the 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.⁸

E. Transition Period

The Proposing Release states that the Commission expects that final Rule 10A-3 would have a delayed implementation date before companies would be subject to any new listing standards and envisions that the listing standards contemplated by proposed Rule 10A-3 would be operative by the self-regulatory organizations no later than the first anniversary of the publication of final Rule 10A-3 in the *Federal Register*.⁹ We support the Commission's proposed approach. We believe that such a transition period is necessary to give listed issuers time to go through an annual meeting election cycle to elect any new directors that would be necessary to meet the new audit committee requirements.

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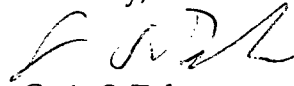
⁸ We note that these aspects of the proposed rule are consistent with the Institute's Report of the Advisory Group on Best Practices for Fund Directors, which recommends that a fund's independent directors have qualified counsel, have express authority to consult with the fund's independent auditors or other experts, and have the authority to use fund assets to retain experts when they deem it necessary to further shareholder interests. See *Investment Company Institute: Report of the Advisory Group on Best Practices for Fund Directors, Enhancing a Culture of Independence and Effectiveness* (June 24, 1999).

⁹ Proposing Release at 2650.

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The Institute appreciates your consideration of our views on the proposed rule. If you have any questions regarding our comments or would like additional information, please contact the undersigned at 202/326-5815, Dorothy Donohue at 202/218-3563 or Greg Smith at 202/326-5851.

Sincerely,



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General Counsel

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