



# INVESTMENT COMPANY INSTITUTE

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January 13, 2003

Mr. Jonathan G. Katz  
Secretary  
U.S. Securities and Exchange Commission  
450 Fifth Street, N.W.  
Washington, D.C. 20549-0609

Re: Auditor Independence Rules Proposed Under the  
Sarbanes-Oxley Act of 2002 (File No. S7-49-02)

Dear Mr. Katz:

The Investment Company Institute<sup>1</sup> appreciates the opportunity to comment on the Securities and Exchange Commission's proposal to implement the requirements in Title II of the Sarbanes-Oxley Act of 2002 (the "Act").<sup>2</sup> The Commission's proposal would (1) prohibit members of an audit engagement team from accepting certain employment positions with audit clients; (2) amend the Commission's existing regulations related to non-audit services; (3) require certain partners to rotate off of an audit engagement team after five years; (4) require approval of audit and non-audit services provided by an auditor; (5) prohibit an audit partner from receiving compensation for non-audit services; (6) require certain communications between auditors and the audit committee; and (7) require disclosure of fees paid to accountants.

While the Institute supports the overall thrust of the proposals, we believe that significant modifications are necessary regarding how the rules will be applied to investment companies. Several of the proposals do not adequately take into account the unique characteristics of investment companies. These include the fact that investment companies, due in part to the strict regulatory scheme to which they are subject under the Investment Company Act of 1940, already have strong systems of controls and procedures in place to protect investors and to ensure the integrity of their financial statements—which are two of the main goals of the Act. In addition, because of the nature of their operations and simplicity of their structures (*e.g.*, limited or no leverage, no off-balance sheet arrangements, no subsidiaries), as well as the fact that investment companies are required to mark their portfolios to market every day, investment company financial statements present a low risk of accounting and auditing problems. Consequently, there is no need for the Commission to apply the Act's requirements to investment companies in an overly broad manner.

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<sup>1</sup> The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,938 open-end investment companies ("mutual funds"), 535 closed-end investment companies and 6 sponsors of unit investment trusts. Its mutual fund members have assets of about \$6.539 trillion, accounting for approximately 95% of total industry assets, and 90.2 million individual shareholders.

<sup>2</sup> SEC Release Nos. 33-8154; 34-46934; 35-27610; IC-25838; IA-2088 (December 2, 2002); 67 Fed. Reg. 76780 (December 13, 2002) (the "Proposing Release").

Moreover, an overly broad application of the Act's provisions on auditor independence will likely have adverse consequences for funds and their shareholders. Auditors of investment companies tend to be specialists in that area; several of the Commission's proposals would significantly limit the number of accounting professionals available to perform audits of investment companies. This will likely diminish the quality of those audits. In addition, several of the Commission's proposals will impose new and unnecessary burdens on funds and their auditors, which will result, among other things, in additional fees and expenses.

In light of the foregoing, our comments include the following:

- ***Conflicts of Interest Resulting from Employment Relationships***
  - We recommend that the rule requiring a one-year cooling-off period for employment of former auditors apply only to covered employment positions at an investment company, its 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 that have no relationship with the investment company's financial statements.
- ***Partner Rotation***
  - We recommend that the Commission only require lead and reviewing partners to rotate off of the audit engagement team.
  - We recommend that only service on the engagement team of the investment company should trigger the rotation of lead and reviewing partners after five years, so that they would be permitted to rotate to audit engagement teams of other investment companies and service providers within the complex.
  - We recommend that the "time-out" period for audit partners be two, rather than five, years.
  - We recommend that the Commission "grandfather" current audit partners for purposes of the partner rotation rule.
- ***Audit Committee Administration of the Engagement***
  - We recommend that the Commission require audit committees to pre-approve only non-audit services provided to investment companies.
- ***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 with a re-audit by providing that the auditor's independence has been impaired.

- ***Audit Fee Disclosure***
  - We recommend 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.
  
- ***Consequences of Violating the Rules***
  - We recommend that certain violations of the rules not be deemed to result in an impairment of auditor independence. In addition, the Commission should provide for a “cure period” for inadvertent violations of the independence rules.

These comments and our other comments are discussed more fully below.

### ***I. Conflicts of Interest Resulting from Employment Relationships***

The proposed rule implementing Section 206 of the Act would render an accounting firm not independent if a former partner, principal, shareholder or professional employee of an accounting firm is in a “financial reporting oversight role” at an “audit client”, unless the individual was not a member of the audit engagement team of the audit client during the one-year period preceding the date that audit procedures commenced. As defined, audit client would include an investment company and any entity within the investment company complex. A financial reporting oversight role would be a role in which a person is in a position to or does exercise influence over the contents of the financial statements or anyone who prepares them. The Commission requests comment on whether the cooling-off period, as applied to *all* entities within the investment company complex, is too broad. For the reasons discussed below, we believe it is too broad and recommend that the rule’s coverage be limited to the investment company itself and a limited number of affiliated entities.

As noted in the Proposing Release, one of the main concerns behind the rule is that a former firm professional could, “by reason of his or her knowledge of and relationships with the audit firm, adversely influence the quality or effectiveness of the audit . . . .”<sup>3</sup> We understand and appreciate the Commission’s concern with respect to audit quality. However, the rule, as applied to the entire investment company complex, would encompass many more entities than is necessary to accomplish the purpose of Section 206. The proposed rule would apply to employment of a former auditor not only at a fund or its investment adviser but also at an affiliated transfer agent, broker-dealer or other service provider that may have no business relationship with the investment company and, thus, no ability to influence the financial reporting or audit process. The Institute believes that the proposal’s application should be narrowed so as to limit the application of the prohibition only to employment with a fund or its investment adviser and with other 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 transfer agents, broker-dealers and

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<sup>3</sup> Proposing Release at 76782 (citing Independence Standards Board Standard No. 3, *Employment with Audit Clients*).

other service providers where those entities, and the former auditors to be employed by those entities, would have no relationship with the investment company's financial statements.

We believe that our recommendation would achieve the purpose of the proposed rule—to prevent former auditors from improperly influencing an audit by reason of their positions with the audit client—without limiting unnecessarily the pool of qualified candidates for employment. This approach is consistent with, and, in fact, would still be broader than required under the Act, which applies to employment with only the “issuer”, *i.e.*, the investment company itself and not with other entities in the investment company complex.

## ***II. Partner Rotation***

The proposed rule under Section 203 of the Act would require audit firm partner rotation every five years, including a five-year “time-out” before the partner can return to the engagement. The Institute recommends that the rule be revised to take into account the unique structure of investment companies. We have suggestions in the following four areas: (1) the scope of partners subject to required rotation; (2) rotation within the investment company complex; (3) the length of the time-out period; and (4) the transition period for the application of the proposed rule.

### ***A. Scope of Partners Subject to Required Rotation***

The proposed rule would require an audit engagement team partner that provides audit, review or attest services to rotate off the audit engagement team every five years. According to the Proposing Release, those required to rotate would include not only the lead and reviewing partner, as required by Section 203, but all partners who perform audit services for the audit client, including “partners who are involved on a continuous basis in the audit of material balances in the financial statements”, as well as certain tax partners.<sup>4</sup> The Commission requests comment on whether the rotation requirements should apply to all partners on the audit engagement team. We recommend that the Commission not go beyond the Act in this area and that the rule apply only to the lead and reviewing partner. The reasons for this recommendation are discussed below.

First, the proposal could significantly reduce the pool of qualified auditors of investment companies. Notwithstanding that the financial statements of investment companies are relatively straightforward,<sup>5</sup> audits of such financial statements require specialized knowledge. For example, investment company auditors must understand the rules relating to valuation of portfolio securities of investment companies and other regulations under the Investment Company Act, and the rules governing how investment companies qualify as “regulated investment companies” under Subchapter M of the Internal Revenue Code. Furthermore, investment company auditors must understand the structure and nature of investment

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<sup>4</sup> Proposing Release at 76791.

<sup>5</sup> See Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Mr. Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, dated November 27, 2002, regarding the Commission's proposal to implement the requirements in Sections 404, 406 and 407 of the Act.

company operations, which are different than those of other reporting issuers.<sup>6</sup> Consequently, the pool of qualified auditors is smaller than the pool of auditors who are able to perform audits of other types of issuers. This problem is especially acute in non-major cities in which the number of auditors having the skills necessary to serve investment companies is even more limited.<sup>7</sup>

The Commission's proposal to expand the scope of the partners subject to the rotation requirement also is likely to increase audit fees due to transition costs and related burdens, and may encourage accounting firms to use fewer partners on an audit engagement team, which likely would have the effect of diminishing the quality of the audit. It also will introduce inefficiencies by increasing the frequency with which institutional knowledge about the client must be re-learned. While these consequences are not unique to investment companies, in light of the limited universe of auditors who specialize in fund matters, they are likely to be especially harsh for investment companies.

We are especially concerned about the proposed rule's potential impact on the supply of qualified tax partners. The Proposing Release notes that because "an assessment of the registrant's tax provision accounted for in accordance with GAAP is a necessary part of the audit engagement . . . there may be 'tax' partners who perform significant services related to the audit engagement."<sup>8</sup> The Proposing Release goes on to state that "[t]o the extent that such services are a necessary part of the accounting firm's ability to complete the audit, partners providing those services would be subject to these rotation requirements."<sup>9</sup> We agree with the Commission that verifying compliance with tax regulations is an important part of the audit process; however, in the investment company context, the role of a tax partner is usually limited to reviewing compliance with the Subchapter M requirements, which involves technical diversification testing and distribution tests, and typically does not require significant subjective evaluations. Because of the limited nature of the tax partner's involvement, we understand that it is common for a single tax partner to cover many more investment company clients than would a tax partner in other industries. Thus, requiring rotation of investment company tax partners will disproportionately affect investment companies. If audit firms respond by hiring more tax partners, this will result in higher fees to investment companies.

For the reasons discussed above, we propose that the Commission limit the partners who are required to rotate to the lead and reviewing partner of an investment company, as

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<sup>6</sup> The fact that auditing investment companies requires specialized skills is highlighted by the facts that investment company financial statements are governed by a separate article in Regulation S-X (Article 6), investment companies are subject to a separate subchapter in the Internal Revenue Code (Subchapter M) and there is a separate audit guide for investment companies (American Institute of Certified Public Accountants Audit and Accounting Guide, Audits of Investment Companies).

<sup>7</sup> In view of the fact that the Sarbanes-Oxley Act and the rules promulgated thereunder will require more frequent communications with issuers and their audit committees and that in general auditors will be more involved with their clients, proximity to the audit client will in fact be increasingly more important. Moreover, the fact that investment company complexes have funds with staggered fiscal years results in auditors being "on site" almost continuously throughout the year. Accordingly, it is crucial that these auditors be based near the auditing site.

<sup>8</sup> Proposing Release at 76791.

<sup>9</sup> *Id.*

provided for in the Act. If the list of partners required to rotate is broader than what the Act requires, investment company complexes could as a practical matter be required to rotate *firms* every five years, rather than audit partners, due to the limited number of qualified partners. We note that the Act specifically rejects the concept of *accounting firm* rotation, instead requiring the Comptroller General of the United States to conduct a study of the potential effects of mandatory firm rotation.<sup>10</sup> As applied to investment company complexes, we believe that the rule as proposed could result in *de facto* accounting firm rotation, thereby conflicting with the policy of the Act.

### ***B. Rotation Within an Investment Company Complex***

The proposed rotation rule would apply to partners providing services to any of the entities in the investment company complex. The Commission requests comment on the scope of the proposed rule. We believe that the proposal is overly broad and should apply only to the investment company.

As discussed above, the supply of qualified audit partners for investment companies is limited. Requiring all of such partners to rotate would adversely impact that already limited supply. Because investment company complexes may include many entities, prohibiting partners from working on audits of any of those entities during the time-out period could significantly limit the scope of potential clients for those partners. This could lead accounting firms to view investment companies as less desirable clients, and thus diminish the quality of investment company audits. Accordingly, we propose that the rule permit rotation among and to service providers within the investment company complex.

We believe that the purpose of requiring rotation of audit partners on an investment company's audit team is to provide a "fresh look" at the investment company's financial statements. To achieve this goal it is only necessary to rotate audit partners working on that specific investment company's financial statements. It should not be necessary to require rotation of an audit partner who, while performing audit services for the investment adviser or another investment company in the complex, has not performed services for the investment company. Accordingly, we urge the Commission not to go beyond the Act in this area and to apply the rotation rules only to those serving as the lead or reviewing partner for an investment company. In this manner, the Commission will not unnecessarily limit the supply of qualified auditors.

If the Commission declines to adopt this approach, we strongly urge the Commission to limit the final rule only to the lead and reviewing partners on the audit engagement team of the investment company, the investment adviser and any service providers that have a financial reporting oversight role with respect to the investment company's financial statements. The rule should not apply to partners serving on the audit engagement teams of transfer agents, broker-dealers and other service providers where those entities, and the auditors providing audit services to those entities, would have no relationship with the investment company's

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<sup>10</sup> See Section 207 of the Act; see also Speech by SEC Staff: Changing the Future, by Jackson M. Day, Acting Chief Accountant, AICPA SEC Current Issues Conference, December 12, 2002, available at <http://www.sec.gov/news/speech/spch121202jmd.htm> ("Consistent with the Act, our current proposal does not call for firm rotation.").

financial statements. The rule should therefore permit partners who must rotate to move to the engagement teams of those entities.

### ***C. Length of the Time-Out Period***

As proposed, the rule would prohibit covered partners from providing audit services to the investment company complex for five years. The Commission requests comment on the length of the time-out period. We strongly believe that the proposed period is too long. For the reasons discussed above relating to the limited supply of qualified auditors, we believe that the time-out period should be two rather than five years.<sup>11</sup> By shortening the time-out period, the rule would alleviate some of the negative effects on the supply of qualified auditors.

### ***D. Transition Period***

As drafted, the proposed rule contains no transition period and no "grandfather" provisions. We are deeply concerned that investment companies whose lead and reviewing partners have been on the audit engagement team for five years will have to step down immediately when the rule becomes effective. This would create substantial problems with respect to institutional knowledge and the audit process, as well as significant administrative issues, all of which would impact severely the quality of the audit. It could force a rotation of the entire firm, which as discussed above, is not consistent with the Act. Therefore, we strongly urge the Commission to "grandfather" the current lead, reviewing and other partners, if any, that the Commission subjects to the rotation requirement<sup>12</sup> and start the "clock" for the five-year period upon effectiveness of the rule. Even if the Commission decides not to start the clock upon the rule's effectiveness and starts the clock at an earlier date, we urge the Commission to grandfather partners whose five years will be "up" within the next two years, so as to ensure an orderly transition and so as not to disrupt the ongoing audit and review process.

## ***III. Audit Committee Administration of the Engagement***

### ***A. Scope of the Proposed Rule***

The proposed rule implementing Section 202 of the Act would require an investment company's audit committee to pre-approve the audit services<sup>13</sup> provided to the investment company by the accountant as well as to approve the non-audit services provided to the

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<sup>11</sup> We note that the AICPA's SEC Practice Section also calls for a two-year time-out period.

<sup>12</sup> As discussed above, we strongly urge the Commission to apply the rule only to the lead and reviewing audit partners. We assume that the AICPA's SEC Practice Section rule calling for rotation every seven years would still apply, such that a lead or reviewing partner that has served for four years upon effectiveness of the rule would not be able to serve an additional five years.

<sup>13</sup> As the Commission notes in the Proposing Release, "the proposed rules recognize audit services to be broader than those services required to perform an audit pursuant to generally accepted auditing standards." The Proposing Release lists as examples of the breadth of audit services, services related to statutory audits and the issuance of comfort letters. Because the proposed rule distinguishes between audit and non-audit services for purposes of the approval process, we request the Commission to clarify the differences between audit and non-audit services beyond the examples discussed in the Proposing Release.

investment company, the investment adviser and affiliates of the investment adviser that provide services to the investment company.<sup>14</sup> With respect to approval of non-audit services, the services must either be pre-approved or approved pursuant to pre-approval policies and procedures or fall within a limited *de minimis* exception.

We strongly believe that as applied in the investment company context, the required approval with respect to non-audit services is overly broad and goes beyond what is required by the Act. The Act requires approval of services provided to the "issuer", *i.e.*, the investment company, whereas the proposed rule applies to services provided to the investment company, the investment adviser and the investment adviser's affiliates that provide services to the investment company. For the reasons discussed below, we urge the Commission to adopt a rule that applies only to services provided to the investment company.

We appreciate the Commission's objective of ensuring that investment company audit committees be apprised of the services that accounting firms provide to entities affiliated with investment advisers so that they can make informed decisions concerning the independence of such firms. However, we believe that this objective already is addressed adequately by current independence standards, which require any auditor to disclose to the audit committee in writing, "all relationships between the auditor and its related entities and the company and its related entities that in the auditor's professional judgment may reasonably be thought to bear on independence. . . ."<sup>15</sup> Current independence standards also require the auditor to discuss the auditor's independence with the audit committee.<sup>16</sup>

We are especially concerned about the additional burdens placed on investment company audit committees by the proposed rule. Under the proposal, these committees would have to meet more frequently.<sup>17</sup> To the extent that the audit committee is required to pre-approve a service to the investment adviser or an affiliate of the investment adviser with which it may not be entirely familiar, the audit committee will have to take a greater amount of time to address each service to be approved than if the entity's audit committee or similar body were considering such service with which it is already familiar.

We also are concerned with the burdens this will place on accounting firms that audit funds that are advised by firms that are part of broadly diversified financial services organizations. These organizations may use their accounting firm to provide many audit and non-audit services. The proposal will provide the audit committee of a single fund with "veto" authority over large-fee services provided to other entities in the financial services organization. We are concerned that this may cause accounting firms to view such funds as undesirable audit

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<sup>14</sup> The audit committee does not have to approve services provided to a sub-adviser whose role is primarily portfolio management and is sub-contracted or overseen by another investment adviser.

<sup>15</sup> See Independence Standards Board Standard No. 1, *Independence Discussions with Audit Committees*.

<sup>16</sup> See *id.*

<sup>17</sup> We note that the proposed rule would allow an audit committee to develop detailed pre-approval policies and procedures rather than pre-approving each service. However, as discussed below, we believe that audit committees will be hesitant to use this option due to the possible stigma resulting from having to disclose separately the fees that were paid to the accountant for services that were approved through this option.



clients, and could substantially limit the universe of accounting firms that these funds are able to retain as auditors.

Due to the nature of investment company complexes and the entities within them, the proposed rule also would create a significant amount of overlapping effort. For example, if the audit committee of an investment adviser meets to consider and approve the provision of a particular non-audit service, the proposed rule would result in two audit committee meetings on the same subject<sup>18</sup>—one at the investment adviser level and one at the investment company level.<sup>19</sup> The Act does not require, and we believe Congress did not intend to create, a system whereby a particular non-audit service must be approved at multiple levels. Such a system not only would be inefficient, but it would provide little or no additional investor protection.

For these reasons, we strongly urge the Commission to apply the rule only to investment companies. This alternative would decrease the rule's burden on investment companies and accounting firms and would decrease any resulting negative economic impact on investors, while at the same time ensuring that the non-audit services provided to the investment company are approved by the investment company's audit committee. We believe that this approach is consistent with the Act, which as discussed above, only applies to services provided to the "issuer". In addition, we also note that the Public Company Accounting Oversight Board may revisit these issues after the independence rules have been in effect for a period of time and therefore, at least initially, the rules should cover only what is required by the Act.

To the extent that the Commission believes that our proposed alternative does not adequately address its concerns and expands the proposal to cover more entities than the investment company, we urge the Commission not to apply the rule to entities beyond the investment company and the investment adviser, as the investment adviser represents the only entity that is directly involved with the management of the investment company and its financial statements.

#### ***B. Scope of Pre-Approval Processes and Procedures***

The proposed rule provides that engagements for non-audit services may be entered into pursuant to pre-approval policies and procedures. However, we note that the Proposing Release states that, among other things, such policies and procedures must be detailed as to the particular service. As applied to investment companies and especially as the rule currently is drafted, audit committees would be required to pre-approve a wide variety of non-audit services provided within the investment complex, including both significant and minor services. We propose that the Commission clarify that the scope of the permitted pre-approval policies and procedures would allow an audit committee to establish a policy that pre-approves all non-audit services the fees for which fall below a specified percentage of the total fees to be

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<sup>18</sup> Indeed, the proposed rule could result in two audit committees disagreeing as to whether a service impairs auditor independence.

<sup>19</sup> If the investment company complex employs a "cluster" board structure (*i.e.*, different boards for different groups of funds), the proposed rule could result in three or more audit committee meetings on the same subject.

paid to the accountant, provided that the audit committee determines in good faith that the specified percentage would not impair the auditor's independence.

Under our proposal, an audit committee would be able to establish a policy that pre-approves all non-audit services the aggregate fees for which fall below a specified percentage (e.g., five percent) of the total fees to be paid to the accountant that are allocated to an investment company. As another example, an audit committee would be able to establish a policy that pre-approves any individual non-audit service the fees for which fall below a specified percentage (e.g., one percent) of the total fees paid to the accountant that are allocated to an investment company. If the Commission declines to follow our recommendation regarding pre-approval of non-audit services and requires pre-approval of services provided to additional entities in the investment company complex, the specified percentage should be in relation to the total fees paid by the investment company complex. In this manner, audit committees would avoid having to pre-approve each insignificant non-audit service or develop detailed pre-approval policies and procedures that contemplate each such non-audit service.

#### ***C. Interaction with Section 32(a) of the Investment Company Act***

Section 32(a) of the Investment Company Act requires that a majority of the directors who are not interested persons appoint the independent accountant of the investment company. The Commission requests comment on who should approve the selection of the accountant of the investment company—*i.e.*, the independent directors, the audit committee or both. We recommend that the audit committee select the accountant and the independent directors ratify the selection, thereby retaining the independent directors as the ultimate decisionmaking authority with respect to accountant selection.

#### ***D. Transition Period***

We strongly urge the Commission to delay effectiveness of the final rule relating to pre-approval of non-audit services for a reasonable period of time so as to permit investment company audit committees to establish pre-approval policies and procedures in order to administer effectively the approval process. Although we urge the Commission to provide for a transition period with respect to the final rule as applied to services provided to investment companies, we are especially concerned about the lack of a transition period to the extent that the rule goes beyond the Act by requiring pre-approval of non-audit services to investment advisers and other affiliated entities within the investment company complex. An investment company audit committee will require a considerable amount of time to develop lines of communication and control procedures to ensure that it complies with the final rule's pre-approval requirements; accordingly, we recommend that the Commission delay effectiveness to ensure smooth implementation of the final rule.

### ***IV. Compensation***

The Commission proposes to amend the auditor independence rules to address the practice of audit partners receiving compensation from their firms for selling non-audit services to their particular audit clients. Under the proposed rule, which is not required by the Act, a partner, principal or shareholder who is a member of the audit engagement team may not,

during the audit and professional engagement period, earn or receive compensation based on the performance or procuring of engagements with that audit client to provide non-audit services. We recognize the Commission's concern with respect to partners attempting to "cross-sell" non-audit services while at the same time acting as "independent" auditors. However, as the term "compensation" is used in the proposed rule, we are concerned that the proposed rule is ambiguous and will be difficult to apply. To avoid confusion and to facilitate compliance, we recommend that the Commission clarify that the rule would apply only to "direct" compensation and not to compensation received in the ordinary course of dividing the firm's overall profits among partners, and that the rule would apply only to compensation for services provided to an investment company.

We understand that the structure of many accounting firms is such that it may be difficult to prevent *all* money derived from non-audit services provided to a particular audit client from becoming intertwined with the audit partner's other compensation. To the extent that a particular partner shares in the overall profits of the accounting firm and some of those profits derive from non-audit services that a partner provided to an audit client, this compensation could arguably fall within the scope of the prohibition in the rule as proposed. Rather than prohibiting *any* compensation that results from the provision of non-audit services to an audit client, we propose that the Commission prohibit the partner from receiving *direct* compensation from such non-audit services.<sup>20</sup> That is, to the extent that a partner receives any additional incentive beyond simply sharing in the accounting firm's profits, such compensation would be prohibited. Prohibited compensation would include, as noted in the Proposing Release, cash bonuses or other incentive programs for selling non-audit services to audit clients. Although the proposed rule will have a far greater impact on auditors than on investment companies, to the extent that a violation of the rule would cause an auditor to be not independent, this will adversely impact investment companies by requiring a re-audit of the investment company's financial statements. These instances could be minimized if the prohibition were limited to direct remuneration from the provision of non-audit services.

We also recommend that, in the event that an accountant *inadvertently* receives prohibited compensation, the Commission, rather than immediately finding that independence has been impaired, provide for disgorgement of profits to the accounting firm or the investment company audit client. A disgorgement remedy would effectively eliminate economic incentives for cross-selling non-audit services while protecting investment company audit clients from falling victim to an inadvertent oversight on the part of the accounting firm.

Finally, we note that the proposed rule refers to compensation for non-audit services provided to an "audit client", which would include all entities within the investment company complex. We urge the Commission to apply the rule only to compensation for services provided to an investment company. We believe that given the limited relationship between an investment company and the other entities within the investment company complex and given that an investment company has its own audit committee that is charged with guarding against

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<sup>20</sup> See Speech by SEC Staff, *supra* note 10 ("The Commission also proposed to prohibit members of an audit engagement team from being *directly* compensated for selling non-audit services to their audit clients.") (emphasis added).

impaired auditor independence, the Commission's goals would be served by applying the rule only to services provided to the investment company.

#### **V. *Communication with the Audit Committee***

The proposed rule implementing Section 204 of the Act would require each registered public accounting firm that audits the financial statements of an audit client to report to the audit committee all critical accounting policies and practices to be used and all alternative accounting treatments.

Under the proposed rule, the report would have to be made to the audit committee prior to filing of the audit report with the Commission. This could create significant burdens in the case of investment companies within a family of funds. Such investment companies often have a common board (or are organized as series companies with a single board), but have staggered fiscal years in order to ensure that work is distributed evenly throughout the year. Under the proposed rule, audit committees of these investment companies would have to meet as frequently as monthly to consider the accountant's report before the audit report is filed.

We note that although the preparation and review of investment companies' financial statements require specialized knowledge and skills, there are very few issues that arise during an audit that require the investment company to make assumptions about matters that are highly uncertain. Indeed, many of the "critical accounting policy" issues that could arise with respect to an investment company (the most notable being valuation processes) may be common to all or many funds within the same family.<sup>21</sup> Therefore, the required report to the audit committee by the accountant will likely be similar for all funds in the family. It is also unlikely that policies will change significantly from year to year. No purpose would be served by requiring an audit committee to receive and consider nearly identical reports of accountants each month before the audit report is filed with respect to that fund. In fact, requiring such frequent reports may undermine the purpose of the rule such that the audit committee likely would attach less importance to the report due to its repetitive and recurring nature. Accordingly, we recommend that the Commission ease the timing constraints present in its proposed rule by instead requiring accountants to make such reports annually (*i.e.*, at least once within any twelve-month period), except in the case of material changes in such policies. This proposal would reduce greatly the burden on audit committees and accountants alike by eliminating duplicative communications.

#### **VI. *Audit Fee Disclosure***

##### **A. *Disclosure Required in Each of Four Categories***

To implement Section 202 of the Act, the Commission proposes to require investment companies to disclose, in each of four categories, the fees billed by the accountant for services

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<sup>21</sup> See Letter to Craig S. Tyle, General Counsel, Investment Company Institute, from Douglas Scheidt, Associate Director and Chief Counsel, Division of Investment Management, U.S. Securities and Exchange Commission (Dec. 8, 1999) at 7, note 16. ("We generally believe...that a board could not arrive at different fair valuations for identical securities held by two or more funds that the board oversees, consistent with its good faith obligation.")

provided to the investment company as well as to the investment adviser and any entity controlling, controlled by, or under common control with the adviser that provides services to the investment company, subject to limited exceptions. The proposed rule requires disclosure under the captions of "Audit Fees",<sup>22</sup> "Audit-Related Fees", "Tax Fees" and "All Other Fees".

The proposed rule describes "Audit Fees" as fees billed for "professional services rendered by the principal accountant for the audit of the registrant's annual financial statements." The Commission further describes this category as services that "generally only the independent accountant can reasonably provide, such as comfort letters, statutory audits, attest services, consents and assistance with and review of documents filed with the Commission."<sup>23</sup> Under the category of "Audit-Related Fees", the investment company would be required to disclose those fees for "assurance and related services" that are "reasonably related to the performance of the audit of the registrant's financial statements" and that are not reported under the caption "Audit Fees". The Proposing Release describes "Audit-Related Fees" as fees for "assurance and related services that are traditionally performed by the independent accountant."<sup>24</sup> With respect to the category of "Tax Fees", the registrant would be required to disclose fees for "tax compliance, tax consulting, and tax planning."

The difference between those services that would be required to be disclosed under "Audit Fees" and those that would be required to be disclosed under "Audit-Related Fees" and "Tax Fees" is not clear. In addition, we can imagine instances in which a service arguably could fall within multiple categories, such as certain tax services provided in the context of due diligence related to business combinations of investment companies in connection with acquisitions by one investment adviser of another.<sup>25</sup> Accordingly, we request that the Commission clarify the types of services that would fall within each category and provide guidance on the procedures to be followed in instances where a particular service reasonably could be described under multiple categories.

### ***B. Application to Fees for Services Provided to Investment Advisers and Their Affiliates***

Under existing proxy rules, investment companies are required to disclose audit fees, as well as the aggregate fees for non-audit services provided to the investment company, its investment adviser and any affiliate of that adviser that provides services to the investment company.<sup>26</sup> Under the Commission's proposal, these disclosures would be moved to the Form N-CSR filing covering the annual period. The Proposing Release requests comment on whether

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<sup>22</sup> With respect to disclosure required under the category of "Audit Fees", the investment company would have to disclose fees for the audit of only the investment company's financial statements.

<sup>23</sup> Proposing Release at 76798.

<sup>24</sup> *Id.*

<sup>25</sup> According to the Proposing Release, due diligence related to mergers and acquisitions would be an audit-related service.

<sup>26</sup> Item 9(e)(1), (2), and (3) of Schedule 14A (17 CFR 240.14a-101, item 9(e)(1), (2), and (3)).

audit fees should also be disclosed on an aggregate basis, or alternatively, whether the disclosure of fees for non-audit services should apply to the issuer only.<sup>27</sup>

Our members inform us that compliance with this disclosure requirement has proved burdensome, particularly where the investment company's adviser is part of a diversified financial services firm. In many instances, an investment company is not immediately aware of the fees billed for each particular service that is provided to the investment adviser or its affiliates. We understand that gathering and formatting this information can be very time consuming. Under the proposal, the burden will be increased inasmuch as the disclosure would be provided annually on Form N-CSR.<sup>28</sup> Moreover, we do not think these disclosures are of interest to investors. For these reasons, we recommend that the disclosure of fees for audit and non-audit services should apply only to services provided to the investment company.

If the Commission is not inclined to make this change, we recommend that it require disclosure only with respect to non-audit services provided to the investment company and the investment adviser. To the extent that investors are concerned about an auditor's independence, information regarding services provided to the investment company and the investment adviser will be most useful to that analysis, as these are the two entities that are most directly involved with the preparation of the investment company's financial statements.

### ***C. Disclosure of Percentage of Fees for Services Approved by Various Methods***

Under the proposed rule, an investment company would have to disclose, for each of the categories of "Audit-Related Fees", "Tax Fees" and "All Other Fees", the percentage of fees derived from services that were approved by the audit committee using each of the (1) pre-approval, (2) approval pursuant to pre-approval policies and procedures and (3) *de minimis* exception "options" permitted under the proposed rule relating to audit committee administration of the audit engagement. For the reasons set forth below, we urge the Commission to eliminate this disclosure.

We note that this form of disclosure would highlight the magnitude of the use of pre-approval policies and procedures, which could suggest that this process is somehow suspect even though it is expressly permitted. This will act to discourage audit committees from approving non-audit services pursuant to pre-approval policies and procedures.

We believe that it is important that investment company audit committees not be discouraged from using pre-approval policies and procedures, given the burdens of approving non-audit services provided to certain other entities within the investment company complex.<sup>29</sup>

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<sup>27</sup> Proposing Release at 76800.

<sup>28</sup> If the Commission requires disclosure of fees for non-audit services paid by the adviser and its affiliates, we do not believe that an investment company principal executive officer and principal financial officer should be required to certify these amounts in Form N-CSR. It would not be reasonable to require these persons to certify fees paid by a third party affiliate to an independent accountant.

<sup>29</sup> As noted above, we believe that these burdens could be substantially lessened if the Commission limited the pre-approval requirement to investment companies.

Accordingly, we urge the Commission to eliminate this portion of proxy statement and annual report disclosure.

### ***VII. Consequences of Violating the Rules***

Title II of the Act, which amended the Securities Exchange Act of 1934, requires only that a violation of the auditor independence rules be treated as a violation of law by the auditor. As proposed, however, nearly all of the rules provide that a violation of the rules would not only result in a violation of the Exchange Act, but also would impair auditor independence, meaning that a violation would require investment companies to obtain re-audits of their financial statements. We appreciate the Commission's concern regarding auditor independence, but we also are concerned that issuers, including investment companies, will bear the burden of an auditor's failure to comply with the rules.

This point is especially troublesome given the lack of control that investment companies have over determining whether an auditor is independent. For example, with respect to the rules relating to compensation of audit partners, an investment company will be in no position to determine whether an audit partner has received a cash bonus or other type of compensation based on non-audit services provided to such investment company. The investment company instead will have to rely on a representation made by the auditor stating that the auditor is independent and has received no such compensation. Given that the penalties for violation of the independence rules could include mandatory re-audits,<sup>30</sup> we urge the Commission to consider removing some or all of the proposed rules from Rule 2-01 of Regulation S-X (relating to auditor independence) so that a violation of those rules does not impair independence.<sup>31</sup>

If the Commission is not inclined to make this change or to the extent that violations of other independence rules could require a re-audit of an investment company's financial statements, we recommend that the Commission adopt a "cure period" for inadvertent violations of the independence rules. A cure period should be available so long as the accounting firm and the investment company had adequate procedures in place to ensure independence and did not know, and were reasonable in not knowing, that a partner or employee lacked independence, and provided further that the firm and the investment company promptly took steps to cure the lack of independence. Such a cure period would further the Commission's goals by requiring both the accounting firm and the investment company to establish appropriate procedures to identify and prevent independence issues, but would not penalize such entities for inadvertent violations of the rules.

In addition, we propose that the Commission implement an additional "back-stop" for instances in which an investment company has an inquiry performed by an outside party (which is knowledgeable about generally accepted auditing standards and independence rules)

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<sup>30</sup> This result is particularly troublesome for open-end investment companies, which continuously offer their shares and must maintain "evergreen" registration statements and prospectuses.

<sup>31</sup> If the Commission does remove some or all of the proposed rules from Regulation S-X, we urge the Commission to incorporate the definitions contained in Regulation S-X into the final rules, including for example, the definition of investment adviser to the extent that it excludes certain sub-advisers.

to determine whether the independence failure impacted the audit of the investment company's financial statements. If the outside party determines that the failure did not have a material adverse impact on the conduct of the audit and the fund's audit committee ratifies such findings, then the accounting firm should be considered "independent" for the purposes of its audit report. Furthermore, if the inquiry determines that an identifiable part of the audit may have been compromised, then the audit committee should be permitted to require that the accounting firm re-perform that part of the audit. Termination of the accounting firm and hiring of a new firm to conduct a complete re-audit should not be required in these circumstances.<sup>32</sup>

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The Institute appreciates your consideration of our views on these important matters. If you have any questions regarding our comments or would like additional information, please contact the undersigned at 202/326-5815, Amy Lancellotta at 202/326-5824 or Greg Smith at 202/326-5851.

Sincerely,



Craig S. Tyle  
General Counsel

cc: Alan L. Beller, Director  
Division of Corporation Finance

Jackson M. Day  
Acting Chief Accountant

Giovanni P. Prezioso, General Counsel  
Office of General Counsel

Paul F. Roye, Director  
Division of Investment Management

Brian D. Bullard  
Chief Accountant, Division of  
Investment Management

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<sup>32</sup> See Appendix A for proposed language relating to the cure period and third party review.



## Appendix A

### Rule 2-01(f)(1) *Cure Period*

A violation of Rule 2-01(c)(2)(iii), (c)(4), (c)(6), (c)(7) or (c)(8) will not be deemed to impair an accountant's independence if (1) the accountant and the issuer had adequate procedures in place to protect against such violation, (2) the accountant and the issuer did not know, and were reasonable in not knowing, that the accountant violated such rule and (3) the accountant and the issuer promptly took steps to cure such violation.

### Rule 2-01(f)(2) *Third Party Review*

(a) In the event of a violation of Rule 2-01, an accountant's independence will not be impaired as a result of such violation if (1) a qualified third party that is unaffiliated with the accountant or the issuer determines that such violation did not have a material adverse impact on the conduct of the audit or review and (2) the issuer's audit committee reasonably and in good faith ratifies such determination.

(b) If the qualified third party determines that such violation did have a material adverse impact on the conduct of a portion of the audit or review, an accountant's independence will not be impaired so long as the accountant performs additional procedures on such portion of the audit or review so as to eliminate the effect of such violation on the conduct of the audit or review.

(c) For purposes of this Rule 2-01(f)(2), a "qualified third party" is a party that the issuer's audit committee reasonably and in good faith determines is qualified to interpret and apply generally accepted auditing standards and the independence standards promulgated by the Commission or by the accounting profession.