The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
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SEC ADOPTS AUDITOR INDEPENDENCE RULES

[15603] January 31, 2003 TO: ACCOUNTING/TREASURERS MEMBERS No. 7-03 CLOSED-END INVESTMENT COMPANY MEMBERS No. 10-03 COMPLIANCE ADVISORY COMMITTEE No. 8-03 SEC RULES MEMBERS No. 13-03 SMALL FUNDS MEMBERS No. 5-03 RE: SEC ADOPTS AUDITOR INDEPENDENCE RULES As directed by Section 208(a) of the Sarbanes-Oxley Act, the Securities and Exchange Commission recently adopted rules intended to strengthen auditor independence requirements.1 These rules (1) expand the types of non-audit services that, if provided to an audit client, impair an accounting firm's independence, (2) require that an issuer's audit committee pre-approve all audit and non-audit services provided by the auditor, (3) require partners to rotate off the audit engagement team after a five or seven year period, (4) prohibit members of an audit engagement team from accepting certain employment positions with audit clients for a one-year period, (5) require the auditor to report certain matters to the issuer's audit committee, including "critical" accounting policies, (6) require disclosure of the types of services provided by, and fees paid to, the independent accountant, and (7) prohibit audit partners from receiving compensation for "cross-selling" non-audit services to audit clients. The final rules reflect many of the Institute's comments on the proposed rules.2 The rules will be effective 90 days after publication in the Federal Register (the "Effective Date"). The rules contain various transition periods, during which existing relationships will not impair an accountant's independence. Those elements of the recently adopted rules that are of most significance to investment companies are summarized below. I. Employment Relationships – One Year "Cooling Off" Period The Commission originally proposed that employment of a former audit engagement team member in a financial reporting oversight role at any entity in the investment company 1 SEC Release No. 33-8183; 34-47265; 35-27642; IC-25915; IA-2103 (January 28, 2003) ("Release"). A copy of the Release is available on the SEC's website at http://www.sec.gov/rules/final/33-8183.htm. 2 See Memorandum to Accounting/Treasurers Members No. 3-03, Closed-End Investment Company Members No. 5- 03, SEC Rules Members No. 8-03, Small Funds Members No. 2-03, dated January 15, 2003. 2 complex during the one-year period after completion of the last audit would impair the independence of the accounting firm with respect to the audit client. As adopted, an accounting firm would not be independent if a former audit engagement team member3 is employed in a financial reporting oversight role with the registered investment company, or any entity in the investment company complex that is responsible for the financial reporting or operations of the registered investment company, or any other registered investment company in the same investment company complex. The final rule prohibits employment for a one-year period in positions at an investment company complex that would allow a former audit engagement team member to bring undue influence over the

audit process of an investment company. The final rule recognizes that certain positions may exist at an entity in the investment company complex that would be considered financial reporting or oversight positions, but that those positions have no direct influence on the financial reporting or operations of an investment company. The final rule would not disqualify an audit firm if the former audit engagement team member is employed in such a position. The rule is effective for employment relationships that commence after the Effective Date. II. Non-Audit Services Consistent with the Commission's original proposal, the final rules prohibit audit firms from providing ten categories of non-audit services to their audit clients. These services include: (1) bookkeeping; (2) financial information systems design and implementation; (3) appraisal or valuation services; (4) actuarial services; (5) internal audit outsourcing; (6) management functions; (7) human resources functions; (8) broker-dealer, investment adviser or investment banking services; (9) legal services; and (10) expert services. The Release makes clear that designing and implementing internal accounting control and risk management systems impair the accountant's independence. However, accountants may evaluate the design, implementation or operation of these systems, and make recommendations for their improvement, as part of an audit or attest service. The Release indicates that an accounting firm can provide tax services to its audit clients without impairing the firm's independence. These services can include tax compliance, tax planning, and tax advice. However, the Release also indicates that certain tax services would impair the accountant's independence, such as representing an audit client before a tax court. In addition, the Release urges audit committees to scrutinize carefully the retention of the accountant in a transaction initially recommended by the accountant, the sole business purpose of which may be tax avoidance. Recognizing that audit clients may need a period of time to exit existing contracts, the rules provide that until 12 months after the Effective Date, provision of non-audit services will not impair an accountant's independence provided those services are pursuant to contracts in existence on the Effective Date. 3 The final rule provides that persons, other than the lead and reviewing partner, who provide ten or fewer hours of audit, attest, or review services during the period are not considered members of the audit engagement team. 3 III. Partner Rotation The Commission originally proposed that all partners on the audit engagement team must rotate after five years of service and that they be subject to a five-year "time-out" period. The final rules apply the five-year rotation and five-year time-out requirements to only the lead and reviewing partner. Other "audit partners" on the engagement team must rotate after seven years and are subject to a two-year time out period. Audit partners for this purpose include partners on the audit engagement team who have responsibility for decision-making on significant auditing, accounting, and reporting matters that affect the issuer's financial statements or who maintain regular contact with management and the audit committee. Under the proposed rule, a partner performing audit, review, or attest services for any entity in the investment company complex could only do so if they if they had not served five consecutive years on any entity in the complex. The rotation requirement would have extended to specialized partners, such as tax partners, that work on significant aspects of the audit. Partners affected by the rotation requirement would have had to remain off any engagement in the investment company complex for a period of five years. The final rule as adopted by the Commission prohibits the rotation of partners between different investment companies in the same complex. However, the final rule does not prohibit accountants from rotating to other entities in the investment company complex. The final rule contains a provision that would allow audit partners auditing multiple investment companies in the same investment company complex to audit each investment company for five or seven complete fiscal years, as appropriate.4 The final rules contain transition provisions for the rotation requirements. The rotation requirements applicable to the lead partner are effective for the

first fiscal year ending after the Effective Date. In determining when the lead partner must rotate, time served in the capacity of lead partner prior to the effective date of the rules is included.5 The rotation requirements for the concurring partner are effective as of the end of the second fiscal year after the Effective Date.6 For other partners covered by the rules, the rules are effective as of the beginning of the first fiscal year after the Effective Date. However, in determining the time served, that first fiscal year will constitute the first year of service for such partners. IV. Audit Committee Administration of the Audit Engagement Consistent with the Commission's original proposal, the final rules require that the audit committee pre-approve all permissible non-audit services provided to the investment company and all audit, review or attest engagements required under the securities laws. All 4 For purposes of calculating five consecutive years of service, audits of registered investment companies with different fiscal-year ends that are performed in a continuous 12-month period count as a single consecutive year. 5 For example, for a lead partner serving a calendar year audit client, if 2003 was that partner's fifth, sixth or seventh year as lead partner for that audit client, he would be able to complete the current year's audit and must rotate off for the 2004 engagement. 6 For example, a concurring partner for a calendar year audit client, where 2003 was his fourth or greater year in that role, would be able to serve in that capacity for the 2004 audit before being subject to rotation. 4 engagements must be either: (1) pre-approved by the audit committee; or (2) entered into pursuant to pre-approval policies and procedures established by the audit committee. The Commission's original proposal also would have required the investment company's audit committee to pre-approve any non-audit services provided to the investment company's investment adviser and any entity controlling, controlled by, or under common control with the investment adviser that provides services to the investment company. The final rules limit the audit committee's pre-approval responsibility to those services provided directly to the investment company and those services provided to an entity in the investment company complex where the nature of the services provided have a direct impact on the operations or financial reporting of the investment company. In addition, the final rules clarify that only those service providers that provide "ongoing" services to the investment company must have their non-audit services pre-approved. In order to ensure that the audit committee is informed of all services the accountant is providing to the investment company complex, the final rules include a requirement that the accountant disclose to the audit committee on a quarterly basis all services provided to the investment company complex, including the fees associated with those services. The Commission's original rule proposal contained a five percent de minimis exception to the pre-approval requirements for non-audit services. The de minimis exception would have calculated the percentage threshold based on the total revenues paid to the investment company's accountant by the investment company, its adviser, and any entity controlling, controlled by, or under common control with the investment adviser that provides services to the investment company. The final rules calculate the five percent threshold based on the total amount of fees for services provided to the investment company complex that were subject to the pre-approval requirements for the investment company's audit committee. These rules apply to all audit, review, and attest services and non-audit services that are entered into after the Effective Date. For arrangements for non-audit services entered into prior to the Effective Date of these rules—regardless of whether or not they were approved by the audit committee—the accounting firm will have 12 months from the Effective Date to complete the engagement. V. Compensation Under the Commission's original proposal, a partner, principal or shareholder who is a member of the audit engagement team may not, during the audit and engagement period, earn or receive compensation based on the performance or procuring of engagements with that audit client to provide non-audit services. The Release notes that commenters expressed concern that the proposed rule was not directly

related to sales activities. For example, under the proposed rule, a partner's compensation could not include a proportionate share of the accounting firm's overall profits, since some of those profits may be derived from non-audit services provided by other firm personnel. To address these concerns, the final rule adopted by the Commission clarifies that compensation concerns exist where the audit partner's compensation is based on the act of selling non-audit services. 5 These rules will be effective in the fiscal period of the accounting firm that commences after the Effective Date. VI. Communications with Audit Committees Consistent with the Commission's original proposal, the final rules require the auditor to report to the audit committee: (1) all critical accounting policies and practices; (2) all alternative treatments within generally accepted accounting principles for policies and practices related to material items that have been discussed with management;7 and (3) other material written communications between the accounting firm and the investment company, such as any management letter or schedule of unadjusted differences. The proposed rules would have required these communications to take place prior to the filing of an audit report with the Commission. For those investment company complexes that have funds with staggered fiscal year-ends, the proposed rules would require these communications to take place as frequently as monthly. As adopted, the final rules require the accountant to communicate to the audit committee of an investment company annually, and if the annual communication is not within 90 days prior to the filing, provide an update within the 90-day period prior to the filing, of any changes to the previously reported information. The adopted rules, in effect, would require the accountant to communicate the required information no more frequently than four times during a calendar year. VII. Disclosure of Fees and Services Consistent with the Commission's proposal, the final rules require issuers to provide disclosure of fees paid to the independent accountant segregated into four categories: (1) audit fees; (2) audit-related fees; (3) tax fees; and (4) all other fees. Issuers are required to describe the types of services provided within each of the latter three categories. Issuers must also disclose any audit committee pre-approval policies procedures, and the percentage of fees in each of the three non-audit service categories representing services that were entered into pursuant to the five percent de minimis exception. This information must be provided for the two most recent fiscal years. The information must be disclosed in any proxy or information statement and in the Form N-CSR filing covering the annual period.8 The Commission's proposal would have required an investment company to disclose the audit fees paid to its accountant and the aggregate fees paid for audit-related, tax services, and other services to the investment company's accountant by the investment company and its investment adviser, and any entity controlling, controlled by, or under common control with the adviser that provides services to the investment company. The final rule requires investment companies to disclose separately those audit and non-audit fees from services provided directly to the investment company and those non-audit fees from services provided 7 The discussion of alternative treatments must include: (1) ramifications of the use of such alternative disclosures and treatments; and (2) the treatment preferred by the accounting firm. 8 The Form N-CSR filing may incorporate by reference the required information from the definitive proxy or information statement. 6 to all other entities in the investment company complex where the services were subject to pre- approval by the investment company's audit committee. The final rule also will require the investment company to disclose if the audit committee has considered whether the provision of non-audit services provided to the investment company's adviser and its related parties that were not subject to the investment company audit committee's pre-approval is compatible with maintaining the principal accountant's independence. These disclosure requirements are effective for annual filings for the first fiscal year ending after December 15, 2003. Gregory M. Smith Director – Operations/ Compliance & Fund Accounting