

MEMO# 11267

September 23, 1999

ISB PROPOSES STANDARD ON MUTUAL FUND AUDITS

1 The Independence Standards Board is a private standard setting body established in 1997 as the result of an agreement between the AICPA and the SEC. Its mission is to develop concepts, principles and standards relating to the independence of auditors of public companies. [11267] September 23, 1999 TO: ACCOUNTING/TREASURERS COMMITTEE No. 30-99 SEC RULES COMMITTEE No. 71-99 RE: ISB PROPOSES STANDARD ON MUTUAL FUND AUDITS _____ The

Independence Standards Board¹ recently issued Exposure Draft 99-1, Certain Independence Implications of Audits of Mutual Funds and Related Entities. The proposed standard would impose specific restrictions on an accounting firm that audits mutual funds. In particular, the firm, the audit engagement team, specified others within the firm, and certain of the firm's retirement plans would have to be independent of all sister mutual funds and all related non-fund entities. The proposed standard, however, would allow: i) all other partners and employees to invest directly in non-audit client sister funds and, ii) spouses and dependents of partners who do not serve on the engagement or serve in the work office to invest in audit client mutual funds through an employee benefit plan. A copy of the exposure draft is attached and summarized below. Comments on the exposure draft must be filed with the ISB by October 31, 1999. If you have any ideas or suggestions that you would like the Institute to consider including in a possible comment letter, please provide them to me by phone: 202/326-5851, fax 202/326-8314 or e-mail: smith@ici.org no later than October 11. Background Independence rules prohibit an auditor from having any direct or material indirect interest in an audit client. Earlier this year, several accounting firms questioned whether investments by an accounting firm's employees or retirement plans in a particular fund would compromise independence with respect to other funds in the same fund complex. SEC staff in the Office of the Chief Accountant indicated that the structure and operation of mutual funds within a complex may be so integrated that an accountant is placed in a position of having an impermissible conflict, if the accountant audits one fund and invests in another mutual fund with the same adviser or within the same family of funds. The SEC asked the ISB to consider whether an accounting firm's independence would be impaired with respect to mutual funds in a group of funds and affiliated entities (such as a broker-dealer) if the firm's employees or retirement plans invest in other mutual funds within the same fund complex. Exposure Draft 22 If the related non-fund entity is an investment adviser (or sub-adviser), the auditor must be independent of all funds it advises, even if they are outside this mutual fund complex. 3 If the fund's investment adviser (or sub-adviser) is outside the mutual fund complex, the independence requirement still applies. That independence restriction further extends to any parent company to which the investment adviser is material, and to all other subsidiaries of those covered parent companies. The exposure draft is limited in scope and focuses on three

issues. Within a mutual fund complex, when is auditor independence required: As to non-client "sister funds," when auditing a fund? (e.g., as to non-client Fund A, when auditing Fund B advised by the same investment adviser) As to related non-client funds, when auditing a related non-fund entity? (e.g., as to non-client Fund A, when auditing a broker-dealer in the same complex) As to all related non-fund entities, when auditing one or more mutual funds? (e.g., as to a broker-dealer or ultimate parent, when auditing Fund B in the same complex). The exposure draft notes that there are risks or conflicts that need to be considered in establishing guidelines for independence with respect to entities within mutual fund complexes. For example, an auditor may encounter a systemic problem during the course of auditing one mutual fund in a complex that would adversely impact another non-client fund in the complex that is held by other individuals in the firm as a direct investment or held through the firm's defined contribution retirement plan. The exposure draft would require a specified set of persons to be independent of all sister funds and all related non-fund entities in order to maintain independence with respect to the client fund. In particular, the accounting firm itself, and its retirement plans (other than self-directed defined contribution employee benefit plans, such as 401(k) plans), the audit engagement team and its "chain of command", and the partners and managerial employees in offices participating in a significant portion of the audit, when the accounting firm is auditing: a fund, must be independent of all sister funds, 2 a related non-fund entity, must be independent of all related non-client funds (i.e., all funds in the complex), 2 one or more funds, must be independent of all related non-fund entities in the mutual fund complex. 3 Accordingly, the proposal proscribes investments in non-audit client sister funds by those on the engagement and by all partners and managerial employees in offices participating in a significant portion of the audit. All other partners will however, be permitted to invest in non-audit client sister funds. In addition, the proposal will permit the accounting firm to have self-directed defined contribution employee benefit plans (e.g., 401(k) plans) with non-client sister fund choices available to all but the engagement team, its chain of command and certain others. The exposure draft would also permit a spouse or dependent of a partner not on the engagement team, not in its chain of command, and not in an office participating in a significant portion 3 of the engagement to invest through an employer sponsored benefit plan in mutual funds that are audit clients of the firm. Currently, these persons are prohibited from investing in mutual funds that are audit clients of the firm.

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