The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

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DRAFT INSTITUTE LETTER ON SEC AUDITOR INDEPENDENCE PROPOSAL; NOTICE OF JANUARY 8 CONFERENCE CALL

[15501] December 31, 2002 TO: ACCOUNTING/TREASURERS COMMITTEE No. 58-02 CLOSED-END INVESTMENT COMPANY COMMITTEE No. 59-02 SEC RULES COMMITTEE No. 110-02 SMALL FUNDS COMMITTEE No. 23-02 UNIT INVESTMENT TRUST COMMITTEE No. 35-02 RE: DRAFT INSTITUTE LETTER ON SEC AUDITOR INDEPENDENCE PROPOSAL; NOTICE OF JANUARY 8 CONFERENCE CALL As we previously informed you, the Securities and Exchange Commission has issued proposed rules and rule amendments addressing auditor independence and audit committee administration of the audit engagement. The proposed rules are intended to implement Sections 201 through 206 of the Sarbanes-Oxley Act. The Institute has prepared a draft comment letter (attached) on the proposal, the most significant aspects of which are described below. Comments on the proposed rules must be received by the SEC no later than January 13, 2003. We have scheduled a conference call for Wednesday, January 8, at 1:00 pm Eastern time to discuss the Institute's draft letter. The dial-in number for the call will be 1-888-391-6745 and the pass code for the call will be Auditor Independence. The conference call leader will be Amy Lancellotta. If you are planning to participate on the call, please notify Stephanie Holly by phone at 202/326-5814 or by e-mail at sholly@ici.org. General Comments The Institute's letter argues that the application of the proposed rules to investment companies is overly broad. As a result, the proposed rules may diminish audit quality by limiting the number of qualified accounting professionals who are available to perform audits. Furthermore, the proposed rules will likely cause auditors to raise their fees, which will be passed on to investors. The letter notes that a common cause of overbreadth in the proposed rules is the use of the term "investment company complex," which is defined in Rule 2-01 of Regulation S-X to include an investment company and its investment adviser and any entity controlled by or controlling an investment adviser, or any entity under common control with an investment adviser if the entity (1) is an investment adviser or (2) is engaged in the business of providing 2 administrative, custodian, underwriting or transfer agent services to any investment company or investment adviser. This definition would include investment advisers' affiliates that provide services to any investment company (and not necessarily to the particular investment company in question). The Institute's letter argues in several instances that the proposed rules should require independence with respect to the fund and its adviser, but not other affiliates in the complex. Conflicts of Interest Resulting from Employment Relationships The Institute's letter recommends that the proposal to require a one-year cooling-off period for employment of former auditors be revised to apply only to

covered employment positions at the investment company, the investment adviser and service providers within the investment company complex that have a financial reporting oversight role with respect to the investment company's financial statements. The rule should not apply to employment with service providers having only an indirect relationship with the investment company's financial statements. Partner Rotation The Institute's letter recommends that the Commission only require lead and reviewing partners to rotate off of the audit engagement team. Furthermore, the "cooling-off" period for audit partners should be two, rather than five, years. Also, audit partners should be permitted to rotate onto other entities in the complex that do not have a financial reporting oversight role with respect to the fund's financial statements. Finally, we recommend that the Commission "grandfather" current audit partners for purposes of the partner rotation rule. This is needed to avoid decimating audit teams within a short period, given that many teams will consist of partners who have all been on the engagement for several years. Audit Committee Administration of the Engagement The draft letter recommends that the Commission require audit committees to pre- approve only non-audit services provided to investment companies and investment advisers, and not require approval of such services provided to affiliates of the adviser that provide services to the investment company. The letter recommends that the Commission expand the scope of the permitted pre-approval policies and procedures to allow an audit committee to establish a policy that pre-approves all non-audit services the fees for which fall below a specified percentage (e.g., five percent) of total fees to be paid to the accountant. The letter urges the Commission to exempt investment companies from that portion of the rule requiring accountants to discuss critical accounting policies and alternative accounting treatments with the audit committee. Compensation We recommend that the Commission provide for disgorgement in the event that an audit partner inadvertently receives direct compensation for cross-selling non-audit services, rather than burdening the audit client issuer with a re-audit by providing that the auditor's independence has been impaired. 3 Audit Fee Disclosure We recommend that proxy statement and annual report disclosure of accountants' fees only be required with respect to services provided to investment companies and investment advisers, and not to all service providers affiliated with the adviser. The draft letter recommends that the Commission eliminate the requirement that investment companies disclose what percentage of fees were derived from services that were approved using each of the three permitted approval methods. Cure Period We recommend that the Commission provide for a "cure period" for inadvertent violations of the independence rules. The letter notes that independence violations may cause issuers to re-audit their financial statements. This result is particularly troublesome for open- end investment companies, which continuously offer their shares and must maintain an "evergreen" prospectus. Gregory M. Smith Director - Operations/Compliance & Fund Accounting Attachment (in .pdf format)

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