INVESTMENT COMPANY INSTITUTE

MEMO# 12675

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ICI COMMENT LETTER ON SEC AUDITOR INDEPENDENCE RULE PROPOSALS

[12675] September 26, 2000 TO: ACCOUNTING/TREASURERS COMMITTEE No. 36-00 CLOSED-END INVESTMENT COMPANY COMMITTEE No. 26-00 SEC RULES COMMITTEE No. 117-00 RE: ICI COMMENT LETTER ON SEC AUDITOR INDEPENDENCE RULE PROPOSALS The Institute has recently filed with the Securities and Exchange Commission a comment letter regarding the Commission's proposed rule amendments to its auditor independence rules. The letter has been modified somewhat from the draft letter we sent to you previously.1 The letter is attached, and it is summarized below. General Principles The Commission's proposal includes a statement of four general principles under which an auditor will be deemed to lack independence from his client. Also included is a non- exclusive list of specific investments in an audit client, and services provided to an audit client, that would violate these general principles. The Institute's letter recommends against incorporating the general principles into the rule. It notes that the combined effect of the general principles and the statement that the list of services and financial relationships is non-exclusive is an open-ended rule that would leave auditors (and issuers) uncertain as to the types of financial relationships and non-audit services that constitute an independence violation. Non-Audit Services The Commission's proposals identify certain non-audit services provided by audit firms that, if provided to an audit client, would be deemed to impair an auditor's independence. Although the Institute's letter agrees with the Commission's view that most of the services identified in the proposed rule raise independence concerns, it questions the need for adopting such a rule at this time in light of recent actions taken by the Independence Standards Board, the Commission and the Exchanges, which are designed to improve the effectiveness of audit committees' oversight in this area. More specifically, the letter questions whether auditors to registered investment companies should be subject to the prohibition, adding that, at the very least, the Commission should exclude from the proposed rule services designed to ensure regulatory compliance for investment advisers and investment companies. 1 Memorandum to Accounting/Treasurers Committee No. 35-00, Closed-End Investment Company Committee No. 24-00, and SEC Rules Committee, No. 113-00, September 15, 2000. 2Proxy Statement Disclosure The proposals would require issuers to disclose in their proxy statements information relating to non-audit services provided by their auditor and the fees associated with those services. The Institute's letter supports enhanced disclosure in this area, but recommends that the Commission's proposed disclosure requirement be modified so that it would provide information that is more useful to investors and others concerned with auditor independence. Financial Relationships The proposals would significantly reduce the number of audit firm employees and family members whose investments in audit clients would be deemed to impair an auditor's independence. Restrictions on auditor investment in audit clients would generally be limited to those who work on or can

influence the audit. Although generally supporting this aspect of the proposal, the Institute's letter notes that the proposed rules are still too restrictive and limit persons from investing in situations where the investment cannot affect the reliability (or perceived reliability) of the audit. The letter adds that this is particularly problematic when an immediate family member of a covered person is investing through an employer-sponsored retirement plan and the range of available investments is largely or exclusively limited to audit client funds. Accordingly, the letter recommends that investments of family members through an employer-sponsored retirement program not be taken into account in assessing the independence of an auditor, or in the alternative only be taken into account when they exceed 5% of the issuer's securities. At the very least, the Commission should exclude investments by family members in non-audit client affiliate funds through an employer-sponsored retirement program. The letter also recommends the elimination of the limitation on investments by “close” family members. The letter explains that the proposed limitation would impose undue burdens on audit firms to track the securities holdings of these persons, which would be particularly true in the case of emancipated children, parents and siblings. Curing Independence Violations The proposals provide a limited safe harbor for an accounting firm if an individual employed by the firm causes it to violate the independence rules. The safe harbor would be available if the firm has adopted certain quality controls and promptly corrects any independence violations identified. The Institute's letter supports this proposal, but recommends that it be expanded in two ways. First, the safe harbor should be provided to an audit firm that has adopted the requisite quality controls even if an individual associated with the firm recklessly or intentionally violated the rules. Second, the Commission should adopt a comparable safe harbor for issuers in order to protect audit clients and their shareholders, who are frequently the innocent bystanders when audit firms breach independence rules, from being unduly penalized for their auditors' missteps. Barry E. Simmons Assistant Counsel Attachment 3Attachment (in .pdf format)