

support for this formulation,⁷³ several others believed the formulation was overly broad and would capture those who may not necessarily control the affiliate, such as outside directors of an affiliate.⁷⁴ These commenters raised concerns similar to those raised regarding our proposal to include partners, members and principals in the compensatory fee prohibition. Many also were concerned that including the term "designee" could inadvertently mean that where there was a controlling shareholder, all directors that were elected, including those that met the independence requirements, could be considered "designees" of an affiliate and disqualified from service because the controlling shareholder had the power to elect all such directors.

After evaluating these comments, we are narrowing the formulation. Under the final rule, only executive officers, directors that are also employees of an affiliate, general partners and managing members of an affiliate will be deemed to be affiliates. The limitation on directors will exclude outside directors of an affiliate from the automatic designation. Also, the reference to executive officers, general partners and managing members of an affiliate includes the positions we intend to cover. This will help clarify that passive, non-control positions, such as limited partners, and those that do not have policy making functions, are not covered. The formulation for being deemed to be an affiliate is narrower than the formulation of covered positions for the indirect acceptance aspect of the "no compensation" prong due to their different purposes. We believe a wider formulation is necessary for the "no compensation" prong to capture those whose compensation is more directly linked to fees from the prohibited services but who otherwise do not hold executive positions. Finally, we have removed the term "designee." However, consistent with our historical interpretations of the term "affiliate," an affiliate could not evade the prohibitions in the rule simply by designating a third party representative or agent that it directs to act in its place.

For issuers that are investment companies, we are adopting, as proposed, the requirement that a member of the audit committee of an investment company may not be an "interested person" of the investment company, as defined in section 2(a)(19)⁷⁵ of the Investment Company

Act.⁷⁶ As described in the Proposing Release, we have 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 to "independence" in the case of investment companies. Commenters supported this substitution.⁷⁷

4. New Issuers

Under Exchange Act section 10A(m)(3)(C), we have the authority to exempt from the independence requirements particular relationships with respect to audit committee members, if appropriate in light of the circumstances. As discussed in the Proposing Release, companies coming to market for the first time may face particular difficulty in recruiting members that meet the independence requirements. Before completion of a company's initial public offering, the board of directors often will consist primarily, if not exclusively, of representatives of venture capital investors and insiders. Such representation is entirely consistent with the desire of these parties to have representation in their private venture. The difficulty of recruiting independent directors before an initial public offering, coupled with the uncertainty of whether the initial public offering will be completed, may discourage companies from accessing the public markets to grow their business and provide liquidity, as well as from achieving the other benefits of being a public company, if all of their audit committee members must be independent at the time of the initial public offering. Further, the audit committee of some new public companies may function more effectively if it can maintain historical knowledge and experience during the transition to public company status.

As a result, we proposed an exemption for one member of a non-investment company issuer's audit committee from the independence requirements for 90 days from the effective date of an issuer's initial registration statement under section 12 of the Exchange Act or a registration

statement under the Securities Act covering an initial public offering of securities of the issuer. We requested comment on whether this exemption should be extended. While not all agreed,⁷⁸ the overwhelming majority of commenters believed the proposed exemption was too restrictive to address the potential problems new issuers may face.⁷⁹ Particularly given the increased focus on board service in general, and audit committee service in particular, commenters argued that additional accommodations in both the length of the exemption and the number of members covered are necessary to not overly burden access to the capital markets.

While we recognize these potential difficulties, we continue to believe that it is important to have at least some independent representation on the audit committee at the time of an initial listing, and that a majority of the committee and the full committee should reach the independence requirements as soon as practicable. Accordingly, to balance the concerns between the need for independence and the ability to recruit qualified candidates, we are adopting a revised exception for non-investment company issuers that requires at least one fully independent member at the time of an issuer's initial listing, a majority of independent members within 90 days, and a fully independent committee within one year.

5. Overlapping Board Relationships

As discussed in the Proposing Release, many companies, particularly financial institutions and other entities with a holding company structure, operate or obtain financing through subsidiaries. For these companies, the composition of the boards of the parent company and the subsidiary are sometimes similar given the control structure between the parent and the subsidiary. If an audit committee member of the parent is otherwise independent, merely serving also on the board of a controlled subsidiary should not adversely affect the board member's independence, assuming that the board member also would be considered independent of the subsidiary except for the member's seat on the parent's board. Accordingly, we proposed an exemption from the "affiliated person" requirement for a committee member that sits on the board of directors of both a parent and a direct or indirect consolidated

⁷⁶ The "interested person" test will apply to business development companies, as well as registered investment companies. Business development companies are a category of closed-end investment company that are not registered under the Investment Company Act, but are subject to certain provisions of that Act. See sections 2(a)(48) and 54–65 of the Investment Company Act [15 U.S.C. 80a–2(a)(48) and 80a–53–64].

⁷⁷ See, e.g., the Letters of ABA; Deloitte; the Investment Company Institute ("ICI").

⁷⁸ See, e.g., the Letter of SWIB.

⁷⁹ See, e.g., the Letters of ABA; AICPA; Amex; CalSTRS; Cleary; CSC; Deloitte; KPMG LLP; National Venture Capital Association ("NVCA"); NYCBA; NYSE; S&C; Vinson & Elkins L.L.P.

⁷³ See, e.g., the Letter of PwC.

⁷⁴ See, e.g., the Letters of ABA; Cravath; S&C.

⁷⁵ 15 U.S.C. 80a–2(a)(19).