The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

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SEC ADOPTS AUDITOR INDEPENDENCE RULES

[12914] December 5, 2000 TO: ACCOUNTING/TREASURERS MEMBERS No. 35-00 CLOSED-END INVESTMENT COMPANY COMMITTEE No. 33-00 SEC RULES MEMBERS No. 79-00 RE: SEC ADOPTS AUDITOR INDEPENDENCE RULES The SEC recently adopted proposals intended to modernize rules for determining whether an auditor is independent in light of investments by auditors, and consulting services provided by audit firms to their audit clients. The amendments significantly reduce the number of audit firm employees and their family members whose investments in audit clients are attributed to the auditor for purposes of determining the auditor's independence. They also identify certain consulting or non-audit services that impair the auditor's independence. The final rules enable accounting firms to cure certain inadvertent independence failures if they have quality controls and satisfy other conditions. Finally, the amendments require companies, including investment companies, to disclose in their annual proxy statement information related to services provided by their auditor during the most recent fiscal year. The rule amendments are effective February 5, 2001. General Standard for Auditor Independence Rule 2-01 of Regulation S-X sets forth qualifications of accountants practicing before the Commission, including independence requirements. Rule 2-01(b) describes a general standard under which the Commission will measure independence. The general standard indicates that the Commission will not recognize an accountant as independent with respect to an audit client if the accountant is not, or if a reasonable investor knowing all relevant facts and circumstances would conclude that the accountant is not, capable of exercising objective and impartial judgement on all issues encompassed within the accountant's engagement. The SEC originally proposed to supplement the general standard in rule 2-01(b) with four governing principles for determining when an auditor lacks independence. The ICI and other commenters suggested that the governing principles were too general and would be difficult to apply to particular situations. In response, the SEC has removed the governing principles from the final rule. However, the governing principles have been included in a "preliminary note" to the final rule. The preliminary note indicates that the governing principles are general guidance only and their application may depend on particular facts and circumstances. Specific Applications of the Independence Standard Rule 2-01(c) sets forth a non-exclusive list of circumstances that are inconsistent with the general independence standard. Paragraphs (c)(1) through (c)(5) address separately situations in which an accountant is not independent of an audit client because of certain: (1) financial 2relationships, (2) employment relationships, (3) business relationships, (4) non-audit services, or (5) contingent fees. A. Financial Relationships Under the rule an accountant is not independent if, at any point during the audit and professional engagement period, the accountant has a direct financial interest or a material indirect financial interest in the accountant's audit client. For this purpose "accountant" includes the accounting firm,

covered persons1 in the firm, and their immediate family members.2 Consistent with the original proposal, the final rule represents a liberalization from prior restrictions that generally reached all partners in the firm, regardless of whether they had any relationship to the audit client. Consistent with the original proposal, the final rule limits investments in audit clients by “non-covered” persons in the firm and their family members to not more than five percent. The final rule provides that an accountant is not independent when any partner or professional employee, any of his or her immediate family members, any close family member3 of a covered person in the firm, or any group of these persons has filed a Schedule 13D or 13G indicating beneficial ownership of more than five percent of an audit client’s equity securities. The restrictions on investments in audit clients extend to certain affiliates of the audit client. For example, an accountant cannot invest in an entity that has control over the audit client, or over which the audit client has control, or which is under common control with the audit client. As to investment companies, the restriction on investments in audit clients extends to all entities in the investment company complex. Accordingly, when an audit client is an entity that is part of an investment company complex, the accountant must be independent of each entity in the investment company complex. This restriction is consistent with ISB No. 2 and the original proposal. 1. Investment Company Complex As proposed, the definition of investment company complex focused on investment advisers and entities in a control relationship with the adviser, including entities under common control with the adviser. The proposed definition was based on ISB No. 2, which defines “mutual fund complex” as the mutual fund operation in its entirety, including all the funds, the sponsor, its ultimate parent company, and their subsidiaries. 1 Covered person includes: (i) the audit engagement team; (ii) the chain of command; (iii) any partner, principal, shareholder or managerial employee of the accounting firm who has provided ten or more hours of non-audit services to the audit client for the period beginning on the date such services are provided and ending on the date the accounting firm signs the report on the financial statements for the fiscal year during which those services are provided, or who expects to provide ten or more hours on non-audit services to the audit client on a recurring basis; and (iv) any other partner, principal, or shareholder from an office of the firm in which the lead audit engagement partner primarily participates in connection with the audit. 2 Immediate family member means a person’s spouse, spousal equivalent and dependents. 3 Close family member means a person’s spouse, spousal equivalent, dependent, parent, nondependent child, and sibling. 3Several commenters expressed concern that the proposed definition was too broad. For example, all subsidiaries of the adviser’s parent company would be included in the investment company complex, even if they engaged in a business unrelated to asset management. In response, the final definition of investment company complex is more limited than the one originally proposed. As adopted, the rule includes an entity under common control with the adviser only if the entity provides services to an investment company in the investment company complex. Consistent with the original proposal, the definition of investment company complex does not include sub-advisers whose role is primarily portfolio management and who provide services pursuant to a subcontract with, or are overseen by, an investment adviser in the complex. 2. Indirect Investments and the Investment Company Exception The final rule indicates that an accountant is not independent when the accounting firm, any covered person in the firm, any of his or her immediate family members or any group of the above persons has any material indirect investment in the audit client. The original proposal indicated that ownership of more than five percent of an entity that has an ownership interest in the audit client constitutes a material indirect investment. In response to comments the Commission eliminated the five percent threshold from the final rule. Instead, the final rule describes material indirect investments in terms of the ability of the accountant or the intermediary to exercise

significant influence over the audit client. In response to comments, the final rule includes an investment company exception intended to ensure that accounting firm personnel can freely invest in diversified investment companies (that are not audit clients or part of a related investment company complex) even if the investment company owns shares in an audit client. The provision eliminates the need for auditors to monitor whether, and to what degree, funds in which they invest hold securities issued by audit clients. 3. Exception for Employee Compensation and Benefit Plans In response to comments by the Institute, the final rules contain an exception to the financial interest rules intended to allow broader participation by immediate family members of auditors in employee compensation and benefit plans. The exception is available to immediate family members (typically spouses) of covered persons, who are covered persons only by virtue of being a partner in the same office as the lead audit engagement partner of, or a partner or manager performing ten or more hours of non-audit services for, an audit client. Under the exception, the spouse can invest in audit client funds through a 401(k) plan if audit client funds are the only available option in the plan. If, however, the immediate family member has an alternative in the 401(k) plan that does not involve investing in a fund complex for which the person's relative is a covered person, then the family member may not invest in the audit client. B. Non-audit Services The Commission's original proposal identified ten non-audit services that, if provided to an audit client, would compromise the auditor's independence. The final rule identifies nine 4such services. The Commission eliminated expert services (e.g., rendering expert opinions for an audit client in legal, administrative or regulatory filings or proceedings) from the list of prohibited services. In addition, the final rule permits two of the nine services (i.e., financial systems design and implementation, and internal audit outsourcing) to be performed under limited circumstances. 1. Financial Systems Design and Implementation Rather than prohibit these services, the final rule permits these services subject to conditions intended to reduce the likelihood that the auditor will be placed in a position of making, and then auditing, managerial decisions. Further, the final rule requires the company's annual proxy statement to disclose information related to the financial systems design services provided by the auditor, as described below. 2. Internal Audit Outsourcing Under the final rule, an auditor's independence is impaired by performing more than forty percent of the audit client's internal audit work related to the internal accounting controls, financial systems, or financial statements.4 3. Broker-dealer Services The original proposal would have prohibited an accountant from designing an audit client's system for complying with broker-dealer or investment adviser regulations. In its comment letter the Institute noted that investment advisers frequently hire their auditor to design, implement, and test their systems intended to ensure compliance with the securities laws, and that these types of consulting engagements do not give rise to the independence concerns identified in the proposal. We are pleased to report that the Commission omitted the prohibition on designing broker-dealer and investment adviser compliance systems from the final rule. C. Curing Independence Violations Consistent with the original proposal, the final rule includes a limited exception pursuant to which inadvertent violations of the independence rules will not disqualify the accounting firm, if the firm maintains certain quality controls and satisfies certain other conditions. The effect of this provision is that an accounting firm that has appropriate quality controls will not be deemed to lack independence when an accountant did not know of the circumstances giving rise to the impairment and, upon discovery, the impairment is quickly resolved. Proxy Disclosure Requirement The proxy disclosure amendments adopted by the Commission require disclosure regarding: (1) fees billed for services rendered by the principal accountant; (2) whether the audit 4 To limit the effect on small businesses, the final rule permits audit clients with less than $200 million in assets to engage their auditor to perform more than forty percent of their internal audit functions. 5committee considered the compatibility of

the non-audit services the company received from its auditor and the independence of the auditor; and (3) the employment of leased personnel in connection with the audit. A. Disclosure of Fees The final rule requires registrants to disclose the fees paid to the auditor for: (1) the annual audit of the company's financial statements, (2) financial information systems design and implementation services, and (3) all other fees, including fees for tax-related services. When disclosing fees for items (2) and (3) above, investment companies must disclose fees billed for services rendered to the registrant, the registrant's investment adviser (not including any sub-adviser), and any entity controlling, controlled by, or under common control with the adviser that provides services to the registrant. B. Audit Committee Disclosure The original proposal would have required companies to disclose in their proxy statements whether, before each non-audit service was rendered, the audit committee approved, and considered the effect on independence of such service. The final rule has been modified to require disclosure only of whether the audit committee considered whether the non-audit services provided are compatible with maintaining the accountant's independence. C. Leased Personnel Issuers must disclose in their proxy statements the percentage of hours worked on the audit engagement by persons other than the accountant's full time permanent employees, if that figure exceeds fifty percent. Effective Date and Transition Rules The new rules will become effective February 5, 2001. However, a transition period of 18 months is provided with respect to appraisal and internal audit services since these services are currently permitted, subject to certain conditions. The rules grandfather contracts for the provision of financial information systems design and implementation in existence at the effective date under certain conditions. Companies must comply with the new proxy disclosure requirements for proxy statements filed after February 5. Gregory M. Smith Director – Operations/ Compliance & Fund Accounting Attachment Note: Not all recipients receive the attachment. To obtain a copy of the attachment to which this memo refers, please call the ICI Library at (202) 326-8304 and request the attachment for memo 12914. ICI Members may retrieve this memo and its attachment from ICINet (http://members.ici.org). Attachment (in .pdf format)
