

§ 9.02 Selecting Independent Accountants

[1]—Accountants

[a]—Background

The SEC has consistently maintained that the independence of the accountants and auditors¹ who examine financial statements is central to the effective implementation of the federal securities laws.² Indeed, the securities laws underscore the crucial function of independent auditors in protecting public investors by requiring, or permitting the Commission to require, that financial statements filed with the SEC by public companies, mutual funds, closed-end funds and others be certified (or audited) by "independent" public accountants.³ These laws also give the Commission the authority to define the term "independent."⁴

[i]—Regulation S-X

Since the SEC's creation in 1934, the Commission has emphasized the need for auditors to remain independent. In 1940, the Commission

¹ The terms "independent accountant," "accountant," "independent auditor," and "auditor" are used interchangeably to refer to any independent public or certified public accountant who performs an audit of a fund's financial statements and whose report is filed with the Commission in accordance with the federal securities laws or the Commission's regulations.

² See Financial Reporting Codification, Section 600—Matters Relating to Independent Accountants.

³ The Securities Act and the Securities Exchange Act expressly require that independent public or certified accountants audit financial statements. Schedule A, Items 25 and 26, of the Securities Act, 15 U.S.C. §§ 77aa(25) and (26); § 17(e) of the Exchange Act, 15 U.S.C. § 78q. The securities laws also authorize the Commission to require the filing of financial statements audited by independent accountants. §§ 12(b)(1)(J) and (K) and 13(a)(2) of the Exchange Act, 15 U.S.C. §§ 78l and 78m; §§ 5(b)(H) and (I), 10(a)(1)(G) of the Public Utility Holding Company Act, 15 U.S.C. § 79e(b), 79j, and 79n; §§ 8(b)(5) and 30(e) of the Investment Company Act, 15 U.S.C. § 80a-8 and 80a-29; §§ 203(c)(1)(D) of the Investment Advisers Act, 15 U.S.C. § 80b-3(c)(1). In accordance with these provisions, the Commission has required that independent accountants audit certain financial statements. See, e.g., Article 3 of Regulation S-X, 17 C.F.R. §§ 210.3-01 *et seq.*

⁴ The federal securities laws grant the Commission the authority to define accounting, technical, and trade terms. § 19(a) of the Securities Act, 15 U.S.C. § 77s(a); § 3(b) of the Exchange Act, 15 U.S.C. § 78c(b); § 20(a) of the Public Utility Holding Company Act, 15 U.S.C. § 79t(a); and § 38(a) of the Investment Company Act, 15 U.S.C. § 80a-37(a).

consolidated various accounting instructions into a single regulation, Regulation S-X.⁵ Rule 2-01 of Regulation S-X provides that “[t]he Commission will not recognize any certified public accountant or public accountant as independent who is not in fact independent.”⁶ In 1982, the Commission collected its accounting and auditing releases relating to auditor independence in Section 600 of the Codification of Financial Reporting Policies, entitled “Matters Relating to Independent Accountants.”⁷ Under the Commission’s regulations:

*“[T]he basic test for auditor independence is whether a reasonable investor, knowing all relevant facts and circumstances, would perceive an auditor as having neither mutual nor conflicting interests with its audit client and as exercising objective and impartial judgment on all issues brought to the auditor’s attention. In determining whether an auditor is independent, the Commission considers all relevant facts and circumstances, and its consideration is not confined to the relationships existing in connection with the filing of reports with the Commission.”*⁸

In certain matters, the Commission has also referred registrants and their auditors to independence requirements adopted by the American Institute of Certified Public Accountants (AICPA), a private-sector organization.⁹

During the 1980s and 1990s, auditor independence issues became more complex as auditors entered into new service areas for their clients, auditing firms merged and restructured their operations, and business practices and technology became more sophisticated and, increasingly, more global in scope. Some of the Commission’s auditor

⁵ 17 C.F.R. §§ 210.1-01 *et seq.*

⁶ 17 C.F.R. § 210.2-01.

⁷ Financial Reporting Codification, Section 600-Matters Relating to Independent Accountants. See “Codification of Financial Reporting Policies,” Investment Company Act Release No. 12376 (April 15, 1982) (codification of certain accounting series releases).

⁸ “The Establishment and Improvement of Standards Related to Auditor Independence,” Investment Company Act Release No. 23029 (Feb. 18, 1998). (Citations omitted.) [Hereinafter Release 23029.]

⁹ See, e.g., Office of the Chief Accountant, Staff Report on Auditor Independence, Appendix II, 5-7 (1994) (discussing AICPA requirements regarding loans to or from an audit client or its officers, directors or stockholders; and stating that the SEC has not adopted additional requirements in this area). For detailed information about the AICPA, see its Web site at www.aicpa.org.

independence regulations, written at the time, did not provide obvious guidance in that business environment. The Commission recognized that an update of its regulations was in order.

[ii]—Independence Standards Board

After intense discussions among the Commission, the AICPA and the big accounting firms, the Independence Standards Board (ISB) was formed in 1997.¹⁰ The ISB was a private-sector organization, created within the AICPA. It was designed to provide leadership in improving auditor independence requirements and to establish and maintain a body of independence standards applicable to the auditors of all SEC registrants. Without abdicating the SEC's statutory responsibilities, the Commission looked to the ISB to set independence standards for the accounting profession. The Commission had taken a similar course in developing its relationship with the Financial Accounting Standards Board (FASB), a standard-setting body designated by the accounting profession to provide leadership in establishing and improving accounting principles.¹¹

Although the Commission looked to the ISB as the private-sector organization responsible for establishing independence standards from 1997 to July 2001, the Commission's authority regarding auditor independence was not affected.¹² During this time, the Commission retained the authority to institute enforcement actions or proceedings against accountants for "improper professional conduct,"¹³ as well as

¹⁰ See: "SEC and AICPA Announce the Creation of a New Independence Standards Board," SEC Press Release (May 21, 1997); Schroeder, "SEC Plans a New Board to Regulate Auditors," *Wall St. J.*, at B10 (May 21, 1997).

¹¹ See: "Statement of Policy on the Establishment and Improvement of Accounting Principles and Standards," Accounting Series Release No. 150 (Dec. 20, 1973) (recognizing establishment of FASB); "General Revision of Regulation S-X," Accounting Series Release No. 280 (Sept. 2, 1980) (commenting on FASB's role in establishing and improving accounting principles).

¹² See Release 23029, N. 8 *supra*.

¹³ Rule 102(e) of the SEC Rules of Practice governs disciplinary conduct concerning accountants and other professionals who practice before the Commission. 17 C.F.R. § 201.102(e). The Rule provides, among other things, that an accountant who engages in "improper professional conduct" may be subject to SEC censure or disbarment. 17 C.F.R. § 201.102(e)(ii). The term "improper professional conduct" is defined in the Rule as:

"(A) Intentional or knowing conduct, including reckless conduct, that results in a violation of applicable professional standards; or

"(B) Either of the following two types of negligent conduct:

to not accept, to modify or to supplement ISB independence standards and interpretations in the same manner that the Commission may modify or supplement accounting standards and interpretations issued by the FASB.¹⁴

In late 1999, when faced with evolving business structures that some accounting firms used and an expanding scope of non-audit services, the ISB requested input and guidance from the Commission to deal with auditor independence issues. One result of this joint undertaking was the Commission's adoption in November 2000 of substantially revised rules regarding the regulation of auditor independence and associated disclosure requirements.¹⁵

Upon completion of this rulemaking, the Commission found that it had addressed the vast majority of the issues for which the ISB had been created. In addition, there was increased public participation on the Professional Ethics Executive Committee of the AICPA, which deals with auditor independence issues. The combination of these two factors led the Commission to conclude in July 2001 that it would no longer look to the ISB to provide leadership in establishing or maintaining independence standards, and the ISB is in the process of ceasing operations.¹⁶ Nevertheless, the Commission has expressly stated that ISB Standard No. 1 (Independence Discussions with Audit Committees) and ISB Standard No. 2 (Certain Independence Implications of Audits of Mutual Funds and Related Entities) continue to have "substantial authoritative support for the resolution of auditor independence issues."¹⁷

"(1) A single instance of highly unreasonable conduct that results in a violation of applicable professional standards in circumstances in which an accountant knows, or should know, that heightened scrutiny is warranted.

"(2) Repeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards, that indicate a lack of competence to practice before the Commission."

17 C.F.R. § 201.102(e)(iv). See Roberts, Swanson and Roberts, "SEC Enforcement Actions and the Accounting Profession—Current Developments," 32 Rev. of Sec. & Comm. Reg. 10, 103 (May 19, 1999).

¹⁴ See Release 23029, N. 8 *supra*.

¹⁵ "Revision of the Commission's Auditor Independence Requirements," Securities Act Release No. 7919 (Nov. 21, 2000).

¹⁶ "Establishment and Improvement of Standards Related to Auditor Independence," SEC Policy Statement, Securities Act Release No. 7793 (July 17, 2001).

¹⁷ *Id.* See: ISB, "Standard No. 1, Independence Discussions with Audit Committees" (Jan. 1999); ISB, "Standard No. 2, Certain Independence Implications of

[iii]—*The Sarbanes-Oxley Act*

In response to a series of high-profile accounting scandals and corporate failings, Congress passed the Sarbanes-Oxley Act, which was signed into law in the summer of 2002.^{17.1} At the time the Act was passed, a wave of corporate scandals had contributed to significant stock market declines and to what some observers called a “crisis of investor confidence.”^{17.2} The Act requires the SEC to implement many new rules that will apply to mutual funds and closed-end funds.

The Sarbanes-Oxley Act mandated the creation of the Public Company Accounting Oversight Board.^{17.3} The Act established the Board to oversee the audit of public companies and, among other things, to establish or adopt rules setting auditing, quality control, ethics, independence and other standards relating to the preparation of audit reports by public companies.^{17.4} The Act requires the SEC to appoint members of the Board, a process which immersed the SEC in political wrangling and controversy that is uncharacteristic of the independent agency.^{17.5}

Audit of Mutual Funds and Related Entities” (Dec. 1999).

^{17.1} Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204 (2002). See also: McGeehan, “After the ‘Darkest Year,’ a Changed Wall St.,” N.Y. Times at § 3, p. 1 (Sept. 8, 2002); Labaton, “Will Reforms With Few Teeth Be Able to Bite?” N.Y. Times at § 3, p. 4 (Sept. 2, 2002).

^{17.2} See: Oppel, “Private Sector; A Point Man on Corporate Change,” N.Y. Times at § 3, p. 2 (July 14, 2002); Eichenwald and Romero, “Turmoil at WorldCom: The Decision Making: The Latest Corporate Scandal is Sudden, Vast and Simple,” N.Y. Times at A1 (June 27, 2002); “Jitters About Corporate Accounting Push Down Shares,” N.Y. Times at C12 (Feb. 13, 2002); Labaton, “Enron’s Collapse: Regulation,” N.Y. Times at C1 (Jan. 24, 2002).

^{17.3} Section 101 of the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204 (2002). The SEC is required to appoint five full-time members of the Public Company Accounting Oversight Board. The Board, in turn, is required to hire staff, adopt rules and take other actions to enable the SEC to determine that the Board is able to carry out its responsibilities under the Act and to begin operations. Six months after the SEC’s determination, it will be illegal for auditors to prepare, issue or participate in the preparation or issuance of an audit report of a public company to be filed with the SEC without being registered with the Board.

^{17.4} Section 101 of the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204 (2002).

^{17.5} At an October 25, 2002 meeting, the SEC announced the selection of Judge William H. Webster to be the founding chairman of the Public Company Accounting Oversight Board. At the meeting, SEC Commissioners sparred along party lines over whether Judge Webster or another candidate, John Biggs, former Chairman and CEO of TIAA-CREF and who had reportedly been the frontrunner for the chair, would be the best chair.

After the selection of Webster, reports emerged that he had headed the audit

With the SEC's early and ongoing concerns about auditor independence, it is not surprising that the Investment Company Act has since its adoption required that a majority of a fund's independent directors select the fund's independent public accountants.¹⁸

[b]—Section 32(a)

[i]—Selection Requirements

[A]—Independent Director Vote

Section 32(a) of the Investment Company Act requires that a majority of a fund's independent directors select the fund's independent public accountants¹⁹—sometimes referred to as “independent audi-

committee of U.S. Technologies, a company that was under SEC investigation for accounting fraud at the time of Webster's nomination. See Labaton, “Audit Overseer Cited Problems in Previous Post,” N.Y. Times at A1 (Oct. 30, 2002). Shortly before his appointment to the Board, Webster told Harvey Pitt, then-chairman of the SEC, about his service on U.S. Technologies' audit committee. Pitt chose not to share this information with the four other commissioners who voted on Webster's appointment. *Id.* This led some observers to raise questions about the screening process used to select Webster. *Id.* After reports of Pitt's failure to disclose Webster's service on U.S. Technologies' audit committee became public, Pitt took the unusual step of ordering the SEC inspector general to investigate allegations that Pitt withheld knowledge from the Bush administration, Congress and SEC colleagues regarding Webster's association with U.S. Technologies. Schroeder, “As Pitt Launches SEC Probe Of Himself, Criticism Mounts,” N.Y. Times at A1 (Nov. 1, 2002).

On November 5, 2002, Harvey Pitt resigned as Chairman of the SEC, citing “the turmoil surrounding [his] chairmanship.” Henriques, “Mr. Pitt's Belated Departure,” N.Y. Times at A30 (Nov. 7, 2002). Six days later, on November 11, 2002, Webster resigned as chairman of the Board amid controversy surrounding his appointment to the Board. Schroeder, “Webster Makes It Official and Quits Accounting Board,” Wall St. Journal at A3 (Nov. 13, 2002). At the time of this writing, both the Board and the SEC were without a chairman.

¹⁸ Investment Company Act, Pub. L. No. 76-768, § 32(a), 54 Stat. 789, 838 (1940).

¹⁹ 15 U.S.C. § 80a-31(a)(1). (As an apparent Congressional oversight, subpart “31” of 15 U.S.C. Section 80a is codified as Section “32” of the Investment Company Act.) Section 31(a)(1) specifically provides:

“(a) It shall be unlawful for any registered management company . . . to file with the Commission any financial statement signed or certified by an independent public accountant, unless —

“(1) such accountant shall have been selected at a meeting . . . by the vote, cast in person, of a majority of those members of the board of directors who are not interested persons of such registered company”

Id. Since all mutual funds and closed-end funds are required to file financial

tors” or “outside auditors.”²⁰ The Section requires that the independent directors, in making the selection, cast their vote “in person” at a meeting.²¹ The SEC staff and presumably the Commission believe that a telephone conference would not satisfy the “in person” requirement.^{21.1}

[B]—Due Diligence

The independent directors should conduct an appropriate level of due diligence in selecting an independent accounting firm. The Business Law Section of the American Bar Association has suggested that directors may want to consider:

- The qualifications and reputation of the proposed accountant/auditor;
- The identify and skill of the potential engagement team; and
- The scope and fees of the proposed audit.^{21.2}

Independent directors also should be mindful of the importance that the SEC places on directors and, in particular, audit committees in satisfying their auditing oversight function.^{21.3} This regulatory emphasis has led many directors to “ask prospective candidates for more-

statements signed or certified by independent public accountants, Section 32(a)(1), in effect, requires all funds to follow this procedure. Rule 6-03(b) of Regulation S-X under the Securities Act also provides that, “[w]here . . . financial statements [of registered investment companies] are required to be audited, the independent accountants shall have been selected and ratified in accordance with Section 32 of the Investment Company Act of 1940.” 17 C.F.R. § 210. 6-03(b).

²⁰ The terms “independent accountant,” “accountant,” “independent auditor,” and “auditor” are used interchangeably to refer to any independent public or certified public accountant who performs an audit of a fund’s financial statements and whose report is filed with the Commission in accordance with the federal securities laws or the Commission’s regulations.

²¹ 15 U.S.C. § 80a-31(a)(1).

^{21.1} See “Time Period During Which the Board of Directors of a Registered Management Investment Company Must Select the Company’s Independent Public Accountants,” Investment Company Act Release No. 16842, n.12 (March 1, 1989) (proposing Rule 32a-3 under the Investment Company Act).

^{21.2} A.B.A. Bus. L. Section, Fund Director’s Guidebook § 8.F (1982).

^{21.3} See: “Temporary Final Rule and Final Rule: Requirements for Arthur Anderson LLP Auditing Clients,” Securities Act Release No. 8070 (March 18, 2002); Herdman, “Making Audit Committees More Effective” Tul. Corp. L. Institute, New Orleans, La. (March 7, 2002).

than-typical assurances that their auditing processes were sound.”²² Practitioners have recommended that independent directors may want to consider asking outside auditors the following questions when conducting their due diligence:

- Is the audit firm making a sufficient effort to test the information provided by the adviser’s internal audit staff? (There is always the danger that the outside firm may assume the internal experts have a better understanding of a situation and may simply yield to them when something is not clear.)
- Will the auditor perform spot-checks on reported net asset values throughout the year? (Auditors will review net asset values once a year for annual filings.)
- To what degree can the auditor’s fair-valuation decisions vary from management’s? (Will the auditor compare the valuation of a security with another fund’s valuation for the same security?)
- Does the auditing firm consider how management’s fair-valuation performance compares to other fund groups?
- How does the auditor review a fund’s expense accounting? (Does it compare the expenses paid to service providers with the original contract or invoice to ensure accuracy?)
- Since funds often share expenses with management or other funds in the complex, does the auditing firm check the accuracy of a fund’s shared expenses to ensure the fund is paying its correct share?
- Is management forthcoming when answering the auditor’s questions and is requested information provided in a timely fashion? (The outside auditor needs to assure the board that management’s internal team is cooperating with the efforts of the independent auditor.)²³

As part of the evaluation process, a fund’s independent directors (or the board’s audit committee) also should consider the “independence” of the proposed outside auditor.²⁴

Independent directors should draw a distinction between the proc-

²² See “Enron Debacle Emphasizes Auditors,” 11 Fund Directions 1, 13 (Jan. 2002).

²³ *Id.* (Questions for Auditors).

²⁴ For a discussion of these board responsibilities, see § 9.02[1][b][ii] (Auditor Independence) *infra*.

ess of deciding whether to re-engage an accounting firm and deciding whether to select a new firm. In the case of a firm that has previously provided services to the fund, directors can evaluate the firm's accounting and audit services firsthand; but for a new firm, the directors would have to obtain information about the services from other sources.²⁵

[C]—Audit Committee

An audit committee composed solely of a fund's independent directors typically selects the fund's independent accountant. Virtually every fund maintains a standing audit committee to comply with Rule 32a-4 under the Investment Company Act in order to avoid shareholder ratification of the independent accountant.²⁶ In addition, an exchange-traded closed-end fund is required to maintain an audit committee to comply with stock exchange rules.²⁷

[D]—Timing of Vote

The independent directors, however, have some flexibility concerning the timing of their vote (i.e., when they select the accountants).²⁸ If a fund is organized in a jurisdiction that does not require it to hold annual shareholder meetings and the fund does not hold a regular annual shareholders' meeting in a given fiscal year, which is the case with *most mutual funds*, the following rules apply:

- For a fund in a fund group in which the funds do not have identical fiscal years, the accountants must be selected at a meeting held within ninety days before or after the beginning of the fund's fiscal year.²⁹
- For a fund that is not in a fund group or is in a group in which the funds have identical fiscal years, the accountants must be selected at a meeting held thirty days before or ninety days after

²⁵ KPMG, *Guidelines for Directors Investment Companies* 27 (1995).

²⁶ 17 C.F.R. § 270.32a-4.

²⁷ For further discussion of fund audit committees, see § 4.04[2][b] (Audit Committees) *supra*.

²⁸ See: "Time Period During Which the Board of Directors of a Registered Management Investment Company Must Select the Company's Independent Public Accountants," Investment Company Act Release No. 17077 (July 21, 1989) (adopting Rule 32a-3 under the Investment Company Act); Release 16842, N. 21.1 *supra*.

²⁹ 17 C.F.R. § 270.32a-3(a)(1).

the beginning of the fund's fiscal year.³⁰

If, however, a fund holds a regular shareholder meeting in a given fiscal year, which is the case with *most closed-end funds*, the following rule applies:

- The accountants must be selected at a meeting held thirty days before or after the beginning of the fund's fiscal year or before the annual meeting of shareholders in that year.

[E]—Shareholder Ratification Not Required.

If a fund's audit committee takes certain measures, Rule 32a-4 under the Investment Company Act provides that fund shareholders are not required to ratify the selection of the fund's independent public accountant.³¹ Section 32(a)(2) of the Act otherwise would require that the selection be "submitted for ratification or rejection at the next succeeding annual meeting of stockholders."³²

Rule 32a-4 is conditioned on three requirements:

- The fund's board of directors has established an audit committee, "composed solely" of independent directors, "that has responsibility for overseeing the fund's accounting and auditing process",³³
- The board has adopted an audit committee charter "setting forth the committee's structure, duties, powers, and methods of operation";³⁴ and
- The fund maintains a copy of the charter and any amendments to the charter.³⁵

The SEC adopted Rule 32a-4 to "permit continuing oversight of the fund's accounting and auditing process by an independent audit committee, in place of the shareholder vote."³⁶

³⁰ 17 C.F.R. § 270.32a-3(a)(2).

³¹ 17 C.F.R. § 270.32a-4.

³² 15 U.S.C. § 80a-32(a)(2).

³³ 17 C.F.R. § 270.32a-4(a).

³⁴ 17 C.F.R. § 270.32a-4(b).

³⁵ 17 C.F.R. § 270.32a-4(c).

³⁶ "Role of Independent Directors of Investment Companies," Investment

[ii]—Auditor Independence

[A]—Sarbanes-Oxley Act Requirements

Section 10A of the Exchange Act, as amended by the Sarbanes-Oxley Act, sets forth a number of requirements intended to ensure auditor independence.^{36.1} Section 10A(g) of the Exchange Act lists nine specific services that, subject to an exemption granted by the new Public Company Accounting Oversight Board, an auditor of a mutual fund or closed-end fund cannot perform for that audit client. These services include:

- (1) Bookkeeping or other services related to the accounting records or financial statements of the audit client;
- (2) Financial information systems design and implementation;
- (3) Appraisal or valuation services, fairness opinions, or contribution-in-kind reports;
- (4) Actuarial services;
- (5) Internal audit outsourcing services;
- (6) Management functions or human resources;
- (7) Broker or dealer, investment adviser, or investment banking services;
- (8) Legal services and expert services unrelated to the audit; and
- (9) Any other service that the Public Company Accounting Oversight Board determines is impermissible.^{36.2}

Company Act Release No. 24816 (Jan. 2, 2001) (adopting certain rule amendments under the Investment Company Act). In proposing Rule 32a-4, the Commission observed that:

“[S]hareholders rarely contest votes over the ratification of the selection of a fund’s independent accountant. Many believe shareholder ratification has become perfunctory. This may have occurred because of the growth of funds, their organization into large complexes, the increased complexity of accounting issues, or the consolidation of accounting firms, which have made it impracticable for shareholders to evaluate the qualifications and independence of fund auditors.”

“Role of Independent Directors of Investment Companies,” Investment Company Act Release No. 24082 (Oct. 14, 1999) (proposing certain rule amendments under the Investment Company Act). The rationale for Rule 32a-4 demonstrates a philosophical evolution in fund governance—a transition to place more responsibility with the directors while recognizing the real world limits of shareholder influence.

^{36.1} 15 U.S.C. § 78f; Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204 (2002).

^{36.2} See § 201 of the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204 (2002).

An auditor may perform non-audit services, including tax services, that do not appear on this list so long as the activity is approved in advance by the audit committee in accordance with Section 10A(i).^{36.3} In addition, the Exchange Act, as amended by the Sarbanes-Oxley Act, requires that a lead audit partner rotate from an audit client after five years of auditing that client's books.^{36.4} Furthermore, an auditor may not perform audit services if a chief executive officer, controller, chief financial officer, chief accounting officer, or any other person serving in an equivalent position for the fund, was employed by that auditor and participated in any capacity in the fund's audit during the previous year.^{36.5}

The noted Exchange Act provisions do not address the implications of audit and non-audit services provided by the fund's auditor to the fund's adviser or the adviser's affiliates. Audit committees may want to consider whether such services raise issues regarding the auditor's independence.

In addition, the SEC has proposed a rule to prevent the improper influence of auditors.^{36.6} Proposed Rule 13b2-2(b) under the Exchange Act would prohibit "any action to fraudulently induce, coerce, manipulate, or mislead" the fund's auditor for the purpose of rendering the fund's financial statements materially misleading.^{36.7} The proposed rule would apply to officers and directors of a fund, as well as officers and directors of the fund's service providers, including, but not limited to, the investment adviser, sponsor, depositor, trustee, and administrator.^{36.8}

^{36.3} 15 U.S.C. § 78j-1; § 202 of the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204 (2002).

^{36.4} 15 U.S.C. § 78j-1(j); § 203 of the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204 (2002).

^{36.5} 15 U.S.C. § 78j-1(l); § 206 of the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204 (2002).

^{36.6} "Improper Influence on Conduct of Audits," Investment Company Act Release No. 25773 (Oct. 18, 2002).

^{36.7} *Id.*

^{36.8} *Id.* The proposed Rule would prohibit these persons from:

- Making a materially false or misleading statement to an accountant in connection with: (1) any required audit of the investment company, or (2) the preparation or filing of any document or report required to be filed with the SEC; or
- Taking any action to mislead an accountant "engaged in the performance of an audit or review" of the investment company's financial statements if that

[B]—Written Assurance

While not a legal requirement, a fund's audit committee often will request some form of assurance that the accounting/audit firm under consideration is, in fact, "independent" from management (i.e., the fund's investment adviser). Historically, auditors have submitted a "qualification" letter to the board for this purpose.³⁷ This practice, as a practical matter, has now been incorporated into the ISB Standard No. 1, which requires auditors to confirm their independence in a letter to their client's audit committees (or the board of directors if there is no audit committee) each year.³⁸

ISB Standard No. 1, which became effective in July 1999, applies to any auditor intending to be considered an independent accountant with respect to any SEC registrant, including mutual funds and closed-end funds.³⁹ At least annually, Standard No. 1 requires that the auditor:

- "a. disclose to the audit committee of the [fund] . . . , *in writing*, all relationships between the auditor and its related entities and the [fund] and its related entities that in the auditor's professional judgment may reasonably be thought to bear on

person "knew or was unreasonable in not knowing" that such action could result in rendering the financial statement materially misleading. *Id.*

The Commission stated that the following conduct, for example, might constitute improper influence on an auditor: (1) offering or paying bribes or other financial incentives, including offering future employment or contracts for non-audit services; (2) providing an auditor with inaccurate or misleading legal analysis; (3) threatening to cancel or canceling existing non-audit or audit engagements if the auditor objects to the issuer's accounting; (4) seeking to have a partner removed from the audit engagement because the partner objects to the issuer's accounting; (5) blackmailing; and (6) making physical threats. *Id.*

³⁷ See KPMG, *Guidelines for Directors Investment Companies* 27 (1995).

³⁸ See: "Establishment and Improvement of Standards Related to Auditor Independence," SEC Policy Statement, Securities Act Release No. 7993 (July 17, 2001); "The Establishment and Improvement of Standards Related to Auditor Independence," Investment Company Act Release No. 23029 (Feb. 18, 1998).

³⁹ ISB "Standard No. 1, Independence Discussions with Audit Committees" (Jan. 1999). While the SEC no longer looks to the ISB to provide leadership in establishing or maintaining independence standards and the ISB is in the process of ceasing operations, the SEC has expressly stated that ISB Standard No. 1 continues to have "substantial authoritative support for the resolution of auditor independence issues." "Establishment and Improvement of Standards Related to Auditor Independence," SEC Policy Statement, Securities Act Release No. 7793 (July 17, 2001). See § 9.02[1][a] (Background) *supra*.

- independence;
- “b. confirm in the letter that, in its professional judgment, it is independent of the [fund] within the meaning of the [federal securities laws]; and
 - “c. discuss the auditor’s independence with the audit committee.”⁴⁰

SEC regulatory requirements concerning auditor independence are provided in Rule 2-01 of Regulation S-X under the Securities Exchange Act.⁴¹ Rule 2-01, which was substantially amended in November 2000,⁴² generally provides that:

“The Commission will not recognize an accountant as independent, with respect to an audit client, if the accountant is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not, capable of exercising objective and impartial judgment on all issues encompassed within the accountant’s engagement.”⁴³

In addition to this general standard, Rule 2-01 includes specific prohibitions.⁴⁴ For example, the Rule provides that an accountant is not independent if the accountant has “a direct financial interest or a material indirect financial interest” in the audit client.⁴⁵ This generally would include situations in which the accounting firm or a person on

⁴⁰ *Id.*

⁴¹ 17 C.F.R. §§ 210.2-01 *et seq.*

⁴² “Revision of the Commission’s Auditor Independence Requirements,” Investment Company Act Release No. 24744 (Nov. 21, 2000) (adopting amendments to Rule 2-01 of Regulation S-X and Schedule 14A); “Revision of the Commission’s Auditor Independence Requirements,” Securities Act Release No. 7870 (July 12, 2000) (proposing amendments to Rule 2-01 of Regulation S-X and Schedule 14A).

⁴³ 17 C.F.R. § 210.2-01(b). The Commission has stated that:

“The independence requirement serves two related, but distinct, public policy goals. One goal is to foster high quality audits by minimizing the possibility that any external factors will influence an auditor’s judgments

“The other related goal is to promote investor confidence in the financial statements of public companies”

“Revision of the Commission’s Auditor Independence Requirements,” Investment Company Act Release No. 24744 (Nov. 21, 2000) (adopting amendments to Rule 2-01 of Regulation S-X and Schedule 14A). (Footnote omitted.)

⁴⁴ See Preliminary Note to 17 C.F.R. § 210.2-01(c)(1).

⁴⁵ 17 C.F.R. § 210.2-01(c)(1).

the audit engagement team has a financial interest in the client fund, a fund in the same complex, or any related service provider, including the investment adviser.⁴⁶

Rule 2-01 also prohibits—with limited exception—an independent accountant from providing non-audit services, such as information technology services, to an audit client or affiliates of the client. The limited exceptions require management to take certain actions and accept certain responsibilities.⁴⁷ If any of these services are provided, the audit committee should consider:

“[W]hether the provision of [information technology and other non-audit services to the fund or its affiliates] is compatible with maintaining the principal accountant’s independence.”⁴⁸

In addition to SEC Rule 2-01 and ISB Standard No. 1, ISB Standard No. 2 prescribes certain independence standards for auditors of mutual funds and closed-end funds in particular.⁴⁹ Standard No. 2,

⁴⁶ 17 C.F.R. § 210.2-01(c)(1)(ii)(G).

⁴⁷ 17 C.F.R. § 210.2-01(c)(4). The particular non-audit services that an independent accountant generally may not provide to an audit client or an affiliate of the client, include:

- Bookkeeping or other services related to the audit client’s accounting records or financial statements (17 C.F.R. § 210.2-01(c)(4)(i));
- Financial information systems design and implementation (17 C.F.R. § 210.2-01(c)(4)(ii));
- Appraisal or valuation services or fairness opinions (17 C.F.R. § 210.2-01(c)(4)(iii));
- Actuarial services (17 C.F.R. § 210.2-01(c)(4)(iv));
- Internal audit services (17 C.F.R. § 210.2-01(c)(4)(v));
- Management functions (17 C.F.R. § 210.2-01(c)(4)(vi));
- Human resources (17 C.F.R. § 210.2-01(c)(4)(vii));
- Broker-dealer services (17 C.F.R. § 210.2-01(c)(4)(viii)); and
- Legal services (17 C.F.R. § 210.2-01(c)(4)(ix)).

⁴⁸ 17 C.F.R. § 240.14a-101(e)(4). For further discussion of responsibilities of a fund’s audit committee, see § 4.04[2][b] (Audit Committee) *supra*.

⁴⁹ ISB “Standard No. 2, Certain Independence Implications of Audits of Mutual Funds and Related Entities” (Dec. 1999). While the SEC no longer looks to the ISB to provide leadership in establishing or maintaining independence standards and the ISB is in the process of ceasing operations, the SEC has expressly stated that ISB Standard No. 2 continues to have “substantial authoritative support for the resolution of auditor independence issues.” “Establishment and Improvement of Standards Related to Auditor Independence,” SEC Policy Statement, Securities Act Release No. 7793 (July 17, 2001). See § 9.02[1][a] (Background) *supra*.

which became effective in November 2000,⁵⁰ requires the audit firm, certain of its retirement plans, the audit engagement team, and those in influential positions, when auditing a fund, to be independent of all funds in the fund complex and all related service providers, including the investment adviser.⁵¹

[iii]—Disclosures

A fund may be required in its proxy statement to disclose certain board actions with respect to accounting independence issues.⁵² Schedule 14A under the Securities Exchange Act sets forth proxy requirements for, among others businesses, mutual funds and closed-end funds.⁵³ If a proxy solicitation is made on behalf of a fund and it relates to the election of directors or “the election, approval or ratification” of the fund’s outside accountant, Schedule 14A requires the proxy statement to disclose:

“[W]hether the audit committee . . . has considered whether the provision of [information technology and other non-audit services to the fund or its affiliates] is compatible with maintaining the principal accountant’s independence.”⁵⁴

The SEC believes that this disclosure provides “useful information to investors.”⁵⁵ In adopting the requirement, the Commission noted that they are requiring issuers to disclose only whether the audit committee has considered these matters. They were “not requiring issuers to disclose the conclusions of the audit committee deliberations.”⁵⁶

⁵⁰ “Revision of the Commission’s Auditor Independence Requirements,” Investment Company Act Release No. 24744 (Nov. 21, 2000) (adopting amendments to Rule 2-01 of Regulation S-X and Schedule 14A); “Revision of the Commission’s Auditor Independence Requirements,” Securities Act Release No. 7870 (July 12, 2000) (proposing amendments to Rule 2-01 of Regulation S-X and Schedule 14A).

⁵¹ ISB “Standard No. 2, Certain Independence Implications of Audits of Mutual Funds and Related Entities” (Dec. 1999).

⁵² 17 C.F.R. § 240.14a-101(e)(4).

⁵³ 17 C.F.R. § 240.14a-101.

⁵⁴ 17 C.F.R. § 240.14a-101(e)(4). For further discussion of responsibilities of a fund’s audit committee, see § 4.04[2][b] (Audit Committee) *supra*.

⁵⁵ “Revision of the Commission’s Auditor Independence Requirements,” Investment Company Act Release No. 24744 (Nov. 21, 2000) (adopting amendments to Rule 2-01 of Regulation S-X and Schedule 14A).

⁵⁶ *Id.*

Accordingly, the Commission saw “little possibility of private liability arising from these disclosures.”⁵⁷

[iv]—Other Requirements

Employment Termination Right. The Investment Company Act provides a fund with the right to terminate the employment of its independent accountant.⁵⁸ To terminate the employment, the holders of a majority of the fund’s securities would be required to vote at a meeting called for that purpose.⁵⁹

Accountants’ Certificate or Report. An independent accountant to a fund is required under the Investment Company Act to address both the fund’s board of directors and fund shareholders in any certificate or report concerning financial statements filed with the Commission.⁶⁰

[2]—Principal Accounting Officer

Section 32(b) of the Investment Company Act governs a fund’s selection of its controller or other principal accounting officer.⁶¹ In order to participate in the preparation of the fund’s registration statement, the Section requires that this person was selected either by the fund’s board of directors or shareholders.⁶²

⁵⁷ *Id.*

⁵⁸ 15 U.S.C. § 80a-31(a)(3).

⁵⁹ *Id.*

⁶⁰ 15 U.S.C. § 80a-31(a)(4).

⁶¹ 15 U.S.C. § 80a-31(b).

⁶² *Id.*