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SEC RULE PROPOSALS ON AUDITOR INDEPENDENCE AND AUDIT COMMITTEE ADMINISTRATION OF THE AUDIT ENGAGEMENT

[15434] December 9, 2002 TO: ACCOUNTING/TREASURERS COMMITTEE No. 53-02 CLOSED-END INVESTMENT COMPANY COMMITTEE No. 52-02 SEC RULES COMMITTEE No. 102-02 UNIT INVESTMENT TRUST COMMITTEE No. 29-02 RE: SEC RULE PROPOSALS ON AUDITOR INDEPENDENCE AND AUDIT COMMITTEE ADMINISTRATION OF THE AUDIT ENGAGEMENT The Securities and Exchange Commission has proposed new rules and rule amendments intended to enhance the independence of accountants that audit financial statements.1 The proposed rules also address audit committee administration of the audit engagement and communications between the independent accountant and the audit committee. The proposed rules are intended to implement Sections 201 through 206 of the Sarbanes-Oxley Act of 2002 (the "Act"). Comments on the proposal are due thirty days after its publication in the Federal Register. We plan to hold a conference call on the proposal shortly and will inform you of the date and time via email as soon as possible. As summarized below, the Commission's proposal would do the following: • Revise the rules related to non-audit services that, if provided to an audit client, would impair the audit firm's independence; • Define the circumstances whereby an issuer's audit committee should pre-approve all audit and allowable non-audit services provided to the issuer by the auditor of the issuer's financial statements. The proposed rules would require investment company directors to pre-approve non-audit services provided by the fund's auditor to the investment adviser; • Require audit firm partner rotation every five years, including a five-year "time-out" before the partner can return to the engagement. The proposed rules would prohibit 1 Strengthening the Commission's Requirements Regarding Auditor Independence, SEC Release Nos. 33-8145; 34-46934; 35- 27610; IC-25838; IA-2088; FR-64 (December 2, 2002) (the "Proposing Release"). The Proposing Release is available at the Commission's website at http://www.sec.gov/rules/proposed/33-8154.htm. 2 rotation onto other entities in the investment company complex. • Institute a one year "cooling off" period for auditors seeking employment with audit clients; • Require the auditor of an issuer's financial statements report certain matters to the issuer's audit committee, including "critical" accounting policies used by the issuer and alternative available accounting treatments that have been discussed with management; • Prohibit auditors from receiving compensation for cross-selling non-audit services to audit clients; and • Require increased disclosure of audit and non-audit fees paid to the independent accountant in the proxy statement and annual report. A. One Year Cooling Off Period Under the proposed rule, an audit firm would lose its independence if an audit client employs a member of the audit engagement team in

a financial reporting oversight role within the one-year period prior to the commencement of procedures for the current audit engagement. The term “financial reporting oversight role” refers to any individual who has direct responsibility for oversight over those who prepare the registrant’s financial statements and related information that are included in filings with the Commission. The term “audit client” is currently defined as the entity whose financial statements are being audited and any affiliates.2 For this purpose, affiliates include other entities in the investment company complex, including i) the investment adviser and other investment companies, and ii) any entity controlled by or controlling the investment adviser, or any entity under common control with the investment adviser, if that entity provides services to the investment company.3 • The Proposing Release requests comment on whether the cooling off period should apply to all entities in the investment company complex. Is this too broad? Why or why not? B. Prohibited Non-audit Services The proposed rules make it unlawful for an accounting firm that performs an audit of an issuer’s financial statements to provide to that issuer, contemporaneously with the audit, ten specified non-audit services. Many of the services prohibited by the proposed rules are already prohibited by existing Commission rules. Significant differences between the proposed rules and the existing rules are described below. 2 Regulation S-X, Rule 2-01(f)(6). 3 Regulation S-X, Rule 2-01(f)(14). 3 1. Financial Information Systems Design and Implementation Existing Commission rules enable auditors to provide financial information systems design and implementation services to their audit clients under certain conditions. The proposed rules generally prohibit auditors from providing these types of services to their audit clients. Under the proposed rule, an accountant is not independent if the accountant designs or implements a hardware or software system that aggregates source data underlying the financial statements or generates information that is significant to the audit client’s financial statements. 2. Appraisal or Valuation Services, Fairness Opinions, Contribution-in-Kind Reports Existing Commission rules enable auditors to provide appraisal or valuation services to their audit clients under certain conditions. The proposed rules, however, generally prohibit auditors from providing these types of services to their audit clients. Under the proposed rule, an accountant would not be deemed independent if the accountant provided any appraisal service, valuation service, fairness opinion, or contribution-in-kind report for an audit client, where it is reasonably likely that the results of these services will be subject to audit procedures during the audit of the client’s financial statements. 3. Internal Audit Outsourcing Existing Commission rules allow a company to outsource part of its internal audit function to its independent auditor. Under the Commission’s proposal, however, the auditor would not be deemed independent when performing internal audit services related to the internal accounting controls, financial systems, or financial statements, for an audit client. The proposed rule does not include operational audits unrelated to internal accounting controls, financial systems, or financial statements. 4. Expert Services Existing Commission rules do not provide that an auditor is deemed to lack independence when providing expert services to an audit client. The Act, however, includes expert services in the list of prohibited services. The proposed rules state that an accountant’s independence is impaired as to an audit client if the accountant provides expert opinions for an audit client in connection with legal, administrative, or regulatory proceedings or acts as an advocate for the audit client in such proceedings. 5. Tax Services According to the Proposing Release, nothing in the proposed rules is intended to prohibit an accounting firm from providing tax services to its audit clients when those services have been pre-approved by the client’s audit committee. The Proposing Release indicates that the issuer’s audit committee should consider whether the proposed non-audit service is an allowable tax service or constitutes a prohibited legal service or expert service.4 4 The Proposing Release indicates that as part of this process, the audit committee should be mindful of three basic principles which cause an auditor to lack

independence with respect to an audit client: 1) the auditor cannot audit his own work; 2) the auditor cannot function as part of management; and 3) the auditor cannot serve in an advocacy role for the client. 4 C. Partner Rotation Existing AICPA rules call for the engagement partner to rotate off the engagement after seven years and to remain off the engagement for two years. Section 203 of the Act specifies that the lead audit partner and the reviewing audit partner should serve on the engagement in that capacity for no more than five consecutive years. The Commission's proposed rules prohibit an audit engagement team partner from performing audit, attest or review services for an issuer for more than five consecutive years. In addition, the proposed rules prohibit the partner from returning to the engagement for five years. The proposed rules would require rotation of not just the lead and reviewing partner, but also other partners who perform audit services for the issuer. This rotation requirement would include the lead partner, the concurring review partner, the client service partner, and other "line" partners directly involved in the performance of the audit. Under the proposed rules, a partner performing any audit, review or attest services for an investment company could only do so if they had not performed such services for any entity within the investment company complex during the previous five consecutive years. For example, the proposed rule would prohibit a partner from rotating between two separate investment company issuers within an investment company complex. The proposed rule would also prohibit a partner from rotating between an investment company issuer and any other entity within the investment company complex. • The Proposing Release requests comment on whether the rotation requirements should apply to all partners on the engagement team. If not, which partners should be subject to the requirements? • Is the five-year "time out" period necessary or appropriate? • Are the partner rotation requirements as proposed for investment company issuers or other entities in the complex too broad? Instead, should they only prohibit rotation between investment company issuers in the same complex? Why or why not? D. Audit Committee Administration of the Engagement Under the proposed rules, the audit committee must pre-approve all engagements related to audit, review and attest reports required under the securities laws.5 The audit committee also would have sole authority to pre-approve the engagement of the company's independent accountant to perform non-audit services. However, the proposed rules would permit the auditor to perform non-audit services if the engagement is entered into pursuant to pre-approval policies and procedures established by the audit committee and the audit committee is informed of each service.6 In addition, the rules provide a de minimis exception 5 Unit investment trusts are exempt from the pre-approval requirements. The Proposing Release requests comment on whether this exemption is appropriate. 6 These policies and procedures would be disclosed in the annual proxy statement and in Form N-CSR. See Item G – Expanded Disclosure below. 5 from the pre-approval requirements for services that were not recognized to be non-audit services at the time of the engagement.7 The proposed rules would require pre-approval by the investment company's audit committee not only of the non-auditing services provided to the investment company issuer, but also of the non-auditing services provided to the fund'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 proposed rule would not, however, require the audit committee of an investment company to approve the audit or non-audit services provided: (1) to another investment company registrant within the complex; (2) to a sub-adviser; and (3) to other entities within the complex that do not provide services to the fund. Under the proposed rule, the investment company's audit committee would be able to establish policies and procedures for pre-approving non-audit services provided not only to the investment company issuer, but also to its investment adviser and related entities that provide services to the fund. The proposed rule would permit, for purposes of determining whether a non-audit service meets

the de minimis exception, the investment company's audit committee to aggregate the total amount of revenues paid to the investment company's accountant by the investment company, its investment adviser, and any entity controlling, controlled by, or under common control with the investment adviser that provides services to the fund. • Should the audit committee be required to pre-approve any non-audit services provided to the investment adviser and "control entities" that provide services to the fund? Should the scope of the pre-approval requirement be expanded or narrowed? • For purposes of the de minimis exception, the audit committee may aggregate the total revenues paid to the fund's accountant by the fund, its investment adviser and "control entities" that provide services to the fund. Should the de minimis exception be determined separately based on the total revenues paid to the investment company's accountant by each entity? • The Investment Company Act currently requires that a majority of the directors who are not interested persons appoint the independent accountant. The proposed rules would require the audit committee to separately approve the accountant. Who should approve the accountant? If both, should the audit committee nominate the accountant with the independent directors making the selection? E. Auditor Compensation The proposed rules provide that an accountant is not independent if, at any point during the audit and professional engagement period, any partner who is a member of the audit engagement team earns or receives compensation based on the performance of, or procuring of, 7 To qualify for this exception, the aggregate amount of all such services cannot be more than five percent of the total amount of revenues paid by the audit client to its accountant during the fiscal year in which the services are provided. 6 engagements with that audit client, to provide any services, other than audit, review, or attest services. F. Communication with Audit Committees The proposed rules would require the independent accountant to report to the audit committee prior to the filing of the audit report with the Commission: (1) all critical accounting policies and practices used by the issuer; (2) all alternative accounting treatments of financial information available under GAAP that have been discussed with management, including ramifications of the use of such alternative treatments and the treatment preferred by the accounting firm; and (3) other material written communications between the accounting firm and the issuer.8 Under the proposal, communications pursuant to (1) and (2) above may be written or oral. • Should auditors to investment companies be required to make these communications with investment company audit committees? Why or why not? G. Expanded Disclosure 1. Accountants' Fees Current proxy rules require disclosure of fees paid to the auditor during the most recent fiscal year for: (1) audit services; (2) financial information systems design and implementation; and (3) all other services. The proposed rules would increase the categories of fees to be disclosed from three to four. The categories of reportable fees would be: (1) audit fees; (2) audit- related fees; (3) tax fees; and (4) all other fees. In addition, the proposed rules require disclosure for each of the two most recent fiscal years. The proposal expands the types of fees that can be included with the "audit fees" category. The new "audit-related fees" category is intended to capture assurance and related services (e.g., employee benefit plan audits and internal controls reviews). 2. Audit Committee Pre-approval Policies and Procedures The proposed rules would require disclosure of any policies and procedures developed by the audit committee concerning pre-approval of the independent accountant to perform both audit and non-audit services. 3. Disclosure The proposed rules require disclosure of the items described above in proxy or information statements relating to election of directors or ratification of the independent accountant. Disclosure would also be required in periodic reports. For investment companies, 8 According to the Proposing Release, communications the Commission believes material to the issuer would include: (1) the management representation letter; (2) reports on observations and recommendations on internal controls; (3) a schedule of

material adjustments and reclassifications proposed, and a listing of adjustments and reclassifications not recorded, if any; (4) the engagement letter; and (5) the independence letter. 7 periodic report disclosure would be provided in the Form N-CSR filing that relates to the annual period. • Would the expansion of the professional fees paid to the auditor provide useful information to investors? • Should investment companies be required to provide the disclosure in their semi-annual report on Form N-CSR? • Investment companies are required to disclose audit fees billed for the registrant only. The other categories of fees must be disclosed in the aggregate for the fund, its investment adviser and any “control entity” that provides services to the fund. Is this appropriate, or should audit fees also be disclosed on an aggregate basis? Alternatively, should the rules require disclosure of audit-related fees or other categories of fees for the registrant only and not on an aggregate basis? H. Transition Period Under the Act, the proposed rules are required to be adopted by January 26, 2003. The Commission notes that certain of its proposed rules go beyond the provisions of the Act but proposes that those provisions be effective upon adoption of the final rules. However, the Commission is considering the appropriate timing for the implementation of the final rules and how best to allow for an orderly transition as a result of the new requirement imposed by the proposals. Gregory M. Smith Director - Operations/Compliance & Fund Accounting

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