Final Rule: Revision of the Commission's Auditor Independence Requirements

SECURITIES AND EXCHANGE COMMISSION

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Revision of the Commission's Auditor Independence Requirements

AGENCY: Securities and Exchange Commission

ACTION: Final rule

SUMMARY: The Securities and Exchange Commission ("SEC" or "Commission") is adopting rule amendments regarding auditor independence. The amendments modernize the Commission's rules for determining whether an auditor is independent in light of investments by auditors or their family members in audit clients, employment relationships between auditors or their family members and audit clients, and the scope of services provided by audit firms to their audit clients. The amendments, among other things, significantly reduce the number of audit firm employees and their family members whose investments in audit clients are attributed to the auditor for purposes of determining the auditor's independence. The amendments shrink the circle of family and former firm personnel whose employment impairs an auditor's independence. They also identify certain non-audit services that, if provided by an auditor to public company audit clients, impair the auditor's independence. The scope of services provisions do not extend to services provided to non-audit clients. The final rules provide accounting firms with a limited exception from being deemed not independent for certain inadvertent independence impairments if they have quality controls and satisfy other conditions. Finally, the amendments require most public companies to disclose in their annual proxy statements certain information related to, among other things, the non-audit services provided by their auditor during the most recent fiscal year.

Effective Date: February 5, 2001.

Transition Dates: Until August 5, 2002, providing to an audit client the non-audit services set forth in § 210.2-01(c)(4)(iii) (appraisal or valuation services or fairness opinions) and § 210.2-01(c)(4)(v) (internal audit services) will not impair an accountant's independence with respect to the audit client if performing those services did not impair the accountant's independence under pre-existing requirements of the SEC, the Independence Standards Board, or the accounting profession in the United States. Until May 7, 2001, having the financial interests set forth in § 210.2-01(c)(1)(ii) or the employment relationships set forth in § 210.2-01 (c)(2) will not impair an accountant's independence with respect to the audit client if having those financial interests or employment relationships did not impair the accountant's independence under pre-existing requirements of the SEC, the Independence Standards Board, or the accounting profession in the United States. Until December 31, 2002, § 210.2-01(d)(4) shall not apply to offices of the accounting firm located outside of the United States. Registrants must comply with the new proxy and information statement disclosure requirements for all proxy and information statements filed with the Commission after the effective date.

FOR FURTHER INFORMATION CONTACT: John M. Morrissey, Deputy Chief Accountant, or Sam Burke, Assistant Chief Accountant, Office of the Chief Accountant, at (202) 942-4400, or with respect to questions about investment companies, John S. Capone, Chief Accountant, Division of Investment Management, at (202) 942-0590, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549.

SUPPLEMENTARY INFORMATION: The Commission today is adopting amendments to Rule 2-01 of Regulation S-X[1] and Item 9 of Schedule 14A[2] under the Securities Exchange Act of 1934 (the "Exchange Act").[3]

I. Executive Summary

We are adopting amendments to our current rules regarding auditor independence.[4] The final rules advance our important policy goal of protecting the millions of people who invest their savings in our securities markets in reliance on financial statements that are prepared by public companies and other issuers and that, as required by Congress, are audited by independent auditors.[5] We believe the final rules strike a reasonable balance among commenters' differing views about the proposals while achieving our important public policy goals.[6]

Independent auditors have an important public trust.[7] Investors must be able to rely on issuers' financial statements.[8] It is the auditor's opinion that furnishes investors with critical assurance that the financial statements have been subjected to a rigorous examination by an objective, impartial, and skilled professional, and that investors, therefore, can rely on them. If investors do not believe that an auditor is independent of a company, they will derive little confidence from the auditor's opinion and will be far less likely to invest in that public company's securities.[9]

One of our missions is to protect the reliability and integrity of the financial statements of public companies. To do so, and to promote investor confidence, we must ensure that our auditor independence requirements remain relevant, effective, and fair in light of significant changes in the profession, structural reorganizations of accounting firms, and demographic changes in society.[10] There have been important developments in each of these areas since we last amended our auditor independence requirements in 1983.[11]

More and more individual investors participate in our markets, either directly or through mutual funds, pension plans, and retirement plans. Nearly half of all American households are invested in the stock market.[12] As technology has advanced, investors increasingly have direct access to financial information, and they act decisively upon relatively small changes in an issuer's financial results. These and other market changes highlight the importance to the market and to investor confidence of financial information that has been audited by an auditor whose only master is the investing public.[13]

As discussed in the Proposing Release and below, the accounting industry has been transformed by significant changes in the structure of the largest firms. Accounting firms have woven an increasingly complex web of business and financial relationships with their audit clients. The nature of the non-audit services that accounting firms provide to their audit clients has changed, and the revenues from these services have dramatically increased. In addition, there is more mobility of employees and an increase in dual-career families.

We proposed changes to our auditor independence requirements in response to these developments. As more fully discussed below, we are adopting rules, modified in response to almost 3,000 comment letters we received on our proposal, written and oral testimony from four days of public hearings (about 35 hours of testimony from almost 100 witnesses), academic studies, surveys and other professional literature.

The Independence Standard. Independence generally is understood to refer to a mental state of objectivity and lack of bias.[14] The amendments retain this understanding of independence and provide a standard for ascertaining whether the auditor has the requisite state of mind. The first prong of the standard is direct evidence of the auditor's mental state: independence "in fact." The second prong recognizes that generally mental states can be assessed only through observation of external facts; it thus provides that an auditor is not independent if a reasonable investor, with knowledge of all relevant facts and circumstances, would conclude that the auditor is not capable of exercising objective and impartial judgment. The proposed amendments to Rule 2-01 included in the rule four principles for determining whether an accountant is independent of its audit client. While some commenters supported our inclusion of the four principles in the rule,[15] others expressed concerns about the generality of these principles and raised questions concerning their application to particular circumstances.[16] In response, we have included the four principles instead in a Preliminary Note to Rule 2-01 as factors that the Commission will consider, in the first instance, when making independence determinations in accordance with the general independence standard in Rule 2-01(b).

The amendments identify certain relationships that render an accountant not independent of an audit client under the standard in Rule 2-01(b). The relationships addressed include, among others, financial, employment, and business relationships between auditors and audit clients, and relationships between auditors and audit clients where the auditors provide certain non-audit services to their audit clients.

Financial and Employment Relationships. Current requirements attribute to an auditor ownership of shares held by every partner in the auditor's firm, certain managerial employees, and their families. We believe that independence will be protected and the rules will be more workable by focusing on those persons who can influence the audit, instead of all partners in an accounting firm. Accordingly, we proposed to narrow significantly the application of these rules. Commenters generally supported our efforts to modernize the current rules because they restrict investment and employment opportunities available to firm personnel and their families in ways that may no longer be relevant or necessary for safeguarding auditor independence and investor confidence.[17] Not all commenters agreed with all aspects of the proposals.[18] We have modified the proposal in some respects, but the final rule, like the proposal, shrinks significantly the circle of firm personnel whose investments are imputed to the auditor. The rule also shrinks the circle of family members of auditors and former firm personnel whose employment with an audit client impairs the auditor's independence.

Non-Audit Services. As we discuss below,[19] there has been growing concern on the part of the Commission and users of financial statements about the effects on independence when auditors provide both audit and non-audit services to their audit clients. Dramatic changes in the accounting profession and the types of services that auditors are providing to their audit clients, as well as increases in the absolute and relative size of the fees charged for non-audit services, have exacerbated these concerns. As the Panel on Audit Effectiveness (the "O'Malley Panel") recently recognized, "The potential effect of non-audit services on auditor objectivity has long been an area of concern. That concern has been compounded in recent years by significant increases in the amounts of non-audit services provided by audit firms."[20]

We considered a full range of alternatives to address these concerns. Our proposed amendments identified certain non-audit services that, when rendered to an audit client, impair auditor independence. The proposed restrictions on non-audit services generated more comments than any other aspect of the proposals. Some commenters agreed with our proposals.[21] Others believed that the proposals were not restrictive enough and recommended a total ban on all non-audit services provided by auditors to their audit clients.[22] Still other commenters opposed any Commission rule on non-audit services.[23] After careful consideration of the arguments on all sides, and for the reasons discussed below, we have determined not to adopt a total ban on non-audit services, despite the recommendations of some, and instead to identify certain non-audit services that, if provided to an audit client, render the auditor not independent of the audit client.

In response to public comments,[24] in several instances we have conformed the restrictions to the formulations set forth in the professional literature or otherwise modified the final rule to better describe, and in some cases narrow, the types of services restricted. For example, the final rule does not ban all valuation and appraisal services; its restrictions apply only where it is reasonably likely that the results of any valuation or appraisal, individually or in the aggregate, would be material to the financial statements, or where the results will be audited by the accountant. The rule also provides several exceptions from the restrictions, such as when the valuation is performed in the context of certain tax services, or the valuation is for non-financial purposes and the results of the valuation do not affect the financial statements. These changes are consistent with our approach to adopt only those regulations that we believe are necessary to preserve investor confidence in the independence of auditors and the financial statements they audit.

We recognize that not all non-audit services pose the same risk to independence. Accordingly, under the final rule, accountants will continue to be able to provide a wide variety of non-audit services to their audit clients. In addition, they of course will be able to provide any non-audit service to non-audit clients.

Quality Controls. The quality controls of accounting firms play a significant role in helping to detect and prevent auditor independence problems. The final rule recognizes this role by providing accounting firms a limited exception from being deemed not independent for certain independence impairments that are cured promptly after discovery, provided that the firm has certain quality controls in place.

Disclosure of Non-Audit Services. Finally, we continue to believe that disclosures that shed light on the independence of public companies' auditors assist investors in making investment and voting decisions. Accordingly, we proposed and are adopting requirements for disclosures that we believe will be useful to investors.[25] In response to commenters' concerns about the breadth of the proposed disclosure requirements,[26] however, we have modified them in the final rule.

II. Background

Our Proposing Release generated significant comment and broad debate. We received nearly 3,000 comment letters. In addition to soliciting comments in the Proposing Release, we held four days of public hearings, including one day in New York City, so that we could engage in a public dialogue with interested parties. At the hearings, we heard from almost 100 witnesses, representing investors, investment professionals, large and small public companies, the Big Five accounting firms, smaller accounting firms, the AICPA, banking regulators, consumer advocates, state accounting board officials, members of the Independence Standards Board ("ISB"), academics, and others.[27] In addition, the Subcommittee on Securities of the Senate Committee on Banking, Housing, and Urban Affairs held a hearing about our proposal.[28]

We received thoughtful and constructive input from a broad spectrum of interested parties. That input helped us to understand better the sincere and strongly-held views on all sides and to shape final rule amendments that incorporate these views to the extent consistent with our public policy goals. As discussed specifically below, the final rule amendments, particularly those related to non-audit services, have been modified from the proposals.

Nevertheless, some commenters expressed concern that we have "rushed to regulate,"[29] and they asked that we take more time before addressing auditor independence issues generally, and especially the issues regarding the provision of non-audit services to audit clients. As many commenters noted, however, the issues presented by this rulemaking are not new,[30] and recent and accelerating changes in the accounting profession and in society have made resolution of these issues more pressing. For many years the profession has been discussing modernization of the financial and employment relationship rules, and the scope of services issue has been on the horizon even longer.[31] Many previous Commissions have studied these issues.[32] Against this backdrop, in light of the comments that our proposals generated, and informed by our experience and expertise in these matters, we believe that it is appropriate to act now.[33]

III. There Is a Need for Commission Rulemaking

A. The Independence Requirement Serves Important Public Policy Goals

The federal securities laws require, or permit us to require, that financial information filed with us be certified or audited by "independent" public accountants.[34] To a significant extent, this makes independent auditors the "gatekeepers" to the public securities markets.[35] This statutory framework gives auditors both a valuable economic franchise and an important public trust. Within this statutory framework, the independence requirement is vital to our securities markets.

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 auditor must approach each audit with professional skepticism and must have the capacity and the willingness to decide issues in an unbiased and objective manner, even when the auditor's decisions may be against the interests of management of the audit client or against the interests of the auditor's own accounting firm.

The other related goal is to promote investor confidence in the financial statements of public companies. Investor confidence in the integrity of publicly available financial information is the cornerstone of our securities markets. Capital formation depends on the willingness of investors to invest in the securities of public companies. Investors are more likely to invest, and pricing is more likely to be efficient, the greater the assurance that the financial information disclosed by issuers is reliable.[36] The federal securities laws contemplate that that assurance will flow from knowledge that the financial information has been subjected to rigorous examination by competent and objective auditors.

The two goals -- objective audits and investor confidence that the audits are objective -- overlap substantially but are not identical. Because objectivity rarely can be observed directly, investor confidence in auditor independence rests in large measure on investor perception.[37] For this reason, the professional literature, such as the AICPA's Statement on Auditing Standards (SAS) No. 1, has long emphasized that auditors "should not only be independent in fact; they should also avoid situations that may lead outsiders to doubt their independence."[38] The Supreme Court has emphasized the importance of the connection between investor confidence and the appearance of independence:

The SEC requires the filing of audited financial statements in order to obviate the fear of loss from reliance on inaccurate information, thereby encouraging public investment in the Nation's industries. It is therefore not enough that financial statements _be_ accurate; the public must also _perceive_ them as being accurate. Public faith in the reliability of a corporation's financial statements depends upon the public perception of the outside auditor as an independent professional. . . . If investors were to view the auditor as an advocate for the corporate client, the value of the audit function itself might well be lost.[39]

The Commission's independence requirements have always included consideration of investor perceptions.[40] Many foreign countries have similar requirements. A comparative analysis of the independence requirements of eleven countries concluded, "With the possible exception of Switzerland, most of the countries stress both the appearance and the fact of independence."[41] In Canada, Rules of Professional Conduct require that the auditor be free of influence that would impair its judgment "or which, in the view of a reasonable observer, would impair . . . professional judgment or objectivity."[42] David A. Brown, Chair of the Ontario Securities Commission, testified that the importance of the perception of auditor independence "cannot be overstated."[43]

International organizations and standard setters also stress the appearance of independence. In its comment letter, the Federation of European Accountants stated, "In dealing with independence, one must address both: Independence of mind . . . and Independence in appearance, [i].e. the avoidance of facts and circumstances, which are so significant that an informed third party would question the statutory auditor's objectivity."[44] Although the European Union has not defined independence for auditors, a Green Paper from 1996 provides, "In dealing with independence, it is necessary to address both independence in mind . . . and independence in appearance, i.e. the avoidance of facts and circumstances which are so significant that an informed third party would question the statutory auditor's objectivity."[45]

The concept of "appearance" as used in the final rule is not unbounded. "Appearance" as used in our operative legal standards is not a reference to what anyone might think under any circumstances. Rather, as explained below,[46] it is an objective test, keyed to the conclusions of reasonable investors with knowledge of all relevant facts and circumstances.

B. Recent Developments Have Brought the Independence Issues to the Forefront

The accounting industry is in the midst of dramatic transformation. Firms have merged, resulting in increased size, both domestically and internationally. They have expanded into international networks, affiliating and marketing under a common name. Increasingly, accounting firms are becoming multi-disciplinary service organizations and are entering into new types of business relationships with their audit clients. Accounting professionals have become more mobile, and geographic location of firm personnel has become less important due to advances in telecommunications. In addition, there are more dual-career families, and audit clients are increasingly hiring firm partners, professional staff, and their spouses for high level management positions.

In conjunction with these changes, accounting firms have expanded significantly the menu of services offered to their audit clients, and the list continues to grow.[47] Companies are turning to their auditors to perform their internal audit, pension, financial, administrative, sales, data processing, and marketing functions, among many others.[48]

As we noted in the Proposing Release, U.S. revenues for management advisory and similar services[49] for the five largest public accounting firms (the "Big Five") amounted to more than $15 billion in 1999.[50] Moreover, revenues for these service lines are now estimated to constitute half of the total revenues for these firms.[51] In contrast, these service lines provided only thirteen percent of total revenues in 1981.[52] From 1993 to 1999, the average annual growth rate for revenues from management advisory and similar services has been twenty-six percent; comparable growth rates have been nine percent for audit and thirteen percent for tax services.[53]

For the largest firms, the growth in management advisory and similar services involves both audit clients and non-audit clients. For the largest public accounting firms, MAS fees from SEC audit clients have increased significantly over the past two decades. In 1984, only one percent of SEC audit clients of the eight largest public accounting firms paid MAS fees that exceeded the audit fee.[54] For the Big Five firms, the percentage of SEC audit clients that paid MAS fees in excess of audit fees did not exceed 1.5% until 1997.[55] In 1999, 4.6% of Big Five SEC audit clients paid MAS fees in excess of audit fees,[56] an increase of over 200% in two years. For the Big Five firms, average MAS fees received from SEC audit clients amounted to ten percent of all revenues in 1999.[57] Almost three-fourths of Big Five SEC audit clients purchased no MAS from their auditors in 1999. This means that purchases of MAS services by one-fourth of firms' SEC audit clients account for ten percent of all firm revenues.[58]

Some smaller firms are consolidating their audit practices and seeking public investors in the resulting company.[59] Other firms are entering into agreements to sell all of their assets, except their audit practices, to established financial services companies. As part of these agreements, the financial services companies hire the employees, and in some cases the partners, of the accounting firm, and then lease back the majority or all of the assets and audit personnel to the "shell" audit firm. These lease arrangements allow the financial services firm to pay the professional staff for "nonprofessional" services for the corporate organization as well as professional attest services rendered for the audit firm.[60]

Recently, Ernst & Young sold its management-consulting business to Cap Gemini Group SA, a large and publicly traded computer services company headquartered in France.[61] KPMG has sold an equity interest in KPMG Consulting to Cisco Corporation[62] and is in the process of registering additional shares in its consulting business to sell to the public in an initial public offering.[63] In addition, PricewaterhouseCoopers has publicly announced an intention to sell portions of its consulting businesses. Also, Grant Thornton recently sold its e-business consulting practice.[64]

Simultaneous with this metamorphosis of the accounting profession, public companies have come under increasing pressure to meet earnings expectations. Observers suggest that this pressure has intensified in recent years, especially for companies operating in certain sectors of the economy.[65] The extent of the pressure becomes apparent each time a company loses a significant percentage of its market capitalization after failing to meet analysts' expectations.[66] These intense pressures on companies lead to enhanced pressure on auditors to enable their clients to meet expectations.[67]

As discussed below, the changes in the accounting profession, combined with increasing pressures on companies, raise questions about auditor independence and investor confidence in the financial statements of public companies that those auditors audit. To respond to some of these questions, we proposed, and are now adopting, new rules relating to the financial and employment relationships independent auditors may have with their audit clients, business and financial relationships between accounting firms and audit clients, and the non-audit services that auditors can provide to audit clients without impairing their independence.

C. Independence Concerns Warrant Restrictions on the Scope of Services Provided to Audit Clients

The rules that we adopt today include provisions restricting the scope of services that an auditor may provide to an audit client without impairing the auditor's independence with respect to that client. The proposed restrictions on non-audit services generated most of the public comment on our proposals, both in written comment letters and in testimony provided during our public hearings. Commenters expressed a range of views from full support to staunch opposition.[68]

After careful consideration of the arguments on various sides, we have determined that it is in the public interest for us to adopt certain restrictions on the provision of non-audit services to audit clients. We act on the basis of our evaluation of the potential impact of non-audit relationships on audit objectivity and also on the basis of indications that investor confidence is in fact affected by reasonable concerns about non-audit services compromising audit objectivity.

1. The Expansion of Non-Audit Service Relationships with Audit Clients Has Long Been Viewed as a Potential Threat to Auditor Independence

It has long been recognized that an unchecked expansion of non-audit relationships between auditors and their audit clients could affect both an auditor's objectivity and investor confidence in financial statements.[69] In the 1970s, Congress seriously considered limiting the types of non-audit services that independent auditors could provide. Even though non-audit services did not constitute a large percentage of audit firms' revenues at that time, and Congress ultimately determined not to take legislative action, the deliberations highlighted significant concerns bearing on the independence issue.[70]

These concerns gradually became the subject of increasing debate and study. In 1979, the then-Chairman of the POB expressed concern about the expansion of non-audit services to audit clients:

The [POB] believes that there is a possibility of damage to the profession and the users of the profession's services in an uncontrolled expansion of MAS [management advisory services] to audit clients. Investors and others need a public accounting profession that performs its primary function of auditing financial statements with both the fact and the appearance of competence and independence. Developments which detract from this will surely damage the professional status of CPA firms and lead to suspicions and doubts that will be detrimental to the continued reliance of the public upon the profession without further and more drastic governmental intrusion.[71]

A 1994 Report of the AICPA Special Committee on Financial Reporting noted that users of financial statements believed that non-audit service relationships could "erode auditor independence" and that those users were "concerned that auditors may accept audit engagements at marginal profits to obtain more profitable consulting engagements."[72] A separate 1994 report of the Advisory Panel on Auditor Independence noted the increased basis for investor concerns, describing the trend toward non-audit services as "worrisome" because "[g]rowing reliance on nonaudit services has the potential to compromise the objectivity or independence of the auditor."[73]

In 1994, the SEC staff also studied the issues and issued a Staff Report.[74] While concluding that no action was warranted at the time, the staff recognized the need "to be alert" to independence problems that may be caused by auditors' provision of non-audit services.[75] A 1996 General Accounting Office (GAO) study predicted that the "concern over auditor independence may become larger as accounting firms move to provide new services that go beyond traditional services."[76]

2. The Growth of Certain Non-Audit Services Jeopardizes Independence

A common theme running through the reports described above is concern that future expansion of non-audit services may make regulatory action necessary. We believe that the circumstances about which the Commission was warned are coming to pass. An auditor's interest in establishing or preserving a non-audit services relationship raises two types of independence concerns. First, the more the auditor has at stake in its dealings with the audit client, the greater the cost to the auditor should he or she displease the client, particularly when the non-audit services relationship has the potential to generate significant revenues on top of the audit relationship. Second, certain types of non-audit services, when provided by the auditor, create inherent conflicts that are incompatible with objectivity.

a. Non-Audit Services Create Economic Incentives that May Inappropriately Influence the Audit

As explained above and in the Proposing Release, the rapid rise in the growth of non-audit services has increased the economic incentives for the auditor to preserve a relationship with the audit client, thereby increasing the risk that the auditor will be less inclined to be objective.[77] Some commenters supported this analysis,[78] while others took issue with it.[79] The principal criticisms were: (i) the economic stake in the relationship with the audit client in fact had not materially increased and any such increase is offset by countervailing incentives on the auditor not to compromise his or her independence; and (ii) there is no proof that changing the mix of incentives has affected auditor behavior. We have considered each of these criticisms and address them below.

(i) The Mix of Economic Incentives Has Changed

Commenters generally agreed that there has been enormous growth in non-audit services and in their importance to the firms that provide them. Several commenters took issue with whether this growth enhanced any potential conflict of interest. These commenters argued, in essence, that there has always been the potential for a conflict of interest, since the auditor is paid by the client.[80] They argue that because Congress adopted this arrangement in enacting the federal securities laws, by choosing the statutory independence requirement rather than creating a corps of government-paid auditors, Congress implicitly condoned these types of conflicts of interest.

The argument proves too much; it assumes that because Congress permitted one form of potential conflict of interest, it intended to permit all forms. Taken to its logical conclusion, this argument, of course, would read the independence requirement out of the statute. If Congress believed that all conflicts were equal in kind or degree, it would not have required that auditors be independent. Congress apparently chose to tolerate a degree of potential conflict of interest rather than supplant the private auditing profession. Simply because Congress chose to tolerate an unavoidable degree of conflict inherent in the relationship between a private auditor and a paying client, it hardly follows that all conflicts of interest beyond the unavoidable minimum were approved by Congress or that the statutes express indifference to conflicts of interest.

A related argument is that, despite the rapid growth of services, the economic stakes have not really changed for the auditor. The argument is that, despite the growth of non-audit services generally, these services are rarely as significant to the auditor, from an economic standpoint, as maintaining the audit relationship.[81] Put another way, while non-audit services (excluding tax) account for as much as fifty percent of audit firm revenue, only ten percent of revenues come from providing these services to audit clients. But, as noted above, the trend of available data suggests a rapid increase in the provision of non-audit services to audit clients -- in 1999, 4.6% of Big Five SEC audit clients paid MAS fees in excess of audit fees, an increase of over 200% in two years.

The increasing importance of non-audit services to accounting firms is further evidenced by suggestions that the audit has become merely a "commodity" and that the greater profit opportunities for auditors come from using audits as a platform from which to sell more lucrative non-audit services.[82] An AICPA practice aid entitled "Make Audits Pay: Leveraging the Audit Into Consulting Services" provides a step-by-step guide for auditors to become "business advisers" to their audit clients. The book quotes an AICPA officer as follows: "We see the greater viability of the CPA going forward as being a strategic business adviser, an information professional being viewed by the public as the person for solid big-picture business advice - applied to a broader information world instead of a financial information world."[83] At the same time, the book acknowledges that "[t]he business adviser is a client advocate. The entire business adviser audit process is based on understanding the client's business from the owner's perspective and acting in the owner's best interest,"[84] which, of course, is contrary to the duty of the auditor to the public.

At our public hearings and in comment letters, we also heard a great deal about the "loss leader" phenomenon. When an auditor uses the audit as a loss leader, the auditor, in essence, "low-balls" the audit fee - even offering to perform it at a loss - in order to gain entry into and build a relationship with a potential client for the firm's non-audit services.[85] Low-balling creates a variety of independence issues.[86] Use of audits as loss leaders to be made up for with more lucrative consulting contracts further suggests the growth in importance of non-audit services as compared to audits.[87]

Changes in legal standards have also affected incentives. Professor John C. Coffee, Jr. testified that the legal constraints on accountants have loosened considerably in recent years, and as a result, there has been a significant decrease in the threat of liability. It has become much more difficult, and less worthwhile, for private plaintiffs to assert civil claims against auditors even in cases where the plaintiffs believe that an audit failure flowed from a lack of auditor independence.[88] He specifically described the following four significant developments in the law since 1994 that he believes have reduced the likelihood of success in private lawsuits against auditors: (i) the passage of the Private Securities Litigation Reform Act of 1995, which affected pleading standards and substituted proportionate liability for joint and several liability, which makes it less attractive to sue accountants "because even if you're successful you're only going to get a portion of the total liability assessed against them, and that may not justify the cost"; (ii) passage of the Securities Litigation Uniform Standards Act of 1998, which preempted certain state or common law claims in securities fraud actions against auditors in both state and federal court;[89] (iii) the Supreme Court's decision in Central Bank of Denver in 1994,[90] eliminating liability in private litigation for aiding and abetting a securities fraud violation, "which was the principal tool used to sue accountants by the plaintiff's bar"; and (iv) the elimination of the threat of treble damage liability as a result of amendment to the Racketeer Influenced and Corrupt Organization Act.[91]

Professor Coffee summarized the effect of these developments by noting that while lawsuits involving accounting irregularities have actually increased since 1995, "those suits today rarely involve . . . the outside accountant, as a defendant, and when they do they're often very easily and quickly dismissed," which would preclude relevant evidence from coming to light. In view of these developments in the law, he noted that an auditor today "faces greatly increased benefits through the existence of non-audit advisory services that are subject to the discretion of management, and it faces greatly reduced liabilities."

In part because the risks of liability have changed, as described by Professor Coffee, we do not believe, as urged by at least one commenter,[92] that liability insurance premiums are a barometer of the extent to which non-audit services pose a risk to audit quality. Professional malpractice premiums reflect the risk that the liability insurer will have to fund a judgment or settlement imposing money damages on the auditor. This risk of liability is attributable to a variety of factors, only one of which is the risk of audit failure. The likelihood of audit failure, in turn, is attributable to many factors, only one of which is auditor independence. And auditor independence, in turn, can be threatened in numerous ways, only one of which is the provision of non-audit services. In assessing overall litigation risk, it is entirely possible, for example, that a liability insurer would conclude that an enhanced risk of misconduct is offset by a small probability of discovery, as well as a diminishing likelihood, owing to changes in the law, that even known misconduct would result in a judgment or settlement that the insurer would have to fund. Consequently, even if insurers were to provide auditors substantially the same professional malpractice coverage at approximately the same cost despite increases in their provision of non-audit services, that indicates at most that, from the insurers' perspective, overall litigation risks have not increased. Because there are numerous explanations as to why auditors' professional liability premiums might or might not increase, we are not persuaded that insurance premiums are a useful measure of the effect of non-audit services on auditor independence.

(ii) Changes in Incentives Are Likely to Affect Behavior

In the Proposing Release, we discussed our concern that the enhanced incentive to perpetuate a client relationship involving non-audit services increases the so-called "self-serving bias" auditors experience in favor of an audit client. We heard during our public hearings from academics who have studied the "self-serving bias," including in connection with the behavior of auditors. Two academics presented research tending to show that subtle but powerful psychological factors skew the perceptions and judgments of persons - including auditors - who have a stake in the outcome of those judgments.[93] Other academics, by contrast, pointed out that the issue may be more complicated because, even where an auditor has some stake in an outcome, the auditor also has countervailing reputational interests,[94] and concerns about, for example, legal liability,[95] audit committee review,[96] and peer review.[97]

We do not question that there are influences on the auditor and an accounting firm beyond a "self-serving bias." We accept also that firms have incentives to avoid situations that expose them to liability and reputational harm. But, again, the argument proves too much. Even with these disincentives, audit failures and impairments of independence occur.[98] Other studies tend to show that the reputational interests of the audit firm are not the same as the reputational interests of the audit engagement partner or the office of the partner that performs most of the work for an audit client. Specifically, these studies suggest that the audit engagement partner and the office have more to gain by, for example, acquiescing to the client's aggressive accounting treatment than they have to lose if it results in audit failure, particularly if the client engagement contributes substantially to the partner's income and the office's revenues. Reputational damage will be spread across the entire firm, whereas income from the client will be concentrated in the partner and the office out of which he or she works.[99] In addition, in a two-phase study commissioned by the ISB, Earnscliffe reported that "[m]ost believe that accounting firms today are not indifferent about their reputation for quality audits, but are more focused on raising the profile, reputation, and profitability of non-audit services."[100]

While we do not purport to resolve a debate among scholars, it is plain that there is ample basis to conclude that the more a person, including an auditor, has at stake in a judgment, the more likely his or her judgment is to be affected.[101] We stress that the influences that we are concerned with can be "extremely subtle," as stated by the Comptroller of the Currency, John D. Hawke, in testimony supporting our proposal to restrict internal audit outsourcing.[102] Paul A. Volcker, the former Chairman of the Federal Reserve, in his testimony supporting our proposal, noted the real threat posed by the "insidious, hard-to-pin down, not clearly articulated or even consciously realized, influences on audit practices" that flow from non-audit relationships with audit clients.[103]

b. Certain Non-Audit Services Inherently Impair Independence

Our rule lists services that, regardless of the size of the fees they generate, place the auditor in a position inconsistent with the necessary objectivity. Bookkeeping services, for example, place the auditor in the position of later having to audit his or her own work and identify the auditor too closely with the enterprise under audit. It is asking too much of an auditor who keeps the financial books of an audit client to expect him or her to be able to audit those same records with an objective eye.

In much the same way, performing certain valuation services for the audit client is inconsistent with independence. An auditor who has appraised an important client asset at mid-year is less likely to question his or her own work at year-end. Similarly, an auditor who provides services in a way that is tantamount to accepting an appointment as an officer or employee of the audit client cannot be expected to be independent in auditing the financial consequences of management's decisions. And an auditor who has helped to negotiate the terms of employment for an audit client's chief financial officer is less likely to bring quickly to the audit committee questions about the new CFO's performance.

3. The Expansion of Non-Audit Service Relationships with Audit Clients Is Affecting Investor Confidence in the Independence of Auditors

Recent studies indicate that there is a growing disquiet among investors and other users of financial statements about auditor independence in light of the multi-faceted relationships between auditors and their audit clients. Recently, Earnscliffe found that most interviewees "felt that the evolution of accounting firms to multi-disciplinary business service consultancies represent[ed] a challenge to the ability of auditors to maintain the reality and the perception of independence."[104] In Phase II of its study, Earnscliffe reported that interviewees generally had confidence in and are satisfied with the current standard of financial reporting in the U.S. Nonetheless, the study noted, "[m]ost [interviewees] felt that the risks of unfavorable perceptions of auditor independence are growing, due largely to the provision of non-audit services to auditees."[105]

Though the O'Malley Panel did not reach consensus on whether changes to the independence rules are needed, over the past year it surveyed preparers and users of financial statements, auditors, regulators, academics, lawyers, and analysts about the provision of non-audit services, and heard from witnesses at the Panel's public hearings. The Panel found that,

[M]any people continue to be concerned - some very concerned - that the performance of non-audit services could impair independence, or that there is at least an appearance of the potential for impairment. Almost two-thirds of the respondents to the Panel's survey from outside the profession who addressed non-audit services expressed such concerns.[106]

In a June 2000 study, Brand Finance plc surveyed analysts and representatives of companies listed on the London Stock Exchange. Brand Finance reported,

Analysts are concerned that the acceptance of non-audit fees by auditors is likely to result in the independence of the audit being compromised. 94% of analysts stating an opinion believe that significant non-audit fees are likely to compromise audit independence. 76% of companies stating an opinion felt that auditor independence is likely to be compromised where significant non-audit fees are received from audit clients.[107]

Brand Finance also found that "83% of analysts who expressed an opinion believe objectivity is threatened even when the non-audit fee is less than the audit fee."[108]

In another recent survey, the Association for Investment Management and Research ("AIMR") surveyed its members and certified financial analyst candidates regarding auditor independence issues. AIMR reported that "[p] otential threats to auditor independence, resulting from audit firms providing non-audit services to their audit clients [were] troublesome to many . . . respondents."[109]

A recent poll was conducted by Public Opinion Strategies[110] to determine, among other things, how the investing public views our proposed rules.[111] The results showed that eighty percent of investors surveyed favor (forty-nine percent strongly favor; thirty-two percent somewhat favor) an SEC rule that generally would require restrictions on the types of consulting services accounting firms can provide their audit clients,[112] and fifty-one percent thought the new rule was "very important" to protecting individual stock market investors.[113] As summarized by James C. Stadler of Duquesne University, "The results of our national poll indicate that average American investors, in fact, overwhelmingly support the need for some new rulemaking in this area." He further stated, "The survey results confirm what most practitioners have felt for decades - that large consulting engagements for audit clients can raise serious concerns regarding audit independence."[114]

Witnesses at our public hearings and written comments on our proposed rules supplied additional indications that investor confidence in auditor independence is in fact being undermined by non-audit relationships between auditors and audit clients.[115] For example, representatives of TIAA-CREF, CalPERS, the New Hampshire Retirement System, and the AFL-CIO, organizations with responsibilities for the sound investment of hundreds of billions of dollars for the benefit of millions of participants, all came forward to express precisely that concern and to urge us to adopt the restrictions we proposed, or even more stringent restrictions.[116]

Paul Volcker, former Chairman of the Federal Reserve Board, testified as follows about investors' perceptions of a conflict of interest when auditors provide non-audit services to audit clients:

The perception is there because there is a real conflict of interest. You cannot avoid all conflicts of interest, but this is a clear, evident, growing conflict of interest, given the relative revenues and profits from the consulting practice, and a conflict of interest is there.[117]

Richard Blumenthal, the Attorney General of Connecticut stated in his testimony before us, "The tough-minded questions and vigorous standards that the public has traditionally associated with the term `independent auditor' have been compromised by the interdependent business relationship between the auditors and the audited."[118] Manuel H. Johnson, a public member of the ISB and the former Vice Chairman of the Federal Reserve Board, testified that,

[T]he growing complexity of financial and economic relationships and the extent of non-audit services provided to audit clients by major accounting firms have significantly increased the perception and the potential for conflicts of interest and threatens the integrity of the independent audit function.[119]

At a Congressional subcommittee hearing regarding our proposals, John H. Biggs, Chairman, President, and Chief Executive Officer of TIAA-CREF, said,

The concern about auditor independence in the presence of substantial management consulting fees has been with us for years, and has caused much questioning and study in the profession. Investor uneasiness and suspicion of the quality of audited financial statements is growing rapidly along with the dramatic rise in the percentage of audit firm revenues that come from cross-sold services.[120]

We recognize there are different views as to whether investor confidence is being undermined.[121] For example, in Phase I of its study, Earnscliffe reports "The vast majority of respondents believe that auditors are currently performing audits, which meet a high standard of objectivity and independence."[122] In Phase II, Earnscliffe reports that with respect to the investing public surveyed, "Most had a high degree of confidence in the quality and reliability of the information that was available for them to use in making investment decisions."[123] In addition, two professors from North Carolina State University submitted a study tending to suggest that "non-audit services had a positive influence on participants' perceptions of auditor independence, consistent with the contention that nonaudit services enhance auditor independence."[124] Some commenters also cited a survey commissioned by the AICPA and conducted by Penn Schoen & Berland Associates,[125] which found that ninety-one percent of investors surveyed believe audited financial statements are credible.[126]

We take seriously the indications of investor unease, along with indications that investor opinion may be divided. We focus on degrees of investor confidence, and we cannot take lightly suggestions that even a minority portion of the population is "mildly worried" about a possible appearance problem or that their confidence is being undermined.[127] We also take into account the durability of investor concerns. For decades there have been some who were troubled at the growth of non-audit services.[128] Those who were troubled remain troubled, only more so, and they have been joined by new voices from disparate quarters. We also consider whether the concerns that we hear will likely persist, or are merely transitory and unreasonable fears that inevitably will be allayed. In this instance, we believe that the indications of unease are reasonably based and thus likely to endure and increase, absent preventive action by the Commission.

4. The Rules Are Appropriately Prophylactic

Some commenters and witnesses argue that there is "no empirical evidence to support the notion that providing non-audit services to audit clients has had any adverse effect on the quality of audits."[129] This argument fails to take into account not only the extensive body of research and comments discussed above that document investor concerns, but also the extent to which our approach is, and must be, prophylactic. Moreover, as we explain below, the asserted absence of conclusive empirical evidence on this point is not particularly telling.

a. The Commission's Independence Rules Must Be Prophylactic

Our approach to auditor independence traditionally has been, as it must be, prophylactic. Independence rules are similar, though not identical, to conflict of interest rules. To minimize the risks of bias, the independence rules, like conflict of interest rules, proscribe certain relationships or circumstances, whether or not one can show that biased behavior inevitably results from the conflict.[130] The independence rules are preventive both because of the difficulty in proving the link from circumstance to state of mind, as discussed below, and because of the need to act in the public interest and protect investor confidence before it has been significantly undermined.

The Commission's obligation to protect investors requires it to act before there has been a serious erosion of confidence in our nation's securities markets. Our view on this point is quite different from the suggestion from the CEO of an accounting firm that we should wait to adopt restrictions on non-audit services until there has been "a train wreck or a stockmarket crash."[131] Our mission is not to pick up the pieces of such a "train wreck," but to prevent one.

We have adopted other rules with a similar attentiveness to the need to sustain investor confidence in the public securities markets. For example, in our Order regarding rule changes by the Municipal Securities Rulemaking Board to address "pay to play" practices in the municipal securities market, we stated that the proposed rule changes were intended, among other things, "to bolster investor confidence in the integrity of the market by eliminating the opportunity for abuses in connection with the awarding of municipal securities business."[132] Regulation FD provides another example of our acting to protect investor confidence.[133] There, our concern was, among other things, that "the practice of selective disclosure leads to a loss of investor confidence in the integrity of our capital markets."[134]

The courts have specifically rejected the need for proof of prior harm as an antecedent to government action designed to safeguard public confidence in the integrity of public actors and processes. For example, the court in Blount v. Securities and Exchange Commission,[135] articulated this principle in the context of those rules limiting "pay to play" practices in the municipal securities markets, stating, "Although the record contains only allegations, no smoking gun is needed where, as here, the conflict of interest is apparent, the likelihood of stealth great, and the legislative purpose prophylactic."[136]

In promulgating rules concerning auditor independence, we are making judgments about incremental probabilities. We must make judgments about the circumstances that render a loss of auditor objectivity more or less likely. "Objectivity" is not merely the absence of a conscious intention to skew audit results in a client's favor; it is a willingness to go without reluctance wherever the data lead. For us, the question is not whether an auditor who otherwise would be without bias will inevitably become biased and then intentionally disregard a false statement in a client's financial statements. We do not believe the appropriate benchmark for action is whether new rules are needed to make "bad" auditors good, malleable ones stronger, or sales-oriented ones focus solely on the audit. Rather, the actual issue is whether providing these services makes it unacceptably likely that there will be an effect on the auditor's judgment, whether or not the auditor is aware of it.

Similarly, our mandate to enhance investor confidence in our securities markets requires us to make judgments as to effects on degrees of confidence. Investor confidence in the securities markets arises from a multiplicity of sources. Investor confidence is currently high. We must consider not whether otherwise confident investors will lose confidence in our markets, but whether there is a significant enough probability that enough investors will lose enough confidence if we fail to act. In our judgment, the risk is present, and we should address it.

b. The Commission Should Not Delay Action to Engage in Further Study

In any event, the assertion that no empirical evidence conclusively links audit failures to non-audit services misses the point.[137] First, "audit quality," which we seek to protect, is about more than just avoiding major audit failures or financial fraud. Auditing, we are often reminded, is not mechanical, but requires numerous subtle judgments.[138] It is important that these judgments be made fairly and objectively, whether or not they relate to matters that are material to the financial statements. As four previous SEC Chairmen stated,

Some will say that action now is premature or unwarranted. They argue that there's no harm unless you can directly tie a firm's nonaudit services to a failed audit. But this claim belies the environment in which many tough business decisions are made. It is rarely the black-and-white issues that an auditor faces. The danger lies in the gray area - where the pressure to bend to client interest is subtle, but no less deleterious.[139]

The number of "audit failures" says nothing about misjudgments in the gray area.

"Audit failures" in all likelihood also demonstrate relatively little about the incidence of auditor error. An "audit failure," as we use the term, refers to an instance in which the issuer's financial statements are materially misstated and in which the auditor either failed to discover the misstatement or acquiesced in the inclusion of the misstatement in the issuer's financial statements. The Commission is aware of only those audit failures it discovers or that are made public; presumably there are more. And, presumably, every error by an auditor does not lead to an audit failure. Moreover, audit failures arise from a multiplicity of causes, of which an impairment of independence is but one. To demand, as a predicate for Commission action, evidence that each loss of independence produces an audit failure is a bit like demanding proof that every violation of a fire safety code results in a catastrophic fire.[140]

Second, the subtle influences that we are addressing are, by their nature, difficult to isolate and difficult to link to any particular action or consequence. The asserted lack of evidence isolating those influences and linking them to questionable audit judgments simply does not prove that an auditor's judgment is unlikely to be affected because of an auditor's economic interest in a non-audit relationship. Indeed, it is precisely because of the inherent difficulty in isolating a link between a questionable influence and a compromised audit that any resolution of this issue must rest on our informed judgment rather than mathematical certainty.

Except where an auditor accepts a payment to look the other way,[141] is found to have participated in a fraudulent scheme,[142] or admits to being biased, we cannot know with absolute certainty whether an auditor's mind is, or at the time of the audit was, "objective." It is even harder to measure the impact that a particular financial arrangement with the audit client had on the auditor's state of mind.[143] Similarly, it is difficult to tie a questionable state of mind to a wrong judgment, a failure to notice something important, a failure to seek important evidential matter, a failure to challenge a management assertion, or a failure to consider the quality - not just the acceptability - of a company's financial reporting. As the POB noted, "Specific evidence of loss of independence through MAS [management advisory services], a so-called smoking gun, is not likely to be available even if there is such a loss."[144]

Testimony during our hearings provided informed, real-world perspectives bearing on the practical difficulty of establishing a conclusive link between non-audit service relationships and compromised audit judgments. Many who provided those perspectives nonetheless urged that we proceed with our rule.[145]

Based on his thirty-three years of law enforcement experience and several cases involving unlawful and questionable conduct by auditors, Robert M. Morgenthau, the District Attorney for the County of New York, testified, "in most cases, it was impossible to tell whether financial considerations played a role in the auditor's issuing the opinion he did."[146] In these instances, absent the sort of admission referenced above, we can look only to circumstantial evidence of influences or incentives affecting the auditor.[147] A number of plaintiffs' lawyers agreed that the hard evidence opponents of the proposals seek will be rare because even where the evidence does exist, it is unlikely that it will be made public. Charles Drott, a CPA and a forensic examiner, testified that "the only time these issues come to light . . . is when there is significant litigation. . . . The accounting firm[s] [are] not sharing this information, and I don't know of any vehicle at the present time that requires them to do so."[148] Stuart Grant, an attorney who regularly represents institutional investors in securities litigation, stated that, based on his experience, he thought it unlikely that an auditor, like any party to a lawsuit, would ever concede that it made an accounting judgment in part to protect its consulting business.[149] Jay W. Eisenhofer, Mr. Grant's partner, noted that even if a case involving independence allegations were to proceed to trial, any information relevant to the alleged violation that was produced in discovery likely would be protected from general disclosure by a confidentiality order.[150]

While these witnesses and commenters said that, based on their experience, we should not expect to have an abundance of evidence showing a direct link between the provision of non-audit services and audit failures, others pointed to cases where they believed the connection was apparent.[151] Richard Blumenthal, Attorney General of the State of Connecticut, described a matter investigated by his office which he believed did involve a significant audit failure linked to a loss of audit objectivity caused by the auditor's non-audit business relationship with the audit client. Mr. Blumenthal stated, "Connecticut residents have personally experienced the financial hardship occasioned by the loss of independence and objectivity in the accounting profession. * * * While investors eventually recovered a portion of their losses, many surely never recovered their faith in . . . the accounting profession."[152]

William S. Lerach, of Milberg Weiss Bershad Hynes & Lerach LLP, which represents investors in securities litigation, provided his perspective on this issue. He stated,

It has been asserted there is as yet no `empirical evidence' demonstrating a loss of auditor independence in providing consultant and other non-audit services. In fact, we know otherwise.

In prosecuting securities fraud cases against public companies and their auditors, we obtain access to internal corporate documents that are sealed from public view by confidentiality orders and are never made available to the Commission. Over the years, we have seen repeated instances where auditors are unable to maintain independence from their clients. Not infrequently, the lack of independence arises most directly from the fact that the auditing firm has substantial consulting relationships with the client - relationships that are extremely lucrative - much more lucrative than the auditing work.[153]

Finally, we are also cognizant that concerns about the impact of non-audit services on independence have been steadily with us, and growing, during relatively prosperous times, and that any economic downturn may heighten concern over some of these issues. As one analyst stated during our public hearings,

If we're asking hard questions about independence and the appearance of independence now, won't our concerns be magnified during times of economic distress? It's not hard to imagine an economic environment where firms may be more prone to pushing the envelope of reliable accounting and reporting, and that's when you would want an auditing profession possessing unquestionable independence. If we have qualms about that independence now, it will be worse in an economic downturn, and that's when investor confidence may be tested on issues other than auditor independence.[154]

5. Our Two-Pronged Approach Responds to Various Aspects of Auditor Independence

As discussed above, some non-audit services, by their very nature, raise independence concerns because, for example, they place the auditor in the position of auditing his or her own work. We are otherwise concerned about non-audit services because of the overall economic incentives they create and because of the interdependence that develops between the auditor and the audit client in the course of the non-audit relationship.

The greatest assurance of auditor independence would come from prohibiting auditors from providing any non-audit services to audit clients. We solicited comment on this approach, and some commenters strongly urged that we adopt such an exclusionary ban.[155] That way, the auditor would never be placed in a conflict-of-interest position, nor would the auditor have any economic incentive, beyond continuation of the audit relationship, that might give rise to a biased attitude. We believe, however, that the better course is for us to eschew a single bright line and instead to draw a series of lines, based on our assessment of particular factual circumstances, understanding that identifying dangerous circumstances in this area is more a matter of informed judgment than measurement. We believe that the two-pronged approach we are taking in the final rules -- requiring disclosure of the fees billed by the auditor for the audit, financial information systems design and implementation services, and other non-audit services, and identifying particular services that are incompatible with independence -- best protects the audit process. Our approach also permits us to restrict non-audit services only to the extent necessary to protect the integrity and independence of the audit function. Accountants will continue to be able to provide a wide variety of non-audit services to their audit clients. They also will be able to provide any non-audit service to non-audit clients.

Under the proxy disclosure rule being adopted, registrants will have to disclose, among other things, the aggregate fees billed for the audit in the most recent fiscal year, the aggregate fees billed for financial information systems design and implementation, and the aggregate fees billed for non-audit services performed by the auditor in the most recent fiscal year. In addition, companies must provide certain disclosures about their audit committee. Investors will be able to evaluate for themselves whether the proportion of fees for audit and non-audit services causes them to question the auditor's independence. As discussed above, in recent years there has been a dramatic growth in the number of non-audit services provided to audit clients and the magnitude of fees paid for non-audit services.[156] Moreover, there may be less information available to investors about these services since the SECPS has stopped publishing information about audit firms' provision of non-audit services.[157]

Surveys confirm that investors expect that the information that will be disclosed under the final rule will be useful in making investment decisions. In its Phase II study, Earnscliffe found that "[m]any advocate[] a requirement of full disclosure as a way to both deter an unhealthy relationship between auditor and client, and to inform investors of any risks" related to the relationship.[158] In addition, the Penn Schoen Survey found that "[n]ine in ten investors want to know if a company's auditor also provides other services."[159] Eighty-nine percent of respondents in that study said, "It would be important for shareholders to know if a company's auditor also provides consulting services to that company."[160]

We considered a disclosure-only approach and solicited comment on that approach. Some commenters favored a disclosure-only approach to the independence issues created by auditors' provision of non-audit services.[161] We, however, do not believe that such an approach is appropriate for several reasons. First, our federal securities laws require that auditors be independent, and we do not believe that disclosure can "cure" an impairment of independence.[162] Second, as discussed above, by their very nature, certain non-audit services provided by auditors can affect an auditor's independence, regardless of whether investors are made aware of the provision of the services. As a representative of one of the largest pension funds commented, "While we do not believe that disclosure in and of itself is adequate to deal with the independence problems involved here, shareholders have a right to know about relationships that may compromise the independence of audits on which they rely."[163]

6. The Final Rules Will Assist Audit Committees in Their Oversight Role

Issuers and other registrants have strong incentives to promote auditor independence. It is their financial statements that an auditor examines. They have the legal responsibility to file the financial information with the Commission, as a condition to accessing the public securities markets, and it is their filings that are legally deficient if auditors who are not independent certify their financial statements.

For most public companies, audit committees have become an essential means through which corporate boards of directors oversee the integrity of the company's financial reporting process, system of internal accounting control, and the financial statements themselves. Among other things, an audit committee serves as the board's principal interface with the company's auditors and facilitates communications between the company's board, its management, and its internal and independent auditors on significant accounting issues and policies.

The Commission is an advocate of effective and independent audit committees. Most recently, the Commission and three major exchanges adopted important audit committee rules. The New York Stock Exchange, the National Association of Securities Dealers, Inc., and the American Stock Exchange changed their listing standards. These changes require listed companies to have independent audit committees, and require audit committees to play a significant role in overseeing the company's auditors.[164]

Also, we adopted new disclosure rules regarding audit committees and auditor reviews of interim financial information[165] in response to recommendations of the Blue Ribbon Committee.[166] Those rules require that companies include in their proxy statements reports of their audit committees that state whether, among other things, the audit committees received the written disclosures and the letter from the independent auditors required by ISB Standard No. 1,[167] and discussed with the auditors the auditors' independence. ISB Standard No. 1 requires each auditor to disclose in writing to its client's audit committee all relationships between the auditor and the company that, in the auditor's judgment, reasonably may be thought to bear on independence and to discuss the auditor's independence with the audit committee.[168]

The final rule supplements those required disclosures with an additional disclosure as to whether the issuer's audit committee "has considered whether the provision of non-audit services] is compatible with maintaining the principal accountant's independence." The disclosure focuses particularly on non-audit services and requires disclosure of whether the audit committee itself has focused on the issue. We believe that our final rule, our new audit committee disclosure rules, and the new requirements of the NYSE, AMEX, NASD, and ISB should encourage auditors, audit committees, and management to conduct robust and probing discussion on all issues that might affect the auditor's independence. According to the Blue Ribbon Report, "If the audit committee is to effectively accomplish its task of overseeing the financial reporting process, it must rely, in part, on the work, guidance and judgment of the outside auditor. Integral to this reliance is the requirement that the outside auditors perform their service without being affected by economic or other interests that would call into question their objectivity and, accordingly, the reliability of their attestation."[169]

Our final rule does not impose any new legal requirements on audit committees.[170] While the rule may serve to direct the attention of audit committees to the potential for independence issues arising from non-audit services, any action taken by audit committees will be business judgments. Nonetheless, the rule should help audit committees carry out their existing responsibilities by codifying the key legal requirements that may bear on audit committees' exercise of their business judgment.[171] We believe that audit committees, as well as management, should engage in active discussions of independence-related issues with the outside auditors.[172] As with discussions over the quality and acceptability of management's judgments, audit committees can be useful in considering whether assertions of independence rest on conservative or aggressive readings of the independence rules. Similarly, audit committees may wish to consider whether to adopt formal or informal policies concerning when or whether to engage the company's auditing firm to provide non-audit services.[173]

In this latter connection, we note that recently the O'Malley Panel recommended certain guiding factors for audit committees to consider in making business judgments about particular non-audit services. According to the O'Malley Panel, one guiding principle should be whether the "service facilitates the performance of the audit, improves the client's financial reporting process, or is otherwise in the public interest."[174] Other matters to be considered are:

- Whether the service is being performed principally for the audit committee
- The effects of the service, if any, on audit effectiveness or on the quality and timeliness of the entity's financial reporting process
- Whether the service would be performed by specialists (e.g., technology specialists) who ordinarily also provide recurring audit support
- Whether the service would be performed by audit personnel and, if so, whether it will enhance their knowledge of the entity's business and operations
- Whether the role of those performing the service (e.g., a role where neutrality, impartiality and auditor skepticism are likely to be subverted) would be inconsistent with the auditor's role
- Whether the audit firm's personnel would be assuming a management role or creating a mutuality of interest with management
- Whether the auditors, in effect, would be auditing their own numbers
- Whether the project must be started and completed very quickly
- Whether the audit firm has unique expertise in the service
- The size of the fee(s) for the non-audit service(s)[175]

These factors expand upon the four factors in the Preliminary Note to Rule 2-01. Additionally, the O'Malley Panel recommends that audit committees pre-approve non-audit services that exceed a threshold determined by the committee. We believe that the O'Malley Panel recommendations represent a thoughtful and appropriate approach to these issues by audit committees, and we encourage audit committees to consider the Panel's recommendations.

Some commenters suggested that the Commission and investors rely primarily on corporate audit committees to monitor and ensure auditor independence.[176] Other commenters, however, including investor representatives, indicated that this approach, without more, was inadequate.[177] While we welcome active oversight by audit committees with respect to auditor independence, we do not believe that this oversight obviates the need for the rule we adopt today. Audit committees bring business judgment to bear on the financial matters within their purview. Their purpose is not to set the independence standards for the profession, and we are not attempting to saddle them with that responsibility. On the other hand, we believe that the final rule facilitates the work of audit committees by establishing clear legal standards that audit committees can use as benchmarks against which to exercise business judgment.

7. The Final Rules Will Not Diminish Audit Quality

Some commenters expressed concern that the proposed restrictions on non-audit services would hurt audit quality.[178] These commenters assert that the auditor gains valuable knowledge about an audit client's business by providing non-audit services. The more the auditor knows about the client, these commenters assert, the higher the quality of the audit. These commenters further assert that accounting firms need broad technical skills to provide high quality audits and that the necessary array of skills can be acquired only if the accounting firm has a multidisciplinary practice. Finally, the commenters assert that the rules will affect accounting firms' ability to recruit and hire talented professionals, which in turn will lead to less capable professionals performing lower quality audits. We note that the rules we adopt today are significantly less restrictive than the proposed rules. We are adopting without substantial alteration restrictions that already appear in the professional literature with respect to the majority of the nine services that are covered by our rules. In any event, we are not persuaded by these arguments.

a. Auditors Will Continue to Have the Expertise Necessary for Quality Audits

The suggestion that the more the auditor knows about the audit client, the better its capacity to audit, is flawed. It is an argument without limitation that takes no account of the negative impact on audit quality from an independence impairment. As the former Chief Accountant of the SEC explained several years ago, "Arguments that more knowledge of the audit client increases the quality of the audit . . . taken to the extreme, would have the auditor keeping the books and preparing the financial statements. Once a firm has worked closely with a client to improve the client's operations or reporting systems, it would appear that the firm would have difficulty in providing a `critical second look' at those operations and systems,"[179] as the investing public relies on the auditor to do.

In addition, the argument incorrectly assumes that all additions to an auditor's knowledge about the client's business are relevant to an audit. With respect to the full-scale non-audit practices of some firms, however, the O'Malley Panel said,

Audit firms' management consulting practices have expanded far beyond the skills required for audit support and the traditional areas related to financial planning and controls. For example, some firms now offer certain investment banking and legal services, outsourcing of a variety of corporate functions, strategic business planning and business process reengineering advice.[180]

Further, the argument that the more an auditor knows about an audit client, the better the audit, assumes that knowledge gained by an accounting firm's consultants is inevitably transferred to the firm's auditors. We are skeptical about this claim. Some testified that there is no sharing of firm personnel between the consulting side and auditing side. The General Counsel of Andersen Consulting said, "[I]n our experience there is no meaningful crossover of personnel between the audit divisions and these other business consulting functions. The skills necessary to perform high quality audits are vastly different from those needed to perform consulting services of the type covered by the rule."[181]

Available evidence suggests that even without the opportunity to provide non-audit services to audit clients, auditors will have the expertise to perform quality audits.[182] First, under the final rules, auditors will be able to continue to provide non-audit services to non-audit clients. They can gain the technical and other expertise that they believe they need by providing the non-audit services to all of their other clients who are not also audit clients. Second, the great majority of companies do not purchase any non-audit services from their auditors in any given year. In the most recent year for which data are available, approximately seventy-five percent of the public company clients of the Big Five accounting firms received no non-audit services from their auditor.[183] This would mean that the financial statements of thousands of public companies were audited by firms who provided no non-audit services to them in that year. We do not believe that the lack of non-audit services resulted in inadequate audits of the financial statements of seventy-five percent of all public companies. As J. Michael Cook, former Chairman and Chief Executive Officer of Deloitte & Touche said, "Some suggest that consulting services are essential to the performance of a quality audit. That assertion, in my opinion, is incorrect. The vast majority of all audits are for companies who purchase little or no consulting services from the audit firm, and those audits are of high quality and always have been."[184]

We also note that accounting firms that do not provide consulting can focus more readily on the audit function, which could in turn improve audits. As the Chairman of Ernst & Young said regarding his firm's recent sale of its consulting practice,

[N]ow that we have sold this practice, we have not discovered that we are somehow enfeebled, unable to perform effective audits or to maintain a top-notch audit and tax practice. In fact, we have found the opposite to be true: without a large consulting practice to manage, we are now more targeted and more focused on our core audit and tax business. . . . We have had a greater string of "wins" in obtaining new audit clients since we sold our management consulting practice than we have had at any time in recent history - four new Fortune 500 clients, including two Fortune 50 companies, just within the last six months.[185]

Some commenters[186] have cited the O'Malley Panel Report as evidence that the provision of non-audit services positively affects audit quality, reciting the statement from the Report that "[o]n about a quarter of the engagements in which non-audit services had been provided . . . those services had a positive impact on the effectiveness of the audit."[187] It may well be that -- independence concerns aside -- providing certain non-audit services can be said to enhance the "efficiency" of the audit. But, as Laurence H. Meyer, a Governor of the Federal Reserve Board, said in support of our proposed restriction on internal audit outsourcing, "auditor independence is more valuable than these asserted efficiencies."[188]

Furthermore, we are concerned that as non-audit services become more important, firms may care less about auditing and more about expanding their service lines, which itself may have a negative effect on audit quality.[189] The factors that drive a high-quality audit, including the core values of the auditing profession, may diminish in importance to the firm, as will the influence of those firm members who exemplify those core values.[190] Equally important, the training and compensation that auditors receive may stress the importance of cross-selling at the expense of auditing.[191] The O'Malley Panel, for example, noted a sense that accounting firms "treat the audit negatively - as a commodity."[192] The O'Malley Panel also agreed that, "[i]n their zeal to emphasize the array of services that CPAs offer, audit firms and the AICPA scarcely acknowledge auditing services in the public images that they portray. This serves to exacerbate the independence issue and to downplay the importance of auditing."[193] This is a trend that we and the accounting profession alike must guard against because, as one commenter remarked, "the value of [a CPA] license and the public's perception of that license is going to be diminished when it becomes another one of the alphabet soup titles that people in the various professions now use."[194]

b. Many Factors Affect Firms' Recruiting Efforts

We take concerns about recruiting and retention very seriously. Nonetheless, we are skeptical about the claim that the capacity to offer non-audit services to audit clients is critical to the auditing profession's ability to recruit and retain talented professionals.

Today's prosperity, with record lows in unemployment, has intensified the recruiting pressures on all sectors of the economy, not just the accounting profession.[195] Enabling auditors to provide all types of non-audit services to audit clients is not likely to solve the auditor recruiting issues for the accounting firms. From 1993 to 1999, the average annual growth rate for revenues from management advisory and similar services was twenty-six percent.[196] Over approximately the same time frame, according to data from the U.S. Census Bureau, the number of candidates sitting for the first time for the CPA exam dropped from 53,763 (1991) to 38,573 (1998),[197] and the percentage of students majoring in accounting dropped from four percent of all graduates in 1990 to two percent in 2000.[198] In other words, while accounting firms have been dramatically expanding their consulting practices, there has been a steady decline in certain indicators of interest in the accountancy profession as a career choice, and the firms have been hiring fewer accounting graduates.[199]

According to some commenters, potential recruits have negative perceptions about the accounting profession, including that accounting work is unsatisfying and that accountants have no interaction with clients, and these perceptions must be overcome in order for the profession to attract the best and brightest students. [200] By "selling" the non-audit practice to recruits, the commenters suggest that they will be able to dispel negative perceptions of the auditing profession.

If a bar to successful recruiting is the perception that auditing is not especially rewarding, the profession must take some responsibility for creating it.[201] As noted above, some firms increasingly regard the audit as a "commodity," downplay its importance, and present themselves to the public as business advisors first and only incidentally as independent, objective auditors. If large multidisciplinary firms downplay to the general public the importance of auditing, they do little to dispel negative impressions of the auditing profession to the public or to potential recruits.[202]

Moreover, the salaries of accountants, particularly in comparison to the salaries of consultants, may exacerbate recruiting problems. Dennis Spackman, Chairman of the National Association of State Boards of Accountancy, testified, "[T]here is a disparity in what [the accounting firms] [a]re willing to pay somebody to come on to their consulting staff with what they're willing to pay for somebody to come on the audit staff."[203] In Mr. Spackman's view, the "big salary differential" gives incentives to recruits who are looking for a promising career path to work at a public accounting firm in the nonattest area, rather than the attest area.[204] Publicly available statistical data support the conclusion that firms pay accounting recruits less than consulting recruits and that salaries for accounting recruits have increased at a significantly slower pace than starting salaries for consultants.[205]

Undoubtedly, there are many factors contributing to the decline in interest in careers in the accounting profession.[206] The O'Malley Panel noted a similar concern about the decline in the attractiveness of auditing as a career, identifying increased educational requirements, issues of compensation, heavy workloads and issues of family or lifestyle as contributing factors. In addition, the Panel noted that the decline

also has been influenced by the perception that alternative career opportunities are more exciting, challenging and rewarding than auditing. . . . The profession will need to restore the historic attractiveness of auditing as a profession and convince the "best" people that it offers excellent long-term career opportunities. To do so it will have to lift the public perception of the profession to a higher plane and convincingly demonstrate the worth of the profession. This is an effort that will require a partnership among audit firms, professional societies and the academic community.[207]

Finally, our revised rules on investments may assist the accounting profession in addressing their difficulties in recruiting and retaining professionals. In particular, by, among other things, significantly shrinking the circle of accounting firm employees to whom restrictions on investments in audit clients apply, the final rules will allow more accountants to take greater advantage of investment opportunities, and therefore, may make the accounting profession more attractive.[208]

c. The Rules Need Not Lead to Restructurings

Some commenters said that our proposals, if adopted, would require accounting firms to restructure their business by, for example, spinning off their consulting practices.[209] It was not, and is not, our intention to cause any firms to restructure. In any event, we remain skeptical of the claim that our rules will be the cause of wholesale restructuring of the accounting profession. Before we proposed these amendments, three of the Big Five firms had either consummated or announced their intention to enter into transactions that would separate their auditing and consulting practices,[210] and other firms undertook restructurings while the proposals were pending. That suggests that reasons, apart from this rulemaking, prompted those business decisions. Indeed, one industry leader commented that his firm was splitting off its consulting business and "it wasn't done for cultural reasons, it was done for different business reasons than that, and it certainly wasn't done for independence issues."[211]

Moreover, while a few commenters asserted that accounting firms will sell their consulting practices if we adopt a final rule, they did not provide us with any basis beyond assertion for evaluating their comments. While it would have been preferable to have information describing the economic impact of the proposed rules upon them, these commenters have not elaborated on the claim.[212]

Without information supporting it, the argument that firms will sell off their consulting practices solely because they cannot provide certain consulting services to audit clients seems similarly questionable. As noted in the Proposing Release, while firms will be prevented from providing some consulting services to their audit clients, they will gain potential clients from other firms who are similarly situated.[213] Even assuming some accounting firms will lose the ability to market their consulting services based on asserted synergies with their audit services, no other firm will be better situated. Every consulting firm, including non-accounting firms, will have to compete for consulting business on the same footing.

8. The Final Rules Will Apply to Small Accounting Firms Only if They Have SEC Audit Clients

The final rule applies only to public companies and other entities registered with the Commission or otherwise required to file audited financial statements with the Commission. It does not apply to audits of financial statements not required to be filed with us. Big Five firms audit the vast majority of the financial statements of public companies. Data from the SECPS public files indicate that, in 1999, non-Big Five firms earned less than one percent of their annual revenues from consulting services provided to public company audit clients.[214] Consequently, we believe there will be only an incidental impact on accounting firms that provide audit and non-audit services principally to audit clients that are private companies not registered with the SEC.

We received many letters from small accounting firms expressing strong support for our proposal,[215] and the National Conference of CPA Practitioners, a national organization comprised of 1,200 member firms that represent 5,000 CPAs and service between 400,000 and 500,000 small and medium sized business clients, similarly wrote to express support for the proposal.[216] Indeed, some commenters pointed out that rather than harming the interests of the small practitioners, the rules could provide smaller firms with new business opportunities to provide non-audit services to companies that previously used their auditors to provide those services.[217]

Some commenters expressed concern about a possible derivative effect of our rule amendments on smaller or regional accounting firms that provide audit and non-audit services solely or principally to private companies.[218] The concern is that state boards of accountancy, which regulate and license certified public accountants, may adopt rules analogous to our own for all accountants in their jurisdiction without regard to whether the companies to which they provide non-audit services are public or private companies.[219] This certainly is not our intention. Our concern throughout this rulemaking has been with investors in public companies and the public securities markets.

As we noted in the Proposing Release, the proposals were not intended to "alter the relationship between federal and state authorities" or to "affect the ability of the states to adopt different regulations in those areas they currently regulate." Though several state boards suggested that our rules would have a high degree of influence over their state regulations,[220] other commenters pointed out that state boards of accountancy have a strong independent tradition.[221] We fully expect that the state boards will continue their practice of exercising independent judgment in determining the extent to which our rules should be imported into what may be a different context.

9. The Rules Take Into Account the Work of the ISB

During this rulemaking process, members of the ISB provided thoughtful and constructive comments and testimony.[222] We appreciate their commitment and professionalism in pursuing their mandate, and their work laid the foundation for our rulemaking. Several commenters requested that we defer to the ISB[223] with respect to financial and employment rules and scope of services rules,[224] while others stated their belief that the Commission is the appropriate body to act, and that we should act now.[225]

In crafting our rules, we were, and continue to be, mindful of the work of the ISB, and we give due regard to their requests for our guidance. For example, the ISB noted in ISB Standard No. 2 that the standard would not take effect until the SEC revises its rules on independence.[226] Importantly, public members of the ISB have stated that the Commission is the appropriate body to take action with respect to the scope of services issues, and have requested that we do so. As William T. Allen, Chairman of the ISB, stated at our public hearings, the scope of services issue is "not well-suited for a board of our character. It's really a public policy choice that the government needs to make, I think. And that's, I think the view of us all."[227] Similarly, Robert Denham, a public member of the ISB, stated, "the Commission is uniquely well-suited to making the difficult public policy choices that are required to protect independence in an environment that has become increasingly complex."[228] Mr. Denham also stated,

As a public member of the ISB I have encouraged the Commission to exercise its authority in this area, because the Commission is the only entity able to balance and evaluate the difficult policy issues that are involved. I am comfortable that the rules proposed regarding scope of services represent a rational, coherent and thoughtful set of policies that will substantially improve protection for auditor independence.[229]

Manuel H. Johnson, another public member of the ISB, stated, "I do feel it's important the SEC undertake a new rulemaking not only to strengthen the standards and guidance of the ISB but also to directly address in a timely fashion the difficult policy issues surrounding the proper scope of services appropriate for accounting firms charged with the trust of performing independent audits."[230] We believe that these considerations, and our evaluation of the important public policy goals addressed by our rulemaking, require us to act.

10. The Final Rules Encourage International Efforts in This Area

Foreign companies increasingly seek to raise capital in the U.S. securities markets,[231] and holdings by U.S. investors of foreign company securities have risen. With the increasing globalization of the markets, regulators worldwide have been re-examining current regulatory requirements applicable to cross-border offerings. We, and regulators around the world, have an interest in promoting high quality international accounting, auditing, and independence standards, while at the same time preserving or enhancing existing investor protections.

We have been involved in and support efforts to raise the level and quality of information available to investors in connection with cross-border flows of capital, consistent with our mandate to protect investors. We worked on a project in which the International Accounting Standards Committee ("IASC") developed the principal components of a core set of international accounting standards. Earlier this year, the International Organization of Securities Commissions ("IOSCO")[232] announced that it completed its assessment of the IASC core set of standards, and recommended that its members allow multinational issuers to use the IASC standards, as supplemented by reconciliations, disclosure and interpretation where necessary.[233] In order to determine whether and under what conditions we should accept financial statements of foreign issuers using the IASC standards, earlier this year we issued a Concept Release on International Accounting Standards, seeking comment on the necessary elements of a high quality global financial reporting framework that also upholds the high quality of financial reporting domestically.[234] In addition, last year, we amended our non-financial statement disclosure requirements for offerings by foreign issuers to conform to the international disclosure standards adopted by IOSCO in 1998.[235]

The International Federation of Accountants ("IFAC"), in which the accounting profession participates actively, has several recent initiatives to establish global auditing standards.[236] Most recently, the IFAC Ethics Committee issued for comment an Exposure Draft proposing a framework for independence.[237] In the Exposure Draft, IFAC presents a conceptual or principle-based approach to addressing auditor independence. Some commenters on our proposal, particularly foreign-based firms and organizations such as the Federation Des Experts Comptables Europeens ("FEE"), suggested that we too adopt a conceptual approach, as opposed to a rules-based approach.[238] Several of these commenters argued that while a rules-based approach has certain advantages and is consistent with the historical U.S. approach, a conceptual approach, particularly in the area of non-audit services, is more efficient and flexible.[239]

We understand that many regulators do not agree with the conceptual approach,[240] and several foreign countries prohibit certain non-audit services though standards vary from country to country.[241] Standards vary for a number of reasons, including that in some countries, audits are conducted by statutory auditors who are directly responsible to shareholders, and in some cases audits may be conducted for other than financial reporting purposes.

We believe that our final rules combine important and useful elements of both approaches. As noted, Rule 2-01(c) does not set forth all circumstances that may impair an auditor's independence from its audit client. For other services, and in particular future services, the Preliminary Note makes clear that in applying the general standard in Rule 2-01(b), we will look in the first instance to the four factors. The four factors provide guiding principles for the Commission, similar to what a "conceptual approach" would provide.

We recognize that our system of regulation is not universal. We have worked, and will continue to work closely, both directly and through IOSCO, with our foreign counterparts on the important issue of auditor independence.

D. It Is Appropriate to Ease Restrictions on Financial and Employment Relationships

In our approach to financial and employment relationship restrictions, we have attempted to draw lines that promote investor confidence but recognize the problems confronting dual career families and employees of huge accounting firms. Specifically, in the investment and employment area, we have adopted investment and employment rules that allow auditors to maximize the opportunities available to them, while promoting the public interest and protecting investor confidence.

As noted in the Proposing Release and above, there have been significant demographic changes, changes in the accounting profession, and changes in the business environment that have affected accounting firms. Among other things, there has been an increase in dual-career families and an ever-increasing mobility among professionals. Accounting firms have expanded internationally. Most SEC registrants now have their financial statements audited by firms that have offices and professionals stationed in hundreds of cities around the globe, and many of those offices and professionals have no connection to, or influence over, a company's audit.

The current rules on financial and employment relationships of auditors were developed largely when the accounting firms were smaller and less diversified. The trends discussed above, and others, have highlighted the need for us to effect a modernization in these areas. In particular, the current rules describing the financial and employment relationships that an audit partner's spouse could have with a firm's audit client called for modernization. For example, under the current rules, the spouse of a partner at an accounting firm could not hold certain positions at an audit client or stock in an audit client, even through an employee stock compensation or 401(k) plan, even if the partner had no connection to the audit. In light of the trends noted above, including the growth in dual-career families, we sought to address this and similar situations.

Accordingly, we are adopting final rules that, among other things, reduce the pool of people within audit firms whose independence is required for an independent audit of a company and shrink the circle of family members whose employment by an audit client impairs an accountant's independence. As noted above, we are adopting these changes not because doing so will itself enhance independence, but because the current rules are broader than necessary to protect investors and our securities markets.

IV. Discussion of Final Rules

A. The Preliminary Note

We have included a Preliminary Note to Rule 2-01 that explains the Commission's approach to independence issues. Rule 2-01 does not purport to, and the Commission could not, consider all circumstances that raise independence concerns. The Preliminary Note makes clear that, in applying the standard in Rule 2-01(b), the Commission looks in the first instance to whether a relationship or the provision of a service:

(a) creates a mutual or conflicting interest between the accountant and the audit client;[242]

(b) places the accountant in the position of auditing his or her own work;[243]

(c) results in the accountant acting as management or an employee of the audit client; or[244]

(d) places the accountant in a position of being an advocate for the audit client.[245]

These factors are general guidance and their application may depend on particular facts and circumstances. Nonetheless, we believe that these four factors provide an appropriate framework for analyzing auditor independence issues. We had proposed to include these four factors in the general standard of Rule 2-01(b). While some commenters agreed with including the four principles in the rule,[246] others did not. Some commenters believed that the principles were too general and difficult to apply to particular situations.[247] Others suggested that the principles should more appropriately be used as "guide posts" and included in a preamble instead of in the rule text.[248]

While the principles were derived from current independence requirements, because of these concerns, we are including them in the Preliminary Note. In the context of this Preliminary Note, the four factors play a role comparable to that of the Ethical Considerations in the American Bar Association's Model Code of Professional Responsibility. The Model Code contains three separate but interrelated parts.[249] Ethical Considerations "represent the objectives toward which every member of the profession should strive. They constitute a body of principles upon which the lawyer can rely for guidance in many specific situations."[250] Like those Ethical Considerations, the four principles constitute a body of principles to which accountants and audit committees can look for guidance when an independence issue is raised that is not explicitly addressed by the final rule.

The Preliminary Note states that "these factors are general guidance only and their application may depend on particular facts and circumstances." The Preliminary Note also reflects the notion that the influences on auditors may vary with the circumstances and, as a result, Rule 2-01 provides that the Commission will consider all relevant facts and circumstances in determining whether an accountant is independent.

B. Qualifications of Accountants

Rule 2-01(a) remains unchanged and requires that in order to practice before the Commission an auditor must be in good standing and entitled to practice in the state of the auditor's residence or principal office. This requirement has existed since the Federal Trade Commission first adopted rules under the Securities Act.[251] It acknowledges our deference to the states for the licensing of public and certified public accountants.

C. The General Standard For Auditor Independence

Our rule provides a general standard of auditor independence as well as specifying circumstances in which an auditor's independence is impaired. As to circumstances specifically set forth in our rule, we have set forth a bright-line test: an auditor is not independent if he or she maintains the relationships, acquires the interests, or engages in the transactions specified in the rule. In identifying particular circumstances in which an auditor's independence is impaired, we have taken into account the policy goals of promoting both auditor objectivity and public confidence that auditors are unbiased when addressing all issues encompassed within the audit engagement. We have also taken into account the value of specificity, and we have tried to give registrants and accountants substantial guidance and predictability. The particular circumstances that are set forth in our rule as impairing independence are those in which, in our judgment, it is sufficiently likely that an auditor's capacity for objective judgment will be impaired or that the investing public will believe that there has been an impairment of independence.

Circumstances that are not specifically set forth in our rule are measured by the general standard set forth in final Rule 2-01(b). Under that standard, we will not recognize an accountant as independent with respect to an audit client if the accountant is not, or if a reasonable investor knowing all relevant facts and circumstances would conclude that the accountant is not, capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement.[252]

The general standard in paragraph (b) recognizes that an auditor must be independent in fact and appearance. Some commenters suggested that the use of an appearance-related standard departs from current rules.[253] As discussed above and in the Proposing Release, the Commission, courts, and the profession have long recognized the importance of the appearance of independence.[254]

Moreover, the general standard we are adopting merely reflects the different means of demonstrating a lack of objectivity. Objectivity is a state of mind,[255] and except in unusual circumstances, a state of mind is not subject to direct proof.[256] Usually, it is demonstrated by reference to circumstantial evidence. Accordingly, the final rule is formulated to indicate that an auditor's independence is impaired either when there is direct evidence of subjective bias, such as through a confession or some way of recording the auditor's thoughts, or when, as in the ordinary case, the facts and circumstances as externally observed demonstrate, under an objective standard, that an auditor would not be capable of acting without bias.

The appearance standard incorporated in the general standard is an objective one. Appearance is measured by reference to a reasonable investor. The "reasonable person" standard is embedded in the law generally. In particular, the "reasonable investor" standard is reflected in the concept of materiality under the federal securities laws.[257]

Commenters expressed concern that a general standard based on the conclusion of a "reasonable investor" may have some imprecision. They urged that the general standard require only independence "in fact." We believe, however, that we have reduced imprecision substantially by describing in some detail particular circumstances that give rise to an impairment of independence. Moreover, reliance solely on independence "in fact" would increase the imprecision beyond a "reasonable investor" test, because independence "in fact" is essentially an inquiry into the subjective workings of the accountant's mind, whereas a "reasonable investor" test relies on observable circumstances and is thus better suited to uniform and consistent application.

We recognize that there is an irreducible degree of imprecision in the notion of independence. We will be mindful of this imprecision, and the range of reasonable views that it engenders, in applying the auditor independence rules. We do not, for example, seek to discourage the development of non-audit services that do not raise independence issues. In considering our response to services not explicitly covered by these rules, we will take into account the nature of the service, prior contacts with the staff, relevant public statements by the Commission or staff, and any related professional literature.

Paragraphs (c)(1) through (5) require the accountant to be independent during the "audit and professional engagement period."[258] This term is defined in Rule 2-01(f)(5) to mean the period covered by any financial statements being audited or reviewed, and the period during which the auditor is engaged either to review or audit financial statements or to prepare a report filed with us, including at the date of the audit report.[259] The use of the word "during" in paragraphs (c)(1) through (5) is intended to make clear that an accountant will lack independence if, for example, he or she is independent at the outset of the engagement but acquires a financial interest in the audit client during the engagement.

We have further confined the legal standard by including the explicit reference to "all relevant facts and circumstances." To make this explicit, we have included the language in the rule text. We have also modified the language to refer to whether a reasonable investor would "conclude" as opposed to "perceive" that the accountant was not capable of exercising objective and impartial judgment. While this is not a substantive change, it makes clear that independence is an objective standard measured from the perspective of the reasonable investor.

Current Rule 2-01(c) provides that we will look to all relevant circumstances, including all relationships between the accountant and the audit client and not just those relating to reports filed with the Commission. We proposed to include this language in Rule 2-01(e). Under the adopted rule, however, the language appears in Rule 2-01(b) in order to highlight that in applying the general standard in Rule 2-01(b), we will consider "all relevant circumstances."

We remind registrants and accountants that auditor independence is not just a legal requirement. It is also a professional and ethical duty. That duty requires auditors to remain independent of audit clients,[260] and includes an obligation to "avoid situations that may lead outsiders to doubt [the auditor's] independence."[261]

In certain situations, whether or not legally required, the best course may be for the accountant to recuse himself or herself from an audit engagement. On occasion, there may be a relationship, apart from those contemplated by any standard or rule, that has an important meaning to an individual accountant and could create, or be viewed by a reasonable investor with knowledge of all relevant facts and circumstances as creating, a conflict with the accountant's duty to investors.[262] In this and any similar situation, we encourage accountants to seek to recuse themselves from any review, audit, or attest engagement, whether or not specifically required by the Commission's, the ISB's, or the profession's rules.

D. Specific Applications of The Independence Standard

Rule 2-01(c) ties the general standard of paragraph (b) to specific applications. Paragraphs (c)(1) through (c)(5) address separately situations in which an accountant is not independent of an audit client because of certain: (1) financial relationships, (2) employment relationships, (3) business relationships, (4) transactions or situations involving the provision of non-audit services, or (5) transactions or situations involving the receipt of contingent fees.[263]

The proposed rule included a provision under which an accountant's independence would have been impaired if the accountant had any of the relationships or provided any of the services described by proposed Rule 2-01(c), or "otherwise [did] not comply with the standard" of paragraph (b). We have eliminated from the text of the rule the language regarding the accountant's failure "otherwise" to comply with the standard. Instead, we have modified the structure of paragraph (c) to make clear that the paragraph sets forth a "non-exclusive specification of circumstances" that are inconsistent with the standard of paragraph (b).

1. Financial Relationships

Rule 2-01(c)(1) sets forth the general rule regarding financial relationships that impair independence. It addresses, among other things, direct or material indirect investments, trustee positions involving investment decision-making authority, investments in common with audit clients, debtor-creditor relationships, deposit accounts, brokerage accounts, commodity accounts, and insurance policies.

Rule 2-01(c)(1) contains the general standard that "[a]n accountant is not independent if, at any point during the audit and professional engagement period, the accountant has a direct financial interest or a material indirect financial interest in the accountant's audit client." The rule then specifies certain financial interests that constitute a direct or material indirect financial interest in an audit client. As the rule indicates, the list of specified interests is not intended to be exclusive. The specified interests represent common types of financial interests that impair independence, but the effect of other types of financial interests on auditor independence will be determined under the general standards of paragraphs (b) and (c)(1).

In applying the financial relationship provisions of the rule, it is important to bear in mind the definition of "audit client." "Audit client," when used in the rule, includes some "affiliate[s] of the audit client," as that term is defined in the rule.[264] Accordingly, financial relationships with certain affiliates of audit clients are subject to the provisions of Rule 2-01(c)(1). In this discussion, as well as in the rule, references to "audit client" should be understood to include the appropriate affiliates of the audit client.

For the most part, the specified financial interests described in this section of the rule impair independence only if they are financial interests of the accounting firm, covered persons in the firm, or immediate family members of covered persons. (The exception concerns situations involving beneficial ownership of more than five percent of an entity, or control of an entity.) This represents a liberalization from prior restrictions that generally reached all partners in the firm regardless of whether they had any relationship to the audit of the particular client.

While the comments we received reflected widespread (although not universal) agreement with our goal of modernizing the financial relationships restrictions, some commenters urged us not to liberalize these restrictions to the extent we proposed. Generally, these commenters argued in favor of the prophylactic value of a rule precluding a broader scope of persons from having a financial interest in an audit client of the firm.[265] Several of these commenters also spoke of the importance of a firm culture that treats all clients as clients of the firm, and in which the firm can call on any partner to assist with the audit of any client on short notice without having to consider whether the partner's personal financial interests preclude it.[266]

On the other hand, some commenters, while agreeing generally with our proposal to scale back the scope of persons whose financial interests are restricted, advocated that we further narrow the group of persons who are included in the restrictions. These commenters generally expressed a preference for a "tiered" approach that would restrict even fewer people with respect to some types of financial interests.[267]

The balance we struck between these two sets of concerns was viewed favorably by many commenters.[268] We believe that fair, meaningful, and relevant independence rules concerning financial relationships should reflect a calibrated approach to determining what specific relationships realistically give rise to independence concerns. After considering the comments we received, we have drawn the lines essentially where we proposed --

"covered persons in the firm" and their immediate family members -- though we have modified slightly the definition of "covered persons" in the firm.[269] The final rule, like the proposed rule, would attribute all investments by a covered person's "immediate family members," that is, the covered person's spouse, spousal equivalent, and dependents, to the covered person.

a. Investments in Audit Clients

Rule 2-01(c)(1)(i) describes investments that impair an accountant's independence as to a particular audit client. Paragraph (A) provides that an accountant is not independent of an audit client if the accounting firm, any covered person in the firm, or any immediate family member of any covered person has a "direct investment" -- such as stocks, bonds, notes, options, or other securities -- in the audit client. As the language of the rule makes clear, this is not an exclusive list of all ownership interests subject to the rule. Other than with respect to the scope of persons encompassed by the rule, paragraph (A) does not represent any substantive change to our rules on direct investments.

We noted in the Proposing Release that "as under current law, the rule cannot be avoided through indirect means."[270] We stated, as an example, that an accountant precluded from having a direct investment in an audit client could not evade that restriction by investing in the client through a corporation or as a member of an investment club.[271] Some commenters proposed that we address that issue with specific rule text, and they proposed language.[272] While not adopting the language proposed by commenters, we have, in the interest of increased clarity, included in the final rule language addressing that issue.

Specifically, we have added the proviso that an investment through an intermediary shall constitute a "direct investment" in the audit client if either of two conditions is satisfied: "(1) The accounting firm, covered person, or immediate family member, alone or together with other persons, supervises or participates in the intermediary's investment decisions or has control over the intermediary; or (2) The intermediary is not a diversified management investment company . . . and has an investment in the audit client that amounts to 20% or more of the value of the intermediary's total investments." If either of these criteria is satisfied, the investment is treated as a direct investment in the audit client and, therefore, impairs independence. If an investment through an intermediary does not satisfy either of these two criteria, however, the investment is considered "indirect," and it impairs independence only if it crosses one of the thresholds set out in Rule 2-01(c)(1)(i)(D) or (E).

Rule 2-01(c)(1)(i)(B) provides that an accountant is not independent when "[a]ny partner, principal, shareholder, or professional employee of the accounting firm, any of his or her immediate family members, any close family member of a covered person in the firm, or any group of the above persons has filed a Schedule 13D or 13G[273] [] with the Commission indicating beneficial ownership of more than five percent of an audit client's equity securities, or controls an audit client, or a close family member of a partner, principal, or shareholder of the accounting firm controls an audit client." Paragraph (B) is the only one of the financial relationship provisions that specifically encompasses a range of persons beyond covered persons and their immediate family members. The broader scope of coverage under paragraph (B) is based on the view that when a financial interest in an audit client of the firm becomes particularly large, the fact that the person holding that interest is distanced from the audit engagement no longer sufficiently mitigates the potential for a conflict.

We have made one substantive addition to the proposed paragraph (B). We have added at the end of the paragraph the clause "or a close family member of a partner, principal, or shareholder of the accounting firm controls an audit client." This provision identifies additional circumstances that impair independence, beyond the circumstances in our proposed rule.[274] For instance, this provision would provide that independence is impaired when the sister or parent of a partner in the firm who is not a covered person controls an audit client. We agree that the circumstances described by this provision would result in an impairment of independence. In addition, we note that this provision is consistent with existing rules.[275]

Rule 2-01(c)(1)(i)(C) provides that an accountant is not independent when "[t]he accounting firm, any covered person in the firm, or any of his or her immediate family members, serves as voting trustee of a trust or executor of an estate containing the securities of an audit client, unless the accounting firm, covered person in the firm or immediate family member has no authority to make investment decisions for the trust or estate." Because a trustee or executor typically has a fiduciary duty to preserve or maximize the value of the trust's or estate's assets, we believe it is appropriate to treat the trustee's or executor's interest as a direct financial interest in the audit client and to deem the auditor's independence impaired. We understand, however, that a person might serve as a trustee or executor without having any authority to make investment decisions for the trust or estate. Because we see no reason to consider an auditor's independence impaired in those circumstances, we have added the proviso at the end of paragraph (C) to include an exception for those circumstances.

Rule 2-01(c)(1)(i)(D) covers material indirect investments in an audit client. The basic rule provides that an accountant is not independent when "[t]he accounting firm, any covered person in the firm, any of his or her immediate family members, or any group of the above persons has any material indirect investment in an audit client." This provision carries over the existing proscription on material indirect investments in audit clients.[276]

At the proposing stage, paragraph (D) included two examples of what would constitute a material indirect investment: (1) ownership of more than five percent of an entity that has an ownership interest in the audit client, and (2) ownership of more than five percent of an entity in which the audit client has an ownership interest. A number of commenters, however, proposed eliminating those examples as unnecessarily restrictive and burdensome. We agree that the examples would have consequences beyond what we intended. Accounting firms may, through their pension plans or otherwise, acquire more than five percent stakes in other entities. In these situations, it may well be impracticable for an accounting firm regularly to monitor whether that entity has any financial interest in an audit client or whether an audit client has any financial interest in the entity.[277] Accordingly, we have omitted those examples in the final rule.

Because the material indirect investment rule is a general standard, we have also decided to include one additional provision to clarify the meaning of "material indirect investment" in the context of mutual fund investments. Specifically, the rule makes explicit that the term "material indirect investment" does not include ownership by any covered person in the firm, any of his or her immediate family members, or any group of the above persons, of five percent or less of the outstanding shares of a diversified management investment company that invests in an audit client.[278] Consequently, the material indirect investment rules, as adopted, allow auditors to invest in management investment companies, provided that the company is diversified as defined under the Investment Company Act of 1940.[279] If an investment company is non-diversified under the Investment Company Act of 1940,[280] the company must disclose that fact in its prospectus. As a result, an accountant can easily determine by reviewing the prospectus whether the company is diversified for purposes of the rule. In addition, this provision does not constitute any substantive change from the proposed rule, because the general categories of examples in the proposed rule would have covered this situation. This provision is intended to ensure that all firm personnel and their family members can freely invest (up to the five percent cap) in diversified mutual funds that are not audit clients and are not part of an investment company complex that includes an audit client, without bearing the burden of constantly monitoring whether, and to what degree, those funds invest in an audit client's securities.[281]

We have not included accounting firms within this provision for two reasons. First, in contrast to most individual investors, accounting firms through their pension funds may invest large sums and, therefore, better access diversified investment vehicles, such as managed accounts that do not invest in their audit clients. At the same time, the large amounts that may be invested by an accounting firm, through its pension plan or otherwise, increase the chances that the indirect investment may be material to the audit client. This should not be understood, however, to prevent accounting firms from investing in diversified mutual funds. Rather, when they invest in such funds, they must comply with the general "material indirect investment" standard.

Second, at the suggestion of commenters,[282] we have included a new paragraph (E) that governs (1) investments in entities that invest in audit clients ("intermediary investors") and (2) investment in entities in which audit clients invest ("common investees"). We have decided to codify in our rule the substance of the existing AICPA restrictions applicable to those situations.[283] We have codified those restrictions in paragraph (c)(1)(i)(E).

Paragraph (E), like the AICPA rule, is framed in terms of material investments and the ability to exercise significant influence over an entity.[284] In the case of an intermediary investor, paragraph (E) provides that an accountant is not independent if the firm, a covered person, or an immediate family member of a covered person has either (1) a direct or material indirect investment in an entity that has both an investment in an audit client that is material to that entity and the ability to exercise significant influence over the audit client,[285] or (2) the ability to exercise significant influence over an entity that has the ability to exercise significant influence over an audit client.[286]

In the case of a common investee, paragraph (E) provides that an accountant is not independent if the firm, a covered person, or an immediate family member of a covered person has either (1) a direct or material indirect investment in an entity in which an audit client has a material (to the audit client) investment and over which the audit client has the ability to exercise significant influence,[287] or (2) any material investment in an entity over which an audit client has the ability to exercise significant influence.[288]

With respect to paragraph (c)(1)(i)(E)(2), which turns in part on whether a covered person's or immediate family member's investment in an entity is material to that person, we do not anticipate that compliance requires a firm constantly to monitor the net worth of all covered persons and their immediate family members in order to know at all times whether any particular investment is material to them. We anticipate that monitoring for compliance with this paragraph will involve routine monitoring of the investments of all covered persons and their immediate family members, combined with monitoring of the identity of entities over which the firm's audit clients have the ability to exercise significant influence. When overlap between those categories appears, the firm can take additional steps to determine whether the relevant investment is material to the covered persons or immediate family members holding the investment.

If an "intermediary investor" or a "common investee" becomes an affiliate of the audit client under paragraph (f)(4)(i) or (iv), then paragraph (E) no longer governs the question of independence. Rather, paragraph (A)'s provision concerning direct investments in audit clients will apply to that intermediary investor or common investee, and any investment in that entity by the firm, a covered person, or an immediate family member of a covered person would impair independence.

b. Other Financial Interests

Rule 2-01(c)(1)(ii) describes other financial interests of an auditor that would impair an auditor's independence with respect to an audit client because they create a debtor-creditor relationship or other commingling of the financial interests of the auditor and the audit client. In some situations, the continued viability of the audit client may be necessary for protection of the auditor's own assets (e.g., bank deposits or insurance) or for the auditor to receive a benefit (e.g., insurance claim). These situations reasonably may be viewed as creating a self-interest that competes with the auditor's obligation to serve only investors' interests. We have adopted Rule 2-01(c)(1)(ii) largely as proposed, though we have made some modifications, described below.

(i) Loans/Debtor-Creditor Relationships

Rule 2-01(c)(1)(ii)(A) provides that an accountant will not be independent when the accounting firm, any covered person in the accounting firm, or any of the covered person's immediate family members has any loan (including any margin loan) to or from an audit client, or an audit client's officers, directors, or record or beneficial owners of more than ten percent of the audit client's equity securities. As proposed, we have also adopted exceptions for four types of loans:[289] (1) automobile loans and leases collateralized by the automobile; (2) loans fully collateralized by the cash surrender value of an insurance policy; (3) loans fully collateralized by cash deposits at the same financial institution; and (4) a mortgage loan collateralized by the borrower's primary residence provided the loan was not obtained while the covered person in the firm was a covered person.

As adopted, paragraph (A) varies from the proposed rule in two respects, one representing a substantive change and one a clarifying change. The substantive change involves increasing to ten percent (up from the proposed five percent) the percentage of an audit client's securities that a lender may own without posing an independence impairment for an accountant who borrows from that lender. We have made this change because we believe that doing so will not make the rule significantly less effective, and may significantly increase the ease with which one can obtain the information necessary to assure compliance with this rule. The ten percent threshold corresponds to the definitions in the Commission's Regulation S-X of a "principal holder of equity securities,"[290] as well as a "promoter."[291] In addition, other aspects of the securities laws attach significance to an equity interest in excess of ten percent.[292] These definitions and substantive legal provisions clearly classify ten percent shareholders as having a special and influential role with the issuer. Accordingly, a lender owning more than ten percent of an audit client's securities would be considered to be in a position to influence the policies and management of that client.

The clarifying change involves the wording of paragraph (A)(4), which describes the mortgage loan exception. The proposed rule referred to a mortgage loan "collateralized by the accountant's primary residence." In the final rule, we have changed "accountant" to "borrower," because we intend for the exception to apply also to mortgage loans obtained by an immediate family member of a covered person. The proposed rule also specified that this exception was limited to loans "not obtained while the borrower was a covered person in the firm or an immediate family member of a covered person in the firm." In the final rule, we have changed this language to "not obtained while the covered person in the firm was a covered person." This change is intended only as a way of clarifying that the test focuses on the status of the relevant covered person at the time of the mortgage loan.

(ii) Savings and Checking Accounts

Rule 2-01(c)(1)(ii)(B) concerns savings and checking accounts. It provides that an accountant is not independent when the firm, a covered person, or an immediate family member of a covered person "has any savings, checking, or similar account at a bank, savings and loan, or similar institution that is an audit client, if the account has a balance that exceeds the amount insured by the Federal Deposit Insurance Corporation or any similar insurer, except that an accounting firm account may have an uninsured account balance provided that the likelihood of the bank, savings and loan, or similar institution experiencing financial difficulties is remote."

At the suggestion of commenters, we have modified this provision from the proposed rule by adding the exception for accounting firm accounts with institutions that have no more than a remote likelihood of experiencing financial difficulties.[293] Large firms often maintain account balances well in excess of FDIC limits, and the heavy daily volume of large transactions imposes such demands on a financial institution that there is, as a practical matter, a very limited universe of banks capable of servicing those accounts. Under the circumstances, we are persuaded that it is necessary to provide an exception that would allow accounting firms (but not individuals who are covered persons) to maintain balances above insured limits even if the financial institution is an audit client. We emphasize that this is a narrow exception mandated by practical necessity, and that, even so, the exception only applies as long as there is no more than a remote likelihood of the institution experiencing financial difficulties. If there is more than a remote likelihood of the institution experiencing financial difficulties, then an uninsured balance will impair independence because the auditor would be placed in the situation of having to decide whether to express an opinion about the institution as a going concern when the auditor's own assets may be at risk.

(iii) Broker-Dealer Accounts

Rule 2-01(c)(1)(ii)(C) provides that an accountant will not be independent when the accounting firm, any covered person in the firm, or any of the covered person's immediate family members, has any brokerage or similar accounts maintained with a broker-dealer that is an audit client if any such accounts include any asset other than cash or securities (within the meaning of "security" provided in the Securities Investor Protection Act ("SIPA")), or where the value of the assets in the accounts exceeds the amount that is subject to a Securities Investor Protection Corporation ("SIPC") advance for those accounts, under Section 9 of SIPA. Those final provisions are as we proposed.

In addition, we have added to paragraph (C) a provision intended to ensure that brokerage accounts maintained outside of the U.S. not covered by SIPA will nonetheless not impair independence so long as the value of the assets in those accounts is insured or protected pursuant to a program similar to SIPA. Some commenters noted that SIPC insurance is not available in jurisdictions outside the U.S. and suggested that we add this provision.[294] We believe that this addition represents a logical extension of our purpose in originally proposing the SIPA exception. Again, however, the insurance must be similar to SIPA for the exception to apply.

(iv) Futures Commission Merchant Accounts

Rule 2-01(c)(1)(ii)(D) provides that the accountant will not be independent when the accounting firm, any covered person in the firm, or any covered person's immediate family member has any futures, commodity, or similar account maintained with a futures commission merchant that is an audit client. Few commenters commented on this provision,[295] and we have adopted it exactly as proposed.

(v) Credit Cards

Rule 2-01(c)(1)(ii)(E) provides that an accountant is not independent when the accounting firm, any covered person in the firm, or any covered person's immediate family member has "[a]ny aggregate outstanding credit card balance owed to a lender that is an audit client that is not reduced to $10,000 or less on a current basis taking into consideration the payment due date and any available grace period." This represents a slight modification from the rule as proposed. Under the proposed rule, independence would have been impaired the moment that a relevant credit card balance exceeded $10,000. Commenters, noting the occasional use of credit cards for large consumer purchases, college tuition, and tax payments, asked that we modify the rule so that the $10,000 limit applies only as of the due date.[296] We agree that the issue we seek to address in this paragraph (E) is equally well addressed with a more flexible approach, taking account of the realities of day-to-day life, that allows a credit card balance to exceed $10,000 so long as the balance is brought back down below $10,000 within the immediate credit card payment cycle.

(vi) Insurance Products

Rule 2-01(c)(1)(ii)(F) provides that an auditor's independence is impaired whenever any covered person in the firm or any immediate family member of a covered person holds any individual insurance policy issued by an insurer that is an audit client unless: (1) the policy was obtained at a time when the person in the firm was not a covered person; and (2) the likelihood of the insurer becoming insolvent is remote. The final rule reflects two modifications from the proposed rule.

First, the rule that we proposed would have provided that an accounting firm's independence was impaired by having a professional liability policy originally issued by an audit client. We have reconsidered this issue in light of comments pointing out that professional liability insurance for accountants is provided by relatively few insurers and, moreover, complex syndication relationships among those insurers make it unreasonable to expect that any given professional liability insurer will ever be completely absent from the coverage scheme that insures its auditor.[297] The final rule, therefore, does not provide that a professional liability policy gives rise to an independence impairment. In addition, by leaving the word "individual" in our final rule, we intend to make clear that the rule does not apply to professional liability or any other type of insurance policy held by an accounting firm.

Second, the rule that we proposed would have provided that independence was impaired by a covered person or immediate family member having any individual policy originally issued by an insurer that is an audit client. Commenters pointed out how this provision could work a hardship where, for example, an accountant obtains a life insurance policy from an audit client of the firm, but obtains the policy when he or she is not a covered person with respect to the client. If that accountant later becomes a covered person with respect to that insurer, our proposed rule effectively would have required that accountant to obtain that insurance from another carrier. Changing life insurers, however, could prove to be very difficult and expensive depending on many other factors that could have changed since the accountant first obtained the insurance.

We believe that the goal of this paragraph (F) can be served equally well by a provision that largely averts that potential hardship. The final rule, therefore, provides that, so long as the likelihood of the insurer becoming insolvent is remote, independence is not impaired if a covered person or immediate family member obtains a policy from an audit client when the covered person is not a covered person with respect to that audit client.[298] If, however, the likelihood of the insurer becoming insolvent is not remote, then independence is impaired regardless of the lack of "covered person" status at the time the policy was obtained. In any event, when the likelihood of insolvency is remote, and the policy was obtained when the covered person was not a covered person, it is our intention that the covered person be able to renew the policy and increase the coverage if done pursuant to the pre-existing contractual terms of the policy.

Finally, as discussed in more detail below, recusal remains an option in some circumstances. If a person or a member of that person's immediate family wished to obtain insurance from an audit client, the person may be able to recuse himself or herself from being a covered person for that audit client. For instance, depending on a firm's organization, persons that are covered persons only because they are within the definition of the "chain of command" may be able to re-structure their supervisory role with respect to a particular audit client so as to fall outside that definition with respect to the audit client.

(vii) Investment Companies

Rule 2-01(c)(1)(ii)(G) addresses investments in an entity that is part of an investment company complex. The rule provides that, when an audit client is part of an investment company complex, an accountant is not independent if the accounting firm, a covered person, or an immediate family member of a covered person has any financial interest in an entity in the investment company complex. Technically, this provision represents an explicit statement of a concept that otherwise necessarily follows from other aspects of the rule. Specifically, because the definition of "affiliate of the audit client" includes any entity that is part of an investment company complex (as defined in Rule 2-01(f)(14)) that includes an audit client,[299] the restrictions included in paragraphs (c)(1)(i) and (c)(1)(ii) necessarily apply to any such entity. We have singled out these entities in paragraph (G) to minimize the possibility that a reader focused on the financial relationship provisions might overlook those entities' inclusion as "an affiliate of the audit client." We solicited comment on whether we should follow ISB Standard No. 2,[300] and our intent, as stated in the Proposing Release, was to codify the substance of ISB Standard No. 2. Commenters generally did not object to this concept, although several expressed concerns about the definition of "investment company complex" as discussed below.[301] We have reworded paragraph (G) from the Proposing Release solely for the purpose of clarity. No substantive change is intended.

c. Exceptions

We are adopting Rule 2-01(c)(1)(iii) regarding limited exceptions to the financial relationship rules substantially as proposed, with slight modifications, and we are adding one additional exception. These exceptions recognize that there are situations in which an accountant, by virtue of being given a gift or receiving an inheritance, or because the accounting firm has taken on a new audit client, may lack independence solely because of events beyond the accountant's control. In these circumstances, independence is not deemed to be impaired if the financial interest is promptly disposed of or the financial relationship is promptly terminated. These exceptions operate to avert an independence impairment only with respect to the financial interests referenced in the exceptions. These exceptions do not have the effect of averting an independence impairment caused by any other factors, such as employment relationships or non-audit services.

(i) Inheritance and Gift

Rule 2-01(c)(1)(iii)(A) provides that an accountant's independence will not be impaired by virtue of an unsolicited financial interest, such as a gift or inheritance, so long as the recipient disposes of the interest as soon as practicable, but in no event later than thirty days after the recipient has knowledge of, and the right to dispose of, that interest. Our proposed version of this provision required that the interest be disposed of no later than thirty days after the recipient has a right to dispose of it. We have added the phrase "has knowledge of" to avoid the unfairness that could result in a case where the recipient of a financial interest does not learn of that interest immediately upon acquiring it. In addition, several commenters from foreign jurisdictions noted that there are situations abroad in which an accounting firm may be appointed executor of an estate without its advance knowledge.[302] We have modified the rule to address these situations. Specifically, we have expanded it to cover "unsolicited financial interests" even if not acquired through inheritance or gift.

(ii) New Audit Engagement

We are adopting Rule 2-01(c)(1)(iii)(B) substantially as proposed. It is designed to allow accounting firms to bid for and accept new audit engagements, even if a person has a financial interest that would cause the accountant to be not independent under the financial relationship rules. This exception is available to an accountant so long as the accountant did not audit the client's financial statements for the immediately preceding fiscal year, and the accountant was independent before the earlier of (1) signing an initial engagement letter or other agreement to provide audit, review, or attest services to the audit client, or (2) commencing any audit, review, or attest procedures (including planning the audit of the client's financial statements).

The new audit engagement exception of Rule 2-01(c)(1)(iii)(B) is necessary because an auditor must be independent, not only during the period of the auditor's engagement, but also during the period covered by any financial statements being audited or reviewed. Because of an existing financial relationship between an accounting firm or one of its employees and a company (that is not an audit client), an accounting firm may not be able to bid for or accept an audit engagement from the company without this exception. This exception allows firms to bid for and accept engagements in these circumstances, provided they are otherwise independent of the audit client and they become independent of the audit client under the financial relationship rules before the earlier of the two events specified in paragraphs (B)(2)(i) and (ii).

We have modified the audit engagement exception slightly from the proposed rule. As proposed, the exception would have applied only if the firm was independent under the financial relationship rules before the earlier of beginning work on the audit or accepting the engagement to provide audit, review, or attest services. Commenters have pointed out that it would be reasonable to allow for some grace period to divest of financial interests after the audit client and the accountant first agree to an audit relationship. Otherwise, an accountant would have little choice but to come into compliance with the financial interest rules before even bidding to become the auditor for a particular client.

Accordingly, we have revised paragraph (B)(2)(i) to focus on the "signing of an initial engagement letter or other agreement," rather than "accepting the engagement." By this change, we mean to afford accountants a divestiture window between the time they first understand that a new client has selected them to perform audit, review, or attest services -- or there has been an oral agreement to that effect -- and the time that an initial engagement letter or other written agreement is actually signed, or audit procedures commence. If an accountant is in compliance with the financial relationship rules before the earlier of that signing or the commencement of audit, review, or attest services, the accountant's independence is not impaired by the operation of the financial relationship rules of paragraphs (c)(1)(i) and (c)(1)(ii).

(iii) Employee Compensation and Benefit Plans

We are adopting an additional exception to the financial interest rules in response to concerns expressed by several commenters. These commenters encouraged us as part of this modernization to allow for broader participation by immediate family members of auditors in employee compensation and benefit plans.[303] This additional exception is consistent with our goal of updating the independence rules in ways that recognize the realities of the modern economy (and dual income households) and continue to protect the public interest.

The exception is necessary because our employment rules will allow an immediate family member of a covered person (most typically a spouse) to be employed by an audit client in a position other than an "accounting role or financial reporting oversight role" without impairing the auditor's independence. In these situations, the immediate family member would remain subject to our financial interest rules and therefore could not have a direct financial interest in the audit client. Accordingly, an employee in this situation could be prevented from participating in a stock-based compensation program.

We are adopting an additional exception to the financial interest rules to provide some relief in these situations. The exception will apply to investments in audit clients by immediate family members of covered persons who are covered persons only by virtue of being a partner in the same office as the lead audit engagement partner of, or a partner or manager performing ten or more hours of non-audit services for, an audit client. This exception will allow the immediate family members of these covered persons to acquire an interest in an audit client, if the immediate family member works for the audit client and acquires the interest as an "unavoidable consequence" of participating in an employee compensation program in which employees are granted, for example, stock options in the employer as part of their total compensation package, without impairing the audit firm's independence. The phrase "unavoidable consequence" in this paragraph means that, to the extent the employee has the ability to participate in the program but has the option to select investments in entities that would not make him or her an investor in an audit client, the employee must choose other investments to avoid an impairment of independence.

Immediate family members of this subset of covered persons must dispose of the financial interest as soon as practicable once they have the right to do so, however, and they may not otherwise invest in the audit client without impairing the firm's independence. Where there are legal or other similar restrictions on a person's right to dispose of a financial interest at a particular time, the person need not dispose of the interest until the restrictions have lapsed. For example, a person will not have to dispose of an investment in an audit client if doing so would violate an employer's policies on insider trading. On the other hand, waiting for more advantageous market conditions to dispose of the interest would not fall within the exception.

This exception is similarly available to immediate family members of the same subset of covered persons who must invest in one or more audit clients in order to participate in their employer's 401(k) or similar retirement plan. Accordingly, under the exception, the spouse or another immediate family member of this subset of covered persons can participate in a 401(k) plan, even if his or her only investment option within the plan is, for example, a mutual fund that is in the same investment company complex as a mutual fund that is an audit client. If, however, the immediate family member has an alternative in the 401(k) plan that does not involve investing in a fund complex for which the person's relative is a covered person, then the family member may not invest in the audit client without impairing the auditor's independence. We highlight that the exception in paragraph (c)(1)(iii)(C) is available only to immediate family members of covered persons who are covered persons by virtue of being in the same office as the lead audit engagement partner of an audit client (paragraph (f)(11)(iv)) or because they perform ten or more hours of non-audit services for an audit client (paragraph (f)(11)(iii)).

The Investment Company Institute proposed that the exception apply to the immediate family members of all covered persons in the firm.[304] We believe, however, that the exception we are adopting is sufficiently broad. As discussed elsewhere in this release, even absent this exception, the rules we are adopting significantly shrink the circle of firm personnel to whom the financial interest rules apply.

d. Audit Clients' Financial Relationships

Rule 2-01(c)(1)(iv) specifies two sets of circumstances in which an audit client's financial interests in the accounting firm cause an accountant to be not independent of that audit client. We have modified the proposed rule as discussed below.

(i) Investments by the Audit Client in the Auditor

As discussed in the Proposing Release, when an audit client invests in its auditor, the auditor may be placed in the position of auditing the value of any of its securities that are reflected as an asset in the financial statements of the audit client. In addition, the accountant may reasonably be presumed to have a mutuality of financial interest with the owners of the firm, including an audit client-shareholder.[305]

Under Rule 2-01(c)(1)(iv)(A), an accountant is not independent with respect to an audit client when the audit client has, or has agreed to acquire, any direct investment in the accounting firm, such as stocks, bonds, notes, options, or other securities, or the audit client's officers or directors are record or beneficial owners of more than five percent of the equity securities of the accounting firm. In applying this provision, it is important to remember that the definition of accounting firm includes "associated entities" of the accounting firm, including any that are public companies. Paragraph (A) seeks to prevent a situation in which an accountant, in order to audit asset valuations of a client that holds securities of the accounting firm, must value the accounting firm's own securities. Paragraph (A) also seeks to prevent a situation in which the audit client, or in some circumstances its officers and directors, can exercise any degree of influence over the accounting firm, whether by virtue of the accounting firm's fiduciary obligation to its investors or by nominating and voting for directors.

The AICPA noted in its comment letter that its current rules also do not permit an audit client to hold any investment in its auditor.[306] The AICPA was critical of the application of our proposed provision, at least without a materiality threshold, to subsidiaries and other entities related to the accounting firm. Consistent with our general approach, we have decided to apply this rule to not only the corporate entity performing the audit, but also its subsidiaries and associated entities. We note that we have eliminated the definition of "affiliate of the accounting firm," which many commenters argued captured more entities with some relation to the accounting firm than necessary.[307]

The proposed rule did not include any provision restricting audit client officers and directors from owning the accounting firm's securities. In that respect, our proposed approach was more liberal than existing law, which deems independence impaired if an audit client's officers or directors own any equity securities of the accounting firm. We sought comment, however, on whether the rule's prohibitions should also apply to other situations in which the audit client has a financial interest, such as when the audit client's CEO invests in the accounting firm. Although some commenters opposed the addition of this notion,[308] we have determined that the final rule should liberalize existing law, simply not to the extent we proposed. Accordingly, the final rule provides that independence is impaired if an officer or director of the audit client owns more than five percent of the equity securities of the accounting firm. We believe that investments in the accounting firm by audit client officers and directors do not routinely give rise to independence concerns, but that concerns arise when an officer or director of the audit client accumulates a significant stake in the accounting firm. Because record or beneficial ownership interests exceeding five percent will be reflected in Schedule 13D filings relating to the accounting firm, the firm will be able to monitor for compliance with this provision, without having to rely solely on an intrusive investigation or audit client monitoring of its officers' and directors' investments.

(ii) Underwriting

Rule 2-01(c)(1)(iv)(B) provides that an accountant is not independent of an audit client when the accounting firm "engages an audit client to act as an underwriter, broker-dealer, market maker, promoter, or analyst with respect to securities issued by the accounting firm." Few transactions are as significant to the financial health of a company, including an accounting firm, as the sale of its securities, whether in private or public offerings. In an offering, an underwriter either buys and then resells a company's securities or receives a commission for selling the securities. In either circumstance, were an audit client to act as underwriter of an accounting firm's or its associated entity's securities, the audit client would assume the role of advocate or seller of the accounting firm's securities. Moreover, depending on the terms of the underwriting, the underwriter could for a time become a significant shareholder of the accounting firm. There also may be indemnification agreements that place the underwriter and auditor in adversarial positions.

In addition, the accounting firm would have a direct interest in ensuring the underwriter's viability and credibility, either of which could be damaged as the result of an audit. Moreover, the auditor would have a clear incentive not to displease an audit client to which it had entrusted a critical financial transaction. Similar conflicts of interest may arise if an audit client or an affiliate of an audit client is engaged to perform other financial services for an accounting firm, such as making a market in the accounting firm's securities or issuing an analyst report concerning the securities of the accounting firm.

We have reworded paragraph (B) from the proposed wording to avert an unintended consequence. The proposed rule provided that independence would be impaired if an audit client "performs any service for the accounting firm related to underwriting, offering, making a market in, marketing, promoting, or selling securities issued by the accounting firm, or issues an analyst report concerning the securities of the accounting firm." Worded that way, the provision could be read to impair independence any time, for example, a broker-dealer issues an analyst's report making a favorable recommendation concerning the securities of any associated entity of an accounting firm, because, in a broad sense, that report could benefit the accounting firm and could be seen as a "service for" the accounting firm. To avoid any possibility of that construction, we have reworded paragraph (B) to make clear that independence is impaired only if the accounting firm actually "engages" the audit client for the purpose of obtaining those services.

2. Employment Relationships

We are adopting, substantially as proposed, Rule 2-01(c)(2), which sets forth the employment relationships that impair an auditor's independence. As discussed in the Proposing Release, independence requirements related to employment relationships between accountants or their family members and audit clients are based on the premise that when an accountant is employed by an audit client, or has a close relative or former colleague employed in certain positions at an audit client, there is a significant risk that the accountant would not be capable of exercising the objective and impartial judgment that is the hallmark of independence.

We are modernizing the employment relationship rules in a manner consistent with the public interest and investor protection. We are keenly aware of the changes in traditional family structures, the increased mobility of professional employees, the recent globalization of accounting firms, and similar changes in society at large. We have determined that, in this environment, existing restrictions on employment relationships between accountants or their family members and audit clients are more restrictive than necessary to protect investors. Accordingly, we are narrowing those restrictions.

We received a number of comments on our proposals to modernize the employment relationship rules. The vast majority of commenters who spoke to this issue supported modernization in general, even if they did not support all aspects of our proposals.[309] For example, some commenters who agreed with the objectives of our proposals questioned if the ISB rather than the Commission should prescribe requirements in this area.[310] Some commenters expressed a preference for the language used in ISB proposals and ISB Standard No. 3.[311] ISB Standard No. 3, "Employment with Audit Clients," states, "An audit firm's independence is impaired with respect to an audit client that employs a former firm professional who could, by reason of his or her knowledge of and relationships with the audit firm, adversely influence the quality or effectiveness of the audit, unless the firm has taken steps that effectively eliminate such risk." The standard also describes the types of safeguards that the ISB believes would effectively eliminate the risk of an impairment of independence.

We appreciate the concepts underlying ISB Standard No. 3 and strongly support firms' use of quality controls and "safeguards" to encourage their partners and employees to be aware of and adhere to auditor independence standards. We are concerned, however, that a "safeguards" approach, which is dependent on a firm's self-analysis and self-reviews, will not provide a definitive standard. In our view, independence is better assured by consistent and uniform rules, rather than by rules that rely on the auditor's assessment of the extent of its own self-interest. Furthermore, it has been our experience that the existence of safeguards or quality controls alone does not ensure compliance with even the most basic independence regulations.[312] Accordingly, we have chosen a more objective standard for employment relationships, which is described in paragraph (c)(2).[313]

Like the financial interest rules we are adopting, the employment relationship rules greatly reduce the pool of people within audit firms whose families are affected by the independence requirements. Paragraph (c)(2) sets forth the general rule that an auditor is not independent of an audit client if the accountant or a family member has an employment relationship with an audit client. The provision includes a non-exclusive list of employment relationships that are inconsistent with the general standard of paragraphs (b) and (c)(2). Employment relationships not specifically described in paragraphs (c)(2)(i) through (c)(2)(iv) are subject to the general test of paragraphs (b) and (c)(2).

The following are examples of employment relationships that impair an auditor's independence under the final rule.[314]

- A current partner of an accounting firm serves as a member of the board of directors of the audit client;
- A sibling of a covered person is employed by an audit client as the director of internal audit;
- A former professional employee of an accounting firm who resigned from the accounting firm two years ago is employed by an audit client in an accounting role and the former employee receives a pension from the firm tied to the firm's revenues or profits;
- A former partner of an accounting firm accepts the position of chief accounting officer at an audit client, and the former partner continues to maintain a capital balance with the accounting firm; or,
- A former director of an audit client becomes a partner of the accounting firm, and that individual participates in the audit of the financial statements of the audit client for a period during which he or she was a director of the audit client.

We discuss each of the rules giving rise to these examples in turn.

a. Employment at Audit Client of Accountant

Rule 2-01(c)(2)(i) continues the principle set forth in current Rule 2-01(b) that to be independent, neither the accountant nor any member of his or her firm can be a director, officer, or employee of an audit client. Paragraph

(2)(i) provides that an accountant is not independent if any current partner, principal, shareholder, or professional employee of the accounting firm is employed by the audit client, or serves as a member of the board of directors or similar management or governing body of the audit client. In the most basic sense, the accountant cannot be employed by his or her audit client and be independent.

b. Employment at Audit Client of Certain Relatives of Accountant

Rule 2-01(c)(2)(ii) provides that certain employment relationships between covered persons' close family members and an audit client will impair the auditor's independence. As discussed below, close family members include the covered person's spouse, spousal equivalent, dependents, parents, nondependent children, and siblings. The application of the rule to close family members stands in contrast to the financial interest rules, where only the interests of the covered person's immediate family members (i.e., spouse, spousal equivalent, and dependents) are attributed to the covered person. As we explained in the Proposing Release, we believe this distinction is appropriate because, while some close family members' investments may not be known to a covered person, the place and nature of such family members' employment should be obvious.

Like the proposed rule, final Rule 2-01(c)(2)(ii) limits the employment relationships that impair auditor independence when held by a close family member of a covered person to those involving an "accounting role or financial reporting oversight role." As a result, an audit client's employment of even an immediate family member will not necessarily impair an auditor's independence, unless that family member is in an "accounting role or financial reporting oversight role."

Not all commenters agreed with the scope of the rule, some arguing that our proposal was too generous and others arguing that the proposal was too restrictive.[315] In this regard, we note that the ISB has taken a more restrictive approach in suggesting that independence is impaired if an immediate family member of a person on the audit engagement team is employed by the audit client in any position.[316] We continue to believe, however, that we need only apply our restriction to family members in an "accounting role or financial reporting oversight role" at an audit client. Some commenters, on the other hand, argued for a rule that did not impose restrictions on close family members of all covered persons. While we acknowledge that individuals who are covered persons because they provide ten or more hours of non-audit services to the audit client or work in the same office as the lead audit engagement partner are less likely to be able to influence an audit than covered persons who are on the audit engagement team or in the "chain of command," we do not agree that the likelihood is so remote as to warrant carving their close family members out of the rule.

We define "accounting role or financial reporting oversight role" in Rule 2-01(f)(3). The definition includes two categories of persons. One category includes those with more than minimal influence over the contents of the accounting records or anyone who prepares them. This typically would include certain persons working in the accounting department or who perform accounting functions. We have not chosen to reach as many persons in the audit client's accounting department as are covered by the "audit sensitive" category in the AICPA's employment rules.[317] The definition also may include certain individuals, such as an accounts receivable supervisor or manager, who are relied upon by management to calculate amounts that are placed directly into the company's financial statements.

The second category includes those who influence the preparers or the contents of the financial statements of the audit client. The definition lists positions in which we believe a person generally wields the type of influence over the financial statements that causes independence concerns, such as a member of the audit client's board of directors (or similar management or governing body), chief executive officer, president, chief financial officer, chief operating officer, general counsel, chief accounting officer, controller, director of internal audit, director of financial reporting, treasurer, vice president of marketing, or any equivalent position.

Several commenters expressed support for the concept of "accounting role or financial reporting oversight role," but recommended that we modify the definition in various ways, for example, by eliminating vice president of marketing from the scope of the rule or making the list an exhaustive list of covered positions.[318] We believe that the vice president of marketing makes important determinations that affect the company's financial results.[319] These include, for example, supervising sales that result in the revenues reported in financial statements, shaping sales policies and procedures, and participating at a high level in the formulation of the company's budget. For these reasons, we consider a vice president of marketing to be involved in a financial reporting oversight role. We have declined to make the list of positions exhaustive because titles alone do not always accurately describe a person's duties and functions.

Other modifications to the definition make explicit our concerns about positions in which the employee would exercise more than minimal influence over the contents of the accounting records or anyone who prepares them, or would exercise influence over the contents of the financial statements or anyone who prepares them. As noted above, the final rule also incorporates the proposed list of examples of positions in which we consider a person to exercise influence over the contents of the financial statements or people who prepare the financial statements. We have singled out these two categories of positions because persons in these positions can influence the financial reporting of the company.

As noted in the Proposing Release, the so-called "five hundred mile rule" has been eliminated under Rule 2-01(c)(2)(ii). Whether a covered person lives near a close family member who is employed by the audit client no longer seems relevant in today's world of instantaneous international communications and global securities markets. Accordingly, we have dispensed with this test of auditor independence.

c. Employment at Audit Client of Former Employee of Accounting Firm

We are adopting Rule 2-01(c)(2)(iii) substantially as proposed, with the minor modifications discussed below. Rule 2-01(c)(2)(iii) describes the circumstances under which an auditor's independence will be impaired by an audit client's employment of a former partner, principal, shareholder, or professional employee of the accounting firm in an accounting role or financial reporting oversight role. As we noted in the Proposing Release, when these persons retire or resign from accounting firms, it is not unusual for them to join the management of former audit clients or to become members of their boards of directors. Registrants and their shareholders may benefit from the former partner's accounting and financial reporting expertise. Investors and the public in general also may benefit when individuals on the board or in management can work effectively with the auditors, members of the audit committee, and management to provide informative financial statements and reports.

When these persons, however, assume positions with the firm's audit client and also remain linked in some fashion to the accounting firm, they may well be in a position to influence the content of the audit client's accounting records and financial statements on the one hand, and the conduct of the audit, on the other. This is particularly true when the individual, while at the accounting firm, was in some way associated with the audit of the client. A close association between a member of the board of directors or of senior management with his or her former firm creates an impression of a mutuality of interest and may well affect the auditor's judgment.[320]

In addition, even under the usual circumstances, there is some possibility that accounting firm partners may compromise their independence in order to secure management positions with the audit clients.[321] That risk is heightened where there is a "revolving door" between the auditor and the client.[322] Finally, there is the risk that the former partner's familiarity with the firm's audit process and the audit partners and employees of the firm will enable him or her to affect the audit as it progresses.[323] Accordingly, under the final rule, as under current requirements, an auditor's independence with respect to an audit client is deemed to be impaired when former partners, shareholders, principals, or professional employees of the firm are employed in an accounting or financial reporting oversight role at an audit client, unless certain conditions are met.

Consistent with our proposal, the final rule provides that independence will not be impaired if certain steps are taken to ensure the individual's separation from the accounting firm. Under the final rule, the former partner, principal, shareholder, or professional employee must not: (i) influence the firm's operations or financial policies, (ii) have a capital balance in the firm, or (iii) have a financial arrangement, other than one providing for regular payment of a fixed dollar amount, as described in paragraphs 2-01(c)(2)(iii)(C)(1) and (2). Any payment of a fixed dollar amount must be made pursuant to a fully funded retirement plan, rabbi trust or similar vehicle. Or, in the case of a former professional employee who was not a partner, principal, or shareholder of the firm and has been disassociated from the accounting firm for more than five years, the fixed payments made to the former employee must be immaterial to him or her.

As proposed, the rule contemplated only fixed payments made pursuant to a fully funded retirement plan or rabbi trust.[324] Several commenters expressed concern about the rule's application in foreign jurisdictions in which rabbi trusts are not recognized.[325] In response to these comments, we have modified the rule to indicate that using a similar payment vehicle will satisfy the rule. If a rabbi trust is available in the jurisdiction, however, the accounting firm and the former professional must use a rabbi trust, rather than some other vehicle.

As noted, to satisfy the conditions of paragraph (C)(1), the retirement plan or rabbi trust must be fully funded.[326] We believe that full funding is critical to breaking the link between the firm and the individual. Any situation that requires the individual to be dependent on the firm to fund his or her retirement payments weds the financial interests of the former employee and the firm, and creates the potential for the firm to exert influence over the individual, or vice versa.

The proposed rule did not contain a "cooling off" period. We solicited comment on whether we should require a mandatory cooling off period for former partners and professional staff of an audit firm who join an audit client.[327] Several commenters supported the notion of a cooling off period,[328] but others disagreed.[329] We have determined that a cooling off period unnecessarily restricts the employment opportunities of former professionals, and we have decided not to adopt a cooling off provision.[330]

We also solicited comment on whether application of the rule should depend on whether the professional leaving the accounting firm was a partner at the firm or non-managerial audit staff. We considered whether to provide a sunset provision so that accounting firms need not track all former professional employees indefinitely to determine, for purposes of this provision, whether they become employed in an accounting role or financial reporting oversight role at an audit client. While we believe that it is usual for accounting firms to know whether their former partners, principals, or shareholders are employed in these roles at an audit client, we understand the practical difficulties firms might have tracking all former professionals who left the firm while at a managerial or staff level. Accordingly, we are adopting a rule under which the accountant's independence will not be impaired when a former professional, who was not a partner, joins an audit client in an accounting role or financial reporting oversight role position after five years, provided the retirement benefits of the former employee are immaterial to him or her.

The materiality provision is necessary because, to satisfy the conditions in paragraph (C)(2), the retirement plan does not have to be fully funded. In the absence of such funding, we believe that the receipt by the former employee of more than an immaterial amount would create the unification of financial interests discussed above.

d. Employment at Accounting Firm of Former Employee of Audit Client

We are adopting Rule 2-01(c)(2)(iv) substantially as proposed. The rule specifies that individuals who were formerly officers, directors, or employees of an audit client and who later become partners, principals, or shareholders of the accounting firm will impair the independence of the firm with respect to that audit client, unless they do not participate in, and are not in a position to influence, the audit of the financial statements of the audit client covering a period during which the individuals were employed by or associated with the audit client. When a former employee of an audit client joins the accounting firm, the independence rules ensure that the employee is not in a position to influence the audit of his or her former employer.[331] Because participating in the audit of the former employer could easily require former employees to audit their own work, the rule provides that independence is impaired unless the former employees do not participate in and are not in a position to influence the audit of the financial statements of the audit client for any period during which they were employed by or associated with that audit client.

The final rule applies to all former employees of the audit client, not only those who were in accounting or financial reporting oversight roles. It also applies to former audit client employees whether they become partners, principals, or shareholders of the accounting firm or professional employees of the firm.[332]

3. Business Relationships

We proposed Rule 2-01(c)(3) to describe the business relationships that impair an auditor's independence from an audit client. We are adopting the rule substantially as proposed with two minor modifications. The rule continues the Codification's current standard that an auditor's independence with respect to an audit client is impaired when the accounting firm, or a covered person in the firm, has a direct or material indirect business relationship with an audit client, or any person associated with the audit client in a decision-making capacity, such as an audit client's officers, directors, or substantial stockholders.

Commenters were generally supportive of the approach we took in the proposal, with the exception of one provision.[333] We proposed that independence was also impaired if the accounting firm or any covered person had a direct or material indirect business relationship with "record or beneficial owners of more than five percent of the [audit client's] equity securities." This formulation was intended to provide a more precise definition of the subset of associated persons who constitute "substantial stockholders" in the existing restrictions on business relationships in the Codification.[334] Commenters, however, expressed concerns with this threshold.[335] Similarly, one large accounting firm expressed concern with the proposed language, asserting that our proposal would "greatly expand[] the universe of venture capital firms with which we could not have any business relationships."[336]

In response to these comments, we are adopting instead the language used in the Codification, which refers to an associated person "in a decision-making capacity, such as an audit client's officers, directors or substantial stockholders." Because our rule, as adopted, conforms more closely to the Codification, we anticipate that it will provide greater clarity to the profession in interpreting Rule 2-01(c)(3) and address the concerns about the proposal that were articulated by several commenters.

We are also clarifying the rule by adding the words "to the audit client" after "provides professional services" in the last sentence of the rule. As discussed in the Proposing Release, the exception for providing professional services is meant only to make clear that Rule 2-01(c)(3) does not address the provision of professional services by the auditor to the audit client. The addition of these four words is intended to make clear that joint business ventures or prime/subcontractor arrangements in which audit clients and auditors jointly provide "professional services" would continue to impair the auditor's independence.[337]

We also proposed defining the phrase "consumer in the ordinary course of business" as part of the definitions explicitly set forth in Rule 2-01(f). Commenters, however, expressed concern that, as defined, this phrase could have unintended consequences.[338] Accordingly, we omit the definition of "consumer in the ordinary course of business" in the rules we are adopting and will continue to apply the term consistent with its use in the Codification.

As we noted in the Proposing Release, we are retaining a number of the examples currently found in the Codification to provide guidance on permissible and impermissible business relationships.[339] We expect that the interpretations and examples that have evolved under the Codification with respect to this rule will continue to provide useful guidance to the profession.

We also solicited comment as to whether we should retain the "direct or material indirect business relationship" formulation or if there was another formulation that could provide additional or more precise guidance. The AICPA asserted that "not all business relationships with audit clients should be proscribed if they are immaterial. . . . The inclusion of a materiality standard in the context both of [sic] all business relationships (direct and indirect) sufficiently mitigates whatever independence risk would be posed."[340] For the same reasons we have explained before, we do not believe that auditors should be allowed to have any direct business relationships with their audit clients other than as a consumer in the ordinary course of business.[341] We have carefully considered the comments we have received and believe that the rule we are adopting constitutes a fair and balanced approach that protects independence without unduly restricting business opportunities for auditors or their clients.

4. Non-Audit Services

a. General Rule

We are adopting a rule that provides that an accountant is not independent if the accountant provides the non-audit services identified in paragraph (c)(4). The rule is derived from current Rule 2-01, our releases that have been incorporated into the Codification, and existing AICPA rules.

The proposed rule identified certain services that could not be provided by the auditor without impairing the auditor's independence with respect to the audit client "[e]ven if the audit client accept[ed] ultimate responsibility for the work that is performed or decisions that are made . . . ." In the final non-audit services rule, Rule 2-01(c)(4), we have eliminated that language. As described below, we have added certain exceptions to the non-audit services that impair an auditor's independence. These exceptions are appropriate only where management takes certain actions and accepts certain responsibilities. For example, we have set forth certain circumstances where an auditor does not lose his or her independence by providing certain actuarial services to insurance company audit clients. The exception, however, is available only where management accepts responsibility for significant actuarial methods and assumptions.

The final amendments identify nine non-audit services that, when provided by the auditor to an audit client, impair the auditor's independence. In the proposed rule, we identified ten such services. For many of the non-audit services that we proposed to include in the rule, we aimed to codify existing restrictions.[342] Commenters expressed concerns, however, that certain of our proposed rules were written more broadly than existing independence rules.[343] In addition, commenters indicated that, to the extent our proposals differed from current standards, they believed current standards more appropriately circumscribed auditors' non-audit activities.[344] In response to these comments, we made several modifications to the rules, including eliminating altogether the provision on expert services.[345]

b. Particular Non-Audit Services that Impair Independence

(i) Bookkeeping or Other Services Related to the Audit Client's Accounting Records or Financial Statements

We proposed and are adopting paragraph (c)(4)(i), which, with limited exceptions, would deem an auditor's independence to be impaired when the auditor performs bookkeeping services for an audit client. Even prior to our proposals, auditors were restricted by AICPA Ethics Rules and the Codification from providing certain bookkeeping services.[346] As explained in the Codification and reiterated in the Proposing Release,[347] providing bookkeeping services for an audit client impairs the auditor's independence because the auditor will be placed in the position of auditing the firm's work when auditing the client's financial statements. It is hard to maintain the requisite objectivity about one's or one's firm's own work. This is especially true where finding an error would raise questions about the adequacy of the bookkeeping services provided by the firm. In addition, keeping the books is a management function, the performance of which leads to an inappropriate mutuality of interests between the auditor and the audit client.

We have modified our final rule in response to several comments.[348] First, commenters believed that the proposed definition should not cover all financial statements, including those not filed with the Commission. For example, auditors sometimes prepare statutory financial statements for foreign companies, and these are not filed with us. At least one commenter requested that we therefore exclude those financial statements from the rule's coverage.[349] Focusing solely on whether the financial statements are filed with us would not be appropriate in all circumstances, since in some instances statutory financial statements form the basis of the U.S. GAAP financial statements that are filed with us. Under these circumstances, an auditor who has prepared the statutory financial statements of an audit client is put in the position of auditing its own work when auditing the resultant U.S. GAAP-converted financial statements. Accordingly, the final rule amendments cover not only financial statements that are filed with us, but also financial statements that form the basis of financial statements that are filed with us. As proposed, the final amendments also cover any service involving maintaining or preparing the audit client's accounting records.

Second, although we proposed to cover services that resulted in the accountant generating financial information that would be disclosed to investors, commenters believed that this language was too broad. As part of the audit process, auditors may generate data in connection with evaluating financial information that eventually may be disclosed to investors.[350] We believe that they should continue to be able to do so. Accordingly, we narrowed the definition to eliminate this language and instead are incorporating wording from the AICPA Ethics Rules to the effect that an accountant cannot prepare source documents or originate data underlying the client's financial statements without impairing independence.[351]

Third, several commenters requested that we provide an exception to the rule so that auditors could perform bookkeeping services in emergency or other unusual situations.[352] The Codification provides such an exception. Example 6 of Section 602.02.c.ii of the Codification states that when, due to the unexpected resignation of a company's comptroller at the end of the year, the accountant was called upon to provide assistance in closing the books and the accountant did not make decisions on a managerial level, the accountant's independence was not impaired.[353] We recognize that there may be emergency or other unusual situations, such as the one described above, in which the auditor will need to provide bookkeeping services that are otherwise prohibited. Accordingly, we are adopting an exception from the bookkeeping restriction for emergency or other unusual situations, provided that the accountant does not act as a manager or make any managerial decisions. We expect that such situations will be rare. We encourage registrants and auditors to contact the staff with any questions about the application of this provision to particular circumstances.

Finally, the final rule contains a limited exception related to bookkeeping for foreign subsidiaries or divisions of audit clients. The Codification provides this type of exception.[354] The Proposing Release noted that the Commission recognized the need for relief in this area, and that therefore we had proposed to retain this section of the Codification.[355] In response to commenters' concerns,[356] however, we are incorporating the exception into the rule. Accountants therefore may provide these services for foreign divisions or subsidiaries of a domestic audit client under certain conditions. First, the services must be limited, routine, or ministerial. Second, it must be impractical for the entity receiving the services to obtain them from another provider.[357] Third, under the adopted rule as under the Codification, the foreign entity for which the accountant is performing these services cannot be material to the consolidated financial statements. Fourth, as under the Codification, the entity must not have employees capable or competent to perform the services. Fifth, the services performed must be consistent with local professional ethics rules.[358] Last, as explained in the Codification, "the Commission believes that a comparison of the fees for the bookkeeping services and the audit should provide a fair test for determining the significance of the work to the registrant and the accountant, and indirectly, the possible effect on the firm's independence," and that therefore a limit on the services can be "based on the relationship of the fee charged for the service to the total audit fee charged to the registrant."[359] Accordingly, the final rule provides that the total fees for the bookkeeping services provided by the auditor to a company's foreign entities collectively (for the entire group of companies) cannot exceed the greater of one percent of the consolidated audit fee or $10,000.[360]

(ii) Financial Information Systems Design and Implementation

Paragraph (c)(4)(ii) identifies certain information technology services that, if provided to an audit client, impair the accountant's independence. Paragraph (c)(4)(ii) also identifies other information technology services that may be provided to an audit client without impairing independence so long as certain conditions are satisfied.

The rule we adopt today on information technology services represents a change from the rule we proposed. Some commenters objected to our proposed rule. This provision lay at the heart of some of the largest accounting firms' arguments that our proposed rules would hinder their access to technology, limit their understanding of their clients' operations, and hurt their recruiting efforts.[361] These arguments compete with the widespread and persistent perceptions that large, lucrative information technology consulting relationships with an audit client may give rise to conflicts of interest, may result in auditors functioning as management, or may result in an auditor auditing his or her own work.

The final rule reflects a pragmatic approach to a difficult issue. The rule singles out certain information technology services as independence impairments under any circumstances, and identifies other categories of information technology services that will not impair independence if certain conditions are fulfilled. Those conditions are designed to minimize the potential for an auditor to end up making management decisions or auditing his or her own work.

The rule also takes a pragmatic approach to the potential independence problem posed by the economic incentives that accompany large consulting contracts. Rather than effectively ban those relationships, we are amending the proxy disclosure rules to require public companies to make specific disclosure of fees paid to their auditor for information technology services. In addition, public companies must disclose that their audit committee (or, if there is no audit committee, the board of directors) considered whether the provision of the information technology services, as well as all other non-audit services, is compatible with maintaining the auditor's independence.

As discussed in greater detail below, we anticipate that audit committees will consider the independence implications of the engagements that are subject to the disclosure requirements. Moreover, the disclosure will provide information to enable investors themselves to evaluate auditor independence, and will enable future study of whether large information technology consulting relationships have an effect on audit quality and auditors' independence.

Paragraph (c)(4)(ii)(A) provides that an accountant is not independent of an audit client if the accountant is "[d]irectly or indirectly operating, or supervising the operation of, the audit client's information system or managing the audit client's local area network." These services impair an accountant's independence under existing AICPA rules,[362] and, under the rules we adopt today, will impair independence under any circumstances.

Under paragraph (c)(4)(ii)(B), "[d]esigning or implementing a hardware or software system that aggregates source data underlying the financial statements or generates information that is significant to the audit client's financial statements, taken as a whole," will impair an accountant's independence unless certain conditions are met.[363] This section of the final rule differs from the proposed rule in that we have modified the description of the hardware and software systems that the rule reaches by adding the phrase "that aggregates source data underlying the financial statements." This change was suggested by commenters.[364] We have adopted this change because, to the extent that the design and implementation activities concern hardware and software systems that aggregate source data, they are likely to be the types of systems that raise independence concerns.

The conditions that the rule imposes are intended to reduce the likelihood that the auditor will be placed in a position of making, and then auditing, managerial decisions. They are also intended to ensure that management will make all significant decisions during the process and, at its conclusion, will be fully responsible for the results of the project including the proper functioning of the company's internal accounting controls.

The first condition, set out in paragraph (c)(4)(ii)(B)(1), is that "the audit client's management has acknowledged in writing to the accounting firm and the audit client's audit committee, or if there is no such committee then the board of directors, the audit client's responsibility to establish and maintain a system of internal accounting controls in compliance with Section 13(b)(2) of the Securities Exchange Act of 1934, 15 U.S.C. § 78m (b)(2)." This condition makes clear that this statutory responsibility cannot be shifted to the accounting firm.

Paragraphs (c)(4)(ii)(B)(2) and (c)(4)(ii)(B)(3), setting out the second and third conditions, complement each other. Paragraph (B)(2) articulates the condition that "the audit client's management designates a competent employee or employees, preferably within senior management, with the responsibility to make all management decisions with respect to the design and implementation of the hardware or software system." Paragraph (B)(3) articulates the condition that "the audit client's management makes all management decisions with respect to the design and implementation of the hardware or software system including, but not limited to, decisions concerning the systems to be evaluated and selected, the controls and system procedures to be implemented, the scope and timetable of system implementation, and the testing, training and conversion plans." These conditions are intended to ensure that an audit client that receives information technology services from its auditor does not delegate to its auditor responsibility for "management decisions" relating to the design and implementation of the system.

The fourth condition, set out in paragraph (c)(4)(ii)(B)(4), is that "the audit client's management evaluates the adequacy and results of the design and implementation of the hardware or software system." Paragraph (c)(4)(ii)(B)(5) sets out the fifth condition, that "the audit client's management does not rely on the accountant's work as the primary basis for determining the adequacy of its internal controls and financial reporting systems." These conditions reiterate the principles that management is to make all substantive decisions, that the auditor should not have a mutual interest in the successful operation of the systems, and that the auditor should not be placed in the position of auditing his or her firm's decisions about the system.

The rule expressly does not limit services in connection with the assessment, design, and implementation of internal accounting and risk management controls, provided the auditor does not act as an employee or perform management functions. During the audit, accountants generally obtain an understanding of their audit clients' systems of internal accounting controls and may recommend ways in which those controls can be improved or strengthened. This service can be valuable to companies and their audit committees, and may also enhance audit quality, without raising independence concerns. In addition, we do not see any significant reason for concern about an audit firm's work on hardware or software systems that are unrelated to the audit client's financial statements or accounting records.

(iii) Appraisal or Valuation Services and Fairness Opinions

We are adopting a rule that, with some exceptions, provides that an accountant is not independent if the accountant provides appraisal or valuation services or any service involving a fairness opinion.[365] Appraisal and valuation services include any process of valuing assets, both tangible and intangible, or liabilities. Fairness opinions are opinions that an accounting firm provides on the adequacy of consideration in a transaction. As explained more thoroughly in the Proposing Release, if an audit firm provides these services to an audit client, when it is time to audit the financial statements the accountant could well end up reviewing his or her own work, including key assumptions or variables suggested by his or her firm that underlie an entry in the financial statements.[366] Where the service involves the preparation of projections of future results or future cash flows, the accountant may develop a mutuality of interest with the audit client in attaining the forecasted results.

We solicited comment on whether we should provide an exception from the rule when the amounts involved are likely to be immaterial to the financial statements that later would be reviewed by the auditor. Several commenters stated that such an exception is warranted.[367] In response, we are limiting application of the rule to the provision of appraisals, valuations, or services involving a fairness opinion where it is reasonably likely that the results, individually or in the aggregate, would be material to the audit client's financial statements[368] or where the results would be audited by the auditor. As a general matter, auditors would be auditing the results when they perform a GAAS audit.

The rule also contains an exception for appraisal or valuation services where the accounting firm reviews and reports on work done by the audit client itself or an independent, third-party specialist employed by the audit client, and the audit client or specialist provides the primary support for the balance recorded in the client's financial statements. In those instances, because a third party or the audit client is the source of the financial information subject to the review or audit, the accountant will not be reviewing or auditing his or her own work.

Another exception allows accountants to continue to value an audit client's pension, other post-employment benefit, or similar liabilities, so long as the audit client has determined and taken responsibility for all significant assumptions and data underlying the valuation.[369] Accountants historically have provided pension assistance to their audit clients, and if appropriate persons at the audit client determine the underlying assumptions and data, we believe that independence is not impaired.

Commenters also stated that an accountant's independence should not be deemed impaired when the accountant performs appraisal or valuation services as a necessary part of permitted tax services. As the rule text and this Release make clear, accountants will continue to be able to provide tax services to audit clients. A few commenters pointed out, however, that unless accountants can perform appraisal and valuation services that are part of a tax planning strategy or for tax compliance purposes, the client would not hire the accountant to provide tax services.[370] The final rule makes clear that accountants can perform appraisal and valuation services for those purposes without impairing independence.

Commenters requested an exception for appraisal and valuation services where the services are for non-financial purposes. Because our principal concern about appraisal and valuation services is that they lead auditors to audit their own work, so long as the results do not affect the financial statements, appraisal or valuation services performed for non-financial purposes do not impair an auditor's independence.

At least one commenter suggested that we include an exception for purchase price allocations.[371] An exception is not appropriate here because these allocation decisions, particularly those regarding the valuation of intangible assets, can have a direct, significant, and immediate impact on companies' financial statements. For example, where a company acquires another company with large, on-going in-process research and development projects, the acquiring company will need to decide how much of the purchase price to allocate to those projects. This may affect in turn the amount charged against earnings in the current year as in-process research and development expense, and the amount to be classified as goodwill and amortized against future years' earnings. Any such allocations later will be reviewed in the course of the audit, leading the firm to audit its own work.[372]

Finally, commenters raised concerns about the restriction on the provision of contribution-in-kind reports.[373] We have removed the language in the rule referring to contribution-in-kind reports because we view such reports to be akin to fairness opinions, which are restricted under the final rules. We understand from commenters that certain foreign jurisdictions require auditors to issue contribution-in-kind reports for their audit clients[374] and that, in some European jurisdictions, auditors may be appointed or approved by an administrative or judicial authority to act as an independent expert and issue a contribution-in-kind report for the audit client.[375] The Commission is sensitive to those issues and in the past has worked with foreign regulators and companies to reach an acceptable resolution.[376] We will continue our practice of determining whether to accept a contribution-in-kind report on a case-by-case basis. In this regard, we encourage registrants and their auditors to contact the staff to discuss particular situations where a foreign jurisdiction requires a contribution-in-kind report to enable the staff to work with the registrant and the foreign jurisdiction in reaching an appropriate resolution.

(iv) Actuarial Services

SECPS rules currently prohibit member accounting firms from providing certain actuarially oriented advisory services to insurance companies.[377] Accountants providing these services assume a key management task. In addition, because actuarially oriented advisory services may affect amounts reflected in an insurance company's financial statements, providing these services may cause an accountant later to audit his or her own work. Rule 2-01(c)(4)(iv) addresses these issues.

Commenters expressed concern that the proposal was broader than a similar SECPS rule, in that the restrictions in the proposal applied to services provided to all public companies, not just insurance companies, and the proposal did not include the four examples of appropriate services that are included in the SECPS rule.[378] We have modified our final rule with respect to actuarial services to parallel closely the SECPS rule, including the four exceptions. The final rule limits only actuarially oriented advisory services involving the determination of insurance company policy reserves and related accounts. We are narrowing the prohibition to services for insurance companies because, as explained in the SECPS rule, it is primarily in these companies that the actuarial function is "basic to the operation and management" of the company.[379]

The final rule states that an auditor's independence is impaired if the audit firm provides certain actuarially oriented advisory services involving the determination of insurance company policy reserves and related accounts, unless three conditions are met. First, the audit client must use its own actuaries or third-party actuaries to provide management with the primary actuarial capabilities. Second, management must accept responsibility for any significant actuarial methods and assumptions employed by the accountant in performing or providing the actuarial services. Third, the accountant cannot render the actuarial services to the audit client on a continuous basis. All of these conditions are designed to ensure that the accountant does not assume a management function for the audit client.

Assuming these conditions are met, the accountant can perform four types of actuarial services for an insurance company audit client without impairing the accountant's independence. The four types of actuarial services are: (i) assisting management to develop appropriate methods, assumptions, and amounts for policy and loss reserves and other actuarial items presented in financial reports, based on the company's historical experience, current practice, and future plans;[380] (ii) assisting management in the conversion of financial statements from a statutory basis to one conforming with GAAP; (iii) analyzing actuarial considerations and alternatives in federal income tax planning; and (iv) assisting management in the financial analyses of various matters, such as proposed new policies, new markets, business acquisitions, and reinsurance needs. Allowing accountants to provide these four types of actuarially oriented advisory services under the three conditions is consistent with the SECPS rule.[381] We believe that if the conditions are met, in the context of state-regulated insurance companies, the four services would not constitute an assumption of the insurance company management's role or responsibilities, and would not impair the auditor's independence.

(v) Internal Audit Services

Although companies are not required to do so, they may, as part of their internal controls, form internal audit departments that are used to make sure that control systems are adequate and working. According to the Committee of Sponsoring Organizations ("COSO"), internal auditors play an important role in evaluating and monitoring a company's internal control system.[382] As explained by Robert Denham, a member of the ISB, at our public hearings, "Good internal auditing . . . requires the internal auditor to be very closely integrated with management. The internal auditor is part of the management team. He or she is identifying problems and providing reports that help management correct those problems."[383] In sum, "the internal audit function is, basically, an arm of management,"[384] and internal auditors are, in effect, part of a company's internal accounting control system.

Although a company may prefer to outsource its internal audit function, management must continue to be responsible for the function.[385] When a company outsources the function to a third-party provider, there may be a concern that management has ceded this responsibility. While this is a concern in any internal audit outsourcing arrangement, there are additional concerns when a company outsources the work to its external auditor. As Comptroller of the Currency John D. Hawke, Jr. testified, "When a bank out-sources its internal audit function to the same firm that performs the bank's external financial audit . . . the possibility for inherent conflicts and impairments of auditor independence and auditor integrity is greatest."[386] Although Mr. Hawke discussed the conflicts in the bank context, his comments are equally applicable to any registrant.

Research commissioned by the Institute of Internal Auditors indicates that the internal auditors surveyed perceive an independence problem where internal audit work is outsourced to the external auditor.[387] In particular, in auditing the company's financial statements, the accountant will consider the extent to which he or she may rely on the internal control system in designing its audit procedures.[388] When the auditor has performed the internal audit work, the auditor will need to consider or examine its own work.

Final Rule 2-01(c)(4)(v) seeks to curb these conflicting interests without precluding companies, particularly small companies, from obtaining internal audit services from their auditors where the auditor's independence would not be compromised. Under the final rule, an auditor's independence is impaired by performing more than forty percent of the audit client's internal audit work related to the internal accounting controls, financial systems, or financial statements, unless the audit client has $200 million or less in assets.

The final rule provides an exception for businesses with $200 million or less in assets. Specifically, the rule provides that audit clients who have less than $200 million in total assets may receive more than forty percent of their internal audit functions from their auditor without giving rise to an impairment of independence. We provide this exception after carefully considering the potential impact of our rules on small businesses. At the proposing stage, we requested comment on whether we should provide an exception for smaller businesses. We adopt this exception in response to comments that we received,[389] and in recognition of the fact that smaller businesses, many of which may be located away from major business centers, could suffer particular hardships if we do not provide some exception.[390]

We chose a $200 million threshold for various reasons. From the available data, the $200 million threshold appears to provide a line below which not only are the companies themselves smaller, but the accounting firms that audit them also tend to be smaller.[391]

Commenters distinguished the situation in which the auditor supplements an audit client's internal audit function from the situation in which the auditor supplants the client's internal audit function. They suggested that an auditor should not be permitted to provide all of the internal audit services required by an audit client but should be allowed to provide a limited amount of internal audit services without impairing the auditor's independence.[392] For example, Ray J. Groves, former Chairman and Chief Executive Officer of Ernst & Young, said that "limited amounts in specific areas of internal out-sourcing make a lot of sense, as opposed to complete out-sourcing, as long as the audit client maintains their own independent internal audit function with capable management and people within it."[393] These comments in large part reflect the current AICPA rule on internal audit outsourcing,[394] which, as explained by a senior official of the AICPA, "prohibit[s] the complete outsourcing."[395] In response to these comments and in recognition of the AICPA rule, our final rule, with respect to registrants with $200 million or more in assets, allows auditors to perform up to forty percent of an audit client's internal audit work.[396]

Several commenters expressed concern about the effect of the proposed rule on small businesses that have no internal audit department or staff. They noted that smaller firms may not have sufficient need for full-time internal auditors but nonetheless, may need some services that internal auditors typically provide, which they obtain from their external auditors. According to these commenters, we should encourage this practice. Unless these companies can turn to their external auditors, they state, the work will not be done at all. Because we agree that small businesses should be encouraged to use internal audit services, the final rule allows auditors to provide an unlimited amount of internal audit services to clients with less than $200 million in assets, provided certain conditions are met.

In addition, the final rule does not restrict internal audit services regarding operational internal audits unrelated to the internal accounting controls, financial systems, or financial statements. This is because our focus is on services that affect the integrity of financial statements and reported financial information.[397]

Under all circumstances in which an auditor performs any internal audit services for an audit client, including with respect to companies with assets under $200 million, the auditor must comply with the six conditions listed in paragraph (B) to avoid an impairment of independence. Four of the six conditions are drawn from a ruling published in 1996 by the Ethics Committee of the AICPA.[398] It states that AICPA members may provide certain internal audit outsourcing services to audit clients without impairing their independence, so long as, among other things, (i) the client designates a competent member of management to be responsible for the internal audit function, (ii) management determines the scope, risk, and frequency of internal audit activities, including those to be performed by the auditor, (iii) management evaluates the findings and results arising from the internal audit activities, including those performed by the auditor, and (iv) management evaluates the adequacy of the audit procedures performed and the findings resulting from performance of those procedures. In addition, consistent with a later ruling by the AICPA, the final rule requires that (v) the audit client acknowledges its responsibility to establish and maintain a system of internal accounting controls in compliance with Section 13(b)(2) of the Securities Exchange Act, and (vi) that management not rely on the auditor's work as the primary basis for determining the adequacy of its internal controls.[399]

In the Proposing Release we noted that we were inclined not to follow the AICPA rule on internal audit outsourcing because we believed that, in providing such services, the auditor assumed a management function and, in the course of the audit, would have to review his or her own work. As discussed above, however, we have been persuaded that the auditor can perform a limited amount of an audit client's internal audit function without supplanting management's role or auditing its own work. In addition, we have been persuaded that encouraging internal audit outsourcing at small businesses is wise public policy. We have, accordingly, determined to allow the limited relationships described above under the conditions recommended and used at this time by the AICPA.

(vi) Management Functions

Current Rule 2-01 of Regulation S-X and the AICPA's rules preclude accountants from acting as management.[400] We are adopting Rule 2-01(c)(4)(vi) as proposed, which provides that an accountant's independence is impaired with respect to an audit client for which the accountant acts, temporarily or permanently, as a director, officer, or employee or performs any decision-making, supervisory, or ongoing monitoring functions.

(vii) Human Resources

Under current SECPS rules, accountants cannot perform certain executive recruiting and human resource services for audit clients.[401] Specifically, under those rules, an accountant's independence would be impaired if the accountant: (a) searches for or seeks out prospective candidates for managerial, executive or director positions with audit clients;[402] (b) engages in psychological testing, or other formal testing or evaluation programs;[403] (c) undertakes reference checks of prospective candidates for executive or director positions with audit clients;[404] (d) acts as a negotiator on the audit client's behalf, such as in determining position, status or title, compensation, fringe benefits, or other conditions of employment;[405] or (e) recommends, or advises an audit client to hire, a specific candidate for a specific job.[406] Those rules do not, however, preclude an accountant from, upon request of the audit client, interviewing candidates and advising an audit client on the candidate's competence for financial, accounting, administrative or control positions.[407]

Excessive involvement in human resource selection or development places the auditor in the position of having an interest in the success of the employees that the auditor has selected, tested, or evaluated. Accordingly, an auditor may be reluctant to suggest that those employees failed to perform their jobs appropriately because doing so would require the auditor to acknowledge shortcomings in its human resource service.

Commenters were concerned that our proposed language expanded upon the limitations in the AICPA and SECPS rules.[408] For example, commenters expressed concern that the proposed rule would prohibit an accountant from advising an audit committee on the competence of a prospective controller or CFO.[409] Commenters also were concerned that the proposed rule limited accountants from providing tax-related services related to structuring compensation packages.[410] We agree that an objective evaluation by the accountant of a candidate's competency for an accounting or financial position may be useful to some, particularly smaller, companies and that the impact of this evaluation is reduced by the proscription that the accountant may not recommend that the audit client hire a particular candidate. We also believe that an accountant should not negotiate regarding the contents of a compensation package the accountant has designed. Accordingly, in light of the comments received, we have modified the final rule, and final Rule 2-01(c)(4)(vii) more closely parallels the SECPS rules.

(viii) Broker-Dealer Services

Current Rule 2-01 states that an accountant's independence is impaired if the accountant is connected with the audit client as an underwriter or promoter.[411] The Codification further states that concurrent engagement as a broker-dealer is incompatible with the practice of public accounting.[412] Rule 2-01(c)(4)(viii) combines these provisions with certain provisions from the AICPA rules.[413] As adopted, the amendments state that an accountant's independence will be impaired if the accountant acts as a broker-dealer, promoter, or underwriter on behalf of an audit client, makes investment decisions on behalf of the audit client or otherwise has discretionary authority over an audit client's investments, executes a transaction to buy or sell an audit client's investment, or has custody of assets of the audit client, such as taking temporary possession of securities purchased by the audit client. As noted in our existing standards, activities such as recommending securities, soliciting customers, and executing orders create a mutuality of interest and the potential for self-review.

Although our intention was to codify current restrictions, commenters believed that our proposal went further.[414] In particular, commenters were concerned that by including the term "investment adviser" we were precluding accountants from providing certain investment advisory or personal financial planning services that they currently provide.[415] In response to these concerns, we have removed the term "investment adviser" from the rule text.

Current AICPA rules specify investment advisory services that accountants may provide to audit clients without impairing their independence. Under these rules, accountants can recommend the allocation of funds that an audit client should invest in various asset classes, based on the client's risk tolerance and other factors; provide a comparative analysis of the client's investments to third-party benchmarks; review the manner in which the audit client's portfolio is being managed by investment account managers; and transmit a client's investment selection to a broker-dealer, provided that the client has made the investment decision and has authorized the broker-dealer to execute the transaction.[416] Accountants may continue to provide those services without impairing their independence.

Current AICPA rules also specify investment advisory services accountants may not provide to audit clients without impairing their independence. The final rule incorporates these restrictions. Accordingly, as under the AICPA's rules,[417] auditors cannot make investment decisions for audit clients or exercise discretionary trading authority over an audit client's account, cannot execute transactions for audit clients, and cannot take custody of an audit client's assets. Providing such services creates a mutuality of interest and may result in the auditor having to audit the value of investments that the auditor made for the client.

The Codification states that "[t]he functions customarily performed [by a broker-dealer] include the recommendation of securities, the solicitation of customers and the execution of orders, any one of which could involve securities transactions of clients either as issuer or investor and provide third parties with sufficient reason to question the accountant's ability to be impartial and objective."[418] Because these activities continue to be encompassed within the meaning of "broker-dealer" under the rule we are adopting, and therefore, when performed on behalf of an audit client, impair an auditor's independence, we have eliminated the language "in any capacity recommending the purchase or sale of an audit client's securities" from the rule text.

By restricting broker-dealer services to those provided "on behalf of the audit client," we do not mean to suggest that an auditor can recommend an audit client's securities to either another audit client or a non-audit client.[419] The language "on behalf of" the audit client encompasses all situations in which the auditor is directly or indirectly compensated for the recommendation.

The final rule, however, will not alter current guidance as to the corporate finance consulting services auditors provide to audit and non-audit clients.[420] For example, accountants, without impairing their independence, may advise audit clients in need of capital that one alternative is to do a public offering of their securities. Also, the staff has indicated that limited activities on the part of the auditor by way of general explanatory work and limited fact finding (such as identifying and introducing an audit client to potential merger partners that meet specified criteria) would not impair an auditor's independence. An auditor's independence would be impaired, however, by entering into preliminary or other negotiations on behalf of an audit client, by promoting the client to potential buyers, or "with respect to subsequent audits of a client if the accountant renders advice as to whether, or at what price a transaction should be entered into."[421] These interpretations of former Rule 2-01(b) apply equally to the amended rule we adopt today. To the extent an auditor is otherwise permitted to provide services to a non-audit client concerning corporate financing transactions to which an audit client is a party, the permissibility of those services does not turn on whether the advice involves transactions in which the consideration provided by an audit client to the non-audit client is in the form of an audit client's securities, as opposed to cash or other assets.

Commenters expressed concern that, because the terms "securities professional" and "analyst" are not defined in the securities laws, they would cause confusion.[422] To avoid any such confusion and to limit concerns about overbroad application of those terms, we have eliminated those terms from the rule text. We note, however, that broker-dealers provide an array of services that may include analyst activities.

Finally, we have not included in the final rule the prohibition relating to designing broker-dealer or investment adviser compliance systems. We have eliminated this provision to conform the rule to current law.

(ix) Legal Services

For the reasons set forth in the Proposing Release, we believe that there is a fundamental conflict between the role of an independent auditor and that of an attorney. The auditor's charge is to examine objectively and report, regardless of the impact on the client, while the attorney's fundamental duty is to advance the client's interests.[423] As discussed in the Proposing Release at greater length,[424] existing regulations,[425] the U.S. Supreme Court,[426] and professional legal organizations[427] have deemed it inconsistent with the concept of auditor independence for an accountant to provide legal services to an audit client. Accordingly, we are adopting the proposed rule as to legal services with a few modifications. Final Rule 2-01 (c)(4)(ix) provides that an accountant is not independent of an audit client if the accountant provides any service to an audit client under circumstances in which the person providing the service must be admitted to practice before the courts of a U. S. jurisdiction.

We understand that some firms, largely through their foreign affiliates, are providing legal services outside of the United States. Moreover, we understand[428] that lawyers affiliated with foreign affiliates of U. S. accounting firms on occasion provide legal services in the United States where they are not required to be admitted to a bar in the United States. The final rule does not address these practices, where local law does not preclude such services and the services relate to matters that are not material to the consolidated financial statements of an SEC registrant or are routine and ministerial. We note, however, that it is clear to us that legal services provided outside the United States raise serious independence concerns under circumstances other than those meeting at least those minimum criteria.

We solicited comment on whether our proposed rule on legal services created uncertainty or complexity since the prohibition focused on the jurisdiction in which the legal services were provided. Commenters stated that indeed the rule should be revised because U.S. attorneys can, under various circumstances, render legal services in jurisdictions where they are not licensed to practice law. For example, when an attorney is not licensed to practice law in a particular jurisdiction, he or she can apply to a court pro hac vice to be able to appear before the court for purposes of the case.[429] Accordingly, we modified the rule so that an accountant's ability to render legal services no longer depends on his or her being licensed in the jurisdiction where the services are rendered, but rather on whether, under the circumstances, the provider of the services must be admitted to practice before the courts of a U.S. jurisdiction.

Some commenters suggested that safeguards, such as firewalls, could prevent or cure any independence problem that might arise by virtue of an accountant providing legal services to an audit client.[430] Recently, the Commission on Multidisciplinary Practice of the ABA considered whether firewalls would address sufficiently issues that might arise if a law firm were to provide both legal and other services.[431] That Commission rejected the firewall approach, stating "[We] explicitly recognize[] the[] incompatibility [of legal and audit services]. [We] do not believe that a single entity should be allowed to provide legal and audit services to the same client."[432] In light of current regulations and the ABA Report, we have determined not to adopt a firewall approach.

(x) Expert Services

We are not adopting the proposal to restrict the provision of expert services. The proposed rule would have provided that an accountant's independence is impaired as to an audit client if the accountant renders or supports expert opinions for the audit client or an affiliate of the audit client in legal, administrative, or regulatory filings or proceedings ("expert services"). Commenters said that our proposals went beyond current rules.[433] For example, AICPA Ethics Standards permit accountants to serve as expert witnesses.[434]

Commenters argued that accountants may need to act as experts in defending work they have done for audit clients before such bodies as the Internal Revenue Service, and indeed, this Commission.[435] As stated in the Proposing Release, we did not intend for our proposals to prohibit an auditor from testifying as a fact witness to its audit work for a particular client. In those instances, the auditor is merely providing a factual account of what he or she observed and the judgments he or she made. Nevertheless, to avoid confusion and any uncertainty that might be created by permitting the accountant to testify in one capacity but not another, we have determined not to adopt a restriction on expert services. When an accountant performs such services, however, he or she should be particularly mindful of his or her duty to maintain objectivity and integrity, as discussed in the AICPA Ethics Regulations.[436]

c. Alternative Approaches to Scope of Services Restrictions

As discussed in the Proposing Release, we considered a number of alternatives concerning scope of services. We solicited public comment on each alternative. After considering the comments received, we have determined not to adopt any of the alternatives proposed.

For the reasons discussed above, we have not adopted a disclosure-only approach or a complete ban on auditors' provision to audit clients of non-audit services. In addition, as discussed above, we welcome and encourage active oversight by audit committees with respect to auditor independence, but do not believe that such oversight obviates the need for the rule we adopt today. In this regard, it is our statutory responsibility to protect the public interest.

We are persuaded that relying on a firewalls approach is also unworkable. Under a firewalls approach, there would be a strict separation between those professionals in the accounting firm who perform audit work for an audit client and those who provide non-audit services for the client. GAAS, however, under certain circumstances requires that auditors seek out a registrant's consultants in the course of an audit to discuss work performed by the consultant.[437] Accordingly, a strict firewalls approach would conflict with GAAS requirements.

5. Contingent Fees

We proposed to restrict the receipt of contingent fees from audit clients, and we continue to believe that contingent fee arrangements result in the auditor having a mutual interest with the client. For example, if an accounting firm arranged to receive an audit fee of $200,000, but half of that fee was contingent on the audit client successfully completing an initial public offering within the following year, the auditor would have a mutual interest with the audit client in the success of the planned IPO and in the continuing viability of the audit client. Consequently, we are adopting a restriction on contingent fees. In response to comments,[438] however, we modified the rules to parallel more closely the existing restrictions.[439]

Final Rule 2-01(c)(5) defines a contingent fee as any fee established for the performance of any service pursuant to an arrangement in which no fee will be charged unless a specified finding or result is attained, or in which the amount of the fee is otherwise dependent upon the finding or result of such service. Contingent fees include commissions and similar payments. Consistent with the AICPA rules, our definition of "contingent fees" contains an exception for fees fixed by courts or other public authorities, or, in tax matters, fees determined based on the results of judicial proceedings or the findings of governmental agencies. We have added the AICPA's exception for fees, in tax matters, determined based on the results of judicial proceedings or the findings of governmental agencies. This exception is based, in part, on the position that when the fee is determined not by the parties but by courts or government agencies acting in the public interest, it is less likely that such fees will be used to create a mutual financial interest between the auditor and audit client. This exception also acknowledges that, as explained above, tax services generally do not create the same independence risks as other non-audit services.

In response to comments, we have eliminated from the rule text the language regarding "value added" fees. Some commenters represented that accounting firms sometimes receive fees where the client determines at the end of the engagement whether the services rendered warrant an additional fee, but there is no agreement (written or otherwise) for the audit client to pay the additional fee. In these situations, the client, at its complete discretion, determines at the end of the performance period that the accountant provided services that had greater value than the amount due under the contract. That type of "value added" fee is not within the scope of the prohibition.[440]

On the other hand, the staff will look closely to determine whether a fee labeled a "value added" fee is in fact a contingent fee, such as where there are side letters or other evidence that ties the fee to the success of the services rendered. For example, as discussed in the Proposing Release, an auditor might undertake a study of certain types of a client's expenditures in order to identify greater amounts of qualifying expenses that would result in greater income tax credits. Fees for such services might be based on a percentage of the tax credits generated, a base fee plus a percentage of tax credits generated over a pre-determined base amount, or a base fee plus a "value added" amount to be added to the base fee. In that case, the accounting firm's economic benefit will be greater if the tax credits are maximized. Because this interest (in the economic benefit) is inconsistent with acting independently in assessing the accuracy of the impact on the income tax accounts and financial statements of the tax credits, those kinds of fee arrangements are prohibited under the final rule.

E. Quality Control Provisions

We recognize that situations may arise where an accountant's independence becomes impaired inadvertently, such as where a family member makes an investment of which the covered person is not aware. Paragraph (d) addresses those situations. We are adopting a limited exception pursuant to which inadvertent violations of these rules by covered persons will not make the accounting firm not independent if the accounting firm maintains certain quality controls and satisfies other conditions. The effect of this provision is that an accounting firm that has appropriate quality controls will not be deemed to lack independence when an accountant did not know of the circumstances giving rise to the impairment and, upon discovery, the impairment is quickly resolved.

As we explained in the Proposing Release, strong quality controls deter, detect, and provide a means to address impairments of an auditor's independence. Our staff has stated repeatedly that it is concerned that firms, particularly larger firms, may lack appropriate worldwide quality controls.[441] The staff has urged certain firms to review and modernize existing procedures.[442]

Many firms have designed and implemented quality controls or are doing so now. In that regard, several commenters wrote that because firms already have quality control procedures in place, there is no need for this provision.[443] Other commenters supported the provision and asked us to adopt it.[444] We are adopting this limited exception to the general principle that attributes to an entire firm independence impairments of individual accountants. We proposed such a limited exception in the belief that adequate quality controls would limit the occasions in which the exception would come into play. Without such a requirement, we fear that the incidence of individual violations would be much greater.

Paragraph (d) provides that an accounting firm's independence will not be impaired solely because a covered person in the firm is not independent, as long as three conditions are met. First, the covered person must not have known of the circumstances giving rise to the lack of independence. The proposed rule provided that to take advantage of the exception, the firm must show that the covered person did not know, and was "reasonable in not knowing," of the circumstances giving rise to the impairment. One commenter suggested eliminating this language because, once a firm implements a quality control system envisioned in the rule (with automated tracking of investments, ongoing training, and inspections and monitoring programs), a person may never be deemed to be "reasonable" in not knowing the circumstances giving rise to an impairment, and the exception would never be available.[445] Accordingly, we have revised the first condition to apply when the covered person did not know of the circumstances giving rise to the impairment.

The second condition is that the covered person's lack of independence was corrected as promptly as possible under the relevant circumstances after the covered person, or the firm, became aware of it. Several commenters suggested adding the phrase "under the relevant circumstances."[446] We agree that this change is appropriate because whether an action is "prompt" depends, at least in part, on the surrounding circumstances. In light of this change, however, we also have revised this provision so that the lack of independence must be corrected as promptly as possible under the relevant circumstances.

The third condition is that the accounting firm must have a quality control system in place that provides "reasonable assurance" that the firm and its employees do not lack independence. As we stated in the Proposing Release, we believe that a quality control system is the first line of defense to guard against independence impairments. We understand that accounting firms vary greatly. The rule we are adopting, as proposed, explicitly states that the quality control provisions may take into account the size and nature of the firm's practice.

In the Proposing Release, we stated that a firm's quality controls should apply to the firm and its affiliates worldwide,[447] and we solicited comment about whether a firm's quality controls should be this comprehensive. We received useful comments about the applicability of this provision to foreign affiliates.[448] Because we have eliminated the definition of affiliate of the accounting firm, however, we have modified the third provision to state that the quality controls must cover at least all employees and associated entities of the accounting firm participating in the engagement, including employees and associated entities located abroad. While we do not necessarily expect a firm making use of the limited exception to demonstrate that it has implemented appropriate quality control systems in each of its offices worldwide, the rule requires that, to avail itself of the limited exception, the firm must have quality control systems that cover each employee and associated entity participating in the engagement for which independence was impaired.

Several commenters stated that while it is appropriate for the Commission to examine whether a firm or a covered person is independent, we should not prescribe quality controls.[449] The rule does not require any firm to adopt quality controls.[450] Rather, for the reasons stated above, it makes adequate quality controls a prerequisite for a limited exception where the firm otherwise would be deemed not independent.

Rule 2-01(d)(4) describes the elements of a quality control system that large accounting firms - those with more than 500 SEC registrants as audit, review, or attest clients - must have in place to qualify for the limited exception.[451] Many of the elements are set forth in a 1999 letter from the staff to the SECPS.[452] While the rule as adopted requires only the larger firms to implement these elements to qualify for the limited exception, we note that some of these elements may be suitable for other firms as well. We discuss the elements below.

1. Written Independence Policies and Procedures

The largest firms' independence policies and procedures must be reduced to writing. As we stated in the Proposing Release, we expect the policies and procedures to be comprehensive, to cover all professionals in the accounting firm, and to address all aspects of independence, including financial, employment, and business relationships, as well as fee arrangements.

2. Automated Systems

Large firms must have automated systems to identify investments that may impair independence. In our proposal, this provision applied to all employees in the firm. Commenters stated, however, that it may not be necessary for the automated quality control system to include the financial investments of persons below the managerial level. Commenters also stated that it may be difficult to establish a system to identify all financial relationships that might impair independence.[453] These commenters suggested revising the provision for an automated tracking system to apply only to partners and managerial employees, while adding a provision providing for timely dissemination of information about its current list of audit clients to all professionals.[454] We agree with these commenters that non-managerial employees have less control over the audit process and, therefore, need not be included in the automated system. However, to meet this limited exception, a firm's quality control system must provide reasonable assurance that nonpartners and managerial employees are complying with the applicable independence rules. We also have clarified the scope of the required automated system, by changing the words "financial relationships" to "investments in securities." Accordingly, an automated system would not need to track covered persons' "other financial interests," such as brokerage and credit card accounts, to qualify for this limited exception. We also note that, for purposes of monitoring compliance with our rule on "material" indirect investments, an automated system need not track covered persons' net worth to determine if an indirect investment is material to that person. Nonetheless, such a system must provide some means of identifying indirect investments that might impair independence under the material indirect investment rule.

3. Timely Information

In light of the changes made to the requirement for automated systems, we added a provision that applies to all professionals. The quality controls of a large firm taking advantage of the limited exception must include a system that provides timely information about the entities from which the accountant must be independent. We expect that this system, for example, would contain current and accurate information about audit, review, and attest clients of the accounting firm and the affiliates of those audit clients. All professionals should be able quickly to determine whether an investment they are about to make may cause the independence of the firm to be impaired.

4. Training

Large firm quality controls also must include annual or ongoing firm-wide training about auditor independence, and we are adopting this provision as proposed. Each professional in a large accounting firm should be able to demonstrate competence with respect to professional standards, legal requirements, and firm policies and procedures.

5. Internal Inspection and Testing

For a large firm to qualify for the limited exception, its quality controls must include an internal inspection and testing program to monitor adherence to the independence requirements of the profession, standard setters, and other regulatory bodies. This would entail procedures to audit, on a test basis, information submitted by employees and partners and information in a client investment database. Firms also should monitor the investments of the firms themselves and their pension and retirement plans, and any business arrangements with their audit clients.

6. Notice of Names of Senior Management Responsible for Independence

We also proposed to require, with respect to large firms, that all firm members, officers, directors, and employees be notified of the name and title of the member of senior management responsible for compliance with the independence requirements. We are adopting this provision as proposed.

7. Prompt Reporting of Employment Negotiations

The quality control system of a large firm must contain written policies and procedures to require firm professionals to report promptly to the firm as soon as they begin employment negotiations with an audit client. The firm also should have appropriate procedures to remove immediately such a professional from an audit client's engagement and review the professional's work related to that audit client. In addition, we believe such engagements should be selected for peer review. As proposed, this provision would have applied to all firm professionals. Commenters, however, suggested that the provision should apply only to partners and covered persons.[455] Because of the number of professionals employed by the larger firms, and because we are most concerned with individuals who may affect the audit, we have revised this provision to apply only to partners and covered persons.

8. Disciplinary Mechanism

As we proposed, the quality control system of a large firm also must have a disciplinary mechanism to ensure compliance. One commenter stated that a disciplinary mechanism may only promote compliance, but cannot ensure it.[456] Although no system can guarantee 100% compliance in all circumstances, a firm's quality controls should be designed and implemented to ensure compliance, not merely to promote it. We are, therefore, adopting this language as proposed.

Several commenters noted that firms operating overseas may be prohibited from requesting certain information based on local restrictions on information gathering, or they may be required to amend an employee's employment contract before doing so.[457] We are sensitive to these concerns and we have responded, in part, by providing for a long transition period for accountants operating abroad, as discussed below. In any event, the SECPS has required member firms to implement quality controls, including many of these provisions.[458] If a firm is unable to apply its quality controls to offices outside the U.S., it may be unable to take advantage of the limited exception we are adopting.

F. Transition and Grandfathering

1. Transition

a. Appraisal or Valuation Services or Fairness Opinions, and Internal Audit Services

We proposed that, for the two years following the effective date of Rule 2-01, providing to an audit client certain non-audit services identified in the rule would not impair the accountant's independence if the services were provided under an existing contract and performing the services would not impair the accountant's independence under existing requirements. As discussed above, we modified eight of the non-audit service provisions proposed to parallel or draw from current independence requirements regarding these services. Because the restrictions embodied in these provisions now more closely parallel current restrictions, we assume that accountants currently comply with them.

With respect to appraisal or valuation services or fairness opinions and internal audit services, however, we are providing for a longer transition because the new rule extends beyond current restrictions. Final Rule 2-01 (e)(1)(i) provides that an accountant's independence will not be impaired if the accountant continues for up to eighteen months to provide to an audit client these services, so long as the services did not impair the accountant's independence under pre-existing independence requirements.

We recognize that adoption of these and other provisions might require a registrant to decide between continuing to engage its auditing firm to audit its financial statements and continuing to engage that firm to provide certain non-audit services. It may not be feasible for the registrant and the auditor to cease all ongoing or scheduled non-audit engagements immediately. The company may need time to find a new provider of those services, to complete works in progress, and to provide for a smooth transition from one provider of services to another. Consequently, with respect to the two identified non-audit services, the final rule provides for an eighteen-month transition.

Under the transition provision proposed, accounting firms could not have entered into any new non-audit service contracts with their audit clients without impairing their independence. In response to commenters' concerns that the viability of these lines of business could be called into question if they were prohibited from entering into new contracts, we modified the provision to allow firms the flexibility to make business decisions over the next eighteen months that, in light of the new rule, are appropriate for their firms.

Final Rule 2-01(e)(1)(i), however, requires performance on any contracts inconsistent with the non-audit service provisions to be completed within eighteen months of the effective date of the final rule. To the extent that work on current contracts and contracts entered into within eighteen months of the effective date cannot be completed before the non-audit service provisions of the final rule take effect, accountants must take whatever steps are necessary to ensure that, at the end of the eighteen-month transition period, they are not providing any non-audit services inconsistent with final Rule 2-01.

b. Other Financial Interests and Employment Relationships

Rule 2-01(e)(1)(ii) provides for a three-month transition for certain of the financial interest rules (paragraph (c)(1)(ii)) and all of the employment provisions (paragraph (c)(2)) in the final rule. We are providing a transition period for these provisions because Rule 2-01 modestly expands current restrictions on certain accounting firm personnel in these areas. Because accounting firms may, therefore, need time to educate their employees and provide guidance on the new rule, we are providing a transition period of three months after the effective date of the rule.

c. Quality Control Systems

As discussed at length above, accounting firms can take advantage of the limited exception to the independence requirements provided by paragraph (d) of the rule, if they have in place a quality control system that, based on several factors, "provides reasonable assurance" that the firm and its employees do not lack independence. Under Rule 2-01(d)(4), the quality control systems of accounting firms that provide audit, review or attest services to more than 500 SEC registrants will not be considered to provide reasonable assurance of independence, unless the systems have certain characteristics. We are providing a transition provision that applies to the implementation date for the specific elements of a quality control system as described in paragraph (d)(4) of the rule.

Recently adopted SECPS provisions require quality controls substantially similar to those described in paragraph (d)(4).[459] Because these SECPS requirements are effective December 31, 2000, which precedes the effective date for the Commission's final rule, no transition date for paragraph (d)(4) is necessary for domestic accounting firms. By the date that this rule becomes effective, SECPS member firms should have appropriate quality control systems in place.

In the Proposing Release, however, we noted that foreign offices, or foreign "associated" or "sister" firms, of domestic firms may require additional time to develop and implement quality control systems that satisfy the requirements of paragraph (d)(4). We solicited comment on whether foreign offices, accordingly, should be afforded a transition period to phase in the quality control systems necessary to take advantage of the limited exception provided by the rule. Some commenters suggested that because establishing and implementing quality controls to apply worldwide would be difficult, we should provide for a long transition period.[460] In response to these comments, we determined to give accounting firms' foreign offices until December 31, 2002 to implement the quality controls described by the final rule.

We believe that investors in our capital markets should have the right to expect that the same quality controls over a firm's adherence to the independence requirements apply irrespective of where the audit, or where parts of the audit, take place. The two-year transition period strikes a reasonable balance between the need for improved quality control systems by all offices participating in an audit and the practical problems inherent in implementing these controls abroad.

As a result of this transition provision, before January 1, 2003, if a domestic firm with more than 500 SEC registrants as audit clients seeks to avail itself of the limited exception in paragraph (d), it must have a quality control system that complies with paragraph (d)(4) and any foreign office of the firm (or foreign associated or sister firm) participating in the audit of that company must have a system that provides reasonable assurance of independence, as required by paragraph (d)(3). After December 31, 2002, the foreign office (or foreign associated or sister firm) also must comply with the requirements in paragraph (d)(4).

2. Grandfathering

The rule provisions related to loans, insurance products, and employment relationships take effect three months after the effective date of the rule. Under the new rule, absent a grandfathering provision, a limited number of accountants or their family members might have been required, for example, to refinance a mortgage loan with an audit client or to leave their current employment with an audit client, in order for the auditor to remain independent. Because we would expect it to be more problematic in some cases for auditors and their family members to refinance a loan or to obtain a replacement insurance policy than, for example, for them to obtain a new credit card (from a non-audit client), we have grandfathered these relationships in Rule 2-01(e)(2), provided that these relationships do not impair independence under existing requirements. The AICPA similarly grandfathered certain loans that auditors and their family members had with audit clients when it revised its independence requirements related to loans in November 1991.[461] Accordingly, under the final rule, auditors and their relatives should not have to alter their loan agreements, change insurance policy providers, or require family members to find different employment for the accountant to maintain his or her independence.

Likewise, we have grandfathered contracts for the provision of financial information systems design and implementation in existence on the effective date of the rule. The information technology rule we adopt today imposes five conditions on these services, but we believe it would be unfair to require auditors providing these services to their audit clients under existing contracts to satisfy these conditions. We do not, however, believe that the conditions are so onerous as to warrant a transition period for new contracts. Accordingly, we are grandfathering contracts that are in place on the effective date of the rule, but requiring all contracts entered after the effective date of the rule to meet the conditions imposed by Rule 2-01(c)(4)(ii)(B).

3. Settling Financial Arrangements with Former Professionals

As discussed above, under Rule 2-01(c)(2)(iii), an accounting firm will not be considered independent of an audit client if a former employee of the firm has an "accounting role or financial reporting oversight role" at the audit client and the firm and the former employee have a financial arrangement that does not satisfy the requirements set forth by Rule 2-01(c)(2)(iii). Rule 2-01(e)(3) provides that, notwithstanding Rule 2-01(c)(2)(iii), an accounting firm will not lose its independence with respect to an audit client if the former employee with whom it maintains a financial arrangement inconsistent with Rule 2-01(c)(2)(iii) assumed an accounting or financial reporting oversight role at the audit client prior to the effective date of this rule. With respect to former firm employees who join an audit client in such a role after the effective date of this rule, however, the firm must ensure that the requirements of paragraph (c)(2)(iii) are met in order to maintain its independence with respect to the audit client. We are including this provision, which essentially grandfathers existing employment relationships between former audit firm employees and audit clients, because our intention was not to require former firm employees who are currently in accounting or financial reporting oversight roles at audit clients to leave their positions to preserve the accounting firm's independence.

G. Proxy Disclosure Requirement

We proposed to require disclosure of certain information regarding, among other things, non-audit services provided by the registrant's auditor to the registrant. We solicited comment on whether the proposed disclosures would be useful to investors. As noted above, most commenters addressing the issue supported a disclosure requirement, though several raised concerns with elements of the proposal.[462] We believe that with the disclosures we are adopting, investors will be better able to evaluate the independence of the auditors of the companies in which they invest.[463] Accordingly, we are requiring companies to provide certain disclosures, but we have modified the proposed disclosure requirement as discussed below.[464] Our disclosure requirement has three components: (1) disclosure regarding fees billed for services rendered by the principal accountant; (2) disclosure regarding whether the audit committee considered the compatibility of the non-audit services the company received from its auditor and the independence of the auditor; and (3) disclosure regarding the employment of leased personnel in connection with the audit.

1. Disclosure of Fees

The final proxy disclosure rule, like the proposal, requires registrants to aggregate and disclose the fee paid for the annual audit and for the review of the company's financial statements included in the company's Forms 10-Q or 10-QSB for the most recent fiscal year.[465] In light of the other modifications described below, we are requiring this fee disclosure under a caption entitled "Audit Fees."

We proposed to require registrants to describe each professional service, other than audit services, provided by their principal accountants during the most recent fiscal year, and to disclose the fee for each of these professional services; however, under the proposed disclosures, a registrant would not have had to describe the service or disclose the fee if the fee for the service was less than the lesser of $50,000 or ten percent of its audit fee. We solicited comment on the scope of this proposed disclosure. Several commenters believed that this proposed disclosure was too detailed. At least one commenter worried that the detailed disclosure requirement could place registrants at a competitive disadvantage when, for example, they disclose that the audit firm was retained to conduct due diligence in connection with a possible acquisition.[466] Other commenters suggested that a simpler disclosure, focused on the aggregate amount of non-audit and audit services provided to a company by its auditor, would be more useful to investors.[467] We were persuaded by these arguments and, accordingly, we are adopting a more limited disclosure requirement.

Under the final rule, we are not requiring registrants to describe each professional service or to disclose the fee for each service. Instead, we are requiring that registrants disclose under the caption, "Financial Information Systems Design and Implementation Fees," the aggregate fees billed for services of the type described in final Rule 2-01(c)(4)(ii)(B)(information technology services)[468] rendered by the registrant's principal accountant during the most recent year, and, under the caption "All Other Fees," the fees billed for all other non-audit services, including fees for tax-related services, rendered by the principal accountant during the most recent year.

Although some commenters suggested that we require disclosure only of the aggregate fees billed by the principal accountant for audit and for non-audit services, we are, in essence, requiring registrants to break non-audit services into two categories - one category focused on information technology services and one category encompassing all other non-audit services. As discussed above, our concern with information technology services relates both to the relative size of non-audit fees to audit fees and the value of the services themselves.[469] Our two-pronged approach responds to both of these concerns.

We are also requiring disclosure of fees billed for non-audit services, other than information technology services, rendered by the principal accountant in the last fiscal year. While we proposed to require disclosure of fees for each service as discussed above, we have determined to require only disclosure of aggregate fees billed for non-audit services, excluding information technology services. As noted above, commenters generally favored more simple disclosure, believing it is more useful to investors. In requiring disclosure of aggregate fees, we are adopting a disclosure requirement that is similar to the disclosure that the United Kingdom has required since 1989. As discussed in the Proposing Release, since 1989, the

British government has required companies to disclose their annual audit fee and fees paid to their auditor for non-audit services.[470] "The [British] government believes that the publication of the existence of, and extent of, non-audit consultancy services provided to audit clients will enable shareholders, investors, and other parties to judge for themselves whether auditor independence is likely to be jeopardized."[471]

Some have argued that disclosure should be our sole response to auditor independence issues and that we should adopt no additional rules, noting that this is the regulatory scheme in the U.K.[472] As we discussed above, we have determined to adopt a two-pronged approach -- disclosure plus restrictions on the provision of certain non-audit services. The U.K. disclosure rules are just one piece of a larger regime in the U.K. to address auditor independence issues. The self-regulatory authority in the U.K. has a majority of public members and generally exercises broad examination authority.[473] An "independent practice inspection unit" sends inspectors to the 20 largest accounting firms (who audit ninety percent of the companies listed on the London FTSE) every year to examine the accounting firms for independence issues.[474] The differences in the U.K. and U.S. regulatory schemes and self-regulatory approaches highlight the need for our two-pronged approach -- disclosure plus restrictions on the provision of certain non-audit services.

We requested comment on whether, in the case of investment companies, the rule should extend beyond the registrant to require the disclosures as to all entities in the investment company complex. One commenter suggested that applying the proxy disclosure requirements to the investment company complex would be of limited utility to investors, particularly where the adviser's parent company is an entity, such as a bank, broker-dealer or insurance company whose operations are completely separate from the investment adviser and the registrant. The commenter suggested requiring disclosure only of the aggregate fees billed for information technology services and other non-audit services provided to certain other service providers in the investment company complex.[475]

We recognize that it could be confusing to provide investors with disclosure concerning audit and non-audit services for all entities (including all the funds) within the investment company complex. We believe, however, that the ability to compare the registrant's audit fee with the aggregate fees billed for non-audit services provided to all the entities that operate an investment company would be useful for investors in evaluating the independence of the investment company's auditor. Because the adviser plays an integral role in managing and overseeing the investment company, we believe the fees billed for non-audit services provided to a fund's adviser are relevant and should be disclosed. In addition, various service providers to the investment company are in a control relationship with the adviser. We believe that investors should be informed of the aggregate amount of the registrant's audit fee and the fees billed for information technology services and other non-audit services provided by the independent principal accountant to these service providers.

As a result, the proxy rules require investment companies to disclose a fund's audit fee and the aggregate fees billed for information technology and other non-audit services provided by the registrant's auditors to the registrant, its adviser, and entities in a control relationship with the adviser that provide services to the registrant. This approach will provide investors with pertinent information about the relationship between the fund's auditor and other entities in the investment company complex.

2. Audit Committee Disclosure

As discussed above, audit committees play an important role in overseeing the financial reporting process and the auditor's independence. We proposed to require that companies disclose in their proxy statements whether, before each disclosed non-audit service was rendered, the company's audit committee approved, and considered the effect on independence of, such service provided by the company's principal accountant. Several commenters encouraged us to wait until the full effects of recently enacted audit committee reforms are known, in particular the effects of ISB Standard No. 1, the new exchange listing rules, and our recent audit committee disclosure rules. However, we think that the disclosure requirements that we are adopting will complement those initiatives by encouraging audit committees to focus particular attention on scope of services issues.

We have modified the proposed disclosure to require disclosure only of whether the audit committee considered whether the principal accountant's provision of the information technology services and other non-audit services to the registrant is compatible with maintaining the principal accountant's independence.[476] In light of the recommendations adopted by the O'Malley Panel and the other audit committee reforms,[477] we believe that companies will be providing useful information to investors under the modified requirement. Investors will be aided by knowing whether the company's audit committee considered whether the provision of non-audit services by the company's principal accountant is compatible with maintaining the accountant's independence. We are requiring issuers to disclose only whether the audit committee considered whether the principal accountant's provision of non-audit services is compatible with maintaining the principal accountant's independence. We are not requiring issuers to disclose the conclusions of the audit committee deliberations. Accordingly, we see little possibility of private liability arising from these disclosures.

3. Leased Employees

Under the final amendments, a company will have to disclose, if greater than fifty percent of the hours expended on the audit engagement, the percentage of hours expended by personnel the principal auditor leased or otherwise acquired from another entity. This disclosure requirement responds to a recent trend by some accounting firms to sell their non-audit practices to financial services companies. Often in these transactions, the partners and employees become employees of the financial services firm. The accounting firm then leases assets, namely professional auditors, back from those companies to complete audit engagements. In such an arrangement, audit professionals become full- or part-time employees of the financial services company, but work on audit engagements for their former accounting firm. They receive compensation from the financial services firm and, in some situations, from the accounting firm, as well.[478] We believe that investors should be informed of arrangements whereby most of the auditors who work on an audit are employed elsewhere.[479]

4. Proxy Statement

Finally, under the final rules, companies must provide the disclosures we are requiring in their proxy and information statements. We solicited comment on whether the disclosure should instead be required in the Form 10-K. Some commenters said that the disclosure should be made in the Form 10-K,[480] with some commenters expressing concern that the proxy statement will become overloaded with information. Other commenters expressed a preference for the disclosure to be in proxy statements.[481] We have determined that the proxy statement is the appropriate place for the disclosure since shareholders often vote on whether to select or ratify the selection of the auditors.[482] Companies must provide the disclosure only in the proxy statement relating to an annual meeting of shareholders at which directors are to be elected (or special meeting or written consents in lieu of such meeting). This disclosure is not required for companies reporting solely under Section 15(d) of the Exchange Act[483] since they are not subject to our proxy rules. Similarly, this disclosure will not be required to be provided by foreign private issuers[484] since they have different corporate governance regimes and are not subject to our proxy rules.

Companies must comply with the new proxy and information statement disclosure requirements for all proxy and information statements filed with us after the effective date.

H. Definitions

As we proposed, we are including definitions of some of the key terms used in Rule 2-01 in paragraph (f) of the Rule. In this section of the release, we provide a more detailed explanation of those defined terms not discussed in the preceding sections. We have made clear in the rule we adopt that paragraph (f) provides definitions only for the purposes of Rule 2-01 and not for other sections of Regulation S-X.

1. "Accountant"

We are adopting, as proposed, Rule 2-01(f)(1) that defines the term "accountant." The rules are written in terms of an accountant's independence from the audit client. The definition of "accountant" includes the accounting firm in which the auditor practices. The definition makes clear that an individual accountant's lack of independence may be attributed to the firm.

2. "Accounting Firm"

We are adopting the definition of "accounting firm" in Rule 2-01(f)(2) with two modifications from the version proposed. As adopted, "accounting firm" means "an organization (whether it is a sole proprietorship, incorporated association, partnership, corporation, limited liability company, limited liability partnership, or other legal entity) that is engaged in the practice of public accounting and furnishes reports or other documents filed with the Commission or otherwise prepared under the securities laws, and all of the organization's departments, divisions, parents, subsidiaries, and associated entities, including those located outside of the United States." The definition also expressly includes "the organization's pension, retirement, investment or similar plans."

The first modification is solely to clarify the definition. We have simplified the description of what public accounting firms are covered under our rule by referring only to those that "furnish reports or other documents filed with the Commission or otherwise prepared under the securities laws." We believe that this description captures the accounting firms subject to our independence requirements. No substantive change from the rule as proposed is intended.

The second change is more significant. As proposed, the definition of "accounting firm" included "affiliate of the accounting firm." The term "affiliate of the accounting firm" was separately defined to include a broad group of entities that are either financially tied to or otherwise associated with the accounting firm enough to warrant being treated like the accounting firm for purposes of our independence requirements. Specifically, we defined as an "affiliate of the accounting firm" any person controlling, controlled by, or under common control with the firm, shareholders of more than five percent of the firm's voting securities, and entities five percent or more of whose securities are owned by the firm. The proposed rule also included any officer, director, partner, or co-partner of any of the foregoing.

We also proposed defining as affiliates of the accounting firm certain entities that are business partners of the accounting firm. In general, these included certain (i) joint ventures in which the accounting firm participates, (ii) entities that provide non-audit services to the accounting firm's audit clients and with which the accounting firm has certain financial interests or relationships, and (iii) entities involved in "leasing" professional services to the accounting firm for their audits. The proposed definition also included all other entities with which the accounting firm is publicly associated in certain ways.

The definition we proposed also attributed to the auditor actions and interests of certain entities involved in joint ventures or partnerships with the accounting firm in which the parties agree to share revenues, ownership interests, appreciation, or certain other economic benefits. It also expressly included any entity that provides non-audit services to an audit client, if the accounting firm has an equity interest in, shares revenues with, loans money to, or if any covered person has certain direct business relationships with, the consulting entity, as well as persons "co-branding" or using the same (or substantially the same) name or logo as the accounting firm, cross-selling services with the accounting firm, or co-managing with the accounting firm.

Finally, the proposed definition of "affiliate of the accounting firm" addressed the situation where full- or part-time employees of an entity other than the firm signing the audit report perform a majority of the audit engagement. The proposal provided that if an auditor "leases" personnel from an entity to perform audit procedures or prepare reports to be filed with the Commission, and the "leased" personnel perform a majority of the hours worked on the engagement, then the actions and interests of the "lessor," and certain persons at the lessor are attributed to the audit firm.

Our proposed definition of "affiliate of the accounting firm" proved to be one of the most controversial aspects of our proposed rule. Many commenters believed that the definition was overbroad and expressed concern over the application of the proposed definition to their business arrangements. The largest accounting firms were concerned that the definition, as a practical matter, would inappropriately restrict their ability to enter into certain types of business relationships, including joint ventures and co-branding arrangements.[485] One of the so-called "middle tier" accounting firms expressed concern that the proposed definition would reach the "alliance" it has arranged with other accounting firms and service providers across the country.[486] Many commenters repeated the AICPA's comment that the definition was "overbroad."[487] Some commenters suggested an alternative, much narrower definition that defined affiliates of the accounting firm as entities that control, are controlled by, or are under common control with the accounting firm.[488] Some firms acknowledged that, at least with respect to the provision of non-audit services, a test based on significant influence may be appropriate.

In light of these comments and after careful consideration, we have decided not to adopt the definition of "affiliate of the accounting firm" we proposed. The issue of what entities other than the legal entity issuing reports or other documents filed with the Commission should be treated as the accounting firm is of relatively recent origin. In recent years, accounting firms have explored new "alternative practice structures" and increasingly entered into new business arrangements with entities not engaged in public accounting. To date, our staff has dealt with these questions by interpreting the existing rules. Our staff's approach has been to analyze these situations in light of all relevant facts and circumstances.[489] We proposed a comprehensive definition that described all the relevant facts and circumstances that might lead us to conclude that a separate legal entity was sufficiently associated with the accounting firm to warrant applying the Commission's independence requirements to that entity. In light of the comments received, we are persuaded that the rule as proposed could have unintended consequences, and that varying criteria of affiliation could be appropriate depending on the regulatory context in which the issue of attribution arises.

Accordingly, we have eliminated the proposed definition of "affiliate of the accounting firm" from the rule we adopt and replaced the phrase "and affiliates of the accounting firm" in the proposed definition of "accounting firm" with "and associated entities, including those located outside of the United States."[490] We intend this phrase to reflect our staff's current practice of addressing these questions in light of all relevant facts and circumstances, looking to the factors identified in our staff's previous guidance on this subject.[491] While the rules we adopt do not provide accounting firms with the certainty of our proposed rule, we are convinced that a more flexible approach is warranted as the types and nature of accounting firms' business arrangements continue to develop.

3. "Affiliate of the Audit Client"

We are adopting a modified definition of "affiliate of the audit client." As proposed, Rule 2-01(f)(4) defined "affiliate of the audit client" as any entity that has "significant influence" over the audit client, or any entity over which the audit client has significant influence. The definition was intended to cover both "upstream" and "downstream" affiliates of the audit client, including the audit client's corporate parent and subsidiary.

We received a number of comments expressing concern about our proposed definition of "affiliate of the audit client." Some members of the accounting profession felt that our proposed definition was overbroad and would require the auditor to maintain independence from entities far removed from the audit client.[492] Some commenters suggested that we should use the "control" test currently found in Rule 1-02 of Regulation S-X to define an affiliate of an audit client. At least one commenter suggested that our proposed definition should be limited to only those affiliates that are "material" to the audit client.[493]

After considering these comments, we have decided to modify substantially our proposed rule. Under the rule we adopt today, entities, if not part of an investment company complex, will be considered affiliates of the audit client if they satisfy the criteria of one of three paragraphs of Rule 2-01(f)(4). First, under paragraph (4)(i), which is based on the control definition currently in Rule 1-02 of Regulation S-X, an entity is an affiliate of the audit client when the entity controls, is controlled by, or is under common control with the audit client. Second, paragraph (4)(ii) defines as an affiliate of the audit client any entity over which the audit client has significant influence, unless that entity is not material to the audit client. Third, paragraph (4)(iii) includes those entities that have significant influence over the audit client, unless the audit client is not material to that entity.

Paragraph (4)(i) now makes clear that entities in a control relationship with the audit client, regardless of materiality considerations, are affiliates of the audit client for independence purposes. This includes the audit client's parent and subsidiaries and is consistent with current Rule 2-01(b). We are not convinced, however, that a control test alone captures all situations in which an entity is sufficiently related to the audit client to require it to be treated as the audit client's affiliate for independence purposes. Our Codification currently considers entities affiliates of the audit client in a number of situations in which control is not present.[494] As under our proposal, we continue to believe that a significant influence test sets a proper baseline threshold for audit client affiliation because, under the equity method of accounting,[495] it results in the marriage of financial information between the audit client and the entity influenced by, or influencing, the financial or operating policies of the audit client. As urged by commenters, however, the addition of the materiality threshold to the significant influence test should avoid undue hardships to accounting firms in situations where their audit clients have numerous affiliates that are immaterial to them.

As in our proposed rule, we continue to use the term "significant influence" in the definition to refer to the principles in APB No. 18. Some commenters suggested that, since the term "significant influence" is not defined in the rules, it would be difficult to apply.[496] Many other commenters, however, did not object to the term or express any uncertainty as to the term's meaning. Given the concept's familiarity to the accounting profession and its use in the profession's independence requirements, we have decided to retain its use without providing an explicit definition in the rules we adopt.

We use the term "significant influence" as it is used in APB No. 18. It recognizes that "significant influence" can be exercised in several ways: representation on the board of directors; participation in key policy decisions; material inter-company transactions; interchange of personnel; or other means. APB No. 18 also recognizes that an important consideration is the extent of the equity investment, particularly in relation to the concentration of other investments. In order to provide a reasonable degree of uniformity in application of this standard, the Board concluded that,

[A]n investment (direct or indirect) of 20% or more of the voting stock of an investee should lead to a presumption that in the absence of evidence to the contrary an investor has the ability to exercise significant influence over an investee. Conversely, an investment of less than 20% of the voting stock of an investee should lead to a presumption that an investor does not have the ability to exercise significant influence unless such ability can be demonstrated.[497]

In addition, we have added a new section to the definition of "affiliate of an audit client" to deal specifically with affiliation questions in mutual fund complexes. Paragraph (4)(iv) provides that when the audit client is part of an investment company complex, each entity in the investment company complex is an "affiliate of the audit client." In this respect, we are following the ISB's Standard No. 2, "Certain Independence Implications of Audits of Mutual Funds and Related Entities."[498]

While this provision was not in our proposed definition of "affiliate of the audit client," it was clearly embodied in our proposed Rule 2-01(c)(1)(ii)(G), which provided, "When the audit client is an entity that is part of an investment company complex, the accountant must be independent of each entity in the investment company complex." As we explained in the Proposing Release, this provision was meant to reflect the standard of ISB Standard No. 2. We pointed out in the Proposing Release that this provision applied to auditor-audit client relationships other than financial interests, and sought comment on whether it should be limited in any context other than financial interests. At least one commenter analyzed our proposed Rule 2-01(c)(1)(ii)(G) as an extension of the definition of "affiliate of the audit client."[499]

While some commenters suggested that we limit this principle through a restriction on the scope of the "investment company complex" definition, few commenters disagreed with the ISB's basic conclusion that the unique structure of mutual fund complexes warrants special rules of affiliation. After considering the comments on this issue, we have decided to adopt this provision substantively as proposed, but to move it to the definition of "affiliate of the audit client" to make its purpose and effect clearer.

4. "Audit and Professional Engagement Period"

We have adopted the definition of "audit and professional engagement period" in Rule 2-01(f)(5), as proposed, with one modification. As defined, the "audit and professional engagement period" is "[t]he period covered by any financial statements being audited or reviewed (the `audit period'); and the period of the engagement to audit or review the audit client's financial statements or to prepare a report filed with the Commission (the `professional engagement period')."

The definition specifies that the professional engagement period begins when the accountant either signs an initial engagement letter (or other agreement to review or audit a client's financial statements) or begins review, audit, or attest procedures, whichever is earlier,[500] and that the professional engagement period ends when the client or accountant notifies the Commission that the client is no longer that accountant's audit client.[501] Some commenters asserted that the professional engagement period should begin when the accountant begins its procedures.[502] Commenters expressed concern that "time will be needed for covered persons and their family members to unwind financial interests or employment relationships."[503] We believe that our rule, as adopted, provides an appropriate amount of flexibility and certainty to the auditor because both signing the initial engagement letter and beginning the audit procedures are entirely within the control of the accountant. An accountant may orally agree to an engagement and then simply delay signing an engagement letter or beginning procedures so as to toll the start of its professional engagement period.

With regard to the termination of the professional engagement period, we note that the current rules of the SECPS require an auditor to notify the Commission in writing that an SEC registrant who was a former client is no longer a client.[504] Similarly, a domestic registrant has an obligation to report changes in its independent auditor on Form 8-K. While no corollary requirement applies to foreign private issuers, there is certainly no prohibition against either such an issuer or its auditor providing us with a private notification that would suffice to end the professional engagement period for purposes of our independence assessment, should this be an issue for the accountant or the registrant.

In response to concerns of commenters,[505] we are providing a limited exception in the definition that applies to foreign private issuers who are offering or listing securities in the United States for the first time. For auditors of those foreign private issuers who previously were not required to, and did not, file any registration statement or report with the Commission, the "audit and professional engagement period" does not include periods ended prior to the beginning of the last fiscal year ended before the issuer first filed or was required to file a registration statement or report with us, provided that the company has fully complied with home country independence standards in those prior periods.

5. "Audit Client"

Rule 2-01(f)(6) defines "audit client." We have defined this term as the entity whose financial statements or other information is being audited, reviewed, or attested. We believe this is how "audit client" commonly is used, and we are adopting this as part of the definition. Use of this definition, of course, in no way changes our position that the auditor "owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public."[506]

We have made one change to the definition. Commenters suggested adding affiliate of the audit client, defined above, to the definition of audit client for the sake of simplicity, and we have done so.[507] The definition of audit client, for purposes of paragraph (c)(1)(i) (investments in audit clients), however, does not include entities that are affiliates of the audit client by virtue of paragraph (f)(4)(ii) or paragraph (f)(4)(iii), which define an affiliate in terms of significant influence. As discussed more fully above, if an entity is an affiliate of the audit client because of a "significant influence" relationship, it is covered by the rules relating to material indirect investments and investments in non-client entities under (c)(1)(i)(D) and (c)(1)(i)(E), and it is not necessary, therefore, to include it in the definition of audit client.

6. "Audit Engagement Team"

Rule 2-01(f)(7) defines the term "audit engagement team." The "audit engagement team" includes the people in the accounting firm who are most directly in a position to influence the audit. Members of the "audit engagement team" are included within the category of "covered persons in the firm," which is the term used to indicate the persons in the firm subject to a number of the specific provisions of paragraph (c) of Rule 2-01.

The "audit engagement team" includes "all partners, principals, shareholders, and professional employees participating in an audit, review, or attestation engagement of an audit client, including those conducting concurring or second partner reviews, and all persons who consult with others on the audit engagement team during the audit, review, or attestation engagement regarding technical or industry-specific issues, transactions, or events."

Commenters who addressed this definition generally agreed that persons in a position to influence the audit, such as the audit engagement team, should be covered persons for purposes of the rule's restrictions on certain relationships with audit clients.[508] We have adopted the definition with only one variation from the proposed definition. The proposed definition included the phrase "all persons who consult, formally or informally, with others . . . ." In the final rule, we have deleted the phrase "formally or informally," to avoid unintended overbreadth. Rather, we use the term "consult" to refer to meaningful discussions related to the audit.

7. "Chain of Command"

Rule 2-01(f)(8) defines the term "chain of command." This term is defined to refer to the group of people in the accounting firm who, while not directly on the audit engagement team, are capable of influencing the audit process either through their oversight of the audit itself or through their influence over the members of the audit engagement team. Like the "audit engagement team," persons in the "chain of command" are included as "covered persons in the firm," and therefore are subject to a number of the provisions in paragraph (c) of Rule 2-01.

Based on the input of commenters, we have modified this definition somewhat from the proposed definition. Commenters stated that our definition included too broad a range of persons, capturing people, such as managers who could "influence the . . . compensation of any member of the audit engagement team," whose connection to the audit is too tenuous to reasonably conclude that they have the ability to influence the audit.[509]

We are persuaded that the proposed definition was broader than necessary, and we have accordingly sharpened its focus and tried to eliminate any ambiguity. As defined in the final rule, "chain of command" includes all persons who (i) supervise or have direct management responsibility for the audit, including at all successively senior levels through the accounting firm's chief executive; (ii) evaluate the performance or recommend the compensation of the audit engagement partner; or (iii) provide quality control or other oversight of the audit."

8. "Close Family Members"

We are adopting, as proposed, Rule 2-01(f)(9) that defines "close family members." Close family members is defined to mean a person's spouse, spousal equivalent, parent, dependent, nondependent child, and sibling.

These terms should be understood in terms of contemporary family relationships. Accordingly, "spouse" means a husband or wife, whether by marriage or under common law; "spousal equivalent" means a cohabitant occupying a relationship generally equivalent to that of a spouse; "parent" means any biological, adoptive, or step-parent; "dependent" means any person who received more than half of his or her support for the most recent calendar year from the relevant covered person; "child" means any person recognized by law as a child or step-child; and "sibling" means any person who has the same mother or father.

"Close family members" includes the persons separately defined as "immediate family members" (spouse, spousal equivalent, and dependent), and adds certain family members who may, as a general matter, be thought to have less regular, but not necessarily less close, contact with the covered person in question (parent, nondependent child, and sibling). We distinguish the two groups, in part, because the less immediate the family relationship to the covered person, the more substantial that family member's relationship to the audit client should be before we deem it to impair the auditor's independence. Commenters, in general, raised few issues with the proposed definition of "close family members" and, therefore, we are adopting this definition as proposed.

9. "Covered Persons in the Firm"

Rule 2-01(f)(11) defines the term "covered persons in the firm." The term includes four basic groups. The first two groups, the "audit engagement team" and the "chain of command," are described above. Their inclusion in the category of "covered persons in the firm" is unchanged from the proposed rule.

We have modified the description of the third category of covered persons from our proposal. The proposed rule referred to "any other partner, principal, shareholder, or professional employee of the accounting firm who is, or during the audit client's most recent fiscal year was, involved in providing any professional service to the audit client or an affiliate of the audit client." We included this category because the auditing literature, quite appropriately, directs the audit engagement team to discuss certain matters with the firm personnel responsible for providing such services to that client.[510]

In response to concerns raised by commenters,[511] we have modified the definition of this category of covered persons in two respects. First, we have changed the term "professional employee" to "managerial employee," to encompass a somewhat narrower scope of persons. Second, we have set a minimum hour threshold that must be crossed before an individual becomes a covered person by virtue of providing a non-audit service to an audit client. This subpart of the definition now includes only those individuals who have "provided ten or more hours of non-audit services to the audit client for the period beginning on the date such services are provided and ending on the date the accounting firm signs the report on the financial statements for the fiscal year during which those services are provided, or who expects to provide ten or more hours of non-audit services to the audit client on a recurring basis."

In this definition, the phrase "beginning on the date such services are provided" refers to the date on which the individual provides his or her tenth hour of non-audit service to a particular audit client within the space of a single fiscal year of that client. For example, if the client's fiscal year runs from January 1 to December 31, and an individual provides eight hours of non-audit services on February 1 and two hours of non-audit services on June 1, then the period described above would commence following the provision of the services on June 1. From that date through the date that the accounting firm signs the report on the financial statements for that fiscal year, that individual is a "covered person in the firm." We reiterate: the individual's status as a covered person does not end at the conclusion of the fiscal year in question, but continues until the firm has signed the report for the financial statements for that fiscal year.

The proposed rule described the fourth category of covered persons as "any other partner, principal, or shareholder from an `office' of the accounting firm that participates in a significant portion of the audit." We included these people on the theory that they are the ones most likely to interact with the audit engagement team on substantive matters and may exert influence over the audit engagement team by virtue of their physical proximity to, or relatively frequent contact with, the audit engagement team.

In response to concerns raised by commenters about the breadth of the category, particularly the inclusion of every "office" that participates in a "significant portion" of the audit,[512] we have modified this definition. The final rule narrows the scope of the definition to "any other partner, principal, or shareholder from an `office' of the accounting firm in which the lead audit engagement partner primarily practices in connection with the audit." We are persuaded that it is reasonable to draw the line at partners, principals, and shareholders, rather than at all "professional employees," and that it is also more reasonable and more practicable to draw a clear line at the "office"[513] of the firm in which the lead engagement partner primarily practices.

A person who is not a covered person at the time an audit engagement begins might nonetheless become a covered person at any time during the audit engagement. As soon as events or circumstances bring a person within any category of covered person defined above, that person is a "covered person in the firm." An individual must be independent of the audit client, pursuant to the provisions of the rule, before becoming a covered person in the firm. That means, for example, that an individual must dispose of any financial interest in the audit client completely and irrevocably before being consulted by another covered person concerning the audit engagement. For example, the rule does not allow the person consulted to participate in a discussion about the audit engagement and then "cure" an independence impairment by later disposing of an investment. Likewise, a person who becomes a covered person by rotating onto an engagement or being promoted into the chain of command must be independent pursuant to the provisions of the rule prior to becoming a covered person.

One commenter suggested that the definition of "covered persons in the firm" should include leased accounting personnel.[514] We note that to the extent leased personnel otherwise fall within any category of "covered persons in the firm," such as by being on the audit engagement team, they will be covered persons in the firm.[515]

Because the rule narrows the scope of firm personnel to whom investment and employment restrictions apply, an accounting firm employee in a distant part of the world, or even down the street, might own an audit client's securities, have a family member in a financial position at the client, or enter into a business relationship with a client without necessarily impairing the firm's independence from the audit client. We expect that many partners and employees who previously could not own securities issued by an audit client will be able to do so under the rule.

It should be noted that insider trading restrictions prohibit any partner, principal, shareholder, or employee of the firm, whether or not he or she performs any service for the client, from trading on the basis of any material nonpublic information about that client.

10. "Immediate Family Members"

We are adopting, as proposed, final Rule 2-01(f)(13), which defines "immediate family members" to mean a person's spouse, spousal equivalent, and dependents. These terms have the same meaning as they do in the definition of "close family members."

"Immediate family members" is a narrower group than "close family members." Again, we believe that the less immediate the family relationship to the covered person, the more substantial that family member's relationship to the audit client should be before we deem it to impair independence. By identifying "immediate family members," we are identifying those persons who have such regular and close contact with a "covered person" that it is fair, for independence purposes, to attribute to the covered person any financial and employment relationships that family member has with the audit client.

We received a few comments on the definition of "immediate family members." Some commenters agreed that the definition should not include emancipated adult children, while others expressed concern that non-dependent children were not included in this group.[516] On balance, we believe that, for purposes of these rules, emancipated children are sufficiently independent of their parents to warrant not imputing their financial interests to their parents. We are, therefore, adopting the definition as proposed.

11. "Investment Company Complex"

As proposed, the definition of "investment company complex" focused on investment advisers and entities in a control relationship with the adviser, including entities under common control with the adviser. The proposed definition was loosely based on ISB Standard No. 2, which defines "mutual fund complex" to mean "[t]he mutual fund operation in its entirety, including all the funds, plus the sponsor, its ultimate parent company, and their subsidiaries."[517]

We solicited comment on the definition proposed, and, in particular, on whether an alternative definition, focusing on the fund's principal underwriter and administrator would be more appropriate. Some commenters expressed concern about the scope of the investment company complex definition, particularly that it included entities that have no direct relationship to investment company operations.[518] These commenters' concern was that all subsidiaries of an adviser's parent company would also be included in the investment company complex. Therefore, an accounting firm could not provide certain non-audit services to, or invest in, subsidiaries of the parent of the adviser, even if those subsidiaries operated businesses unrelated to the investment company business. Under the proposed definition, for example, if a parent company owned an adviser and a manufacturing company, the accountant that audited the adviser (or a fund advised by the adviser) could not invest in the manufacturing company, even though its operations would not be affected by the audit of the adviser (or the fund).

In response to these comments, we have adopted in Rule 2-01(f)(14) a definition of investment company complex that is more limited than the one proposed. As adopted, the rule only includes an entity under common control with the adviser if the entity provides services to an investment company in the investment company complex. More specifically, if a sister entity of the investment adviser, other than another investment adviser, does not provide administrative, custodian, underwriting, or transfer agent services to the adviser or a fund, it is not part of the investment company complex.

As proposed, an entity that would be an investment company but for the exclusions provided by section 3(c) of the Investment Company Act and that is advised by the investment adviser or sponsored by the sponsor is part of the investment company complex. Also, as proposed, the definition does not include sub-advisers whose role is primarily portfolio management and who provide services pursuant to a subcontract with, or are overseen by, an adviser in the complex. There was some support for excluding sub-advisers from the definition of investment company complex.[519] We have determined to exclude sub-advisers from the definition because a fund, or even its adviser, may not be able to know whether the sub-adviser obtained any non-audit services from the fund's or the adviser's auditor. Moreover, considering a sub-adviser or the funds it advises to be part of the investment company complex presents practical difficulties where the sub-adviser is itself an adviser in a separate investment company complex.

12. "Office"

Rule 2-01(f)(15) defines "office" to mean a distinct sub-group within an accounting firm, whether distinguished along geographic or practice lines. The term "office" is an integral part of the description of one category of "covered persons" and, thereby, helps identify firm personnel who cannot have financial or employment relationships with a particular audit client without impairing the firm's independence. The definition has not changed from the proposed definition.

We give "office" a meaning that does more than merely refer to a distinct physical location where the firm's personnel work. By "office" we mean to encompass any reasonably distinct sub-group within an accounting firm, whether constituted by formal organization or informal practice, where the personnel who make up the sub-group generally serve the same clients, work on the same matters, or work on the same categories of matters. In this sense, "office" may transcend physical boundaries, and it is possible that a firm may have a sub-group that constitutes an "office" even though the personnel making up that sub-group are stationed at various places around the country or the world.

At the same time, we intend for "office" also to include reference to a physical location. For this reason, "office" will generally include a distinct physical location where the firm's personnel work. We recognize, however, that in some cases thousands of firm personnel may work at a single, large physical location, but physical divisions may nonetheless effectively isolate different sub-groups of personnel from each other in ways that will warrant treating each sub-group as a separate "office" under the proposed definition.

Some commenters raised concerns about the definition of office.[520] One commenter asserted that the proposed definition is unworkable and does not provide helpful guidance.[521] This commenter expressed a preference for the ISB's approach to the concept of "office or practice unit," in the ISB's Exposure Draft on Financial Interests and Family Relationships.[522]

In some respects, the definition that we adopt overlaps with the ISB approach. Like the ISB approach, our definition will necessarily involve the application of judgment, governed by substance. And under our definition, as under the ISB approach, expected regular personnel interactions and assigned reporting channels may well be more important than an individual's physical location. We have determined to adopt the definition that we proposed, because it is unclear to us that the ISB approach would necessarily encompass each distinct sub-group that, in particular circumstances, should be encompassed.

I. Codification

As previously discussed, the Commission's current auditor independence requirements are found in various rules and interpretations. Section 600 of the Codification provides interpretations and guidance not otherwise available in Rule 2-01. The final rule articulates a number of situations and circumstances, such as financial relationships, employment relationships, and non-audit services that impair auditor independence. Accordingly, we are deleting some interpretations included in the Codification, either because they are reflected in the revised Rule 2-01 or they have been superseded, in whole or in part, by the rule. Because examples have been deleted both because they are no longer necessary and because they are inconsistent with the final rule, inferences should not be drawn from the deletion of a particular example. The revised Codification contains the discussion of the final rule from this release, as well as the background information and interpretations that may continue to be useful in situations not specifically or definitively addressed in paragraph (c). Examples of these items include business relationships, unpaid prior professional fees, indemnification by clients, and litigation.

V. Cost-Benefit Analysis

The amendments to Rule 2-01 modernize the rules for determining whether an auditor is independent in light of (i) investments by auditors or their family members in audit clients; (ii) employment relationships between auditors or their family members and audit clients; and (iii) the non-audit services provided by audit firms to their audit clients. In the Proposing Release, we identified three constituencies affected by the rule: (1) investors; (2) issuers; and (3) accounting firms that provide services affected by this release.[523] Below we discuss the costs and benefits to each of these groups. In all cases, we discuss the costs and benefits relative to the current regulatory environment.[524]

A. Costs and Benefits of the Rule Regarding Investments in and Employment Relationships with Audit Clients

The final rule clarifies, and in some cases eliminates, certain existing requirements under which an accountant's independence is impaired by investment and employment relationships between an accountant, covered persons, or their families, and an audit client. As explained above,[525] changes in business practices and demographics, including an increase in dual-career families, warrant a change in our auditor independence requirements to prevent an unnecessary restriction on the employment and investment opportunities available to auditors and members of their families. To this end, the rule amendments take a more targeted approach, focusing on those persons who are involved in or can influence an audit. In addition, the rule provides a limited exception for accounting firms under which an inadvertent violation of these rules by certain persons will not cause a firm's independence to be impaired, so long as the firm has quality controls that meet certain conditions and the impairment is resolved promptly.

1. Benefits

The elimination of certain investment and employment restrictions should benefit auditors and their families by permitting a wider range of investment and employment opportunities. According to the 1999 annual reports filed by accounting firms with the SECPS, the five largest accounting firms employ approximately 115,000 professionals. Other public accounting firms that audit SEC registrants employ an estimated 5,000 to 25,000 professional staff. The amendments we are adopting will benefit these 120,000 to 140,000 accounting firm professional employees and their families by enabling them to invest in some public companies in which, under the current rules, they cannot invest without impairing the independence of the companies' auditors. In addition, under these amendments, audit clients and their affiliates may, in certain circumstances, employ family members of some audit firm employees without impairing the auditor's independence.

Expanding the set of investment opportunities available to auditors and their family members may increase the return they can earn on their investments and improve their ability to reduce risk through diversification. Opening employment opportunities to auditors and their family members increases their freedom of choice with respect to their employment opportunities and may lead to an increase in their compensation. Consequently, the amendments have the potential to improve the pecuniary and non-pecuniary benefits of employment. These benefits may make accounting firms more appealing as a career choice, and as a result may aid the firms in their recruiting efforts.[526]

In addition, independence requirements are found in various Commission rules, Commission interpretations, staff letters and reports, and, in some cases, AICPA literature. The final rule puts this guidance in an easily accessible format that will save interested parties costs in ascertaining and complying with the rule.

Finally, the rule provides that an accounting firm's independence will not be impaired solely because a covered person inadvertently fails to comply with the independence rules if the firm has adequate independence quality controls in place. This limited exception should provide a benefit to accounting firms and their employees.

2. Costs

Modification of the investment and employment restrictions may require accounting firms, their employees, or others to incur transaction costs, such as one-time costs to modify existing systems that monitor investments and employment relationships, and training costs to prepare professional staff to understand and conform to the revised rules. With respect to the provisions regarding employment relationships and investments, the rule provides a transition period and does not cover loan contracts, insurance products, and employment relationships undertaken prior to the end of this transition period. The rule does not impose any additional costs with respect to the separations of former partners that have occurred prior to the effective date of this rule. Existing rules will apply to these partners. During the transition period, the only cost to separating partners and their firms relates to the timing of the payments made as part of the separation.[527] The new rule applies only to those that leave the firm after the new rule becomes effective. These modifications of the rule from our original proposal will reduce the costs of implementation.[528]

As discussed above, the rule does not require accounting firms to establish quality controls that conform to the rule requirements. In the case of the largest firms, the rule specifies minimum characteristics of these systems.[529] Because the limited exception is elective, any related costs will be assumed voluntarily, if at all, by accounting firms that decide that the benefits of this limited exception justify the costs of any incremental changes that are necessary to make their quality control systems meet the rule's standards.

An accounting firm that chooses to upgrade its existing quality control system to comply with the limited exception should incur only the incrementally small costs of implementing any improvements beyond what is required by GAAS and SECPS membership requirements.[530] GAAS already requires firms to have quality controls for their audit practices and refers auditors to the "Statements on Quality Control Standards" ("SQCS") for guidance regarding the elements of those systems.[531] SQCS No. 2 states that firms' controls should provide "reasonable assurance that personnel maintain independence (in fact and in appearance) in all required circumstances, perform all professional responsibilities with integrity, and maintain objectivity in discharging professional responsibilities."[532] Because foreign accounting firms providing assurance on financial statements filed with the SEC are required to adhere to GAAS, they are also subject to these same quality control standards.[533]

In addition to requirements imposed by GAAS, public accounting firms that are SECPS members must comply with independence quality control membership requirements. Further, SECPS guidelines indicate that its members are required to assist their foreign associated firms to conform to "U.S. independence requirements of the SEC and ISB, and SEC rules and regulations in areas where such rules and regulations are pertinent."[534]

Among other things, member firms with at least 7,500 professionals must implement an electronic tracking system by no later than December 31, 2000.[535] The final rule supplements the GAAS requirement for firms with more than 500 SEC registrants as audit clients by identifying procedures that should be part of their quality control systems. Because an accounting firm with 500 SEC registrants will likely also meet the SECPS' 7,500 professionals requirement, the rule is unlikely to impose a requirement for quality controls that does not already exist under GAAS and SECPS membership requirements.

In the Proposing Release, we asked for comments and data on the assessment of potential costs associated with the proposed quality control provision, but no commenter provided specific or empirical data on this issue. We expect the costs associated with the implementation of an amended quality control system to be small. Firms may choose to maintain the current restrictions if they determine that the costs of establishing the new system exceed the benefits. We nevertheless recognize that public accounting firms and their employees will require some time to familiarize themselves with, and understand, the amended rule. A one-hour review by each of the 120,000 to 140,000 public accounting professionals would result in a $3.6 million to $4.2 million one-time transition cost.[536] We include the $4.2 million in our aggregate cost estimation. Given that accounting firms currently engage in on-going training relating to auditor independence, we believe that these transition costs likely represent an over-estimation of the true cost imposed by this rule. Further, given that the firms must continue the educational process regardless of the rule, we treat this as a one-time cost.

Commenters were generally supportive of the proposals regarding employment relationships between and investments by auditors or their family members and audit clients. As discussed above, after considering the comments received, we are adopting the investment and employment rules, as modified.[537]

B. Costs and Benefits of Restricting Certain Non-Audit Services

There is increasing concern that the growth of non-audit services provided by auditors to audit clients affects auditor independence.[538] There is also concern that auditors' provision of certain non-audit services to audit clients creates a conflict of interest that also affects auditor independence. These effects on auditor independence may be costly to investors if they lead to, among other things, a decrease in the quality of financial reporting, lower investor confidence, or both. Importantly, as a result of the conflicts created by auditors' provision of non-audit services, investors may lose confidence in the quality and integrity of financial reports even if there are relatively few dramatic audit failures or restatements. Given the size of U.S. securities markets, even a small loss in investor confidence has large wealth consequences for investors.

After careful consideration of the testimony from four days of public hearings and a review of the almost 3,000 comment letters received by the Commission, we have narrowed the scope of our proposals regarding non-audit services. In the Proposing Release, we enumerated ten services that if provided by the auditor to an audit client would be considered to be, in whole or in part, incompatible with the concept of auditor independence. As discussed above, in many cases we intended our proposal to track substantially the existing independence requirements of the profession. In response to commenters' concerns that our proposals were broader than existing requirements, we have made certain modifications.[539] As a result of our modifications, the language in the adopted rule substantially mirrors or draws from existing Commission requirements or the professional guidance of the AICPA and SECPS with respect to eight non-audit services (not including internal audit services). There should, therefore, be minimal costs associated with our codification of the provisions regarding these eight services. With respect to most information systems consulting, auditors may continue to provide these services to an audit client without impairing independence, as long as certain conditions are met.

The final rule does impose new limitations on auditors' ability to provide to audit clients internal audit services without impairing independence. If the accounting firm provides both the internal and external audit, it may, in effect, be auditing its own work. In this situation, the firm cannot, in our view, provide a truly independent "second opinion." Without a truly independent second opinion, material defects in the accounting system may not be detected as quickly, if at all. Final Rule 2-01(c)(4)(iv) seeks to curb these conflicting interests without precluding companies, particularly small companies, from obtaining internal audit services from their auditors where the auditor's independence would not be compromised.

Under the final rule, accounting firms may provide all internal audit services to audit clients with assets of $200 million or less, provided certain conditions are met. In addition, accounting firms may provide up to forty percent of the internal audit services of issuers with assets in excess of $200 million, provided the same conditions are met.[540] These conditions are intended to create circumstances in which the auditor can continue to exercise objective and impartial judgment, and the audit retains its value as a "second opinion."

Relative to the Proposing Release, the $200 million threshold in the internal audit provision minimizes the aggregate costs associated with the rule without substantially reducing the benefits of greater investor confidence in audited financial statements. In addition, the $200 million threshold in the internal audit provision minimizes the impact of the provision on smaller companies and smaller accounting firms.

The available data indicate that most SEC registrants are audited by one of the largest accounting firms. sing 1999 SECPS data, we identified 16,653 registrants who filed audited company financial statements with the Commission.[541] Of those 16,653 registrants, the Big Five accounting firms audit 12,769 (76.7%) of these companies; the next three largest firms (referred to as the "second tier firms") audit 942 (5.7%); the next 20 largest accounting firms audit 730 (4.4%); and the remaining 2,212 (13.3%) companies are audited by smaller accounting firms.

In order to estimate the impact of the rule on small companies and small accounting firms, we used the Compustat Database.[542] Our analysis indicates that of the 9,414 Compustat covered companies, 4,326 (46%) have assets of $200 million or more and will be covered by the limitation, whereas 5,088 (54.1%) have assets of less than $200 million[543] and will not be covered by the rule. By excluding companies with less than $200 million in assets from application of the new limitation on these non-audit services for audit clients, the final rule permits, subject to certain conditions, large and small accounting firms to accept consulting engagements with these small companies that would otherwise be prohibited.

The Compustat Database includes 8,732 non-bank companies: 3,735 (42.8%) have assets of $200 million or more, and 4,997 (57.2%) have assets of $200 million or less. The Compustat data indicate that approximately 93.9% of non-bank companies with assets in excess of the $200 million threshold are audited by one of the Big Five accounting firms. Clients of second tier accounting firms account only for 1.3% of this group. The database specifically identifies 107 companies or 2.9% as audited by other smaller accounting firms. The remaining 71 (1.9%) large companies were not identified with an auditor in the database. If we include these 71 companies with the 107 identified as audited by smaller accounting firms, at most 4.8% of the companies with assets in excess of $200 million are audited by the smaller firms and, therefore, potentially impacted by the provision on internal audit services. Conversely, 85.7% of non-Big Five audit clients have assets below $200 million.

Current and past bank regulators expressed concern about the effect of our internal audit proposal on smaller banks serving smaller communities.[544] The $200 million threshold is designed to limit the impact of the rule to larger, national banks. The Compustat Database included 682 bank holding companies. Of these, 591 (86.7%) have assets of $200 million or more and 91 (13.3%) have assets of less than $200 million. Big Five accounting firms audit 382 (64.6%) of the large bank holding companies. The next three largest (second tier) firms audit 31 (5.2%) of the large bank holding companies. Compustat specifically identified 116 (19.6%) as audited by other accounting firms. The data source did not identify an auditor for the remaining 62 (10.5%) companies.[545] The $200 million exemption permits the 91 smaller bank holding companies, likely to serve smaller communities[546], to obtain from their auditors internal audit services. Accordingly, as adopted, the rule should not impose a substantial burden on these institutions and the communities they serve. Further, the Compustat criteria for inclusion in the database may understate the population of smaller bank holding companies.

Evidence suggests that internal audit outsourcing is provided primarily by the largest of the public accounting firms.[547] Under the adopted rule, auditors will still be able to provide internal audit services.[548] We estimate that the auditor could still provide on average as much as sixty-one percent of a company's internal audit activity, including internal audit activities not covered by the rule.[549]

The effect of the rule changes pertaining to internal audit outsourcing is to reduce the costs associated with the final rule without substantially reducing the benefits. To the extent that the final rule, taken as a whole, maintains or increases investors' confidence in the reliability of publicly available financial information, it increases the integrity of the U.S. securities markets. In the Proposing Release, we asked for comments and data on the assessment of costs associated with internal audit outsourcing and information systems consulting. While the staff garnered and analyzed data where it could, we received little data from public commenters that could be used in our analysis.[550]

1. Benefits

Benefits are expected to accrue to investors, issuers, providers of management consulting services, and public accounting firms. Benefits include:

- Greater confidence in auditor independence and increased reliability of financial statements to investors, issuers and other users;
- Centralizing and codifying of the independence rules; and
- Better operational and investment decisions.

a. Investors

For the reasons explained in this release, the Commission believes that the rule will enhance auditor independence. This should result in improved reliability, credibility, and quality of financial statements of public companies. Quality financial statements depend on subtle choices and judgments in reflecting economic events using accounting numbers. Quality financial statements also depend upon highly competent and independent auditors. Investors rely on quality financial statements in order to invest their funds effectively and efficiently. Therefore, the more confidence investors have in the independence of the auditor, the more reliance they will place on the financial statements when making investment decisions.

Several representatives of the largest institutional investors in the country testified that this rule would enhance auditor independence, bolster institutional and individual investor confidence, and benefit their plan participants.[551] One institutional investor associated poor performance with poor quality financial reporting and "a seemingly meek auditor."[552] In a similar vein, another commenter asserted that the rule will increase auditor independence and this, in turn, may reduce the incidence of fraud or lead to its more timely discovery.[553]

Some commenters suggested that there is no empirical evidence that shows that the provision of non-audit services damages investors' confidence in the independence of auditors or the accuracy of financial statements.[554] Commenters suggested that there is, therefore, no basis for our assertion that the rule will benefit investors.[555] One such commenter suggested that the rule might, in fact, decrease investor confidence. This commenter argued that investors believe that the rule may decrease the quality of audits because auditors will know less about the companies they audit.[556] However, other commenters suggested that providing consulting services does not improve the quality of audits.[557] There is also academic and survey evidence that users of financial statements believe that the provision of non-audit services may impair the auditor's independence.[558] A public opinion poll conducted by Public Opinion Strategies found that approximately eighty percent of investors favor a rule that imposes such restrictions.[559] Another survey, conducted by AIMR, reported that over sixty-two percent of responding analysts believe that providing outsourcing services would likely compromise or impair auditor judgment.[560] Brand Finance, in a survey of U.K. analysts, found that ninety-four percent of respondents believed that the current level of non-audit service fees was likely to compromise auditor independence.[561]

b. Issuers

Issuers will benefit from the proposed scope of services regulations in several respects. First, the rule will eliminate some of the uncertainties as to when a registrant's auditor will not be recognized as independent. Second, since increased investor confidence in financial reporting may encourage investment, the rule would facilitate capital formation. Issuers should be able to attract capital at lower rates of return or in some circumstances attract investment where they currently cannot raise capital.[562] Third, the rule will increase the utility of annual audits to the management of issuers.

Management of the issuer also receives benefits from the external audit. No less than other investors, managers need reliable financial information about potential investment opportunities in order to manage their firm's assets. Internally, managers need assurance of the effective functioning of the control and reporting systems that produce the information on which they base their operating decisions. While company managers may obtain the needed assurances through internal processes, including internal audit groups, the external auditor also contributes to the company managers' assurance that the company's internal control processes are functioning effectively and that financial and other data are reliable.

One commenter asserted that to the extent an issuer perceived that buying non-audit services from its auditor increased its cost of capital to such an extent that it outweighed the benefits of purchasing non-audit services, it could protect itself by limiting the amount and types of non-audit services it purchased from its auditor.[563] This argument may not fully capture the incentives of management or the issuer, however. Academic literature describes how managers' incentives can deviate from those of investors.[564] For example, a company manager may have a family or financial relationship with the auditor and may benefit from a lack of complete independence from the company's auditor. It is difficult for the company to credibly pre-commit to restricting the purchase of non-audit services from the auditor. Further, managers rely on auditors that may be unaware that they are subject to subtle biases that may affect their judgments.[565] Finally, management may be frequently marketed to by its auditor to purchase non-audit services. [566]

Although the decision of an individual company to purchase services from the auditor may be in the best interest of the company's investors, it may not be in the interest of investors in all companies as a whole. If decisions by individual company management reduce the reliability of audited financial statements as a whole, aggregate investment may be misallocated even if any individual company is acting in the best interest of its shareholders. It is unlikely that such concerns would enter into the company manager's choice of service provider even if it were a logical consequence of that choice.

Audit committees will also have more concise and clearer guidance to support their enhanced role in overseeing the management/auditor relationship. The amendments to the proxy rules require disclosure of whether the audit committee, or the board of directors if there is no such committee, considered whether the provision of non-audit services by the company's principal accountant is compatible with maintaining the principal accountant's independence. Several commenters stated that the rule enhances the ability of the audit committee to identify situations in which auditor independence may be impaired. For example, the Co-Chairman of the Blue Ribbon Committee stated that he thought that "[this rule] would help audit committees do their job better."[567] Another commenter argued that without this guidance audit committees must rely primarily on auditors to determine their own independence.[568]

c. Public Accounting Firms

The rule provides a general test for, and a list of, non-audit services that, when provided to an audit client, will impair an auditor's independence. Currently, auditor independence requirements are found in several sources, including AICPA guidance, the Codification on Financial Reporting, SECPS rules, and a variety of Commission interpretive releases and staff no-action letters. Consolidating many of these requirements into one rule is an important purpose and benefit to this rule.

Some commenters disagreed that this rule would clarify independence requirements for public accounting firms.[569] These commenters argued that the rule creates confusion and therefore increases the amount of time that accounting firms, and others, will need to spend on compliance.[570] We disagree. As discussed above, in response to comments, we have made significant modifications that clarify the rule's requirements. We realize that any rule inevitably requires some interpretation. We believe that, as modified, this rule will centralize and clarify independence requirements and thus result in increased certainty, resulting in a benefit to public accounting firms.

Some commenters have argued that no benefits at all will be created by the rule. The basic argument is that no tangible evidence exists that independence has been impaired by provision of these non-audit services to audit clients.[571] In testimony, however, several individuals recounted litigation experiences and discussed cases in which they believed that a lack of independence contributed to an audit failure and financial reporting fraud.[572]

Others have argued that economic forces provide sufficient incentives to audit firms to ensure independence.[573] According to one such commenter, auditors lose market share when their reputations are damaged, either as a result of government action or private litigation.[574]

Commenters also suggested that auditors already have strong incentives to maintain their reputations.[575] The auditor's reputation is based on the public's belief in the auditor's objectivity and competence. The actual or perceived loss of either objectivity or competence can be expected to affect negatively the auditor's ability to obtain and retain clients.[576] We also note that the SECPS mandates certain quality controls designed to support auditors' self-monitoring.[577] However, evidence suggests that these mechanisms may not be sufficient.[578] One commenter concluded, based on a model of the auditor's incentives to maintain independence, that under certain circumstances when an auditor can command sufficiently high benefits from the mix of services, audit credibility may be diminished.[579]

Some commenters have suggested that litigation acts as an incentive for the auditor to maintain independence.[580] Conversely, another commenter noted that the expected cost of an auditor's loss of independence due to litigation declined in recent years with the passage of the Private Securities Litigation Reform Act of 1995.[581]

d. Estimation of Benefits of Restricting Certain Non-Audit Services

The primary benefit of this rule is increased investor confidence in reported financial statements. This benefit is spread across all market participants and may manifest itself in changes in the investment patterns of individuals and the borrowing costs of businesses. Given the sheer magnitude of the U.S. financial system, even a small change in investor confidence manifests itself as a large aggregate benefit.

If we measure the increase in investor confidence by a decrease in the required rate of return on an investment, it would lead to increased profitability for investment opportunities. As a result, the change in investor confidence may manifest itself in a revaluation of current securities prices. Everyone in the market benefits from this change in confidence because all participants can potentially take advantage of the increased investment opportunities. All individual investors benefit from the general increase in market values while businesses benefit in reconsidering their investment opportunities within their existing budget constraints and when seeking additional capital from the market. The market revaluation will be the result of many forces, but should be greater than the change in the required rate of return on a percentage basis simply because of the mathematical relationship between cash flows, interest rates and securities values.[582]

Not all market participants may benefit equally. The extent of individual and business benefit depends upon their current resources and assets, investments and investment opportunities. It is not clear whether these conditions would reduce the aggregate economic benefit. Because we cannot observe the distribution of benefits to individuals and businesses, we assume for the purposes of this estimate that benefits accrue primarily to those affected directly by all parts of the rule. This group includes businesses (and investors in those businesses) that will benefit from the increased confidence.

To obtain an estimate of the number of individuals and businesses that may benefit, we note that, in any given year, approximately 74.3% of companies purchase only auditing services from their Big Five auditor.[583] SECPS data further indicate that consulting revenues from SEC clients amount to 22.8% of the Big Five firms' total consulting revenues. It may be reasonable, therefore, to estimate that only twenty-five percent of audit clients will be directly affected by the rule.

However, the Big Five accounting firms provide audit and consulting services to the largest companies listed on the stock exchanges. According to a 1996 GAO report, the then largest six accounting firms audited seventy-eight percent of the nation's publicly traded companies.[584] Approximately ninety percent of all companies with more than $200 million in assets are audited by one of these five firms.[585] Therefore it is likely that the proportional value of the benefits will be significantly greater than twenty-five percent.

If an increase in investor confidence generated by these rules leads to a decrease in the required rate of return, we can estimate the benefits based on the current market capitalization. For example, a decrease in the cost of capital as small as a single basis point (or one one-hundredth of one percent) would lead to an aggregate annual impact of approximately $2 billion.[586] Although increased confidence should benefit the entire market, we provide an estimate that limits the benefit to those directly affected by the rule. Even if we measure the impact on the basis of the proportion of companies that annually purchase services covered by the rule (25%), a one basis point reduction in the required rate of return would result in an annual benefit of approximately $500 million.

Benefits may also accrue to the economy in the form of more efficient contracting, improvements in operating and investing decisions by management, and greater market stability. Each of these benefits is extremely difficult to measure. We know that many parties to contracts rely on financial statement data, management relies on such data when negotiating contracts, and reliable financial data contributes to both the efficiency of contracting and the effectiveness of contract enforcement. Management needs reliable financial information when making operational and investment decisions, and external auditors contribute to management's assurance about financial information. Unexpected financial statement restatements result in large market capitalization drops. Recent examples of large unexpected financial reports restatements and resulting market capitalization losses have been reported.[587] The logical consequence of such market surprises, in addition to the redistribution of gains and losses across investors, is greater uncertainty in the market place.[588] The resulting uncertainty may dissuade investors from participating[589] or may increase the required rate of return as a means of ensuring against the uncertainty. We make no separate estimate of benefits for the above noted items.

We recognize the difficulty in obtaining direct measures of all the benefits associated with each aspect of the rule to each individual or group. Therefore, in this section, we limited our estimate to the broad economic impact on the capital markets that affects all participants.

2. Costs

Some commenters suggested that the only way to enure that the provision of certain services does not impair auditor independence is to completely prohibit the purchasing of those services from the auditor.[590] We do not believe that such a prohibition would serve the investor and issuer communities.

a. Issuers

The final rule has the effect of restricting issuers from purchasing certain non-audit services from their auditors. Most of the rule's limitations, however, are drawn from existing limitations, including the proscription on operating or supervising an audit client's information technology function. Moreover, issuers would still be allowed to obtain most other information technology services and internal audit services from their auditor provided they comply with certain conditions. The rule would have the effect, however, of preventing issuers with more than $200 million in total assets from outsourcing more than forty percent of certain of their internal audit activities to their auditor.

As some commenters noted, the rule may impose costs on some issuers.[591] Issuers that do not competitively bid non-audit services or that would have purchased these newly proscribed non-audit services solely from their auditors and that are limited by the rule will have to look to other professional services firms, including other public accounting firms, to provide these services in the future. These issuers may incur costs from the use of a separate vendor, including the possible loss of any synergistic benefits of having a single provider of both audit and non-audit services. The issuer may also incur one-time transaction costs associated with identifying and choosing another vendor to provide those services.[592] Estimation of these costs is discussed below.

Some commenters have argued that the rule will sometimes force an audit firm to choose between providing an audit or non-audit service to a public company client, and that audit firms may forego providing audit services, thereby reducing competition for both audit and non-audit services.[593] As to internal audit services, in particular, however, available evidence suggests it is unlikely that auditors will cross the threshold that would require them to choose between external audit revenues and internal audit revenues.[594] Further, it is unlikely that any individual firm has particular exclusive expertise in the internal audit function and therefore a suitable number of competitors likely exists to ensure that the issuer can obtain these services elsewhere at a reasonable cost.

b. Public Accounting Firms

Public accounting firms may individually lose a source of revenue because they will no longer be able to sell internal audit services to their audit clients. Any loss may be mitigated by the opportunity to market this service to the audit clients of other public accounting firms. As discussed above, the $200 million asset exemption reduces the impact of the rule on the Big Five and particularly on the second tier and smaller accounting firms.

Of the top three second-tier firms with fewer than 1,000 clients, one firm has stated that it does not perform internal audit outsourcing work for its public company audit clients.[595] Another firm's testimony indicates that it provides minimal proscribed non-audit services to its public audit clients.[596] Thus, it does not appear that at least two of the next three largest firms will be significantly affected by the rule.

c. Shared Costs

The rule might also affect what some contend are synergies (or "knowledge spillovers") that arise from providing non-audit services to an audit client. If they exist, spillovers may provide issuers with a more efficient audit or provide the auditor with additional knowledge that will enhance not only the concurrent audit, but other audits as well. Since synergies may benefit either or both parties to some extent, we consider them a potentially shared benefit or cost. As well, to the extent that the proposed definition of affiliate of the accounting firm or affiliate of the audit client would have reduced the market for the provision of internal audit outsourcing, we consider that here.

Some commenters have suggested that the proposed rule's definition with respect to affiliate of the accounting firm would be restrictive and impose significant costs. We have not adopted the proposed definition of an "affiliate of the accounting firm," and left in place the existing standards for determining those entities associated with a firm that should be deemed to be part of the firm for auditor independence purposes. As such, it imposes no additional cost.

Generally, research on enhanced efficiency or effectiveness of providing non-audit services to audit clients is suggestive, but indirect and inconclusive.[597] The recent sale or proposed sale of the consulting divisions of several large public accounting firms argues against significant knowledge spillovers. If efficient and effective audits require expertise most efficiently maintained through the provision of consulting services to audit clients, there is an incentive to retain consulting practices. Thus, the sale of these consulting practices would appear inconsistent with the existence of significant synergies that would be negatively affected by the rule.[598]

In the Proposing Release, we asked for comment and data on our estimates of the number of accounting firms affected by the rule and the costs imposed by the rule. We also sought comment and data specifically as to the existence and value of such synergies. We received many comments but no data. Instead, we estimate the potential costs associated with the possible loss of synergy as a percent of revenues lost from internal audit outsourcing.

We base our cost estimates on the total audit, accounting and tax revenues for fiscal 1999 for the Big Five public accounting firms.[599] This estimate is $14.9 billion. From this $14.9 billion, we estimate the total costs of the internal audit for Big Five audit clients based on the relationship between internal audit budgets and external audit fees for firms responding to the Manufacturers Alliance survey. On average, firms in this sample spent 1.7 times as much on the internal audit as they did on the external audit.[600] Therefore, we estimate the aggregate cost of internal audits for Big Five audit clients in 1999 to be $25.6 billion.

This estimate of aggregate internal audit costs is likely to overstate the true costs for two reasons. First, the aggregate revenues reported by PAR include tax and accounting services in addition to external audit fees. Second, data in the Manufacturers Alliance survey suggest that the ratio of internal to external audit fees is smaller for smaller companies.[601] In fact, for the smallest firms in their sample, external audit fees exceed the internal audit budget.

Additional information in the Manufacturers Alliance survey indicates that approximately two percent of respondents outsource more than fifty percent of their internal audit.[602] Further, analysis described earlier indicated that on average, companies with assets greater than $200 million could still purchase as much as sixty-one percent of their entire internal audit budget from their external auditor. Together, these estimates imply that at most, the restrictions will reduce internal audit outsourcing fees to the auditor by 0.8%, or $207.7 million. Finally, we apply a growth rate of twenty-one percent to these revenues to arrive at a year 2000 estimate of $251.3 million. [603]

Professor Rick Antle testified to the effect that there is little reliable evidence as to the size of potential synergies from purchasing consulting services from the audit firm, but he has provided an estimate. [604] We agree with Professor Antle's assessment of the difficulties inherent in measuring these effects. In his testimony, Professor Antle estimated that lost synergies could be on the order of ten percent of twice the gross profits before partner compensation and taxes of the consulting practice. Further, he estimates the gross profit margin to be 0.20.[605] We acknowledge that there is little empirical evidence to support this estimate, but it represents the larger of the two estimates presented by the two representatives of the accounting firms.[606] Applying those percentages to our estimate of revenues restricted by the rule results in an annual estimate of lost synergies of $10.1 million for audit clients who will be forced to reduce internal audit outsourcing services from their auditors.

In addition, the rule may impose certain transition costs to be borne by companies that currently have long-term consulting engagements with their auditors for proscribed services. A significant number of consulting engagements are short-term projects.[607] The rule allows for a transition period of eighteen months for certain non-audit services. Over this period, audit firms may continue to contract with their audit clients for the newly covered non-audit services. The firms entering into new contracts, however, will either plan to complete those services by the end of the transition period or to assign or sell those contracts to someone else before the end of the period because at the end of this period, audit firms may no longer provide the newly proscribed services to their audit clients.

In this analysis, we recognize that some companies may face transition costs associated with changing the provider of non-audit services. But, for the reasons discussed above, we believe those costs will be small in the aggregate. Thus, any company whose current contract expires during the transition period faces the same costs as any new purchaser of the services. Those contracting costs are captured above in our analysis of synergies.

By extension, only companies with contracts for the proscribed services extending beyond the transition period will be faced with any re-contracting costs imposed by the rule. We note that those re-contracting costs may be borne by the company itself or by the auditor in its attempt to sell the contract to another provider. We received no information concerning these costs from commenters. Nevertheless, we have included $1.3 million in the cost estimate.[608]

Commenters also suggested that the rule would generate a cost associated with lost effectiveness on the audit and a cost associated with recruiting and retention of staff professionals.[609] We have seen no evidence that the rule will lead to less effective audits. Our cost estimates associated with lost synergies and scope include efficiency costs, if any, associated with an increase in cost to accomplish an effective audit. The sale by certain of the Big Five firms of their consulting practices further undermines the argument that the loss of non-audit business will impair audit effectiveness.

We also are skeptical about comments that suggest that the prohibition of certain services will make the profession less attractive to potential employees,[610] and increase staff recruiting and retention costs. Some argue that less qualified individuals will have to be hired to meet personnel needs and that this will ultimately lead to less effective audits, with a resulting impact on auditing firms, issuers and investors.[611]

We do not believe that the issues of retention and recruitment are caused by this rule.[612] These problems are not new and are more systemic. Several commenters have noted that starting salaries for recent accounting graduates have failed to keep pace with other fields such as information systems, financial and treasury analysis and consulting.[613] Other commenters have stated that accounting firms have de-emphasized the audit function, treating it more like a commodity.[614] In addition, despite increases in university enrollments, interest in technical fields such as accounting, engineering, computer sciences and mathematics have been declining.[615]

C. Costs and Benefits of the Disclosure Requirements

The final rules require public companies to disclose in their proxy statements audit fees, fees for permitted information systems consulting and other fees paid to the auditor. The rule also requires public companies to disclose, when applicable, that personnel who are full- or part-time employees of an entity other than the audit firm performed more than fifty percent of the audit. In addition, the audit committee or the board of directors must state whether it has considered whether the provision of non-audit services by the auditor is compatible with maintaining auditor independence.

Many commenters argued that the provision of information systems consulting in and of itself does not impair auditors' independence.[616] This may be true where the conditions described in the rule are met. Even when these conditions are met, when the information systems consulting fees become large relative to audit fees, auditor independence may be at risk. At the same time, we understand that the level where impairment may occur may be related to other factors such as the closeness of the auditor-client relationship or the nature of the client's business and industry. Therefore, we believe that investors and audit committees are well-suited to determine when provision of these services may cause impairment.

The disclosure of fees from the provision of information systems and other non-audit services provided by a company's auditor is intended to assist investors in deciding whether these services affect the independence of the auditor. Similar disclosures have been provided in the United Kingdom for several years.[617] The disclosure regarding the use of leased personnel to perform an audit is intended to allow investors to know when personnel of an entity other than the audit firm performed a majority of the audit so that investors can consider the independence of the other entity. Under such circumstances, the independence of the other entity and its personnel may be as relevant - if not more relevant - to auditor independence than the independence of the auditor itself. As discussed above, some commenters believe disclosure alone would not be sufficient to alleviate an impairment of auditor independence.

1. Benefits

While the SECPS collects information on non-audit and audit fees from its member firms, it no longer publishes this information. Accordingly, such information is not readily available or easily accessible to the investing public. Further, this information provides a description of types of services provided by the public accounting firm for all of its clients, rather than for each audit client. The rule would provide aggregate fee information for each registrant to the market.[618]

The disclosure related to non-audit services fees received by auditors would give investors insight into the relationship between a company and its auditor. In so doing, the disclosure will reduce uncertainty about the scope of such relationships by providing facts about the magnitude of non-audit service fees. This information may help shareholders decide, among other things, how to vote their proxies in selecting or ratifying management's selection of an auditor.

The disclosure regarding the auditor's use of another entity's employees to perform a majority of the audit work also provides important information to investors. Investors need to know when a majority of the audit work is performed by persons who have financial, business, and personal interests in addition to, or different from, persons employed by the auditor. This disclosure is significant because it reveals when the "principal auditor" (the auditor performing a majority of the audit work) is an entity other than the firm signing the audit opinion.

We believe that investors benefit jointly from the prohibition of certain services and the disclosure discussed above. Investors benefit under the rule from the knowledge that the accounting firms are not providing certain services that impair their independence. They will also be able to assess the relevance of aggregate compensation to the auditor for non-audit services. To the extent that confidence arises from both the prohibition and the disclosure aspects of the rule, our estimate of annual benefits on the order of one half to two billion dollars includes both elements of the rule.

2. Costs

We believe that the disclosure rule will impose relatively minor reporting costs on issuers. Generally, information about auditor fees is readily available to registrants. ISB Standard No. 1 requires auditors to report on certain independence issues to the audit committees of their SEC audit.[619] In addition, the SECPS requires members to report annually to the audit committee, or similar body, the total fees received from the company for management advisory services during the year under audit and a description of the types of such services rendered.[620] Companies also must report the billings from their auditors as expenses and import this billing information into their systems. As a result, companies should have ready access to the information on fees paid to their auditor for non-audit services.

Disclosure of audit and non-audit fees will impose a reporting burden on all issuers subject to the proxy disclosure rules. For the purpose of the Paperwork Reduction Act, we estimated the aggregate reporting cost of $272,620 to complete the appropriate paperwork.[621] Commenters suggested that this estimate is unreasonably low.[622] Some commenters suggested that registrants would spend more time making the required disclosures. We do not agree; the disclosures can be made using information that registrants will have on hand. We also note that the scope of the required disclosure has been significantly reduced from the proposal, limiting it to only aggregate audit, IT, and other non-audit fees. For the purpose of providing an aggregate cost estimate, we consider a range of $272,620 and $1.09 million, but use only the top of this range for the total.

The rule will not impose significant burdens related to storing, analyzing and compiling data, or to training employees. Moreover, even if registrants spend more time in making the required disclosure, the marginal increase in cost will not be significant relative to the overall costs discussed in this section. Even assuming the burden is four times as great to make the disclosure, the annual cost of complying with the disclosure portion of the rule would be $1.09 million.

D. Estimated Aggregate Costs and Benefits

The elements of the total quantified cost of the rule are lost synergies for those currently purchasing proscribed services; transition costs for those currently purchasing both audit and proscribed consulting services; professional training to learn the new rules regarding employment, investment, and independence; and disclosure costs. Using assumptions and methods that tend to overstate costs, we estimate the aggregate cost to the U.S. economy to be approximately $16.6 million for the first year and $12.4 million for subsequent years.[623]

Finally, we have quantified one primary benefit of the rule as increased investor confidence that may lead to a reduction in the required rate of return. In summary the rule benefits (i) auditors and members of their families as a result of changes in restrictions on investment and employment relationships; (ii) family members of auditors as a result of changes in the restrictions on employment relationships; (iii) issuers by eliminating certain uncertainties about their auditor's independence, by increasing investor confidence and thus facilitating issuers in raising capital, and by increasing the utility of annual audits and quarterly reviews; (iv) public accounting firms by clarifying the independence rules; (v) investors who will benefit from increased confidence in the reported financial statements; and (vi) all of the market participants through more efficient contracting, improved operating and investing decisions, and greater market stability.

Even if the rule leads to only a very small change in that rate of return, the annual benefit could be in the range of one half to two billion dollars. Benefits may also accrue to the economy in the form of more efficient contracting, improvements in operating and investing decisions by management and greater market stability. Finally, relaxation of the investment and employment constraints on auditing professionals and their families may also lead to more efficient investments by these persons.

VI. Final Regulatory Flexibility Analysis

We have prepared this Final Regulatory Flexibility Act Analysis in accordance with the Regulatory Flexibility Act ("RFA").[624] This analysis relates to amendments to Rule 2-01 of Regulation S-X and to Item 9 of Schedule 14A[625] under the Exchange Act. The amendments modernize our auditor independence requirements.

The rules as adopted will not have a significant impact on a substantial number of small entities. The vast majority of public companies required under the federal securities laws to submit reports prepared by an independent accountant to the Commission are not "small" for purposes of the RFA. Moreover, as to the impact on small accounting firms, the Big Five accounting firms, which are not small entities, provide auditing services for the vast majority of public companies. The major effects of these rules, therefore, will not be on small entities. Nevertheless, we are mindful of the possible effect of our rules on small entities, and we have made certain modifications, noted below, that should reduce significantly the impact of the new rules on small entities.

A. Reasons for and Objectives of the Rule Amendments

As discussed above, the federal securities laws require registrants to file financial statements that have been audited, and reports that have been prepared, by "independent" accountants.[626] Our auditor independence requirements are found in Rule 2-01 and interpretations, which have been supplemented by staff letters, staff reports, and ethics rulings by the accounting profession. Many of the interpretations are reprinted in Section 600 of the Codification. We have not amended the fact-specific examples in the Codification since 1983. As discussed more fully above, since that time, there has been a dramatic transformation of the accounting industry. Increasingly, accounting firms are becoming multi-disciplinary service organizations and are entering into novel and complex business relationships with their audit clients. At the same time, individual accounting professionals have become more mobile, while the geographic location of personnel has become less important due to advances in telecommunications and the Internet. In addition, an increasing number of American families have two wage earners.

To protect the reliability and integrity of the financial statements of public companies and to promote investor confidence, we must ensure that our auditor independence requirements remain relevant, effective, and fair in light of the new business environment. Consequently, the rule amendments provide a general standard for determining auditor independence and identify relationships that render an accountant not independent of an audit client under the standard in Rule 2-01(b). The relationships addressed include, among others, financial and employment relationships, business relationships, and relationships where auditors provide certain non-audit services to their audit clients. We also are requiring certain public companies to disclose in their annual proxy statements information about, among other things, non-audit services provided by their auditors.

Financial and Employment Relationships. Under former requirements, an auditor's independence was impaired if any partner in the firm, any manager in an office participating in a significant portion of the audit, or certain of their relatives, had a financial interest in, or certain employment relationships with, an audit client. As explained above, these requirements may have unnecessarily restricted employment and investment opportunities for auditors and members of their families.

The amended rule targets application of these particular auditor independence rules to those who can actually influence the audit of a client. The amended rule allows audit firm partners, other professionals, and their families, more freedom in their investments and employment decisions and will allow them to take greater advantage of future opportunities in these areas. The amended rule shrinks significantly the circle of family members and former accounting firm personnel whose employment impairs an auditor's independence; the amended rule similarly reduces significantly the pool of firm personnel whose investments are imputed to the auditor. We believe that the amended rule will maximize the opportunities available to auditors while promoting the public interest and protecting investor confidence.

Non-Audit Services. We, along with certain users of financial statements, have become increasingly concerned about the effects on independence when auditors provide both audit and non-audit services to their audit clients. These concerns have been exacerbated in recent years by changes in the types of non-audit services that accounting firms provide as well as by dramatic increases in the fees, in both absolute and relative terms, for those non-audit services. As we discuss more fully above, the rapid growth of non-audit services has increased the economic incentives for the auditor to preserve a relationship with the audit client, thereby increasing the risk that the auditor will be less vigilant in its objectivity. Additionally, aggregate economic incentives aside, certain types of non-audit services by their very nature can create conflicts incompatible with objectivity. At the same time that more and more individual investors are participating in our capital markets, either directly or through mutual funds, pension plans, and retirement plans, we have seen growing public concern about the increasing importance of non-audit services to accounting firms. The amended rule identifies certain non-audit services that, if performed by an auditor for an SEC audit client, would render the accountant not independent.

Disclosure. As discussed, the types of non-audit services provided by auditors to audit clients have changed, and the fees paid for those services have increased. We are adopting a proxy statement disclosure requirement focused on the fee relationship between registrants and their auditors. Independent studies and the comments we received have shown that concerns are likely to be raised about auditor independence when the consulting fees paid by a registrant are significant when compared to the audit fees. Accordingly, the disclosure we are mandating addresses this area and will be useful to investors in evaluating auditors' independence. The amendments require registrants to disclose in their proxy statements their audit fees, fees for financial information systems design and implementation, and the fees for other non-audit services rendered by the principal accountant to the company. In addition, we are requiring companies to disclose whether their audit committees have considered whether the provision of financial information systems design and implementation services and other non-audit services provided by the company's principal accountant is compatible with maintaining the principal accountant's independence. Investors accordingly will have access to this information when making investment and voting decisions.

B. Significant Issues Raised by Public Comment

The proposals generated significant comment and broad debate. As we discussed in detail above, the final rule amendments, particularly those related to non-audit services, have been modified from the proposals in response to comment letters, written and oral testimony from four days of public hearings, academic studies, surveys, and other professional literature.

At the time we published the Proposing Release, we also prepared an Initial Regulatory Flexibility Analysis (IRFA), a summary of which was published in the Proposing Release. We requested comment on the IRFA, and we received several comments in response. Separately, many commenters representing small accounting firms expressed strong support for the proposal,[627] and other commenters representing small businesses expressed concerns about the proposal.

With respect to procedural issues related to the IRFA, one commenter questioned our procedure, arguing that we should have requested information on the number of small entities affected some time earlier and that neither the Proposing Release nor the IRFA indicates that the Small Business Administration ("SBA") reviewed or commented on the IRFA.[628] At the time that we prepared the Proposing Release, we prepared the IRFA in accordance with the RFA and made it available to the public as required by Section 603 of the RFA. We submitted the IRFA to the SBA, and the SBA had no comments on the IRFA. The same commenter questioned whether the agency assured that small entities had an opportunity to participate in the rulemaking. In addition to soliciting extensive comments in the Proposing Release and holding four days of hearings at which representatives of small accounting firms testified, we published a summary of the IRFA in the Federal Register, and many small firms commented on the proposed amendments.

C. Small Entities Subject to the Rule

For purposes of analyzing the impact on small public companies, the Commission has defined "small business" in Rule 157 under the Securities Act.[629] Rule 157 provides that "small business" means any entity whose total assets on the last day of its most recent fiscal year were five million dollars or less and is engaged, or proposes to engage, in small business financing. A registrant is considered to be engaged, or to propose to engage, in small business financing under this rule if it is conducting, or proposes to conduct, an offering of securities which does not exceed the dollar limitation prescribed by Section 3(b) of the Securities Act.[630] We estimated in the IRFA that there are approximately 2,500 Exchange Act reporting companies that are small businesses.

The Commission also has defined small business for purposes of an investment company in Rule 0-10 of the Investment Company Act.[631] This definition provides that an investment company is a "small business" if it has net assets of $50 million or less as of the end of its most recent fiscal year. In the IRFA, we estimated that approximately 227 investment companies are small businesses.

Our rules do not define "small business" or "small organization" with regard to accounting firms. The SBA, however, has defined a small business, for purposes of accounting firms, as those with under $6 million in annual revenues.[632] In the IRFA, we explained that we have limited data indicating revenues for accounting firms, and that we cannot estimate the number of firms with less than $6 million in revenues. We requested comment on the number of accounting firms with revenues under $6 million in order to determine the number of small accounting firms potentially affected by the rule amendments but received no response. We also requested comment generally on the number of small entities that may be affected by the rule amendments and received no estimates. One commenter believed that we had not identified the full range of types of and number of small entities affected or the types of impacts, but the commenter provided no further information.[633]

Several small accounting firms and small companies expressed concern about a possible derivative effect of our rule on companies that are not registered with us and on the auditors of such companies.[634] These commenters were concerned that state governments, state boards of accountancy, and others may adopt rules similar to ours without regard to whether the companies are public or private. As we explained above, the rules apply to public companies and other entities registered with the Commission or otherwise required to file audited financial statements with the Commission. In addition, the rules are not intended to alter the relationship between federal and state agencies, and they do not affect the ability of the states to adopt their own rules. Moreover, commenters pointed out that state boards have a strong independent tradition.[635] We expect that the state boards of accountancy will continue their practice of exercising independent judgment in determining the extent to which our rules should be imported into their regulatory regimes.

D. Projected Reporting, Recordkeeping, and Other Compliance Requirements

The new rules could potentially affect two primary groups - registrants and auditors. The rules could affect these two groups differently, but in neither case do we expect that the rules would result in significant reporting, recordkeeping or other compliance requirements. The possible effects of the rules on these two groups are as follows:

Investments and Family Relationships. The rule amendments regarding investments and employment relationships liberalize restrictions on investments by, and employment available to, accountants and their families without impairing the accountant's independence. We stated in the IRFA that in this sense, therefore, we are relaxing compliance requirements. One commenter noted that although we correctly state that we are relaxing certain requirements, the proposed threshold regarding a material indirect investment and the proposed definition of affiliate of the accounting firm would restrict the ability of small businesses to invest in, or enter business relationships with, other firms.[636]

We recognize these concerns, and we have revised the rules, in part, to take them into account. As described above, the rule governing a material indirect investment in an audit client is intended to carry over the existing proscription on material indirect investments in audit clients. In addition, in part because of concerns that the definition of "affiliate of the accounting firm" would have unintended consequences on alliances of small accounting firms, we have modified our approach to avoid this result.

Non-Audit Services. The IRFA discussed whether the proposed rule on non-audit services would have a significant effect on small entities. Some commenters expressed concern about the effects of the rules on small registrants that rely on the special expertise of their auditors or that lack resources to engage a second accounting firm to provide non-audit services.[637] Other commenters stated that small businesses have long-term relationships with auditors that provide non-audit services, or are located in an area with few firms able to provide such services.[638] Some small businesses in rural areas may lack the ability to perform the internal audit function on their own.[639]

We are sensitive to these concerns and we have modified the rule so that eight of the non-audit service provisions parallel or draw from current independence requirements regarding those services. We also determined not to adopt a restriction on "expert services." Accordingly, with respect to the eight non-audit services, therefore, we do not believe that the rules would have a significant effect on small businesses.

We have amended our rule regarding financial information systems design and implementation. The rule proposal would have prevented audit firms from providing some information technology consulting to their audit clients without impairing the firm's independence. The final rule singles out certain services as impairing independence and identifies other categories of such services that will not impair independence if certain conditions are met that are designed to ensure that the audit client's management retains responsibility for decision-making authority over the client's financial information systems. Accordingly, if the conditions are met, a small entity could obtain financial information systems design and implementation services.

With regard to internal audit services, we have revised the rule from what we proposed so that the internal audit restrictions do not apply to registrants with less than $200 million in assets, as long as the registrant follows certain conditions. This, of course, largely eliminates the effect of the rule amendments on small entities with respect to the auditor's provision of internal audit services to small entities. This change from the proposed rule would lower the burden on smaller businesses that are not defined as small under our rules. It also has the effect of almost completely excepting smaller accounting firms from the coverage of this provision of the rule, since the firms that audit those companies tend to be smaller. Our analysis indicates that approximately fifty-four percent of registrants have assets of less than $200 million, which, of course, would exclude all companies defined as "small businesses" for purposes of the RFA.

The IRFA also stated that we did not believe that the non-audit services provision would have a significant impact on a substantial number of small accounting firms and requested comment on the impact. Some commenters stated that the rules could harm firms that must offer both audit and non-audit services to stay in business,[640] and one commenter recommended that firms with $1 million or less in revenue be exempt.[641]

Other commenters supported the rule amendments relating to non-audit services. Some noted that rather than harming small accountants, the rules could provide smaller firms with new business opportunities to provide non-audit services to companies that previously used their auditors for these services.[642]

Although we lacked definitive data, the IRFA provided information on accounting firms that were likely to be small accounting firms, and the number of SEC clients of those firms. The majority of SEC registrants are audited by one of the Big Five firms, which are not small entities. We have data regarding the approximately 776 accounting firms with fewer than 20 SEC audit clients.[643] Accounting firms with fewer than 20 SEC audit clients tend to be smaller accounting firms, and we estimate that fewer than twenty percent of these firms provide any consulting or non-audit services to their SEC audit clients. Only ten to twelve percent of the accounting firms with two or fewer SEC audit clients provide any consulting or non-audit services to their SEC audit clients. We also estimated that the fees of the firms with 20 or fewer SEC audit clients that come from consulting and non-audit services provided to SEC audit clients average less than 7.5% of the firms' total fees for non-audit services, and less than one percent of their total fees. We estimated that small accounting firms obtain non-audit or consulting fees, on average, from less than one SEC audit client.

In addition, the change from the proposed rule discussed above-eliminating restrictions on internal audit services for registrants with less than $200 million in assets-would lower the burden on smaller accounting firms. We estimate that approximately eighty-five percent of the clients of non-Big Five firms have assets of less than $200 million.[644] Thus, as long as certain conditions are met, the rule amendments regarding internal audit services would not apply to eighty-five percent of audit clients of all but the Big Five firms.

While we understand that some small businesses may incur some costs as a result of the rule amendments, we believe that few small businesses will be affected, and that any effects will be minimal. The changes we have made in the rules as adopted should ameliorate any burden on small firms significantly. Moreover, while some small businesses may be required to engage a new firm to perform certain functions, there is no comparatively greater effect on small firms with respect to costs incurred to choose a new accounting firm. Such costs apply equally to larger registrants as to smaller registrants.

Quality Controls. The new rules establish a limited exception pursuant to which inadvertent violations of the rules by covered persons in the accounting firm will not render the firm not independent if the accounting firm maintains certain quality controls and satisfies other conditions. SECPS membership requirements and GAAS already require firms to have quality controls over their audit practices, so there should be little additional burden on accounting firms that want to take advantage of the exception.

Disclosure. The new proxy disclosure rules require all companies subject to our proxy rules to disclose information to shareholders regarding fees for audit services, fees for services related to financial information systems design and implementation, and fees for all other non-audit services. Companies also must disclose if the audit committee considered whether the provision of non-audit services by the company's principal accountant is compatible with maintaining the principal accountant's independence. These requirements would apply to small businesses that are subject to the proxy rules, which we estimate to be no more than most of the 2,500 small registrants that file periodic reports, and 227 investment companies.

The rules as proposed required, among other things, a description of each professional service provided by the principal accountant, disclosure of the fee for each, and disclosure of whether the audit committee approved the service. We have modified the disclosure requirement to eliminate the requirements that companies describe each non-audit service provided by their auditors and the fee for each such service. We believe that by making these changes, we have accommodated commenters' concerns while ensuring that investors have the information they need to make judgments about whether the registrant has an independent auditor. In addition, the information required should be readily available to the registrant because of the requirements under ISB Standard No. 1 and the rules of SECPS.[645]

E. Agency Action to Minimize Effect on Small Entities

The RFA directs us to consider significant alternatives that would accomplish the stated objectives, while minimizing any significant adverse impact on small entities. We considered several alternatives, including the following referenced in the RFA: (i) the establishment of differing compliance or reporting requirements or timetables that take into account the resources of small entities; (ii) the clarification, consolidation or simplification of compliance and reporting requirements for small entities; (iii) the use of performance rather than design standards; and (iv) an exemption from coverage of the new rules, or parts of the new rules, for small entities.

We considered each of the four alternatives, and a variety of alternatives to our provisions on non-audit services. With respect to the first alternative -- establishment of differing compliance or reporting requirements -- we stated in the IRFA that, with respect to investments and employment relationships, we believe that the impact of the rules in this area on small entities was already minimal. We did not believe, therefore, that establishing differing requirements would materially decrease the impact of the rules on small businesses, and we did not make special provisions. The IRFA discussed establishing differing standards in the area of non-audit services, and further discussed the three other alternatives contained in the RFA, mentioned above.

Regarding the provision of non-audit and consulting services by small accounting firms, we considered several approaches. As discussed above, however, we have determined that our two-pronged approach of requiring disclosure and identifying particular non-audit services that are incompatible with independence best protects the audit process. [646] In addition, because of the limited amount of non-audit services that small accounting firms provide to their SEC audit clients, we believe that the adoption of any of these approaches would not have a significant impact on a substantial number of small businesses or small accounting firms.

The second alternative -- the clarification, consolidation or simplification of compliance and reporting requirements for small entities -- is addressed below in connection with our discussion of our consideration of the fourth alternative. We have exempted small entities from certain provisions of the rules, which simplifies compliance requirements for those entities.

The third alternative mentioned above -- use of performance rather than design standards -- would be difficult, in part, to implement in this context. As to the quality controls exception we did implement such a performance standard. As to the other components of the rule changes, performance standards would not carry out the Commission's statutory mandate to ensure that registrants file financial statements and reports with us that have been certified by independent public accountants. Rather, we must identify and address influences that impair independence.

Some commenters suggested that we adopt the last alternative-an exemption from coverage of the new rules, or parts of the new rules, for small entities.[647] Other commenters suggested that our rules not apply to audits of smaller public companies, regardless of the size of the auditor. These commenters stated that small public companies may be in greater need of consulting assistance and may not be able to obtain the assistance from anyone other than their auditors.[648] We appreciate this concern and we have made certain changes to the rule.

The changes we have made recognize that, for some small companies, the company's auditor may be the only reasonably available service provider for certain services. The final rules, therefore, take into account that small firms may need internal audit services from their auditors and provide an exception for companies under $200 million in assets, subject to certain conditions. For the reasons discussed above, aside from these limited areas, we do not believe that a further exemption for small entities is appropriate.

VII. Paperwork Reduction Act

Certain of the provisions in the amendment to Item 9 of Schedule 14A contain "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995.[649] We published notice soliciting comments on the collection of information requirements in the Proposing Release and submitted these requirements to the Office of Management and Budget ("OMB") for review in accordance with 44 U.S.C. § 3507(d) and 5 CFR 1320.11. The collections of information are titled "Regulation 14A (Commission Rules 14a-1 through 14b-2 and Schedule 14A)" and "Regulation 14C (Commission Rules 14c-1 through 14c-7 and Schedule 14C)."

OMB approved the rule's collection of information requirements.[650] Regulation 14A (OMB Control No. 3235-0059) was adopted pursuant to Section 14(a) of the Exchange Act and prescribes information that a company must include in its proxy statement to ensure that shareholders are provided information that is material to their voting decisions. Regulation 14C (OMB Control No. 3235-0057) was adopted pursuant to Section 14(c) of the Exchange Act and prescribes information that a company must include in an information statement when a shareholder vote is to be held but proxies are not being solicited. Schedule 14A requires certain disclosure related to a company's independent accountants and Schedule 14C refers to Schedule 14A for the disclosure requirements related to the company's independent accountants. The final rule requires issuers to disclose in Schedules 14A and 14C, among other things, the aggregate fees billed for audit services, for financial information systems design and implementation services, and for other non-audit services provided by the issuer's principal accountant, and certain disclosures regarding the company's audit committee.

The Commission received comments concerning the proposed collection of information requirements. Some commenters suggested that the collections of information lacks practical utility and noted that we rescinded an earlier requirement that issuers disclose information concerning non-audit services provided by their auditors.[651] These commenters generally argued that the proposed disclosure was unnecessary and would be confusing to registrants and investors.[652] Commenters also argued that we had not adequately demonstrated the need for the disclosure requirement.[653] One commenter suggested that the proposed collection of information is duplicative of information available to the Commission from the SECPS.[654]

We believe that the disclosure requirement is necessary, practical, and useful. As discussed more fully above, in recent years there has been a dramatic growth in the absolute and relative size of fees charged for non-audit services provided to audit clients.[655] At the same time, information about audit firms' provision of non-audit services is not as readily available as it was when we rescinded an earlier disclosure requirement.[656] The disclosure we seek is not, contrary to one commenter's assertion, readily available through industry sources.[657] Under circumstances where investors have less information about a matter that has become more important, we believe that the disclosure requirement will prove useful to investors. Further, we have modified the rule from that proposed to make the disclosed information more understandable to investors.[658] For example, under the rule as adopted, registrants will not disclose a line-by-line description of each non-audit service, but rather will disclose relevant amounts in the aggregate. Investors will be able to determine quickly the amounts spent on non-audit services relative to the amount spent on audit services. As discussed below, these modifications lower the already minor burden on registrants of making this disclosure.

Commenters also questioned our estimate of the burden imposed by the new disclosure requirement.[659] Specifically, commenters suggested that issuers will spend more than one hour on completing the new disclosure requirements.[660] Some commenters suggested that in calculating the burden, we did not consider all of the relevant factors.[661] Among other things, some commenters suggested that we failed to consider burdens relating to storing and analyzing the information, training personnel, hiring outside assistance, and putting the information into a reporting format.[662] Further, commenters disagreed with our assertion in the Proposing Release that the information required to make the disclosure should be readily available to respondents.[663]

Commenters also disagreed with our estimate of the number of registrants that would be affected by the disclosure requirement. In the Proposing Release, we stated the burden would fall primarily on one-quarter of registrants because only one-quarter of registrants receive non-audit services from their accountants in any given year. Some commenters disagreed. While it may be true, these commenters suggested, that only twenty-five percent of registrants receive non-audit services in any given year, a larger percentage receives non-audit services in some years and not others.[664] Commenters suggested that the percentage of registrants that would have to maintain records related to the disclosure requirements would therefore be greater than twenty-five percent.[665] At least one commenter stated that all registrants would have to check their records to determine whether they must disclose more than just audit fees.[666]

We believe that our estimate of the burden imposed by the disclosure requirement is reasonable. While all registrants will have to disclose audit fees under the new rule, and, where applicable, registrants must make disclosures concerning the use of leased personnel on the audit, we believe that the time and expense required to make such disclosures will be minimal. In calculating our estimate of the burden imposed by the new disclosure requirement, we carefully considered the relevant factors.[667] Further, as discussed above, we have reduced the amount and narrowed the scope of disclosure that registrants will be required to make. These modifications reduce the amount of time spent in making disclosure. For example, as proposed, the rule would have required a registrant to describe each professional service rendered by its accounting firm, and to disclose the fee paid for each service.[668] Instead, the rule as adopted requires a registrant to disclose the aggregate fees paid for audit, information technology, and other non-audit services.[669] This information is readily accessible to issuers;[670] it is an incremental addition to previously required disclosure about the identity of a company's auditor. In addition, we believe that a registrant will know how much it spent during the previous fiscal year on its audit. A registrant should be able to determine quickly the amounts paid to its auditor for information technology and other non-audit services by consulting its internal records. The rule should not require registrants to seek significant outside assistance, or substantially modify their systems to maintain and collect data. We therefore believe that 2,536 hours is a reasonable estimate of the paperwork burden imposed by the rule.[671]

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number. Compliance with the disclosure requirements is mandatory. There is no mandatory retention period for the information disclosed, and responses to the disclosure requirements will not be kept confidential.

VIII. Consideration of Impact on the Economy, Burden on Competition, and Promotion of Efficiency, Competition, and Capital Formation

Sections 2(b) of the Securities Act, 3(f) of the Exchange Act, and 2(c) of the Investment Company Act require the Commission, when engaging in rulemaking that requires it to consider or determine whether an action is necessary or appropriate in the public interest, also to consider whether the action will promote efficiency, competition, and capital formation.[672] The rule amendments update our independence requirements in light of developments in the accounting profession and in society generally. The rule amendments affect the scope of services an auditor may provide to an audit client without impairing the auditor's independence and also affect the financial, employment and business relationships that an auditor (and certain other persons) may have with an audit client without impairing independence. The purpose of the amendments is to promote investor confidence in the integrity of the audit process and in the audited financial statements that investors use to make investment decisions. As discussed above, investor confidence promotes market efficiency and capital formation. Competition is discussed below.

With respect to the scope of services provisions, some commenters suggested that there is no evidence that auditors' provision to audit clients of non-audit services affects auditor independence or investors' perceptions of auditor independence, and they therefore argued that the rule will not increase investor confidence.[673] Academic studies and other surveys, however, suggest that certain users of financial statements have long believed that an auditor's provision to an audit client of non-audit services could affect both the auditor's objectivity and investor confidence in the financial statements.[674] Furthermore, even a relatively modest increase in investor confidence could have a significant, positive effect on the economy,[675] while a relatively modest decrease in investor confidence could have significant consequences for the capital formation process.

Commenters suggested that the proposals would impede efficiency because the rule may prevent audit clients from selecting the most efficient service provider.[676] As adopted, however, the rule in large part codifies existing limitations on auditors' provision to audit clients of non-audit services. To the extent these existing limitations or new limitations from our rule prevent the choice of the least costly service provider in some situations, we believe such limitations are warranted to achieve our goal of enhancing auditor independence.[677]

With respect to the claim that synergies are created by the auditor's provision of both audit and non-audit services, research on the evidence of such synergies is inconclusive.[678] Moreover, the recent sales or proposed sales by large accounting firms of their consulting divisions[679] suggest that audit firms' provision of at least certain non-audit services creates, at most, limited synergies.

Section 23(a) of the Exchange Act requires the Commission, when adopting rules under the Exchange Act, to consider the impact on competition of any rule it adopts.[680] Some commenters suggested that the rule would inhibit competition. Some of these commenters argued that, in response to the proposed rule, accounting firms would choose not to provide audit services in favor of providing non-audit services, and that firms already providing the audit might not bid on that client's non-audit work.[681] They suggested that this would lead to reduced competition for both audit and non-audit services, reducing issuers' choices and increasing their costs. One commenter further suggested that reduced competition in the bidding process would place firms that chose to split off their consulting competencies at a competitive advantage over those that chose to stay together, and ultimately cause firms to consider splitting off their consulting groups.[682]

The rule as adopted, however, allows issuers to purchase more non-audit services from their auditors than would have been allowed under the rule as proposed. This modification should reduce the effect on competition about which commenters were most concerned.

Some commenters suggested that the proposed rule would hinder the ability of small accounting firms to compete. They argued that the definition of "affiliate of the accounting firm" in the proposal would restrict small firms from participating in alliances and other business relationships, thereby providing larger firms with a competitive advantage by limiting the scope of services available to clients of small firms.[683] Still other commenters suggested that if the rule results in a reshuffling of clients, medium-sized and small firms may suffer a net loss of non-audit service clients. According to these commenters, displaced clients of these firms may be more likely to engage a better-known firm for non-audit services than another small or medium-sized firm.[684] On the other hand, some commenters stated that the proposal would not be harmful to small accounting firms, but rather would allow small accounting firms to compete for audit or non-audit services that could no longer be provided by a company's auditor.[685]

Commenters also suggested that the rule would make it difficult for small businesses to compete. Some expressed concern about the effects of the rules on small businesses that rely on the special expertise of their auditors or that lack the resources to engage a second accounting firm to provide non-audit services; they commented that small registrants would be required to either choose a new accounting firm to perform audits or to provide non-audit services.[686] Other commenters stated that small businesses have long-term relationships with auditors that provide non-audit services, or are located in a geographic area with few firms able to provide such services.[687] Commenters also suggested that accounting firms other than the Big Five may stop serving SEC registrants, or they may stop providing audit services, in both cases leading to less choice and competition.[688]

As discussed elsewhere in this release, we have modified the rule so that the provisions regarding most affected non-audit services do no more than codify existing restrictions. For example, under the rule as adopted, all registrants may purchase most information technology consulting services from their auditors, so long as the stated conditions are met. With respect to internal audit services, the adopted provision does not restrict registrants with $200 or less in assets, as long as certain conditions are met. As a result, small businesses should be able to obtain the services they need.

In addition, approximately eighty-five percent of the public company audit clients of non-Big Five accounting firms have assets of $200 million or less.[689] Accordingly, as long as certain conditions are met, the rule will not preclude smaller firms from providing internal audit services to the vast majority of their public company clients. This modification should alleviate many of the commenters' concerns about the rule's impact on small accounting firms' ability to compete. In any event, to the extent the rule has any anti-competitive effect, we believe it is necessary and appropriate in furtherance of the goals of the Exchange Act.

IX. Codification Update

The "Codification of Financial Reporting Policies" announced in Financial Reporting Release No. 1 (April 15, 1982) is amended as follows:

1. By removing section 602.01.

2. By amending section 602.02 by removing the preamble paragraph immediately preceding the introduction.

3. By amending section 602.02.b.i to remove paragraphs 2 and 3.

4. By amending section 602.02.b.ii to remove examples 1, 2, 3, 4, 6, 7, 8, and 10, and redesignate examples 5 and 9 as examples 1 and 2.

5. By amending section 602.02.b.iii to remove examples 1, 2, and 4, and redesignate example 3 as example 1.

6. By removing section 602.02.b.iv.

7. By amending section 602.02.b.v to remove example 4.

8. By amending section 602.02.c.i to remove the last two paragraphs.

9. By removing section 602.02.c.ii.

10. By removing section 602.02.c.iii.

11. By removing section 602.02.d.

12. By removing section 602.02.e.ii.

13. By removing section 602.02.e.iii.

14. By removing section 602.02.f.

15. By amending examples 2, 3, 4, 5, 6, 7, 8, 10, 13, 15, 16, 20, and 23 in section 602.02.g by replacing the references to "partner," "partners," "certifying accountant," or "accountant" to "covered person," "covered persons," "covered person" and "covered person," respectively, except no change should be made where references to "partner" are preceded by the word "limited" or "general."

16. By amending section 602.02.g to replace the reference to Rule 2-01(b) in the last sentence of the first introductory paragraph with "Rule 2-01" and to remove examples 17, 18, 19, and 22 and redesignate examples 20, 21, 23, and 24 as examples 17, 18, 19, and 20, respectively.

17. By removing section 602.02.h.

18. By adding a new section 602.01, captioned "Discussion of Rule 2-01," to include the text in Section IV of this release.

19. By amending Section 601.03 to include, at the end, the text in Section III.C.6 of this release.

20. By amending section 602.02 to redesignate sections 602.02.b.v, 602.02.e.i, 602.02.e.iv, 602.02.g, 602.02.i.i, and 602.02.i.ii as sections 602.02.b.iv, 602.02.d.i, 602.02.d.ii, 602.02.e, 602.02.f.i, and 602.02.f.ii, respectively.

The Codification is a separate publication of the Commission. It will not be published in the Code of Federal Regulations.

X. Statutory Bases and Text of Amendments

We are adopting amendments to Rule 2-01 of Regulation S-X and Item 9 of Schedule 14A under the authority set forth in Schedule A and Sections 7, 8, 10, 19, and 28 of the Securities Act, Sections 3, 10A, 12, 13, 14, 17, 23, and 36 of the Exchange Act, Sections 5, 10, 14, and 20 of the Public Utility Holding Company Act of 1935, Sections 8, 30, 31, and 38 of the Investment Company Act of 1940, and Sections 203 and 211 of the Investment Advisers Act of 1940.

List of Subjects

17 CFR Part 210

Accountants, Accounting.

17 CFR Part 240

Reporting and recordkeeping requirements, Securities.

Text of Amendments

In accordance with the foregoing, Title 17, Chapter II of the Code of Federal Regulations is amended as follows:

PART 210 - FORM AND CONTENT OF AND REQUIREMENTS FOR FINANCIAL STATEMENTS, SECURITIES ACT OF 1933, SECURITIES

EXCHANGE ACT OF 1934, PUBLIC UTILITY HOLDING COMPANY ACT OF 1935, INVESTMENT COMPANY ACT OF 1940, INVESTMENT ADVISERS ACT OF 1940, AND ENERGY POLICY AND CONSERVATION ACT OF 1975

1. The heading for Part 210 is revised as set forth above.

2. The authority citation for Part 210 is revised to read as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 77z-2, 77z-3, 77aa(25), 77aa (26), 78c, 78j-1, 78l, 78m, 78n, 78o(d), 78q, 78u-5, 78w(a), 78ll, 78mm, 79e(b), 79j(a), 79n, 79t(a), 80a-8, 80a-20, 80a-29, 80a-30, 80a-37(a), 80b-3, 80b-11 unless otherwise noted.

3. By amending § 210.2-01 by adding a Preliminary Note and paragraphs (d), (e) and (f) and revising paragraphs (b) and (c) to read as follows:

§ 210.2-01 Qualifications of accountants.

Preliminary Note to § 210.2-01

Rule 2-01 is designed to ensure that auditors are qualified and independent of their audit clients both in fact and in appearance. Accordingly, the rule sets forth restrictions on financial, employment, and business relationships between an accountant and an audit client and restrictions on an accountant providing certain non-audit services to an audit client.

Rule 2-01(b) sets forth the general standard of auditor independence. Paragraphs (c)(1) to (c)(5) reflect the application of the general standard to particular circumstances. The rule does not purport to, and the Commission could not, consider all circumstances that raise independence concerns, and these are subject to the general standard in paragraph 2-01(b). In considering this standard, the Commission looks in the first instance to whether a relationship or the provision of a service: (a) creates a mutual or conflicting interest between the accountant and the audit client; (b) places the accountant in the position of auditing his or her own work; (c) results in the accountant acting as management or an employee of the audit client; or (d) places the accountant in a position of being an advocate for the audit client.

These factors are general guidance only and their application may depend on particular facts and circumstances. For that reason, Rule 2-01 provides that, in determining whether an accountant is independent, the Commission will consider all relevant facts and circumstances. For the same reason, registrants and accountants are encouraged to consult with the Commission's Office of the Chief Accountant before entering into relationships, including relationships involving the provision of services, that are not explicitly described in the Rule.

(a) * * *

(b) 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. In determining whether an accountant is independent, the Commission will consider all relevant circumstances, including all relationships between the accountant and the audit client, and not just those relating to reports filed with the Commission.

(c) This paragraph sets forth a non-exclusive specification of circumstances inconsistent with paragraph (b) of this section.

(1) Financial relationships. An accountant is not independent if, at any point during the audit and professional engagement period, the accountant has a direct financial interest or a material indirect financial interest in the accountant's audit client, such as:

(i) Investments in audit clients. An accountant is not independent when:

(A) The accounting firm, any covered person in the firm, or any of his or her immediate family members, has any direct investment in an audit client, such as stocks, bonds, notes, options, or other securities. The term direct investment includes an investment in an audit client through an intermediary if:

(1) The accounting firm, covered person, or immediate family member, alone or together with other persons, supervises or participates in the intermediary's investment decisions or has control over the intermediary; or

(2) The intermediary is not a diversified management investment company, as defined by Section 5(b)(1) of the Investment Company Act of 1940, 15 U.S.C. 80a-5(b)(1), and has an investment in the audit client that amounts to 20% or more of the value of the intermediary's total investments.

(B) Any partner, principal, shareholder, or professional employee of the accounting firm, any of his or her immediate family members, any close family member of a covered person in the firm, or any group of the above persons has filed a Schedule 13D or 13G (17 CFR 240.13d-101 or 240.13d-102) with the Commission indicating beneficial ownership of more than five percent of an audit client's equity securities or controls an audit client, or a close family member of a partner, principal, or shareholder of the accounting firm controls an audit client.

(C) The accounting firm, any covered person in the firm, or any of his or her immediate family members, serves as voting trustee of a trust, or executor of an estate, containing the securities of an audit client, unless the accounting firm, covered person in the firm, or immediate family member has no authority to make investment decisions for the trust or estate.

(D) The accounting firm, any covered person in the firm, any of his or her immediate family members, or any group of the above persons has any material indirect investment in an audit client. For purposes of this paragraph, the term material indirect investment does not include ownership by any covered person in the firm, any of his or her immediate family members, or any group of the above persons of 5% or less of the outstanding shares of a diversified management investment company, as defined by Section 5(b)(1) of the Investment Company Act of 1940, 15 U.S.C. 80a-5(b)(1), that invests in an audit client.

(E) The accounting firm, any covered person in the firm, or any of his or her immediate family members:

(1) Has any direct or material indirect investment in an entity where:

(i) An audit client has an investment in that entity that is material to the audit client and has the ability to exercise significant influence over that entity; or

(ii) The entity has an investment in an audit client that is material to that entity and has the ability to exercise significant influence over that audit client;

(2) Has any material investment in an entity over which an audit client has the ability to exercise significant influence; or

(3) Has the ability to exercise significant influence over an entity that has the ability to exercise significant influence over an audit client.

(ii) Other financial interests in audit client. An accountant is not independent when the accounting firm, any covered person in the firm, or any of his or her immediate family members has:

(A) Loans/debtor-creditor relationship. Any loan (including any margin loan) to or from an audit client, or an audit client's officers, directors, or record or beneficial owners of more than ten percent of the audit client's equity securities, except for the following loans obtained from a financial institution under its normal lending procedures, terms, and requirements:

(1) Automobile loans and leases collateralized by the automobile;

(2) Loans fully collateralized by the cash surrender value of an insurance policy;

(3) Loans fully collateralized by cash deposits at the same financial institution; and

(4) A mortgage loan collateralized by the borrower's primary residence provided the loan was not obtained while the covered person in the firm was a covered person.

(B) Savings and checking accounts. Any savings, checking, or similar account at a bank, savings and loan, or similar institution that is an audit client, if the account has a balance that exceeds the amount insured by the Federal Deposit Insurance Corporation or any similar insurer, except that an accounting firm account may have an uninsured balance provided that the likelihood of the bank, savings and loan, or similar institution experiencing financial difficulties is remote.

(C) Broker-dealer accounts. Brokerage or similar accounts maintained with a broker-dealer that is an audit client, if:

(1) Any such account includes any asset other than cash or securities (within the meaning of "security" provided in the Securities Investor Protection Act of 1970 ("SIPA") (15 U.S.C. 78aaa et seq.));

(2) The value of assets in the accounts exceeds the amount that is subject to a Securities Investor Protection Corporation advance, for those accounts, under Section 9 of SIPA (15 U.S.C. 78fff-3); or

(3) With respect to non-U.S. accounts not subject to SIPA protection, the value of assets in the accounts exceeds the amount insured or protected by a program similar to SIPA.

(D) Futures commission merchant accounts. Any futures, commodity, or similar account maintained with a futures commission merchant that is an audit client.

(E) Credit cards. Any aggregate outstanding credit card balance owed to a lender that is an audit client that is not reduced to $10,000 or less on a current basis taking into consideration the payment due date and any available grace period.

(F) Insurance products. Any individual policy issued by an insurer that is an audit client unless:

(1) The policy was obtained at a time when the covered person in the firm was not a covered person in the firm; and

(2) The likelihood of the insurer becoming insolvent is remote.

(G) Investment companies.Any financial interest in an entity that is part of an investment company complex that includes an audit client.

(iii) Exceptions. Notwithstanding paragraphs (c)(1)(i) and (c)(1)(ii) of this section, an accountant will not be deemed not independent if:

(A) Inheritance and gift. Any person acquires an unsolicited financial interest, such as through an unsolicited gift or inheritance, that would cause an accountant to be not independent under paragraph (c)(1)(i) or (c)(1)(ii) of this section, and the financial interest is disposed of as soon as practicable, but no later than 30 days after the person has knowledge of and the right to dispose of the financial interest.

(B) New audit engagement. Any person has a financial interest that would cause an accountant to be not independent under paragraph (c)(1)(i) or (c)(1)(ii) of this section, and:

(1) The accountant did not audit the client's financial statements for the immediately preceding fiscal year; and

(2) The accountant is independent under paragraph (c)(1)(i) and (c)(1)(ii) of this section before the earlier of:

(i) Signing an initial engagement letter or other agreement to provide audit, review, or attest services to the audit client; or

(ii) Commencing any audit, review, or attest procedures (including planning the audit of the client's financial statements).

(C) Employee compensation and benefit plans. An immediate family member of a person who is a covered person in the firm only by virtue of paragraphs (f)(11)(iii) or (f)(11)(iv) of this section has a financial interest that would cause an accountant to be not independent under paragraph (c)(1)(i) or (c)(1)(ii) of this section, and the acquisition of the financial interest was an unavoidable consequence of participation in his or her employer's employee compensation or benefits program, provided that the financial interest, other than unexercised employee stock options, is disposed of as soon as practicable, but no later than 30 days after the person has the right to dispose of the financial interest.

(iv) Audit clients' financial relationships. An accountant is not independent when:

(A) Investments by the audit client in the accounting firm. An audit client has, or has agreed to acquire, any direct investment in the accounting firm, such as stocks, bonds, notes, options, or other securities, or the audit client's officers or directors are record or beneficial owners of more than 5% of the equity securities of the accounting firm.

(B) Underwriting. An accounting firm engages an audit client to act as an underwriter, broker-dealer, market-maker, promoter, or analyst with respect to securities issued by the accounting firm.

(2) Employment relationships. An accountant is not independent if, at any point during the audit and professional engagement period, the accountant has an employment relationship with an audit client, such as:

(i) Employment at audit client of accountant. A current partner, principal, shareholder, or professional employee of the accounting firm is employed by the audit client or serves as a member of the board of directors or similar management or governing body of the audit client.

(ii) Employment at audit client of certain relatives of accountant. A close family member of a covered person in the firm is in an accounting role or financial reporting oversight role at an audit client, or was in such a role during any period covered by an audit for which the covered person in the firm is a covered person.

(iii) Employment at audit client of former employee of accounting firm. A former partner, principal, shareholder, or professional employee of an accounting firm is in an accounting role or financial reporting oversight role at an audit client, unless the individual:

(A) Does not influence the accounting firm's operations or financial policies;

(B) Has no capital balances in the accounting firm; and

(C) Has no financial arrangement with the accounting firm other than one providing for regular payment of a fixed dollar amount (which is not dependent on the revenues, profits, or earnings of the accounting firm):

(1) Pursuant to a fully funded retirement plan, rabbi trust, or, in jurisdictions in which a rabbi trust does not exist, a similar vehicle; or

(2) In the case of a former professional employee who was not a partner, principal, or shareholder of the accounting firm and who has been disassociated from the accounting firm for more than five years, that is immaterial to the former professional employee.

(iv) Employment at accounting firm of former employee of audit client. A former officer, director, or employee of an audit client becomes a partner, principal, shareholder, or professional employee of the accounting firm, unless the individual does not participate in, and is not in a position to influence, the audit of the financial statements of the audit client covering any period during which he or she was employed by or associated with that audit client.

(3) Business relationships. An accountant is not independent if, at any point during the audit and professional engagement period, the accounting firm or any covered person in the firm has any direct or material indirect business relationship with an audit client, or with persons associated with the audit client in a decision-making capacity, such as an audit client's officers, directors, or substantial stockholders. The relationships described in this paragraph do not include a relationship in which the accounting firm or covered person in the firm provides professional services to an audit client or is a consumer in the ordinary course of business.

(4) Non-audit services. An accountant is not independent if, at any point during the audit and professional engagement period, the accountant provides the following non-audit services to an audit client:

(i) Bookkeeping or other services related to the audit client's accounting records or financial statements.

(A) Any service involving:

(1) Maintaining or preparing the audit client's accounting records;

(2) Preparing the audit client's financial statements that are filed with the Commission or form the basis of financial statements filed with the Commission; or

(3) Preparing or originating source data underlying the audit client's financial statements.

(B) Notwithstanding paragraph (c)(4)(i)(A) of this section, the accountant's independence will not be impaired when the accountant provides these services:

(1) In emergency or other unusual situations, provided the accountant does not undertake any managerial actions or make any managerial decisions; or

(2) For foreign divisions or subsidiaries of an audit client, provided that:

(i) The services are limited, routine, or ministerial;

(ii) It is impractical for the foreign division or subsidiary to make other arrangements;

(iii) The foreign division or subsidiary is not material to the consolidated financial statements;

(iv) The foreign division or subsidiary does not have employees capable or competent to perform the services;

(v) The services performed are consistent with local professional ethics rules; and

(vi) The fees for all such services collectively (for the entire group of companies) do not exceed the greater of 1% of the consolidated audit fee or $10,000.

(ii) Financial information systems design and implementation.

(A) Directly or indirectly operating, or supervising the operation of, the audit client's information system or managing the audit client's local area network.

(B) Designing or implementing a hardware or software system that aggregates source data underlying the financial statements or generates information that is significant to the audit client's financial statements taken as a whole, unless:

(1) The audit client's management has acknowledged in writing to the accounting firm and the audit client's audit committee, or if there is no such committee then the board of directors, the audit client's responsibility to establish and maintain a system of internal accounting controls in compliance with Section 13(b)(2) of the Securities Exchange Act of 1934 (15 U.S.C. 78m(b)(2));

(2) The audit client's management designates a competent employee or employees, preferably within senior management, with the responsibility to make all management decisions with respect to the design and implementation of the hardware or software system;

(3) The audit client's management makes all management decisions with respect to the design and implementation of the hardware or software system including, but not limited to, decisions concerning the systems to be evaluated and selected, the controls and system procedures to be implemented, the scope and timetable of system implementation, and the testing, training, and conversion plans;

(4) The audit client's management evaluates the adequacy and results of the design and implementation of the hardware or software system; and

(5) The audit client's management does not rely on the accountant's work as the primary basis for determining the adequacy of its internal controls and financial reporting systems.

(C) Nothing in this paragraph (c)(4)(ii) shall limit services an accountant performs in connection with the assessment, design, and implementation of internal accounting controls and risk management controls, provided the auditor does not act as an employee or perform management functions.

(iii) Appraisal or valuation services or fairness opinions.

(A) Any appraisal service, valuation service, or any service involving a fairness opinion for an audit client, where it is reasonably likely that the results of these services, individually or in the aggregate, would be material to the financial statements, or where the results of these services will be audited by the accountant during an audit of the audit client's financial statements.

(B) Notwithstanding paragraph (c)(4)(iii)(A) of this section, the accountant's independence will not be impaired when:

(1) The accounting firm's valuation expert reviews the work of the audit client or a specialist employed by the audit client, and the audit client or the specialist provides the primary support for the balances recorded in the client's financial statements;

(2) The accounting firm's actuaries value an audit client's pension, other post-employment benefit, or similar liabilities, provided that the audit client has determined and taken responsibility for all significant assumptions and data;

(3) The valuation is performed in the context of the planning and implementation of a tax-planning strategy or for tax compliance services; or

(4) The valuation is for non-financial purposes where the results of the valuation do not affect the financial statements.

(iv) Actuarial services.

(A) Any actuarially-oriented advisory service involving the determination of insurance company policy reserves and related accounts for the audit client, unless:

(1) The audit client uses its own actuaries or third-party actuaries to provide management with the primary actuarial capabilities;

(2) Management accepts responsibility for any significant actuarial methods and assumptions; and

(3) The accountant's involvement is not continuous.

(B) Subject to complying with paragraph (c)(4)(iv)(A)(1) - (3) of this section, the accountant's independence will not be impaired if the accountant:

(1) Assists management to develop appropriate methods, assumptions, and amounts for policy and loss reserves and other actuarial items presented in financial reports based on the audit client's historical experience, current practice, and future plans;

(2) Assists management in the conversion of financial statements from a statutory basis to one conforming with generally accepted accounting principles;

(3) Analyzes actuarial considerations and alternatives in federal income tax planning; or

(4) Assists management in the financial analysis of various matters, such as proposed new policies, new markets, business acquisitions, and reinsurance needs.

(v) Internal audit services. Either of:

(A) Internal audit services in an amount greater than 40% of the total hours expended on the audit client's internal audit activities in any one fiscal year, unless the audit client has less than $200 million in total assets. (For purposes of this paragraph, the term internal audit services does not include operational internal audit services unrelated to the internal accounting controls, financial systems, or financial statements.); or

(B) Any internal audit services, or any operational internal audit services unrelated to the internal accounting controls, financial systems, or financial statements, for an audit client, unless:

(1) The audit client's management has acknowledged in writing to the accounting firm and the audit client's audit committee, or if there is no such committee then the board of directors, the audit client's responsibility to establish and maintain a system of internal accounting controls in compliance with Section 13(b)(2) of the Securities Exchange Act of 1934 (15 U.S.C. 78m(b)(2));

(2) The audit client's management designates a competent employee or employees, preferably within senior management, to be responsible for the internal audit function;

(3) The audit client's management determines the scope, risk, and frequency of internal audit activities, including those to be performed by the accountant;

(4) The audit client's management evaluates the findings and results arising from the internal audit activities, including those performed by the accountant;

(5) The audit client's management evaluates the adequacy of the audit procedures performed and the findings resulting from the performance of those procedures by, among other things, obtaining reports from the accountant; and

(6) The audit client's management does not rely on the accountant's work as the primary basis for determining the adequacy of its internal controls.

(vi) Management functions. Acting, temporarily or permanently, as a director, officer, or employee of an audit client, or performing any decision-making, supervisory, or ongoing monitoring function for the audit client.

(vii) Human resources.

(A) Searching for or seeking out prospective candidates for managerial, executive, or director positions;

(B) Engaging in psychological testing, or other formal testing or evaluation programs;

(C) Undertaking reference checks of prospective candidates for an executive or director position;

(D) Acting as a negotiator on the audit client's behalf, such as determining position, status or title, compensation, fringe benefits, or other conditions of employment; or

(E) Recommending, or advising the audit client to hire, a specific candidate for a specific job (except that an accounting firm may, upon request by the audit client, interview candidates and advise the audit client on the candidate's competence for financial accounting, administrative, or control positions).

(viii) Broker-dealer services. Acting as a broker-dealer, promoter, or underwriter, on behalf of an audit client, making investment decisions on behalf of the audit client or otherwise having discretionary authority over an audit client's investments, executing a transaction to buy or sell an audit client's investment, or having custody of assets of the audit client, such as taking temporary possession of securities purchased by the audit client.

(ix) Legal services. Providing any service to an audit client under circumstances in which the person providing the service must be admitted to practice before the courts of a United States jurisdiction.

(5) Contingent fees. An accountant is not independent if, at any point during the audit and professional engagement period, the accountant provides any service or product to an audit client for a contingent fee or a commission, or receives a contingent fee or commission from an audit client.

(d) Quality controls. An accounting firm's independence will not be impaired solely because a covered person in the firm is not independent of an audit client provided:

(1) The covered person did not know of the circumstances giving rise to the lack of independence;

(2) The covered person's lack of independence was corrected as promptly as possible under the relevant circumstances after the covered person or accounting firm became aware of it; and

(3) The accounting firm has a quality control system in place that provides reasonable assurance, taking into account the size and nature of the accounting firm's practice, that the accounting firm and its employees do not lack independence, and that covers at least all employees and associated entities of the accounting firm participating in the engagement, including employees and associated entities located outside of the United States.

(4) For an accounting firm that annually provides audit, review, or attest services to more than 500 companies with a class of securities registered with the Commission under Section 12 of the Securities Exchange Act of 1934 (15 U.S.C. 78l), a quality control system will not provide such reasonable assurance unless it has at least the following features:

(i) Written independence policies and procedures;

(ii) With respect to partners and managerial employees, an automated system to identify their investments in securities that might impair the accountant's independence;

(iii) With respect to all professionals, a system that provides timely information about entities from which the accountant is required to maintain independence;

(iv) An annual or on-going firm-wide training program about auditor independence;

(v) An annual internal inspection and testing program to monitor adherence to independence requirements;

(vi) Notification to all accounting firm members, officers, directors, and employees of the name and title of the member of senior management responsible for compliance with auditor independence requirements;

(vii) Written policies and procedures requiring all partners and covered persons to report promptly to the accounting firm when they are engaged in employment negotiations with an audit client, and requiring the firm to remove immediately any such professional from that audit client's engagement and to review promptly all work the professional performed related to that audit client's engagement; and

(viii) A disciplinary mechanism to ensure compliance with this section.

(e) Transition and grandfathering.

(1) Transition.

(i) Appraisal or valuation services or fairness opinions and internal audit services.

Until August 5, 2002, providing to an audit client the non-audit services set forth in paragraphs (c)(4)(iii) and (c)(4)(v) of this section will not impair an accountant's independence with respect to the audit client if performing those services did not impair the accountant's independence under pre-existing requirements of the Commission, the Independence Standards Boards, or the accounting profession in the United States.

(ii) Other financial interests and employment relationships. Until May 7, 2001, having the financial interests set forth in paragraph (c)(1)(ii) of this section or the employment relationships set forth in paragraph (c)(2) of this section will not impair an accountant's independence with respect to the audit client if having those financial interests or employment relationships did not impair the accountant's independence under pre-existing requirements of the Commission, the Independence Standards Board, or the accounting profession in the United States.

(iii) Quality controls. Until December 31, 2002, paragraph (d)(4) of this section shall not apply to offices of the accounting firm located outside of the United States.

(2) Grandfathering. Financial interests included in paragraphs (c)(1)(ii)(A) and (c)(1)(ii)(F) of this section and employment relationships included in paragraph (c)(2) of this section in existence on [insert date 3 months after the effective date of this section], and contracts for the provision of services described in paragraph (c)(4)(ii) of this section in existence on [insert the effective date of this section] will not be deemed to impair an accountant's independence if they did not impair the accountant's independence under pre-existing requirements of the Commission, the Independence Standards Board, or the accounting profession in the United States.

(3) Settling financial arrangements with former professionals. To the extent not required by pre-existing requirements of the Commission, the Independence Standards Board, or the accounting profession in the United States, the requirement in paragraph (c)(2)(iii) of this section to settle financial arrangements with former professionals applies to situations that arise after the effective date of this section.

(f) Definitions of terms. For purposes of this section:

(1) Accountant, as used in paragraphs (b) through (e) of this section, means a certified public accountant or public accountant performing services in connection with an engagement for which independence is required. References to the accountant include any accounting firm with which the certified public accountant or public accountant is affiliated.

(2) Accounting firm means an organization (whether it is a sole proprietorship, incorporated association, partnership, corporation, limited liability company, limited liability partnership, or other legal entity) that is engaged in the practice of public accounting and furnishes reports or other documents filed with the Commission or otherwise prepared under the securities laws, and all of the organization's departments, divisions, parents, subsidiaries, and associated entities, including those located outside of the United States. Accounting firm also includes the organization's pension, retirement, investment, or similar plans.

(3) Accounting role or financial reporting oversight role means a role in which a person is in a position to or does:

(i) Exercise more than minimal influence over the contents of the accounting records or anyone who prepares them; or

(ii) Exercise influence over the contents of the financial statements or anyone who prepares them, such as when the person is a member of the board of directors or similar management or governing body, chief executive officer, president, chief financial officer, chief operating officer, general counsel, chief accounting officer, controller, director of internal audit, director of financial reporting, treasurer, vice president of marketing, or any equivalent position.

(4) Affiliate of the audit client means:

(i) An entity that has control over the audit client, or over which the audit client has control, or which is under common control with the audit client, including the audit client's parents and subsidiaries;

(ii) An entity over which the audit client has significant influence, unless the entity is not material to the audit client;

(iii) An entity that has significant influence over the audit client, unless the audit client is not material to the entity; and

(iv) Each entity in the investment company complex when the audit client is an entity that is part of an investment company complex.

(5) Audit and professional engagement period includes both:

(i) The period covered by any financial statements being audited or reviewed (the "audit period"); and

(ii) The period of the engagement to audit or review the audit client's financial statements or to prepare a report filed with the Commission (the "professional engagement period"):

(A) The professional engagement period begins when the accountant either signs an initial engagement letter (or other agreement to review or audit a client's financial statements) or begins audit, review, or attest procedures, whichever is earlier; and

(B) The professional engagement period ends when the audit client or the accountant notifies the Commission that the client is no longer that accountant's audit client.

(iii) For audits of the financial statements of foreign private issuers, the "audit and professional engagement period" does not include periods ended prior to the first day of the last fiscal year before the foreign private issuer first filed, or was required to file, a registration statement or report with the Commission, provided there has been full compliance with home country independence standards in all prior periods covered by any registration statement or report filed with the Commission.

(6) Audit client means the entity whose financial statements or other information is being audited, reviewed, or attested and any affiliates of the audit client, other than, for purposes of paragraph (c)(1)(i) of this section, entities that are affiliates of the audit client only by virtue of paragraph (f)(4)(ii) or (f)(4)(iii) of this section.

(7) Audit engagement team means all partners, principals, shareholders, and professional employees participating in an audit, review, or attestation engagement of an audit client, including those conducting concurring or second partner reviews and all persons who consult with others on the audit engagement team during the audit, review, or attestation engagement regarding technical or industry-specific issues, transactions, or events.

(8) Chain of command means all persons who:

(i) Supervise or have direct management responsibility for the audit, including at all successively senior levels through the accounting firm's chief executive;

(ii) Evaluate the performance or recommend the compensation of the audit engagement partner; or

(iii) Provide quality control or other oversight of the audit.

(9) Close family members means a person's spouse, spousal equivalent, parent, dependent, nondependent child, and sibling.

(10) Contingent fee means, except as stated in the next sentence, any fee established for the sale of a product or the performance of any service pursuant to an arrangement in which no fee will be charged unless a specified finding or result is attained, or in which the amount of the fee is otherwise dependent upon the finding or result of such product or service. Solely for the purposes of this section, a fee is not a "contingent fee" if it is fixed by courts or other public authorities, or, in tax matters, if determined based on the results of judicial proceedings or the findings of governmental agencies. Fees may vary depending, for example, on the complexity of services rendered.

(11) Covered persons in the firm means the following partners, principals, shareholders, and employees of an accounting firm:

(i) The "audit engagement team";

(ii) The "chain of command";

(iii) Any other partner, principal, shareholder, or managerial employee of the accounting firm who has provided ten or more hours of non-audit services to the audit client for the period beginning on the date such services are provided and ending on the date the accounting firm signs the report on the financial statements for the fiscal year during which those services are provided, or who expects to provide ten or more hours of non-audit services to the audit client on a recurring basis; and

(iv) Any other partner, principal, or shareholder from an "office" of the accounting firm in which the lead audit engagement partner primarily practices in connection with the audit.

(12) Group means two or more persons who act together for the purposes of acquiring, holding, voting, or disposing of securities of a registrant.

(13) Immediate family members means a person's spouse, spousal equivalent, and dependents.

(14) Investment company complex.

(i) "Investment company complex" includes:

(A) An investment company and its investment adviser or sponsor;

(B) Any entity controlled by or controlling an investment adviser or sponsor in paragraph (f)(14)(i)(A) of this section, or any entity under common control with an investment adviser or sponsor in paragraph (f)(14)(i)(A) of this section if the entity:

(1) Is an investment adviser or sponsor; or

(2) Is engaged in the business of providing administrative, custodian, underwriting, or transfer agent services to any investment company, investment adviser, or sponsor; and

(C) Any investment company or entity that would be an investment company but for the exclusions provided by Section 3(c) of the Investment Company Act of 1940 (15 U.S.C. 80a-3(c)) that has an investment adviser or sponsor included in this definition by either paragraph (f)(14)(i)(A) or (f)(14)(i)(B) of this section.

(ii) An investment adviser, for purposes of this definition, does not include a sub-adviser whose role is primarily portfolio management and is subcontracted with or overseen by another investment adviser.

(iii) Sponsor, for purposes of this definition, is an entity that establishes a unit investment trust.

(15) Office means a distinct sub-group within an accounting firm, whether distinguished along geographic or practice lines.

(16) Rabbi trust means an irrevocable trust whose assets are not accessible to the accounting firm until all benefit obligations have been met, but are subject to the claims of creditors in bankruptcy or insolvency.

PART 240 - GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

4. The general authority citation for Part 240 is revised to read, in part, as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78f, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 79q, 79t, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4 and 80b-11, unless otherwise noted.

* * * * *

5. By amending § 240.14a-101 to add paragraph (e) to Item 9 to read as follows:

§ 240.14a-101 Schedule 14A Information required in proxy statement.

* * * * *

Item 9. Independent public accountants. * * *

* * * * *

(e)(1) Disclose, under the caption Audit Fees, the aggregate fees billed for professional services rendered for the audit of the registrant's annual financial statements for the most recent fiscal year and the reviews of the financial statements included in the registrant's Forms 10-Q (17 CFR 249.308a) or 10-QSB (17 CFR 249.308b) for that fiscal year.

(2) Disclose, under the caption Financial Information Systems Design and Implementation Fees, the aggregate fees billed for the professional services described in Paragraph (c)(4)(ii) of Rule 2-01 of Regulation S-X (17 CFR 210.2-01(c)(4)(ii)) rendered by the principal accountant for the most recent fiscal year. For purposes of this disclosure item, registrants that are investment companies must disclose fees billed for services rendered to the registrant, the registrant's investment adviser (not including any sub-adviser whose role is primarily portfolio management and is subcontracted with or overseen by another investment adviser), and any entity controlling, controlled by, or under common control with the adviser that provides services to the registrant.

(3) Disclose, under the caption All Other Fees, the aggregate fees billed for services rendered by the principal accountant, other than the services covered in paragraphs (e)(1) and (e)(2) of this section, for the most recent fiscal year. For purposes of this disclosure item, registrants that are investment companies must disclose fees billed for services rendered to the registrant, the registrant's investment adviser (not including any sub-adviser whose role is primarily portfolio management and is subcontracted with or overseen by another investment adviser), and any entity controlling, controlled by, or under common control with the adviser that provides services to the registrant.

(4) Disclose whether the audit committee of the board of directors, or if there is no such committee then the board of directors, has considered whether the provision of the services covered in paragraphs (e)(2) and (e)(3) of this section is compatible with maintaining the principal accountant's independence.

(5) If greater than 50 percent, disclose the percentage of the hours expended on the principal accountant's engagement to audit the registrant's financial statements for the most recent fiscal year that were attributed to work performed by persons other than the principal accountant's full-time, permanent employees.

By the Commission.

Jonathan G. Katz
Secretary

November 21, 2000

Appendix A: Investing in Entities that Invest in Audit Clients

Appendix B: Investing in Entities in Which Audit Clients Invest

Footnotes

[1] 17 CFR 210.2-01.

[2] 17 CFR 240.14a-101.

[3] 15 U.S.C. § 78a et seq.

[4] The amendments were proposed in Securities Act Release No. 7870 (June 30, 2000) (the "Proposing Release") [65 FR 43148].

[5] This release uses the terms "independent auditor," "auditor," "independent public accountant," "accountant," and "independent accountant" interchangeably to refer to any independent certified or independent public accountant who performs an audit of or reviews a public company's financial statements or whose report or opinion is filed with the Commission in accordance with the federal securities laws or the Commission's regulations.

[6] In addition to soliciting comments in the Proposing Release, we held four days of public hearings (July 26, Sept. 13, Sept. 20, and Sept. 21). The public comments we received can be reviewed in our Public Reference Room at 450 Fifth Street, N.W., Washington, D.C., 20549, in File No. S7-13-00. Public comments submitted by electronic mail are on our website, www.sec.gov. The written testimony and transcripts from each of our public hearings (July 26, Sept. 13, Sept. 20, and Sept. 21) are available on our website. For purposes of this release, date references following the names of participants at our public hearings indicate the hearing date for which the participant submitted written testimony and/or appeared as a witness.

[7] The profession's principles of professional conduct state, "Members should accept the obligation to act in a way that will serve the public interest, honor the public trust, and demonstrate commitment to professionalism." American Institute of Certified Public Accountants ("AICPA") Professional Standards: Code of Professional Conduct ("AICPA Code of Professional Conduct"), ET § 53.

[8] Public companies and other public issuers and entities registered with us must have their annual financial statements audited by independent public accountants. See, e.g., Items 25 and 26 of Schedule A to the Securities Act of 1933 (the "1933 Act"), 15 U.S.C. § 77aa(25) and (26), that expressly require that financial statements be audited by independent public or certified accountants. See also infra note 34.

[9] See, e.g., Testimony of John Whitehead, retired Chairman, Goldman Sachs & Co. (Sept. 13, 2000) ("Financial statements are at the very heart of our capital markets. They're the basis for analyzing investments. Investors have every right to be able to depend absolutely on the integrity

of the financial statements that are available to them, and if that integrity in any way falls under suspicion, then the capital markets will surely suffer if investors feel they cannot rely absolutely on the integrity of those financial statements.").

[10] As stated by Baxter Rice, President of the California Board of Accountancy, "[I]n this ever-revolving economy and business environment, it's important that we go back and take a look at these regulations and see whether they are really applicable, and whether or not what we do is going to in any way interfere with or is going to enhance auditor independence, including the public perception of auditor independence." Testimony of Baxter Rice (Sept. 13, 2000).

[11] Financial Reporting Release ("FRR") No. 10 (Feb. 25, 1983).

[12] In 1999, an estimated 48.2%, or 49.2 million, U.S. households owned equities either in mutual funds or individually, up from 19% in 1983. Investment Company Institute and Securities Industry Association, "Bull Market, Other Developments Fuel Growth in Equity Ownership" (available at www.sia.com/html/pr834.html.).

[13] See, e.g., Testimony of Senator Howard Metzenbaum (Ret.), Chairman, Consumer Federation of America (Sept. 20, 2000) ("Our nation's current prosperity and future financial security are tied up as never before in our financial markets. For that reason, whether they know it or not, Americans are enormously dependent on independent auditors, both to . . . ensure the reliability of the information they use to make individual investment decisions and to ensure the efficiency of the marketplace in assigning value to stocks."); Testimony of Ralph Whitworth, Managing Member, Relational Investors LLC (Sept. 13, 2000) ("[A]uditor independence goes to the very essence of our capital markets, and it's linked inextricably to the efficiencies of our capitalist system.").

[14] See discussion in Proposing Release, Section II.B.

[15] See, e.g., Written Testimony of Dennis Paul Spackman, Chairman, National Association of State Boards of Accountancy (Sept. 13, 2000) (The four principles "set a sensible baseline that is simply stated, easy to understand, useable, and square on the mark. They also serve as an exceptional foundation to the other elements of the proposed revision. . . . [T]hey can serve as a bright beacon giving much needed guidance to members of the profession . . . ."); Written Testimony of Robert L. Ryan, Chief Financial Officer, Medtronic, Inc. (Sept. 20, 2000); Written Testimony of John C. Bogle, Member, Independence Standards Board (July 26, 2000).

[16] See, e.g., Letter of Arthur Andersen LLP (Sept. 25, 2000) ("Arthur Andersen Letter"); Written Testimony of the New York Society of Certified Public Accountants (Sept. 13, 2000).

[17] See, e.g., Letter of Ernst & Young LLP (Sept. 25, 2000) ("Ernst & Young Letter"); Written Testimony of James J. Schiro, Chief Executive Officer PricewaterhouseCoopers (Sept. 20, 2000); Written Testimony of the New York State Society of Certified Public Accountants (Sept. 13, 2000); Written Testimony of James E. Copeland, Chief Executive Officer, Deloitte & Touche LLP (Sept. 20, 2000); Arthur Andersen Letter.

[18] Some commenters, for example, believed that the amendments went too far. See, e.g., Written Testimony of J. Michael Cook, former Chairman and Chief Executive Officer, Deloitte & Touche (July 26, 2000) (supporting proposed rule changes in this area but stating that no partner in an accounting firm should have a financial interest in any of the firm's audit clients); Written Testimony of Ray J. Groves, former Chairman and CEO, Ernst & Young (July 26, 2000) (agreeing with proposals but stating preference to retain current proscription of direct investment in an audit client by all partners, principals, and shareholders of an accounting firm); Testimony of Paul B.W. Miller, Professor, University of Colorado at Colorado Springs (July 26, 2000) ("I want to direct my attention ... to the ownership [provisions], and my language is plain. It simply says don't do it"); Written Testimony of Ronald Nielsen and Kathleen Chapman, Iowa Accountancy Examining Board (Sept. 20, 2000). While supporting the goals of the modernization, others provided suggestions to address their concerns about possible unintended consequences. See, e.g., Ernst & Young Letter; Letter of PricewaterhouseCoopers LLP (Sept. 25, 2000) ("PricewaterhouseCoopers Letter").

[19] See infra Section III.C; see also Proposing Release, Section II.C.

[20] The Panel on Audit Effectiveness: Report and Recommendations (the "O'Malley Panel Report"), at ¶ 5.6 (Aug. 31, 2000). The Chairman of the Public Oversight Board ("POB") similarly warned about the "uncontrolled expansion" of management advisory services to audit clients. Letter from John J. McCloy, Chairman, POB (former Chairman of the Board of Chase Manhattan Bank and former President of The World Bank), to Walter E. Hanson, Chairman, Executive Committee, SEC Practice Section ("SECPS") (Mar. 9, 1979).

[21] See, e.g., Testimony of Robert E. Denham, Member, Independence Standards Board ("ISB") (July 26, 2000) ("I think [the proposals] represent a very thoughtful, rational, coherent set of proposals."); Letter of Michael McDaniel (Aug. 14, 2000) (supporting SEC proposal and disagreeing with a Form Letter from the AICPA to its members ("AICPA Form Letter") urging them to write to the SEC to oppose the scope of services proposal); Letter of Randie Burrell, CPA (Aug. 14, 2000) (same); Letter of Leland D. O'Neal, CPA (Aug. 15, 2000) (same); Letter of David A. Storhaug, CPA (Aug. 21, 2000) (same); Letter of Arthur Gross (Sept. 10, 2000); Letter of Kristian Holvoet (Sept. 8, 2000); Letter of Bettina B. Menzel (Sept. 9, 2000); Letter of Robert Hanseman (Sept. 10, 2000); Written Testimony of Thomas S. Goodkind, CPA (Sept. 13, 2000); Testimony of Senator Howard Metzenbaum (Ret.), Chairman, Consumer Federation of America (Sept. 20, 2000); Written Testimony of Bill Patterson, Director, Office of Investments, AFL-CIO (Sept. 20, 2000); Written Testimony of Frank Torres, Consumers Union (Sept. 20, 2000); Testimony of Nimish Patel, Attorney, Pollet & Richardson (July 26, 2000). See also Senator George J. Mitchell (Ret.), "How to Keep Investor Confidence," Editorial, Boston Globe, pg. A15 (Oct. 28, 2000) ("The commission's proposal is well-reasoned and appropriate. . . . [T]he commission should adopt this rule to protect investor confidence and strengthen the most vibrant financial market system in the world.").

[22] See, e.g., Written Testimony of Kayla J. Gillan, General Counsel, California Public Employees' Retirement System ("CalPERS"), which is the largest public retirement system in the United States with over 1.2 million participants (Sept. 13, 2000) ("The SEC should consider simplifying its

Proposal and drawing a bright-line test: no non-audit services to an audit client."); Written Testimony of John H. Biggs, Chairman and CEO of TIAA-CREF, which has 2.2 million participants (July 26, 2000) ("[I]ndependent public audit firms should not be the auditors of any company for which they simultaneously provide other services. It's that simple,"); Written Testimony of Alan P. Cleveland, the New Hampshire Retirement System, with 52,000 members (Sept. 13, 2000) ("We regard the concurrent performance by the company's external auditor of non-auditor services at the direction and under the control of management to be inherently corrosive and fundamentally incompatible with that duty of independence and fidelity owed by the auditor to the investing public"); Testimony of Jack Ciesielski, accounting analyst (July 26, 2000) ("I think the single best way to improve auditor independence and the appearance of auditor independence is to call for an exclusionary ban on non-audit services to audit clients."); Letter of Carson L. Eddy, CPA, (Aug. 22, 2000) ("It is my opinion that the general public would be better served if Certified Public Accountants providing the attest function for a client were unable to do any other consulting work for that client, with the exception for the ability to prepare tax returns."); Letter of William V. Allen, Jr., CPA (Aug. 22, 2000); Letter of Terry Guckes (Sept. 9, 2000); Letter of Art Koolwine (Sept. 8, 2000); Letter of Elliot M. Simon (Sept. 9, 2000); Letter of Melvin Schupack (Sept. 9, 2000); Letter of William Odendahl (Sept. 5, 2000).

[23] See, e.g., Letter of the AICPA (Sept. 25, 2000) ("AICPA Letter"); Letter of KPMG (Sept. 25, 2000) ("KPMG Letter"); Letters of Robert Roy Ward, Chairman and Chief Executive Officer, Horne CPA Group (Sept. 20, 2000), Douglas R. Ream, CPA (undated), Jack W. Palmer (Sept. 9, 2000), Sherry Wilson, CPA (Aug. 28, 2000), and Nathaniel Boyle, CPA (Aug. 16, 2000) (each reiterating concerns expressed in the AICPA's Form Letter).

[24] See, e.g., Ernst & Young Letter; PricewaterhouseCoopers Letter.

[25] Commenters generally agreed that disclosure would be useful to investors. See, e.g., Written Testimony of James W. Barge, Vice President and Controller, Time Warner (Sept. 20, 2000); Letter of The Institute of Internal Auditors (Sept. 5, 2000); Written Testimony of Dennis Paul Spackman, Chairman of the National Association of State Boards of Accountancy (Sept. 13, 2000); Letter of Marsha Payne, President, Association of College & University Auditors (Sept. 25, 2000); Letter of Keith Johnson, Chief Legal Counsel, State of Wisconsin Board (Sept. 20, 2000); Letter of Peter C. Clapman, Senior Vice President and Chief Counsel, Investments, TIAA-CREF (Sept. 21, 2000).

[26] See, e.g., Written Testimony of Clarence E. Lockett, Vice President and Corporate Controller, Johnson & Johnson (Sept. 20, 2000); Written Testimony of Philip A. Laskawy, Chairman, Ernst & Young LLP (Sept. 20, 2000).

[27] See written testimony and transcripts from each of our hearings.

[28] A Proposal by the Securities and Exchange Commission to Modernize Its Rules That Govern the Independence of Accountants that Audit Public Companies, Before the Subcomm. on Securities of the Senate Comm. On Banking, Housing, and Urban Affairs, 95th Cong. 2d Sess. (Sept. 28, 2000).

[29] See, e.g., Letter of KPMG; Written Testimony of Robert K. Elliott, Chairman, AICPA (Sept. 13, 2000) ("There is no reason...for a rush to judgment on these critical issues. We have the time to get it right, and the public is entitled to nothing less."); Written Testimony of Barry Melancon, President and Chief Executive Officer, AICPA (Sept. 13, 2000); Letters of Richard W. Hammel, CPA (Sept. 25, 2000), Roland H. Flyge II, CPA (Sept. 23, 2000), and Daniel P. Naragon, CPA (Sept. 25, 2000) (each reiterating concerns expressed in the AICPA Form Letter).

[30] See Written Testimony of Bevis Longstreth, former SEC Commissioner and member of the Panel on Audit Effectiveness (Sept. 13, 2000) ("The SEC acting upon the need for greater independence, a need long recognized by virtually every group assigned the task of considering the issue (and there have been many), has proposed a rule to meet this need."); Testimony of Senator Howard Metzenbaum (Ret.), Chairman, Consumer Federation of America (Sept. 20, 2000); Written Testimony of Douglas Scrivner, General Counsel, Andersen Consulting (Sept. 20, 2000) ("This issue is not new. The issue has been debated within the profession and by others for over 20 years. The only thing that has changed, in my opinion, is that the risks to the system have increased."); Written Testimony of Dennis Paul Spackman, Chairman of the National Association of State Boards of Accountancy (Sept. 13, 2000) ("[A]ction is needed. Indeed, I believe it is long over due. While further study may enhance the finer points of the issues, it would do nothing to resolve the larger concerns. They have been deliberated far too long."); Testimony of Larry Gelfond, CPA, CVA, CFE, former President of the Colorado State Board of Accountancy (Sept. 13, 2000) ("I firmly believe the SEC is taking a correct position in this long debated area of concern to the profession.").

[31] Congress itself considered the issue of scope of services in the 1970s. See Report on Improving the Accountability of Publicly Owned Corporations and Their Auditors, Subcomm. on Reports, Accounting and Management of the Senate Comm. on Governmental Affairs, 95th Cong., 1st Sess. (Comm. Print Nov. 1977).

[32] In the late 1980s, for example, several of the large public accounting firms filed a petition with us seeking to enter into joint ventures, limited partnership agreements, and other similar arrangements with audit clients. See Letter from Jonathan G. Katz, Secretary, SEC, to Duane R. Kullberg, Arthur Andersen & Co. (Feb. 14, 1989) (denying the petition).

[33] See Richard C. Breeden, Roderick M. Hills, David S. Ruder and Harold M. Williams (former Chairmen of the SEC), Editorial, "Accounting for Conflicts," Wash. Post, at A31 (July 21, 2000) ("This initiative is timely and necessary. . . . [T]he time has come to chart a surer path to preserving the all-important principle of auditor independence from commercial client relationships."); James J. Schiro, Chief Executive Officer, PricewaterhouseCoopers LLP, "Auditor Independence: It's Time to Change the Rules," Wall St. J. (Oct. 10, 2000) ("New rules are needed now. Working together, we can devise rules that will protect the public interest today and for decades to come. The need for change is upon us. Further delay will only prolong confusion at a time when greater clarity is needed.") (emphasis in original); Written Testimony of Senator Howard Metzenbaum (Ret.), Chairman, Consumer Federation of America (Sept. 20, 2000) ("[A] more compelling question is, why wait? . . . Speaking for consumers across the country, we urge the Commission to move forward expeditiously with

this important rule proposal."); Testimony of Professor John C. Coffee, Columbia University (July 26, 2000) ("Right now you have the appropriate moment because the vast majority of firms aren't purchasing dual services. If you wait ten years, that will change, and [it's] much harder to change an existing reality rather than an approaching change. So I think this is the time for action . . . ."); Testimony of J. Michael Cook, former Chairman and Chief Executive Officer, Deloitte & Touche (July 26, 2000) ("[T]he Commission's consideration of this issue at this time is both warranted and necessary. The status quo is not an acceptable answer."); Written Testimony of Professor Curtis C. Verschoor, DePaul University (July 26, 2000) (stating that the question is "[n]ot why so fast, but what took so long?"); Letter of John S. Coppel, CPA, CFO, Electric Power Equipment Company (Aug. 16, 2000) ("I view this rule as a long overdue, greatly needed response to the practices now taking place within the profession.").

[34] For example, Items 25 and 26 of Schedule A to the Securities Act, 15 U.S.C. §§ 77aa(25) and (26), and Section 17(e) of the Exchange Act, 15 U.S.C. § 78q, expressly require that financial statements be audited by independent public or certified accountants. Sections 12(b)(1)(J) and (K) and 13(a)(2) of the Exchange Act, 15 U.S.C. §§ 78l and 78m, Sections 5(b)(H) and (I), 10(a)(1)(G), and 14 of the Public Utility Holding Company Act of 1935 ("PUHCA"), 15 U.S.C. §§ 79e(b), 79j, and 79n, Sections 8(b)(5) and 30(e) and (g) of the Investment Company Act of 1940 ("ICA"), 15 U.S.C. §§ 80a-8 and 80a-29, and Section 203(c)(1)(D) of the Investment Advisers Act of 1940 ("Advisers Act"), 15 U.S.C. § 80b-3(c)(1), authorize the Commission to require the filing of financial statements that have been audited by independent accountants. Under this authority, the Commission has required that certain financial statements be audited by independent accountants. See, e.g., Article 3 of Regulation S-X, 17 CFR 210.3-01 et seq. In addition, public companies must have their quarterly reports reviewed by independent accountants. Article 10 of Regulation S-X, 17 CFR 210.10-01(d) and Item 310(b) of Regulation S-B, 17 CFR 228.310(b). The federal securities laws also grant the Commission the authority to define the term "independent." Section 19(a) of the Securities Act, 15 U.S.C. § 77s(a), Section 3(b) of the Exchange Act, 15 U.S.C. § 78c(b), Section 20(a) of PUHCA, 15 U.S.C. § 79t(a), and Section 38(a) of the ICA, 15 U.S.C. § 80a-37(a), grant the Commission the authority to define accounting, technical, and trade terms used in each Act. Section 17 of the Exchange Act, 15 U.S.C. §78q, and Section 31 of the Investment Company Act, 15 U.S.C. § 80a-30, grant the Commission authority to prescribe accounting principles to be used in the preparation of financial statements required.

[35] Steven M. H. Wallman, "The Future of Accounting and Disclosure in an Evolving World: The Need for Dramatic Change," Accounting Horizons, at 81 (Sept. 1995).

[36] See generally Codification of Financial Reporting Policies (the "Codification") § 601.01 ("An investor's willingness to commit his capital to an impersonal market is dependent on the availability of accurate, material and timely information regarding the corporations in which he has invested or proposes to invest."). Use of the term "Codification" means the Codification that existed prior to the Commission's adoption of the rule amendments in this release. For a list of changes to the Codification resulting from the rule amendments, see infra Section IX.

[37] See, e.g., Testimony of Laurence H. Meyer, Governor, Board of Governors of the Federal Reserve System (Sept. 13, 2000) ("High quality accounting standards . . . can potentially be nullified if there is a perception that auditors lack independence and objectivity in their enforcement role * * * I think if the perception didn't have any basis in reality, it would not necessarily last very long, so there has to be some interconnection between them, but the perception is an important one."); Testimony of David A. Brown, QC, Chair, Ontario Securities Commission (Sept. 13, 2000) ("The reality of independence is difficult, if not impossible. Perceptions of independence, therefore, become almost equal to reality in importance."); Testimony of Kayla Gillan, General Counsel, CalPERS (Sept. 13, 2000) ("It's not only the reality of biased auditing, but also the perception that a biased practice is possible that erodes investor confidence.").

[38] AICPA SAS No. 1, AU § 220.03. As explained in SAS No. 1, "Public confidence would be impaired by evidence that independence was actually lacking, and it might also be impaired by the existence of circumstances which reasonable people might believe likely to influence independence." See also Testimony of Robert K. Elliott, Chairman, AICPA (Sept. 13, 2000) ("[The AICPA] believe[s] that appearances are very important and capital markets require confidence in financial statements and audit reports, and the member firms of the AICPA are basing their business of auditing on their reputations, and that is heavily affected by appearance. There is no question about that. We are not disputing that appearance is important."); Public Oversight Board ("POB"), Scope of Services by CPA Firms, at 27 (Mar. 1979) ("1979 POB Report") (citing A. Arens and J. Loebbecke, Auditing: An Integrated Approach (Prentice-Hall 1976)) ("[The appearance of independence is] a key ingredient to the value of the audit function, since users of audit reports must be able to rely on the independent auditor. If they perceive that there is a lack of independence, whether or not such a deficiency exists, much of that value is lost."); Earnscliffe Research and Communications ("Earnscliffe"), Report to the United States Independence Board: Research into Perceptions of Auditor Independence and Objectivity -- Phase II, at 11 (July 2000) ("Earnscliffe II") ("Perhaps the most overwhelming consensus was the belief that the perception of auditor independence is as critical to the integrity of the financial system, as is the reality.").

[39] United States v. Arthur Young and Co., 465 U.S. 805, 819 n.15 (1984) (emphasis in original). See also Article IV of the AICPA's Standards of Professional Conduct, which provides, "Objectivity is a state of mind . . . . Independence precludes relationships that may appear to impair a member's objectivity . . . ." AICPA Code of Professional Conduct, ET § 55.01 (emphasis added). Elsewhere, the AICPA's SAS No. 1 states that auditors should "avoid situations that may lead outsiders to doubt their independence." SAS No. 1, AU § 220.03 (emphasis added).

[40] See Codification § 601.01.

[41] Belverd E. Needles, Jr. (ed.) Comparative International Accounting Standards 26 (1985) (comparing France, Netherlands, Switzerland, U.K., Germany, Jordan, Kuwait, Canada, Mexico, U.S., and Japan).

[42] Institute of Chartered Accountants of Ontario, Rules of Professional Conduct Rule 204.1 (Objectivity: audit engagements); see also Institute of Chartered Accountants of British Columbia, Rules of Professional Conduct.

Rule 204.1, Objectivity - Assurance and Specified Auditing Procedure Engagements.

[43] Testimony of David A. Brown, QC, Chair, Ontario Securities Commission (Sept. 13, 2000). Principles in Hong Kong regarding the conduct of accountants provide that "a member must at all times perform his work objectively and impartially and free from influence by any consideration which might appear to be in conflict with this requirement." Hong Kong Society of Accountants, Fundamental Principles ¶ 10 (revised April 1999). In addition, a Statement of Professional Ethics in that country provides that an auditor "should be, and be seen to be, free in each professional assignment he undertakes of any interest which might detract from objectivity." Hong Kong Society of Accountants, Statement 1.203, Professional Ethics (Integrity, Objectivity and Independence) ¶ 2 (revised June 2000).

[44] Letter of Helene Bon, President, Federation of European Accountants (Sept. 25, 2000).

[45] In 1998, the European Parliament approved a resolution broadly supporting the Green Paper. Green Paper, The Role, The Position and the Liability of the Statutory Auditor Within the European Union § 4.8 (July 24, 1996), available at http://europa.eu.int. Communication from the Commission, The Statutory Audit in the European Union: The Way Forward (May 7, 1998), C143 8.05.1988-EN, available at http://europa.eu.int.

[46] See infra Section IV.C.

[47] Some firms are seeking to provide expanded services through joint ventures with audit clients or their affiliates. As noted above, as early as 1988, large public accounting firms were looking to enter into joint ventures, limited partnership agreements, and other similar arrangements with audit clients. See Letter from Jonathan G. Katz to Duane R. Kullberg, Arthur Andersen & Co. (Feb. 14, 1989).

[48] See Proposing Release, App. A, for a list of services that auditors provide to their audit and non-audit clients. The list was prepared by the ISB. See also Beverly Gordon, "KPMG spies rapid growth in `shared services,'" Accounting Today, at 12 (June 3, 1996); "KPMG Restructures to Reposition Outsourcing," Public Accounting Report, at 1 (May 15, 1996); websites of Deloitte & Touche (http://www.deloitte.com) and KPMG (http://www.us.kpmg.com).

[49] Management advisory services ("MAS") are a subset of non-audit services.

[50] See Proposing Release, Table 1 in Appendix B. The underlying data are derived from data in "Special Supplement: Annual Survey of National Accounting Firms - 2000," Public Accounting Report (Mar. 31, 2000), annual reports filed with the AICPA Division for CPA Firms by public accounting firms, and from reports prepared by the AICPA Division for CPA firms.

[51] See Proposing Release, Tables 1 and 2 in Appendix B.

[52] See Proposing Release, Table 2 in Appendix B.

[53] See Proposing Release, Table 1 in Appendix B.

[54] See Proposing Release, Table 3 in Appendix B.

[55] Id.

[56] Id.

[57] See Proposing Release, Table 4 in Appendix B.

[58] See Proposing Release, Table 3 in Appendix B. Taken together, the data from Tables 1, 3, and 4 indicate that in 1999 more than 12,700 clients of the five largest public accounting firms paid approximately $9.150 billion for accounting and auditing services.

[59] See, e.g., Rick Telberg, "Anybody can do it! says small-firm consolidator," Accounting Today, at 5 (Jan. 4-24, 1999).

[60] "Done Deal: HRB acquires M&P for $240 million cash, pension obligation," Public Accounting Report, at 1 (July 15, 1999); "AmEx and Checkers Close The Deal," Public Accounting Report, at 1 (Mar. 31, 1997).

[61] "Cap Gemini and Ernst & Young Have Agreed to Terms for the Acquisition of Ernst & Young Consulting" (Feb. 29, 2000) (press release of Ernst & Young).

[62] As clarified by the amended S-1 filed by KPMG Consulting, Inc., in connection with the initial public offering, Cisco may sell up to about half of its stake in that entity. See KPMG Consulting, Inc., Form S-1, Amend. No. 3 (Sept. 25, 2000).

[63] Id.

[64] Albert B. Crenshaw, "Audit Firm Sells Consulting Unit," Wash. Post, Oct. 26, 2000, at E2; see also news release at www.grantthornton.com/esannounce/index.html.

[65] See Earnscliffe, Report to the United States Independence Board: Research into Perceptions of Auditor Independence and Objectivity ("Earnscliffe I") at 16 (Nov. 1999) (finding increased pressure and threat of earnings management in the technology sector); see also Testimony of Jay W. Eisenhofer, Partner, Grant & Eisenhofer (Sept. 13, 2000) ("[I]n the current environment where company stock prices are increasingly dependent on showing growth and on meeting or exceeding the expectations of Wall Street investment analysts [, e]ven one missed profit number can have a significant negative effect on stock price. This places great pressure on company executives to insure that each quarter the profits are in the expected range, regardless of whether the quarter has been as good as the analyst expected. In order to meet these expectations, we often find that corporations will sometimes make questionable assumptions.").

[66] Ann Grimes, "Former McKesson Officials are Charged," Wall St. J., at B6 (Sept. 29, 2000); Sarah Schafer and David S. Hilzenrath, "Orbital to Settle Shareholder Suit," Wash. Post, at E1 (July 18, 2000); Paul Sweeney, "Accounting Fraud: Learning from the Wrongs," Fin. Exec. (Sept./Oct.

2000); Mike McNamee, "Accounting Wars," Bus. Wk., 157, 160 (Sept. 25, 2000); Bernard Condon, "Pick a Number, Any Number, Forbes (Mar. 23, 1998).

[67] See O'Malley Panel Report, supra note 20, ¶ 1.10 ("The growth in equity values over the past decade has introduced extreme pressures on management to achieve earnings, revenue or other targets. These pressures are exacerbated by the unforgiving nature of the equity markets as securities valuations are drastically adjusted downward whenever companies fail to meet `street' expectations . . . . These pressures on management, in turn, translate into pressures on how auditors conduct audits and in their relationship with audit clients.").

[68] See supra notes 21-23.

[69] See Proposing Release, Section II.C.2; O'Malley Panel Report, supra note 20, at App. D (chronicling the debate since 1957); The Commission on Auditors' Responsibilities, Report, Conclusions and Recommendations 95-96 (1978). See also infra notes 92, 98 (citing recent studies).

[70] Report on Improving the Accountability of Publicly Owned Corporations and Their Auditors, Subcomm. On Reports, Accounting and Management of the Senate Comm. on Governmental Affairs, 95th Cong., 1st Sess. (Comm. Print Nov. 1977). In the Report, the Subcommittee stated that it "agrees with the Cohen Commission and many others that the accounting profession must improve its procedures for assuring independence in view of the public's needs and expectations. Several activities of independent auditors have raised questions. Among them are public advocacy on behalf of a client, receiving gifts and discounts from clients, and maintaining relationships that detract from the appearance of arm's-length dealings with clients. Such activities are not appropriate." Id. at 16. The Subcommittee also stated that "[t]he best policy . . . is to require that independent auditors of publicly owned corporations perform only services directly related to accounting. Non-accounting management services . . . should be discontinued." Id. at 16-17. In a letter to Harold Williams, Chairman, SEC, Senator Thomas F. Eagleton, Chairman, Subcomm. on Governmental Efficiency and the District of Columbia, of the Senate Comm. on Governmental Affairs, recommended that "[t]here must be a requirement that independent auditors of publicly owned corporations perform only services directly related to accounting." Letter from Senator Thomas F. Eagleton to Harold Williams (Apr. 6, 1978) (attached list of recommendations) (reprinted in Securities and Exchange Commission Report to Congress on the Accounting Profession and the Commission's Oversight Role (July 1978)).

[71] Letter from John J. McCloy, Chairman, POB (former Chairman of the Board of Chase Manhattan Bank and former President of The World Bank), to Walter E. Hanson, Chairman, Executive Committee, SECPS (Mar. 9, 1979).

[72] Special Committee on Financial Reporting, AICPA, Improving Business Reporting - A Customer Focus: Meeting the Information Needs of Investors and Creditors, at 104 (1994).

[73] Advisory Panel on Auditor Independence, Strengthening the Professionalism of the Independent Auditor: Report to the Public Oversight Board of the SEC Practice Section, AICPA, at 9 (Sept. 13, 1994).

[74] Office of the Chief Accountant, SEC, Staff Report on Auditor Independence (Mar. 1994) ("Staff Report"). Between 1979 and 1981, public companies were required to disclose in their proxy statements certain information about non-audit services provided by their auditors. See infra Section IV.G. (discussing these disclosure requirements).

[75] See Staff Report, supra note 74, at 84; Proposing Release, notes 40-42.

[76] GAO, THE ACCOUNTING PROFESSION - Major Issues: Progress and Concerns, at 8 (GAO/AIMD-96-98, Sept. 1996).

[77] See supra Section III.B.; Proposing Release, Section II.C.2(b).

[78] See, e.g., Testimony of Kayla Gillan, General Counsel, CalPERS (Sept. 13, 2000) ("The concept that an auditor who has a greater financial incentive to please management than to criticize it will tend to find ways to avoid negative comment is intuitive and obvious."); Letter of B. Raymond Dunham ("I understand that actual hard evidence may not be apparent on the surface. However, it becomes obvious that auditing judgment may be clouded when large sums of potential revenues are dependent upon an auditing decision from any firm that derives great revenues from consulting services to the same organizations it is responsible for auditing. . . . The separation of consulting and auditing is intuitive if a firm is to maintain independence in its auditing procedures."); Letter of David T. DeMonte, CPA ("The conflict of interest potential is so patently obvious.").

[79] See, e.g., Testimony of Thomas C. DeFazio, Executive Vice President and Chief Financial Officer, VirtualCom, Inc. (Sept. 13, 2000) ("[T]he provision of non-audit services does not pressure the audit firms to look the other way."); Testimony of Thomas M. Rowland, Senior Vice President, Fund Business Management Group, Capital Research & Management Co. (Sept. 20, 2000) ("[A]t no time during my career did I feel pressure from other partners in the firm . . . not to do the right thing.").

[80] See, e.g., Testimony of Robert K. Elliott, Chairman, AICPA (Sept. 21, 2000).

[81] See, e.g., Letter of Financial Accounting Standards Committee, American Accounting Association (Oct. 12, 2000),

[82] See O'Malley Panel Report, supra note 20, ¶ 4.4 at 99 ("Focus group participants often indicated that not only clients, but also engagement partners and firm leaders, treat the audit negatively - as a commodity.").

[83] AICPA Practice Aid Series, Make Audits Pay: Leveraging the Audit Into Consulting Services, at 3 (1999).

[84] Id. at 24.

[85] See, e.g., Letter of William S. Lerach, Milberg Weiss Bershad Hynes & Lerach LLP (Sept. 22, 2000) ("In some instances, public companies bid out auditing work demanding low bids, while indicating to the bidding firms that

low auditing bids will be rewarded with lucrative consulting work"). Texas adopted a statutory provision to prevent the use of audits as loss leaders in order to protect small audit firms that could not compete in a market where audits were underpriced. Tex. Rev. Civ. Stat. art. 41a-1, § 20A (1994). See also Testimony of K. Michael Conaway, Presiding Officer, Texas State Board of Accountancy (Sept. 20, 2000) (explaining that the worry was that "big firms would predatory price their way into markets and . . . in effect, gain a competitive advantage over smaller firms that couldn't discount their work to the same extent"); Written Testimony of Wanda Lorenz, CPA, Lane Gorman Trubitt (Sept. 20, 2000) ("[M]ost of the problems that exist today can be tied to fee negotiations on audits. . . . Therefore the profession has accepted being bargained with like a shopkeeper in some bazaar in order to perform other more lucrative work.") (emphasis in original).

[86] See Testimony of Larry Gelfond, CPA, CVA, CFE, former President of the Colorado State Board of Accountancy (Sept. 13, 2000) ("Audit failures occur because auditors become careless and in the oversight or reliance on something, they may be taking a shortcut. Clearly, where an audit is low bid, there is that concern.").

[87] Low-balling also sends a message to the auditor that the audit relationship is not as valuable as the consulting relationship. See Testimony of Roderick Hills, former Chairman, SEC (Sept. 20, 2000). Low-balling sends a message inside the audit firm as well. We are concerned that the shift in a firm's emphasis away from auditing and toward non-audit services causes, over time, a cultural shift within the firm. The factors that drive a high quality audit, including the core values of the auditing profession, may diminish in importance to the firm, as will the influence of those firm members who exemplified those core values in their own professional careers.

[88] Testimony of Professor John C. Coffee, Jr., Columbia University (July 26, 2000) ("[T]he expected costs facing the accountant who might be [] tempted to shirk his duties in order to please management have vastly declined in just the last five or six years."); see also Written Testimony of Professor Coffee.

[89] Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 (codified in scattered sections of the U.S.C.) (requiring most private class actions alleging fraud in the sale of nationally traded securities to be based on federal law and brought in federal court).

[90] Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164 (1994).

[91] The Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737, amended 18 U.S.C. § 1964(c) to eliminate "fraud in the purchase or sale of securities" as a predicate act for RICO liability unless the defendant has been criminally convicted.

[92] AICPA Letter (citing AICPA, Serving the Public Interest: A New Conceptual Framework for Auditor Independence (Oct. 20, 1997) ("AICPA White Paper")). We note that the data relied on in the AICPA White Paper and referred to in the AICPA Letter was collected in 1997. As we discuss throughout this release, the magnitude of non-audit services has increased dramatically over the past several years.

[93] See Testimony of Professor Max H. Bazerman, Northwestern University (July 26, 2000); Testimony of Professor George F. Loewenstein, Carnegie Mellon Institute (July 26, 2000); see also Max H. Bazerman, Kimberly P. Morgan, and George F. Loewenstein, "The Impossibility of Auditor Independence," Sloan Management Review at 91, 94 (Summer 1997) (reviewing empirical research showing that "[w]hen people are called on to make impartial judgments, those judgments are likely to be unconsciously and powerfully biased in a manner that is commensurate with the judge's self interest," and concluding that, despite their best intentions, "there is good reason to believe that auditors will unknowingly misrepresent facts and will unknowingly subordinate their judgment due to cognitive limitations"); Jesse D. Beeler and James E Hunton, "Contingent Economic Rents; Insidious Threats to Auditor Independence," manuscript (2000).

[94] Testimony of Don N. Kleinmuntz, Professor, University of Illinois at Urbana-Champaign (Sept. 21, 2000); Testimony of Urton Anderson, Professor, University of Texas at Austin (Sept. 21, 2000) (presenting results of research commissioned by Arthur Andersen, Deloitte & Touche, KPMG, and the AICPA); see also Testimony of Professor Rick Antle, Yale University (July 26, 2000) (researcher for the AICPA presenting personal views on data).

[95] See supra notes 88-91.

[96] See infra Section III.C.5.

[97] At least one witness challenged the effectiveness of the current peer review system. She testified that, as enacted, peer review has no "teeth." Testimony of Wanda Lorenz, CPA, Lane Gorman Trubitt, LLP (Sept. 20, 2000).

[98] See, e.g., In the Matter of PricewaterhouseCoopers LLP, AAER No. 1098 (Jan. 14, 1999).

[99] W.R. Kinney, Jr., "Auditor Independence: Burdensome Constraint or Core Value?" Accounting Horizons (March 1999); G. Trompeter, "The effect of partner compensation schemes and generally accepting accounting principles on audit partner judgment," Auditing: A Journal of Practice and Theory (Fall 1994); Paul M. Clikeman, "Auditor Independence: Continuing Controversy," Ohio CPA Journal (Apr.-Jun. 1998).

[100] Earnscliffe II, supra note 38, at 6. Interviewees included chief executive officers, chief financial officers and controllers, auditors, buy-side and sell-aside analysts, audit committee chairs, and regulators.

[101] The Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees noted with respect to independent directors that, even absent objective verification, "common sense dictates that a director without any financial, family, or other material personal ties to management is more likely to be able to evaluate objectively the propriety of management's accounting, internal control and reporting practices." The Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (the "Blue Ribbon Committee"), Report and Recommendations, at 22 (1999) (the "Blue Ribbon Report"). Copies of the Blue Ribbon Report are available at www.nyse.com or www.nasd.com

[102] Written Testimony of John D. Hawke, Jr. (July 26, 2000).

[103] Written Testimony of Paul A. Volcker (September 13, 2000). Aggregate economic incentives aside, non-audit services can have the effect of aligning the accountant's interests with those of management. When the accountant acts as a consultant, the accountant must answer to management, and a "consultant . . . will be judged by the ultimate usefulness of his advice in bringing success to management's efforts. He has had a hand in shaping managerial decisions and will be judged by management on the same basis that the management itself will be judged." R.K. Mautz and Hussein A. Sharaf, The Philosophy of Auditing at 222 (Am. Acct. Ass'n 1961). As the auditor becomes increasingly involved with the audit client and its managers, the auditor is more likely to perceive himself as a part of the management team and place less emphasis on his or her primary loyalty to investors. In Earnscliffe I, Earnscliffe reported that many individuals interviewed believed that pressures on auditors have been increasing and are becoming problematic, and that "auditors are developing a stronger interest in their relationship with management, perhaps at the expense of their responsibilities to shareholders." Earnscliffe I, supra note 65, at 9.

[104] Earnscliffe I, supra note 65, at 46 (Nov. 1999). The study also found that many individuals interviewed believed that "auditors are developing a stronger interest in their relationship with management, perhaps at the expense of their responsibilities to shareholders." Id. at 9.

[105] Earnscliffe II, supra note 38, at 5 (July 2000).

[106] The O'Malley Panel Report, supra note 20, at ¶ 5.20.

[107] Brand Finance plc, The future of audit - "Back to the Future," ch. 1 (June 2000).

[108] Id.

[109] Written Testimony of Mauricio Kohn, CFA, CMA, CFM, AIMR (Sept. 20, 2000) (submitting survey). AIMR is a global, non-profit organization of investment professionals.

[110] The results were published by the A.J. Palumbo School of Business Administration at Duquesne University ("Duquesne Poll"). PricewaterhouseCoopers provided funding for the poll.

[111] The 800 adults had incomes greater than $50,000.

[112] Duquesne Poll, supra note 110, Question 12.

[113] Duquesne Poll, supra note 110, Question 13. The Poll also found that 37% of respondents thought the new rule was "somewhat important," 6% thought it "not very important," and 3% thought it "not at all important."

[114] Mr. Stadler is Dean of the John F. Donahue Graduate School of Business and the A.J. Palumbo School of Business Administration.

[115] For written comments, see, e.g., Letter of Samuel Fleishman (Sept. 9, 2000) ("My confidence in the audits is greatly decreased by knowing that

the same company is or could be doing consulting work for the company they are auditing."); Letter of George R. Jensen (Sept. 8, 2000) ("Investors have a right to expect that sanctity [of the audit] as it is promised without having to wonder about the same firm monkeying with the audit to preserve or enhance their consulting business."); Letter of Goran LindeOlsson (Sept. 9, 2000) ("The mere possibility that audits may not be 100% objective is reason enough to toughen the rules and keep accounting and consulting services separate."); Letter of Vivian D. Kilgore Jr. ("No public confidence should be given to any report of any firm that engages in this practice."); Letter of John Dossing (Sept. 10, 2000) ("Common sense tells me and other indivi[d]ual invest[o]rs this conflict of interests will lead to at the very least the appearance of conflict of interest. How can we trust any audits with the appearance of a conflict of interest. Why invest if we can't trust the figures presented to us in the financial statements?").

116 See Testimony of John H. Biggs, Chairman and CEO of TIAA-CREF (July 26, 2000); Testimony of Kayla J. Gillan, General Counsel, CalPERS (Sept. 13, 2000); Testimony of Alan P. Cleveland, New Hampshire Retirement System (Sept. 13, 2000); Testimony of Bill Patterson, Director, Office of Investment, AFL-CIO (Sept. 20, 2000).

117 Testimony of Paul A. Volcker (Sept. 13, 2000).

118 Written Testimony of Richard Blumenthal (Sept. 20, 2000).

119 Testimony of Manuel H. Johnson (July 26, 2000). See also Testimony of William T. Allen, Chairman, ISB (July 26, 2000) ("[T]he evolution of the auditing profession into multi-service professional firms has given rise to reasonable concerns that the integrity of financial data is being or may be adversely affected or at least that markets may become suspicious of that fact and impose an additional risk premium.").

120 Written Testimony of John H. Biggs before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Development (Sept. 28, 2000).

121 See, e.g., Testimony of John Guinan, Partner, KPMG (Sept. 13, 2000) ("There's no fundamental unease within the marketplace on this subject."); Testimony of Richard J. Stegemeier, Chairman Emeritus, Unocal Corp. (Sept. 13, 2000) ("I do not believe that [a clear and present danger to investors] exists.").

122 Earnscliffe I, supra note 65, at 8.

123 Earnscliffe II, supra note 38, at 44. At the request of the AICPA, Gary Orren, a professor at the John F. Kennedy School of Government, reviewed and evaluated Earnscliffe I and II. Memorandum from Gary Orren to AICPA (Sept. 19, 2000). Mr. Orren concluded that the findings do not support our proposals, and that the studies were methodologically flawed. At the same time, he acknowledged that among the respondents in the studies, "[a] larger number, about half, thought that a perception problem might develop in the future," that the majority of groups interviewed perceived a "slight appearance problem" today, that the respondents registered "mild misgivings" about the effects of non-audit services on independence, and that the respondents were "mildly worried" about a possible appearance problem in the future. Id. at 3, 4, and 7.

124 J. Gregory Jenkins and K. Krawczyk, North Carolina State University, Perceptions of the Relationship Between Nonaudit Services and Auditor Independence, manuscript (2000) (synopsis). In this study, the researchers interviewed 289 users of financial statements, including business professionals, graduate business students, and accounting professionals at Big Five firms and Non-Big Five firms.

125 Penn Schoen & Berland Associates, Inc., National Investors Survey (Sept. 12, 2000) ("Penn Schoen Survey").

126 Id. at 4. What the Penn Schoen Survey did not report, but what we believe to be equally important, however, is that among all investors surveyed, only 54% said that they believe audited financial statements are "very credible," 37% believe they are only "somewhat credible," 5% believe they are "not credible," and the remaining 3% do not know if they are credible. See Judith Burns, "Investors Unconcerned About Auditor Independence," Dow Jones New Service (Sept. 12, 2000). We do not believe that investors or the accounting profession are well-served by a situation in which 37% of investors in a survey think public companies' audited financial statements are only "somewhat credible." In addition, according to the Penn Schoen Survey, 23% of investors surveyed believed that regulators should play a bigger role than they do now in prohibiting accounting firms from offering a range of services (id. at 10) and 33% of investors surveyed disagreed that if our rules proposals were implemented audit firms will know less about the companies they audit and the quality of the audit will suffer (id. at 13).

127 Some have suggested that perception is not an appropriate basis for regulation. See AICPA White Paper, at App. A (paper by Gary Orren, "The Appearance Standard for Auditor Independence: What We Know and Should Know" (Oct. 20. 1997)). Others believe that "investor perceptions constitute an economically legitimate and theoretically sound basis for regulatory intervention." See, e.g., Written Testimony of Rajib Doogar (Sept. 20, 2000).

128 See supra Section III.C.1; see also Arthur A. Schulte, Jr., "Compatibility of Management Consulting and Auditing," Accounting Rev. 586 (July 1965) (survey of four respondent groups - research and financial analysts of brokerage firms, commercial loan and trust officers of banks, investment officers of insurance companies, and investment officers of domestic mutual funds - indicated a third of all respondents believed that the provision of both audit and non-audit services was a conflict of interest); Abraham J. Briloff, "Old Myths and New Realities in Accountancy," Accounting Rev. 490-94 (July 1996) (finding that a significant number of academics, members of financial community, and accountants believed that an auditor's provision of management-advisory services detracted from the quality of the audit); Pierre L. Titard, "Independence and MAS - Opinions of Financial Statement Users," J. Accountancy 47 (July 1971) (finding that a significant number of parties who represented major investment concerns believed that an auditor's provision of management advisory services impaired auditor independence).

129 Letter of Deloitte & Touche (Sept. 25, 2000) ("Deloitte & Touche Letter").

[130] In this regard, our rule addresses potential conflicts in a way that is similar to rules regarding the conduct of federal judges. For example, § 455 of title 28 of the federal code provides that a federal judge is to disqualify himself (and may be disqualified by the appellate court) in any proceeding where the judge's "impartiality might reasonably be questioned." 28 U.S.C. § 455(a). The courts have explained that "disqualification is required if a reasonable person who knew the circumstances would question the judge's impartiality, even though no actual bias or prejudice has been shown." Gray v. University of Arkansas, 883 F.2d 1394, 1398 (8th Cir. 1989).

[131] "The Ties That Bind Auditors," The Economist at 63 (Aug. 12, 2000) ("Usually there is a train wreck or a stock market crash prompting this sort of radical legislation.").

[132] Notice of Proposed Rule Change by the Municipal Securities Rulemaking Board Relating to Political Contributions and Prohibitions on Municipal Securities Business, Exchange Act Release No. 33482 (Jan. 14, 1994) [59 FR 3389]; see also "Exceptions to Rules 10b-6, 10b-7, and 10b-8 Under the Securities Exchange Act of 1934 for Distributions of Foreign Securities to Qualified Institutional Buyers, Securities Act Rel. No. 6999 (May 5, 1993) [58 FR 27686] ("Rules 10b-6, 10b-7, and 10b-8 (`Trading Rules') are prophylactic in nature and designed to protect investors purchasing a security in a distribution from paying a price that has been artificially influenced (i.e., raised or supported) by those persons who have the greatest incentive to engage in manipulative activity. Because the Trading Rules protect investors against artificial price movements, they promote the integrity of the pricing process and public confidence in the U.S. securities markets.").

[133] "Selective Disclosure and Insider Trading," Release No. 33-7881 (Aug. 15, 2000) [65 FR 51715].

[134] Id.

[135] 61 F.3d 938 (D.C. Cir. 1994).

[136] Id. at 945. Similarly, even in the First Amendment context of restrictions on campaign contributions, the Supreme Court has upheld the validity of prophylactic rules. Nixon v. Shrink Missouri Government, 528 U.S. 377 (2000) (relying on the seminal case of Buckley v. Valeo, 424 U.S. 1 (1976)).

[137] The widespread perception among sophisticated members of the financial community that non-audit services are jeopardizing audit reliability at the very least suggests that there is in fact a problem. Moreover, at least one published study has found a statistical link between the provision of non-audit services and the frequency of audit qualifications. Graeme Wines, "Auditor Independence, Audit Qualifications and the Provision of Non-Audit Services: A Note," 34 Acc. & Fin. 76 (May 1994). The author analyzed the audit reports put out between 1980 and 1989 by 76 companies publicly listed on the Australian Stock Exchange. He found that "the auditors of companies not receiving an audit qualification of any type over the period derived a significantly higher proportion of their remuneration from non-audit services fees than the auditors of companies receiving at least one audit qualification." Id. at 76. While the author acknowledges that his research is by no means conclusive, it does corroborate the common-sense

expectation that "auditors are less likely to qualify a given company's financials statements when higher levels of non-audit fees are derived." Id. at 83.

[138] See Testimony of Robert L. Ryan, CFO, Medtronic, Inc. (Sept. 20, 2000) ("[T]o my mind one of the most sacred things in the whole audit process is judgment. . . . [T]here is so much judgment that goes into a financial statement and I want to feel that if I'm sitting across from a partner . . . that audit is the primary thing . . . .").

[139] Richard C. Breeden, Roderick M. Hills, David S. Ruder and Harold M. Williams, Editorial, supra note 33.

[140] See, e.g., Written Testimony of J. Michael Cook, former Chairman and Chief Executive Officer, Deloitte & Touche (July 26, 2000) ("I do not share the view that proof of such a linkage is the only appropriate basis for regulatory action. To the contrary, I believe that most independence rules today are the result of appearance-based rather than fact-based concerns. Further, I agree with the Commission that the absence of "proof" does not justify inaction, particularly when such evidence cannot be expected to be demonstrable."); Paul B.W. Miller, Ph.D., CPA, Professor, University of Colorado at Colorado Springs, and Paul R. Bahnson, "The Spirit of Accounting" (draft column to appear in Accounting Today, submitted as Addendum to Written Testimony of Paul Miller (July 31, 2000) ("[A]udit failure is the wrong factor to consider. . . . The issue is not whether the auditor can avoid catastrophic failure but whether the audit can increase the credibility of the statements enough to make investors perceive a lower risk of being misled."); Testimony of Robert E. Denham, Member, ISB (July 26, 2000) ("[I]t's a mistake to focus too much on the cases of major audit failure and try to draw lessons from whether independence played a role in those. . . . [T]he better question for guiding the Commission . . . is what set of rules is more likely to produce better accounting, better financial reporting in the ordinary circumstances of the good companies . . . .").

[141] See, e.g., SEC v. Jose Gomez, AAER No. 57 (May 8, 1985).

[142] See, e.g., SEC v. Christopher Bagdasarian and Sam White, AAER No. 825 (Sept. 26, 1996).

[143] Article IV of the AICPA's Code of Professional Conduct provides, "Objectivity is a state of mind, a quality that lends value to a member's services. It is a distinguishing feature of the profession. The principle of objectivity imposes the obligation to be impartial, intellectually honest, and free of conflicts of interest. Independence precludes relationships that may appear to impair a member's objectivity in rendering attestation services." AICPA Code of Professional Conduct, ET § 55.01.

[144] 1979 POB Report, supra note 38, at 34 n.103. As the POB noted, "[T]he Board recognizes that the nonexistence of such evidence does not necessarily mean that there have not been instances where independence may have been impaired. Not all situations where an auditor's objectivity is compromised will result in a lawsuit." Id. at 35.

[145] While we considered testimony from our public hearings in evaluating the need for the rules as a matter of public policy, there was no fact finding with respect to particular cases and we have not reached any conclusions

as to the presence or absence of securities law violations in cases discussed by witnesses.

[146] Testimony of Robert M. Morgenthau (Sept. 13, 2000).

[147] See Testimony of Jay W. Eisenhofer, Partner, Grant & Eisenhofer (Sept. 13, 2000) ("It's always difficult to prove [that the auditor was influenced by large consulting fees] as a certainty, but what you're attempting to do is to use that information to demonstrate that the auditor had a motive that in combination with other facts that you're able to elicit demonstrates that the auditor at least recklessly disregarded its obligations, if not intentionally did so.").

[148] Testimony of Charles R. Drott (Sept. 13, 2000).

[149] Testimony of Stuart Grant, Partner, Grant & Eisenhofer (Sept. 20, 2000). Mr. Grant testified at the request of his client, the Council of Institutional Investors, although he stated that he was expressing his own views.

[150] Testimony of Jay W. Eisenhofer (Sept. 13, 2000).

[151] But see Testimony of Barry Melancon, President and Chief Executive Officer, AICPA (Sept. 21, 2000) ("Even if there was some isolated case[s] in which non-audit services were found to be linked to audit failures that would not establish a proper basis for the drastic action proposed by this rule.").

[152] Written Testimony of Richard Blumenthal (Sept. 20, 2000).

[153] Letter of William S. Lerach (Sept. 22, 2000). See also Letter of Britton Davis (Aug. 14, 2000) ("I have witnessed several instances of `rolling over' on issues that affected our clients, for no other reason than the apparent conflict sticking to our guns would have caused (thus threatening our revenue stream)."); see also Testimony of Charles R. Drott, CPA, CFA (Sept. 13, 2000) ("My overall conclusion... has been that in most of the cases that I have been involved in, meaning at least 50 cases that I have been involved in regarding audit failures, that the underlying cause of most of these situations was compromised auditor independence. This involved auditors auditing their own work, acting as advocates for their clients, entering into improper business relationships with their clients, and acting as management for their clients.").

[154] Testimony of Jack T. Ciesielski, accounting analyst (July 26, 2000).

[155] See supra note 22.

[156] As discussed above and in the Proposing Release (Section II.C), there have been significant changes in the accounting profession and the provision of non-audit services since 1982, when we rescinded our previous proxy statement disclosure requirement regarding non-audit services. From 1978 to 1982, we required companies to include in their proxy statement disclosures about non-audit services provided by their auditors, including the percentage of the fees for all non-audit services compared to total audit fees and the percentage of the fee for each non-audit service compared to total audit fees ("Disclosure of Relationships with Independent Public

Accountants," ASR No. 250 (June 29, 1978)). Although our concerns about the provision of consulting and other non-audit services remained unchanged, we later determined to rescind the proxy disclosure requirement ("Rescission of Certain Accounting Series Releases and Adoption of Amendments to Certain Rules of Regulation S-X Relating to Disclosure of Maturities of Long-Term Obligations," ASR No. 297 (Aug. 20, 1981)). Among other reasons, our review of proxy disclosures convinced us that accounting firms then, in contrast to now, were not providing extensive non-audit services to their audit clients. In addition, we noted that, even without the proxy statement requirement, investors had access to useful data provided to and made public by the SECPS. As discussed below, that data are no longer readily available.

[157] In particular, summarized information regarding the relationship between non-audit and audit fees is provided to the SECPS by its member firms. Until recently, the SECPS published aggregate information regarding the mix of services provided by an accounting firm to all of its clients. Investors, however, would be primarily interested in the receipt of non-audit services by the companies in which they invest.

[158] Earnscliffe II, supra note 38 at 9.

[159] Penn Schoen Survey, supra note 125, at 15.

[160] Id.

[161] See, e.g., Arthur Andersen Letter.

[162] Testimony of Jack Ciesielski, accounting analyst (July 26, 2000).

[163] Letter of Peter C. Clapman, Senior Vice President and Chief Counsel, Investment, TIAA-CREF (Sept. 21, 2000).

[164] The New York Stock Exchange ("NYSE"), National Association of Securities Dealers, Inc. ("NASD"), and the American Stock Exchange ("AMEX") also changed their company listing standards to make it clear that the auditor is ultimately accountable to the board of directors and the audit committee, as opposed to management, and that the audit committee and the board of directors have the ultimate authority and responsibility to select, evaluate and, when appropriate, replace the auditor. See Order Approving Proposed Rule Change by the NASD, Exchange Act Rel. No. 42231, File No. SR-NASD-99-48 (Dec. 14, 1999); Order Approving Proposed Rule Change by the NYSE, Exchange Act Rel. No. 42233, File No. SR-NYSE-99-39 (Dec. 14, 1999); and Order Approving Proposed Rule Change by the AMEX, Exchange Act Rel. No. 42232, File No. SR-Amex-99-38 (Dec. 14, 1999).

[165] "Audit Committee Disclosure," Exchange Act Rel. No. 42266 (Dec. 22, 1999).

[166] In its report, the Blue Ribbon Committee noted that with respect to independent directors, even absent objective verification, "common sense dictates that a director without any financial, family, or other material personal ties to management is more likely to be able to evaluate objectively the propriety of management's accounting, internal control and reporting practices." Blue Ribbon Report, supra note 101, at 22.

[167] ISB Standard No. 1, "Independence Discussions with Audit Committees" (Jan. 1999). Copies of standards issued by the ISB are available on the ISB's website at www.cpaindependence.org.

[168] In a letter to the SECPS, ISB Chairman William Allen clarified the use of the auditor's judgment under the standard. He stated:

[I]n asking itself whether a fact or relationship is material in this setting the auditor may not rely on its professional judgment that such fact or relationship does not constitute an impairment of independence. Rather the auditor is to ask, in its informed good faith view, whether the members of the audit committee who represent reasonable investors, would regard the fact in question as bearing upon the board's judgment of auditor independence.

Letter from William T. Allen, Chairman, ISB, to Michael A. Conway, Chairman, Executive Committee, SECPS (Feb. 8, 1999). We believe that Chairman Allen's interpretation is appropriate.

[169] Blue Ribbon Report, supra note 101, at 40.

[170] See Testimony of Barry Melancon, President and Chief Executive Officer, AICPA (Sept. 21, 2000) ("[I]t's the audit firm's responsibility to determine that they are independent. . . . [T]he obligation is clearly on the auditor. The auditor cannot put that obligation off solely to the audit committee in any form or fashion. And even if the audit committee were to determine things were okay, the firm is still responsible to make an independent judgment that they are in fact independent.").

[171] See Testimony of John Whitehead, former Chairman, Goldman Sachs & Co. (Sept. 13, 2000).

[172] See, e.g., Testimony of Robert L. Ryan, Chief Financial Officer, Medtronic, Inc. (Sept. 20, 2000) ("We believe that we should continue to require our audit committees, who are in the best position to evaluate independence, to play an active role in this assessment process as the proposed rule changes outline.").

[173] Companies have differing approaches to hiring their auditors to provide non-audit services. For example, John H. Biggs testified that TIAA-CREF does not hire its auditors to provide non-audit services (Testimony of John H. Biggs (July 26, 2000)), while Judy Lewent, Senior Vice President and CFO, Merck & Co., Inc., testified that her company employs a set of principles and practices for determining whether to hire their auditors to provide non-audit services, such as rotating its lead auditor every five years and requiring the audit committee to approve each request to use the outside audit firm for non-audit services. She noted that the company's process for such determinations has resulted in the use of their audit firm for non-audit services only in limited circumstances (Testimony of Judy Lewent (Sept. 13, 2000)).

[174] O'Malley Panel Report, supra note 20, at ¶ 5.29.

[175] Id. at 116-17.

[176] See, e.g., Testimony of Philip D. Ameen, Chair, Committee on Corporate Reporting, FEI-CRR (Sept. 20, 2000); Letter of Caroline Rook, Acxiom Corp. (Sept. 7, 2000); Letter of Allen J. Krowe, retired Vice Chairman, Texaco, Inc. (Sept. 5, 2000).

[177] See, e.g., Testimony of Bill Patterson, Director of the Office of Investment, AFL-CIO (Sept. 20, 2000).

[178] See, e.g., AICPA Letter.

[179] Letter from Michael H. Sutton, Chief Accountant, SEC to William T. Allen, Chairman, ISB (Dec. 11, 1997), at 6-7 (attaching SEC Staff Analysis of AICPA White Paper).

[180] O'Malley Panel Report, supra note 20, at ¶ 5.11. But see Testimony of James E. Copeland, Chief Executive Officer of Deloitte & Touche (Sept. 20, 2000) (asserting that it is the overall competencies gained by providing non-audit services to audit clients and non-audit clients that improve the quality of audits).

[181] Written Testimony of Douglas Scrivner, General Counsel, Andersen Consulting (Sept. 20, 2000). Scrivner also is a former partner of Arthur Andersen. See also Testimony of Thomas Goodkind, CPA (Sept. 13, 2000) ("I have rarely seen [a transference of knowledge] occur in my experience.").

[182] See Testimony of Stephen G. Butler, Chairman and Chief Executive Officer, KPMG (Sept. 21, 2000) ("[C]learly we don't believe that we will not be able to do a quality audit today in the structure that we have," with KPMG having incorporated its consulting business and prepared for an initial public offering of that business). Auditors of course have a professional obligation to have the expertise required to perform quality audits, and during the audit process, to gather all the evidence needed to evaluate, test, and render an opinion on the client's financial statements. See, e.g., General Standard No. 1 of Generally Accepted Auditing Standards ("GAAS") ("The audit is to be performed by a person or persons having adequate technical training and proficiency as an auditor."); Standards of Field Work No. 3 of GAAS ("Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit."). AU § 150.02. Where auditors do not have the requisite expertise in house, they can hire others outside the firm to provide the skills needed. As observed by Jack Ciesielski, "Auditors have always had to call in specialists when matters are outside their understanding." Testimony of Jack Ciesielski, accounting analyst (July 26, 2000). See also Testimony of John J. Costello, Senior Director of Litigation, Gursey, Schneider & Co., LLP (Sept. 20, 2000) ("[I]n my experience over the years, many times have we had to go and get an independent consultant that was not part of the firm . . . . It is not something that's new. It's been there for a long time and could be done again.").

[183] See Proposing Release, Table 3 in Appendix B.

[184] Written Testimony of J. Michael Cook, former Chairman and Chief Executive Officer, Deloitte & Touche (July 26, 2000). See also Written Testimony of Philip A. Laskawy, Chairman, Ernst & Young (Sept. 20, 2000)

("[T]he argument that you have to have 30,000 consultants to do an audit is not real, it never was real, because . . . what percentage of clients are you doing consulting for and it is usually in the 20 to 30 percent range. So, the other 70 percent, I hope, are getting good audits.").

185 Written Testimony of Philip A. Laskawy, Chairman, Ernst & Young (Sept. 20, 2000).

186 See, e.g., KPMG Letter; Deloitte & Touche Letter; Arthur Andersen Letter.

187 O'Malley Panel Report, supra note 20, at ¶ 5.18. Some of the eight members of the Panel, however, issued a separate statement calling for an outright ban (with very limited exceptions) on auditors providing non-audit services to audit clients because of their belief in the "central importance of independence to the profession of auditing in general, and to the effectiveness of the audit process in particular," and "the severe and growing challenges to independence that the audit profession faces in the current environment." Id., ¶ 5.32.

188 Written Testimony of Laurence H. Meyer (Sept. 13, 2000). Moreover, it has been suggested that these efficiencies can "be partially appropriated as rents to the CPA firm supplier, and hence can themselves create a threat to independence." Dan A. Simunic, "Auditing, Consulting, and Auditor Independence," 22 J. Accounting Research 679, 681 (Autumn 1984).

189 E.g., Letter of Ronald J. Marek, CPA (Aug. 17, 2000) ("Over the past twenty to thirty years, the big accounting firms started placing a higher value on selling skills and less on being `a good accountant.' This change is appropriate if the goal is generating more fees. This change has resulted in a deterioration of audit quality."); Letter of Mike McDaniel, CPA (Aug. 14, 2000) ("[T]he focus was sharper and firm operations had many fewer conflicts during the period when consulting services were not a central profit center for the Firms.").

190 See Testimony of Douglas Scrivner, General Counsel, Andersen Consulting (Sept. 20, 2000) ("What is necessary to maintain audit quality is a sustained focus and investment in the audit profession rather than in non-audit services in order to keep up with the complexity and sophistication of business in a rapidly changing environment.").

191 See, e.g., Letter of John L. Marty, CPA (Sept. 9, 2000) ("If the practice of `cross-selling' of services were constrained, it may cause a renewed emphasis on effective auditing and thereby, enhance the reliability of audited financial statements and protect the investing public."); Testimony of Larry Gelfond, CPA, CVA, CFE, former President of the Colorado State Board of Accountancy (Sept. 13, 2000) ("Partners are measured by the amount of business that they generate, the referrals that they bring in, and the jobs that they handle. Obviously, their ability to generate more fees has a direct relationship in many of these firms, including my own, to their compensation."); Testimony of Wanda Lorenz, CPA, Lane Gorman Trubitt, LLP (Sept. 20, 2000) (acknowledging the "pressure on [audit partners] to sell - pressure on them to retain the client, pressure on them to build fees").

192 O'Malley Panel Report, supra note 20, ¶ 4.4.

193 O'Malley Panel Report, supra note 20, ¶ 5.23. See also Testimony of Jack Ciesielski, accounting analyst (July 26, 2000) ("[The] accounting profession . . . increasingly seeks to distance itself from the public image as auditor in favor of one that positions accountants in the public's collective mind as business enhancing consultants.").

194 Testimony of Robert Fox, Chair, New York State Board of Public Accountancy (Sept. 13, 2000).

195 See Testimony of Paul Volcker, former Chairman, Board of Governors of the Federal Reserve System (Sept. 13, 2000) ("I suspect that many of the traditional professions are feeling under some pressure from the lure of Wall Street incomes, and the dot com world, and I suspect the Federal Reserve feels that, and auditing firms feel it. It is a fact of life. I don't think you cure that problem by creating a conflict of interest in your own firm.").

196 See supra note 53.

197 U.S. Census Bureau, Statistical Abstract of the United States: The National Data Book (119th ed. 1999).

198 Taylor Research & Consulting Group Study (2000) (commissioned by the AICPA); see generally AICPA Letter (noting trend); see also Letter of W. Steve Albrecht, Professor and Associate Dean, Marriott School of Management, Brigham Young University (Aug. 29, 2000) (noting trends and expressing concern that the proposal regarding non-audit services would cause "further and dramatic declines in the quality and quantity of students wanting to become accountants and auditors" because the accounting field will be narrower).

199 In the 1991-1992 academic school year, the firms hired 22,520 graduates with bachelor and master degrees in accounting. In 1995-1996, that number had fallen to 20,470. AICPA: Supply/Demand Study 1997 ("AICPA Supply/Demand Study") presented to the O'Malley Panel (Aug. 31, 1999).

200 See, e.g., Arthur Andersen Letter; KPMG Letter; Testimony of Joseph F. Berardino, Managing Partner, Assurance and Business Advisory Services, Arthur Andersen (Sept. 20, 2000).

201 See Testimony of David A. Brown, QC, Chair, Ontario Securities Commission (Sept. 13, 2000) ("[F]irms will continue to have difficulty recruiting new talent for the audit department, particularly if new recruits get a sense that other areas of the firm are more highly valued by firm management. . . . I think [the difficulty of recruiting on the audit side is] a very real issue, but I think the issue is clearly exacerbated by the messages being telegraphed to young recruits, and that is that there's a faster partnership track on the consulting side.").

202 We also cannot overlook the extent to which the challenge of recruiting auditors partially may be a result of the firms' own business decisions. As the General Counsel of Andersen Consulting testified at our hearings, "Some of the firms have diverted investment and resources out of the audit function and into non-audit services, thereby reducing the attractiveness of the audit function as a career path." Testimony of Douglas Scrivner, General Counsel, Andersen Consulting (Sept. 20, 2000); Letter of John S.

Coppel, CPA, CFO, Electric Power Equipment Company (Aug. 16, 2000) ("Promising young staff are exiting the audit area, the professions['] most important training ground, after a[ss]essing accurately, that career growth opportunities lie elsewhere within the practice.").

[203] Testimony of Dennis Paul Spackman (Sept. 13, 2000).

[204] Id. ("The profession to a great extent is doing it to itself and it's doing it when it gives up audits in very competitive low ball kinds of bidding processes."); see also Testimony of Thomas Goodkind, CPA (Sept. 13, 2000) (stating, in response to a question from Chairman Levitt about why the profession is having a hard time recruiting auditors, "They're not offering enough money").

[205] W. Steve Albrecht & Robert J. Sack, Accounting Education: Charting the Course Through a Perilous Future 9 (Aug. 2000).

[206] Id. (showing that the number of accounting degrees awarded in the 1998-99 academic year declined 20% compared to those awarded in the 1995-96 academic year). There has been a general decline in students seeking bachelor degrees in business-related fields. See AICPA Supply Demand/Study 1997, supra note 199, which indicates that from 1992 to 1997, the number of students obtaining bachelor degrees in accounting declined by 14%, those obtaining finance degrees declined by 17%, those obtaining general business degrees declined by 8%, and those obtaining marketing degrees declined by 27%.

[207] O'Malley Panel Report, supra note 20, ¶¶ 8.9, 8.10.

[208] See Written Testimony of Testimony of Jack Ciesielski, accounting analyst (July 26, 2000); "Where Have All the Accountants Gone?" Bus. Wk., at 203 (Mar. 27, 2000) (noting that in addition to competition from corporations and startups and increasing college requirements, "also to blame, many are beginning to argue, are regulations that govern auditors' ability to invest in stocks," and that the firms "are having a much harder time addressing the biggest retention problem they face today: regulatory restrictions on stock ownership.").

[209] See generally Deloitte & Touche Letter.

[210] See supra Section III.B.

[211] Testimony of Stephen G. Butler, Chief Executive Officer, KPMG LLP (Sept. 21, 2000).

[212] Because we believed that it would have been useful to have additional data concerning the revenue mix of accounting firms, as well as the extent to which fees to audit clients for non-audit services exceed fees for audits, we solicited comment on revenue data. In addition, SEC Commissioner Isaac C. Hunt, Jr. informed the Big Five firms that these data would help the Commission in its deliberations. See Transcript of July 26 hearing for questions of Commissioner Isaac C. Hunt, Jr. posed to Joseph F. Berardino, Managing Partner, Assurance and Business Advisory Services, Arthur Andersen LLP, Robert R. Garland, National Managing Partner, Assurance & Advisory Services, Deloitte & Touche, and J. Terry Strange, Global Managing Partner, Audit, KPMG LLP (July 26, 2000); see also Letters from

Commissioner Isaac C. Hunt, Jr. to Joseph F. Berardino, Robert R. Garland, and J. Terry Strange (Aug. 18, 2000) and Letters from Commissioner Isaac C. Hunt, Jr. to Kenton J. Sicchitano, Global Managing Partner - Independence and Regulatory Affairs, PricewaterhouseCoopers LLP, and Mr. Robert Herdman, Vice Chair - AABS Professional Practice, Ernst & Young (Sept. 14, 2000). Counsel to Arthur Andersen LLP, Deloitte & Touche LLP and KPMG LLP indicated that some of these data might be provided by mid-September (Letter from John F. Olson, Gibson, Dunn & Crutcher LLP to Commissioner Isaac C. Hunt, Jr. (Sept. 1, 2000). However, no data were submitted by any of the five firms.

[213] See Albert B. Crenshaw, "Breakup of Andersen Firm Approved," Wash. Post, at E3 (Aug. 8, 2000) (quoting former Arthur Andersen Chief Executive James Wadia).

[214] See Proposing Release, Table 4 in Appendix B.

[215] See, e.g., Letter of Joseph F. Simontacci, CPA (Aug. 14, 2000); Letter of Leland D. O'Neal, CPA (Aug. 15, 2000); Letter of Danny M. Riddle, CPA (Aug. 16, 2000); Letter of Frank Chovanetz, CPA (Aug. 16, 2000).

[216] Letter of National Conference of CPA Practitioners (Sept. 25, 2000).

[217] Testimony of Larry Gelfond, CPA, CVA, CFE, former President of the Colorado State Board of Accountancy (Sept. 13, 2000); see also Letter of John Mitchell, CPA (Aug. 14, 2000).

[218] See Testimony of Harold L. Monk, Jr., Chairman of the PCPS Executive Committee, AICPA (Sept. 21, 2000); Letter of Peter J. Hackett, Clark, Schaefer, Hackett & Co. (July 25, 2000); Letter of Frank P. Orlando (July 28, 2000); Letter of Michael L. Toms, York, Neel and Co. (Aug. 16, 2000).

[219] See, e.g., Testimony of Thomas J. Sadler, Past Chair, Washington State Board of Accountancy (Sept. 20, 2000); Letter of Mark A. Maurice, Chief Financial Officer, Avenir Group, Inc. (Aug. 15, 2000); Letter of Allan W. Nietzke, CPA (Sept. 23, 2000); Letter of Steven F. Farrel, CPA, ABV Gaither Rutherford & Co. LLP (Sept. 22, 2000); Letter of Honkamp Krueger and Co., P.C. (Sept. 22, 2000).

[220] See, e.g., Letter of Baxter Rice, President, California Board of Accountancy (Sept. 25, 2000); Letter of James E. Houle, CPA, Chair, Oregon Board of Accountancy (Sept. 24, 2000).

[221] See, e.g., Testimony of K. Michael Conaway, Presiding Officer, Texas State Board of Public Accountancy (Sept. 20, 2000); Letter of William D. Baker, President, Arizona Board of Accountancy (Sept. 20, 2000).

[222] See Letter from Arthur Siegel, Executive Director, ISB (Aug. 31, 2000); Testimony of William T. Allen, John C. Bogle, Manuel H. Johnson, and Robert E. Denham (July 26, 2000).

[223] In this regard, we note that in FRR No. 50, we stated that we were not abdicating our responsibilities in this area and that our existing authority regarding auditor independence was not affected. ISB standards and interpretations do not take precedence over our regulations or interpretations. See FRR No. 50 (Feb. 18, 1998). In FRR No. 50, we also

stated that "[i]n view of the significance of auditor independence to investor confidence in the securities markets, the Commission also will review the operations of the ISB as necessary or appropriate and, within five years from the date the ISB was established, will evaluate whether this new independence framework serves the public interest and protects investors." Id. Some witnesses acknowledged that changes to the ISB structure, such as having a majority of public members, may benefit the process and enhance the public's perception of the Board as a body focused on the public interest and protecting investors. See e.g., Testimony of William T. Allen, Chairman of the ISB (July 26, 2000) ("[I]informally we have discussed whether or not it would be desirable to increase the public membership of the board to a majority. I don't think it would [change] the outcome of our deliberations, but I recommended that we consider doing that on the notion that it might help the perception of the world, thinking that perhaps we were compromising to get standards done."); Testimony of Clarence Lockett, Vice President and Corporate Controller, Johnson & Johnson (Sept. 20, 2000) ("I believe that [having a majority of public members] would certainly go a long way in establishing that body in giving the appearance of greater independence from the profession of that body and its role in establishing independence."); Testimony of Philip A. Laskawy, Chairman, Ernst & Young (Sept. 20, 2000); Written Testimony of James J. Schiro, Chairman and Chief Executive Officer, PricewaterhouseCoopers (Sept. 20, 2000); Testimony of John J. Costello, Senior Director of Litigation, Gursey, Schneider & Co., LLP (Sept. 20, 2000); see also the Memorandum by Shaun O'Malley, Chair of the O'Malley Panel, to the O'Malley Panel, dated Aug. 31, 2000, identifying the expansion of the public representation on the ISB as a "major recommendation" of the Panel.

[224] See, e.g., KPMG Letter; AICPA Letter; Written Testimony of Philip D. Ameen, Philip B. Livingston, Roger W. Trupin, Financial Executives Institute (Sept. 20, 2000); Written Testimony of the New York State Society of Certified Public Accountants (Sept. 13, 2000).

[225] See, e.g., Letter of Kayla J. Gillan, General Counsel, CalPERS (Sept. 25, 2000) ("While CalPERS supports the work of the [ISB], only this Commission has the legal authority and effective ability to weigh the competing public interests that are represented in this area and reach conclusions about the best way to protect shareowners and the integrity of the financial markets.").

[226] ISB Standard No. 2, "Certain Independence Implications of Audits of Mutual Funds and Related Entities," ¶ 5 (Dec. 1999).

[227] Testimony of William T. Allen, Chairman, ISB (July 26, 2000).

[228] Testimony of Robert E. Denham, Member, ISB (July 26, 2000).

[229] Written Testimony of Robert E. Denham (July 26, 2000).

[230] Testimony of Manuel H. Johnson, Member, ISB (July 26, 2000).

[231] During 1999, approximately 120 foreign companies from 26 countries entered our markets for the first time. At year-end, there were over 1,200 foreign companies from 57 countries filing reports with us, and public

offerings by foreign companies totaled over $244 billion. SEC, Annual Report, at 76 (1999).

232 IOSCO is an association of securities regulatory organizations and has over 100 members. See IOSCO Annual Report (1999), App. III.

233 IOSCO, Press Release, IASC Standards (May 17, 2000), available at www.iosco.org/iosco.html.

234 "International Accounting Standards," Securities Act Rel. No. 7801 (Feb. 16, 2000) [65 FR 8,896].

235 "International Disclosure Standards," Exchange Act Rel. No. 41936 (Sept. 28, 1999) [64 FR 53,900].

236 The Institute of Management Accountants, the AICPA, and the National Association of State Boards of Accountancy are members of IFAC.

237 IFAC Ethics Committee, Independence: Proposed Changes to the Code of Ethics for Professional Accountants (Exposure Draft: Sept. 15, 2000).

238 See, e.g., Letter of Horst Kaminski, German Institut der Wirtschaftsprufer (Institute of Certified Public Accountants) (Sept. 18, 2000); Letter of Ernst & Young (UK practice) (Sept. 7, 2000); Testimony of Jack Maurice, Member of Ethics Working Party, Federation des Experts Comptables Europeens (Sept. 21, 2000).

239 See, e.g., Letter of Mike Rake, Chairman, KPMG Europe (Sept. 22, 2000); Letter of Ernst & Young (UK practice) (Sept. 7, 2000).

240 See Letter from Phillipe Danjou, COB, to Lynn Turner, Chief Accountant, SEC (Oct. 10, 2000) ("I can assure you that many regulators in Europe (mainly continental Europe) do not agree with FEE's [conceptual] approach and have made their views known to the European commission when it started its consultation on the proposed Recommendations on statutory auditors' independence. I wrote a letter to Karel Van Hulle, Head of Unit, European Commission, to make clear that COB is not ready to accept a purely conceptual system without clear prohibitions.").

241 Id. (noting that France, Germany, Italy, Spain, Belgium and others presently have a system based primarily on specific prohibitions of non-audit services, with exceptions for special circumstances). See also Letter from Michel Prada, President, COB, to Marilyn Pendergast, Chairman, Ethics Committee, IFAC (Sept. 15, 2000) (commenting on IFAC's Exposure Draft and noting that "we believe that the thrust of the exposure draft should be reversed from an `allowed if . . .' system to a `forbidden except when . . .' system. The proposed change from a prescriptive approach to a framework approach is flawed by the absence of a clear definition of an auditor's unique role and position"). In Australia, securities regulators recently settled a case with one of the Big Five firms where the firm agreed to undertakings that restrict its ability to provide certain non-audit services. For example, one of the covenants is that the firm agreed not to "accept an audit engagement where [the firm] has valued an asset and the valuation is material to the audit engagement. The valuation constitutes a service which is a barrier to the firm's ability to provide an independent audit opinion on the client's financial statements." Media Release, Australia Securities and

Investments Commission (Nov. 2, 2000), available at www.asic.gov.au. See also Staff Report, supra note 74, at Appendix II; Michael Firth, "The Provision of Nonaudit Services by Accounting Firms to their Audit Clients," Contemporary Accounting Research Vol. 14, No. 2, pp. 1-21 (Summer 1997). With respect to a recognized need by foreign regulators to take some type of regulatory action in this area, see Testimony of David A. Brown, Q.C., Chair, Ontario Securities Commission (Sept. 13, 2000) (noting that for over a year, the Ontario Securities Commission has publicly raised concerns about the issue of auditor independence, and that "[a]lthough we've not begun to frame a regulatory solution, it has become increasingly evident in Canada that some form of regulatory involvement in a solution will be essential.").

[242] See, e.g., Codification §§ 601.01 and 601.04.

[243] See, e.g., Codification § 602.02.c.i.

[244] See Rule 2-01(b), 17 CFR 210.2-01(b) (accountant cannot act as "director, officer or employee" of audit client and remain independent for purposes of Regulation S-X); Codification § 602.02.d.

[245] See, e.g., Arthur Young, 465 U.S. at 819 n.15; Codification §§ 602.02.e.i and ii.

[246] See supra note 15.

[247] See supra note 16; see also Written Testimony of Dan L. Goldwasser, Vedder, Price, Kaufman & Kammholz (July 26, 2000) (while acknowledging that "these concepts are not novel and can be found throughout the audit literature," stating that they "should not be adopted as guiding principles to be invoked each time a novel situation is encountered.").

[248] See, e.g., Testimony of K. Michael Conaway, Presiding Officer, Texas State Board of Accountancy (Sept. 20, 2000) ("[W]e would ask that [the four principles] be better placed in a preamble or a guidance document."); Testimony of Clarence E. Lockett, Vice President and Corporate Controller, Johnson & Johnson (Sept. 20, 2000) ("[W]e do not believe the four governing principles should be stated as firm rules [but rather] be part of the framework and serve [as] guiding principles.").

[249] Thomas D. Morgan and Ronald D. Rotunda, eds., The Model Code of Professional Responsibility (1995).

[250] Id. at Preliminary Statement (citing "Professional Responsibility: Report of the Joint Conference," 44 A.B.A.J., at 1159 (1958)).

[251] Federal Trade Commission, Rules and Regulations Under the Securities Act of 1933, art. 14 (July 6, 1933).

[252] Cf. Staff Report, supra note 74, at 12-16. See also SEC, Tenth Annual Report of the Securities and Exchange Commission, at 205-207 (1944), which states:

[T]he Commission has found an accountant to be lacking in independence with respect to a particular registrant if the relationships which exist between the accountant and the client are such as to create a reasonable doubt as to whether the accountant will or can have an impartial and objective judgment on the questions confronting him.

[253] See, e.g., KPMG Letter.

[254] See supra note 38-40; Proposing Release, Section II.B.

[255] See supra note 39.

[256] See United States v. Gamache, 156 F.3d 1, 8 (1st Cir. 1998) ("Now, undoubtedly, establishing intent, short of a situation in which it is admitted, is difficult and usually depends on the use of circumstantial evidence.").

[257] See TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976) (information is material if it would be "viewed by the reasonable investor as having significantly altered the `total mix' of information made available"); Basic, Inc. v. Levinson, 485 U.S. 224, 234-236 (1988).

[258] See also AICPA Code of Professional Conduct, ET § 101.02 (revised Feb. 28, 1998).

[259] Rule 2-01(f)(5) states that the engagement period ends when the registrant or accountant notifies the Commission that the registrant is no longer the accountant's audit client. This notice typically would occur when the registrant files with the Commission a Form 8-K with disclosures under Item 4 "Changes in Registrant's Certifying Accountant." In some cases, however, a Form 8-K is not required, such as when the registrant is a foreign private issuer or when the audited financial statements of a non-reporting company are filed upon its acquisition by a public company. Notification to the Commission in these cases would occur by the filing of the next audited financial statements of the foreign private issuer or the successor corporation. Registrants or auditors in these situations, however, may provide earlier notice to the Commission on Form 6-K or by other appropriate means.

[260] See AICPA SAS No. 1, AU § 220.03; AICPA Code of Professional Conduct, ET § 101. Of course, accountants also have to comply with applicable state law on independence. Id.

[261] AICPA SAS No. 1, AU § 220.03.

[262] Cf. AUSA Life Ins. Co. v. Ernst & Young, 206 F.3d 202, 205 (2d Cir. 2000) (noting "E&Y's failure lay in the seeming spinelessness" of the audit engagement partner and that "[p]art of the problem was undoubtedly the close personal relationship between" that partner and the company's chief executive officer, a former co-partner in the firm) (quoting 991 F. Supp. 234, 248 (S.D.N.Y. 1997) (district court opinion)).

[263] A number of the specified situations are based on examples in the Codification and the AICPA and SECPS membership rules.

[264] See infra Sections IV.H.3 and IV.H.5, for detailed discussions of the definitions of "audit client" and "affiliate of the audit client." As explained below, the affiliates of the audit client that are deemed to be included in the term "audit client" for purposes of the financial relationship provisions in

paragraph (c)(1)(i) are more limited than the group included in other parts of the rule.

265 See, e.g., Written Testimony of Thomas M. Rowland, Senior Vice President, Fund Business Management Group, Capital Research and Management Company (Sept. 20, 2000) (restrictions should extend to persons in the firm beyond the scope of "covered persons"); Letter of John Spadafora (June 28, 2000) (narrowing the scope of persons whose investments are restricted "is another step backwards creating temptations to pass inside information to those whose investments are not restricted.").

266 See generally Written Testimony of J. Michael Cook, former Chairman and Chief Executive Officer, Deloitte & Touche (July 26, 2000); Testimony of Ray J. Groves, former Chairman and Chief Executive Officer of Ernst & Young (July 26, 2000).

267 See, e.g., Ernst & Young Letter.

268 See, e.g., Written Testimony of William R. Kinney, Jr., Professor, University of Texas at Austin (Sept. 20, 2000) (proposed changes will "reduce aggregate regulatory compliance without affecting audit quality or increasing independence impairment risk for investors"); Testimony of Robert L. Ryan, Chief Financial Officer, Medtronic, Inc. (Sept. 20, 2000) (proposed financial relationship rules are "logical, less bureaucratic, and we're completely in agreement").

269 See infra Section IV.H.9 for a detailed discussion of the definition of "covered persons in the firm."

270 Proposing Release, Section III.C.1(a) citing Codification § 602.02.b.ii (Example 1).

271 Proposing Release, Section III.C.1(a).

272 See Ernst & Young Letter; PricewaterhouseCoopers Letter.

273 17 CFR 240.13d-101, 13d-102.

274 Cf. Ernst & Young Letter; PricewaterhouseCoopers Letter (suggesting a similar provision for immediate family members of all partners in the firm).

275 See Codification § 602.02.h (Examples 1 and 5).

276 See former Rule 2-01(b).

277 The analysis is different with respect to situations where the entity has a material investment in the audit client, or the audit client has a material investment in the entity. We address those situations in Rule 2-01(c)(1)(i)(E), discussed below.

278 The term "diversified management investment company" refers to those entities meeting the definitions of "management company" and "diversified company" in Sections 4(3) and 5(b)(1) of the Investment Company Act, 15 U.S.C. §§ 80a-4(3) and 80a-5(b)(1).

[279] Under the Investment Company Act, a "diversified" management company must meet the following requirements: at least 75% of the value of its total assets is in cash, cash items, Government securities, securities of other investment companies, and other securities limited in respect of any one issuer to an amount not greater in value than five percent of the value of the total assets of such management company and not more than ten percent of the outstanding voting securities of such issuer. 15 U.S.C. § 80a-5(b)(1).

[280] One commenter recommended that diversification be measured under Subchapter M of the Internal Revenue Code rather than the Investment Company Act of 1940. See Letter of Investment Company Institute (Sept. 25, 2000) ("ICI Letter"). Under Subchapter M, at the end of each calendar quarter of the taxable year, at least 50% of the value of the fund's total assets must be represented by cash, cash items, U.S. Government securities, securities of other investment companies, and investments in other securities, which, with respect to any one issuer, do not represent more than five percent of the value of total assets of the fund or more than ten percent of the voting securities of the issuer. In addition, no more than 25% of the value of the fund's total assets may be invested in securities of any one issuer. The Commission determined not to adopt the tax code diversification test because an investment company could concentrate its investments in a smaller number of issues and requires diversification only at the close of each quarter.

[281] See Written Testimony of Thomas C. Rowland, Senior Vice President, Fund Business Management Group, Capital Research and Management Company (Sept. 20, 2000) (suggesting a similar rule).

[282] See Ernst & Young Letter; PricewaterhouseCoopers Letter.

[283] See AICPA Code of Professional Conduct, ET § 101-8.

[284] Here, as elsewhere in the rule, we use the term "significant influence" as it is used in Accounting Principles Board Opinion No. 18, "The Equity Method of Accounting for Investments in Common Stock" (Mar. 1971) ("APB No. 18"). See infra Section IV.H.3. Because we have included a specific rule on investments in non-clients, as well as the material indirect investment rule of paragraph (D), we have decided that a more limited definition of "affiliate of an audit client" is warranted for purposes of the investment rules in paragraph (c)(1)(i). The definition of "audit client" provides that, for purposes of paragraph (c)(1)(i), audit client does not include "entities that are affiliates of the audit client only by virtue of paragraph (f)(4)(ii) or (f)(4)(iii) of the section." In other words, the only "affiliates of the audit client" that are included in the term "audit client" in section (c)(1)(i) are those that are in a control relationship with the audit client or that are part of the same investment company complex as the audit client. The rules on investments specifically state that an investment in certain entities that significantly influence, or are significantly influenced by, the audit client, impair the auditor's independence. Accordingly, there is no need to include those entities within the more general definition of an "affiliate of the audit client."

[285] See Rule 2-01(c)(1)(i)(E)(1)(ii).

[286] Rule 2-01(c)(1)(i)(E)(3). The operation of paragraphs (E)(1)(ii) and (E)(3) is illustrated in the chart attached as Appendix A.

[287] Rule 2-01(c)(1)(i)(E)(1)(i).

[288] Rule 2-01(c)(1)(i)(E)(2). The operation of paragraphs (E)(1)(i) and (E)(2) is illustrated in the chart attached as Appendix B.

[289] Consistent with the Proposing Release, we have treated credit card debt as a separate category. See discussion of paragraph (c)(1)(ii)(E) below.

[290] Regulation S-X, Rule 1-02(r), 17 CFR 210.1-02(r).

[291] Regulation S-X, Rule 1-02(s)(2), 17 CFR 210.1-02(s)(2).

[292] See, e.g., Section 16 of the Securities Exchange Act of 1934, 15 U.S.C. § 78p.

[293] See Ernst & Young Letter; PricewaterhouseCoopers Letter.

[294] See generally, Deloitte & Touche Letter.

[295] See Deloitte & Touche Letter (agreeing that such accounts "might, in certain circumstances, create a perception that an accounting firm's independence has been impaired").

[296] See, e.g., AICPA Letter.

[297] Letter of XL Capital Limited (Sept. 25, 2000); AICPA Letter; Letter of Swiss Re (Sept. 22, 2000).

[298] See AICPA Letter (suggesting this approach).

[299] See Rule 2-01(f)(4)(iv).

[300] ISB Standard No. 2, "Certain Independence Implications of Audits of Mutual Funds and Related Entities," at ¶ 3 (Dec. 1999).

[301] See infra Section IV.H.11.

[302] See Letter of KPMG Europe (Sept. 22, 2000); Written Testimony of Institute of the Chartered Accountants in England & Whales ("ICAEW") (Sept. 13, 2000).

[303] See, e.g., ICI Letter; Deloitte & Touche Letter; see also Letter of the Association of Private Pension and Welfare Plans (Aug. 7, 2000).

[304] ICI Letter.

[305] See Letter from POB to ISB (Jan. 12, 2000) ("Public ownership in an audit firm or in its parent or in an entity that effectively has control of the audit firm would add another form of allegiance and accountability to those identified by the Supreme Court - a form of allegiance that in our opinion will be viewed as detracting from, if not conflicting with, the auditor's `public responsibility'").

[306] See AICPA Letter.

[307] See infra Section IV.H.2.

[308] See Written Testimony of William Travis, McGladrey & Pullen LLP (Sept. 20, 2000).

[309] See PricewaterhouseCoopers Letter ("We endorse and applaud the SEC's initiatives to modernize the archaic financial interest and employment rules in order to reflect today's social and business realities. We support, for the most part, the treatment of these topics in the Release.").

[310] See, e.g., Deloitte & Touche Letter; Letter of Steven Ryan, Chair, Financial Accounting Standards Committee, American Accounting Association (Oct. 12, 2000); Written Testimony of John C. Bogle, Public Member, ISB (July 26, 2000).

[311] See, e.g., AICPA Letter; Written Testimony of William T. Allen, Chair, ISB (July 26, 2000).

[312] See, e.g., Letter from Lynn E. Turner, Chief Accountant, SEC, to Charles A. Bowsher, Chairman, Public Oversight Board (Dec. 9, 1999); Letters from Lynn E. Turner, Chief Accountant, SEC, to Michael A. Conway, Chair, SECPS (Nov. 30, 1998; Dec. 9, 1999). These letters are available on our website.

[313] Nevertheless, we encourage, and we expect, firms to follow the steps described in ISB Standard No. 3, including the steps to be taken in the period after the firm's professional reports an intention to join an audit client and the steps to be taken after the professional actually joins the audit client. We also anticipate that peer reviews conducted by the POB will cover firms' compliance with these steps.

[314] These examples are illustrative only and should not be relied upon as a complete list of employment relationships that impair an accountant's independence under paragraphs (b) and (c)(2).

[315] Compare Letter of Paula Morris, MPA, CPA, Assistant Professor, Kennesaw State University (Sept. 25, 2000) (expressing her concerns about loosening the rules regarding spouses' and dependents' employment relationships) with Deloitte & Touche Letter (suggesting that an audit client's employment of a close family member of a covered person who is not on the audit engagement team or in the chain of command, should not be deemed to impair the auditor's independence, even if the person holds an accounting or financial reporting oversight role because there is only a "remote likelihood" that such a person could influence the audit).

[316] ISB, "Invitation to Comment 99-1: Family Relationships Between the Auditor and the Audit Client" (July 1999).

[317] AICPA Code of Professional Conduct, ET § 101.11.

[318] AICPA Letter ("For the most part, the specific positions listed in the definition . . . are appropriate and provide helpful advice to practitioners. . . . however . . . we do not believe the vice president of marketing should be included in this list."); Ernst & Young Letter.

[319] See, e.g., In the Matter of Jimmy L. Duckworth, CPA, AAER No. 1205 (Nov. 10, 1999); In the Matter of Pinnacle Micro, Inc., Scott A. Blum, and Lilia Craig, AAER No. 975 (Oct. 3, 1997).

[320] See AICPA, Auditing Standards Division, "Audit Risk Alert - 1994, General Update on Economic, Accounting, and Auditing Matters," at 35 (1994).

A few litigation cases suggest auditors need to be more cautious in dealing with former coworkers employed by a client. None of these cases involved collusion or an intentional lack of objectivity. Nevertheless, if a close relationship previously existed between the auditor and a former colleague now employed by a client, the auditor must guard against being too trusting in his or her acceptance of representations about the entity's financial statements. Otherwise, the auditor may rely too heavily on the word of a former associate, overlooking that a common interest no longer exists.

[321] See Paul M. Clikeman, "Close revolving door between auditors, clients," Accounting Today, at 20 (July 8-28, 1996); Cf. In the Matter of Richard A. Knight, AAER No. 764 (Feb. 27, 1996) (individual allegedly learned of accounting misstatements while he was engagement partner for firm conducting audit and resigned to become registrant's executive vice president and chief financial officer).

[322] See, e.g., AUSA Life Ins. Co. v. Ernst & Young, 206 F.3d 202 (2d Cir. 2000); AICPA Board of Directors, Meeting the Financial Reporting Needs of the Future: A Public Commitment From the Public Accounting Profession, at 4 (June 1993) ("AICPA Board Report"); see also Staff Report, supra note 74, at 51-52; In addressing an example of this problem, the court in Lincoln S&L v. Wall, 743 F. Supp. 901, 917 n.23 (D.D.C. 1990) wrote:

Atchison, who was in charge of the Arthur Young audit of Lincoln, left Arthur Young to assume a high paying position with Lincoln. This certainly raises questions about Arthur Young's independence. Here a person in charge of the Lincoln audit resigned from the accounting firm and immediately became an employee of Lincoln. This practice of "changing sides" should certainly be examined by the accounting profession's standard setting authorities as to the impact such a practice has on an accountant's independence. It would seem that some "cooling off period" perhaps, one to two years, would not be unreasonable before a senior official on an audit can be employed by the client.

[323] In response to these and other concerns, the AICPA Board of Directors suggested in 1993 that we prohibit a public company from hiring the partner responsible for the audits of that company's financial statements for a minimum of one year after the partner ceases to serve that company. See AICPA Board Report, supra note 322, at 4. Our staff has indicated, however, that, if implemented, this suggestion would take the form of the firm's independence being impaired for a period of time from the date the individual left the audit engagement, rather than as a prohibition on hiring the former partner. Staff Report, supra note 74, at 52 n.146. See also Committee of Sponsoring Organizations of the Treadway Commission ("COSO"), "Fraudulent Financial Reporting: 1987-1997: An Analysis of U.S. Public Companies," at 21 (1999) (finding, with respect to companies where there was fraudulent financial reporting, that among 44 companies for

which there was information available on their CFO's background, 11% of the companies' CFOs had previous experience with the companies' audit firms just before joining the company).

324 As noted in the Proposing Release, to avoid adverse tax consequences to the individual, accounting firms often settle their retirement obligations to former partners by fully funding a "rabbi trust" from which payments will be made to the individual. Under Rule 2-01(f)(16), a "rabbi trust" is an irrevocable trust whose assets are not accessible to the firm until all benefit obligations have been met but are subject to claims of the firm's creditors in bankruptcy or insolvency. We are adopting the definition of "rabbi trust" as proposed.

325 See, e.g., Written Testimony of ICAEW (Sept. 13, 2000).

326 We would not consider an individual's 401(k) account to constitute a financial arrangement with the accounting firm to be fully funded for these purposes because, although the investment remains subject to market risk, the account balance is not dependent on the accounting firm's financial performance even if the firm continues to administer the account for the former firm personnel.

327 With regard to cooling off periods, see AICPA Board Report, supra note 322, at 4 (June 1993) (suggesting that the Commission prohibit a public company from hiring the partner responsible for the audits of that company's financial statements for a minimum of one year after the partner ceases to serve that company) and Lincoln S&L v. Wall, 743 F. Supp. at 917 n.23 ("It would seem that some `cooling off period,' perhaps one to two years, would not be unreasonable before a senior official on an audit can be employed by the client.").

328 See, e.g., Letter of Pamela Roush, Ph.D., CMA (undated).

329 See, e.g., Written Testimony of Mauricio Kohn, CFA, CMA, CFM, AIMR (Sept. 20, 2000) ("We do not believe it is necessary to impose a mandatory `cooling-off period,' prohibit clients from hiring audit firm professionals, or stipulate that an audit firm's independence is impaired when its professionals accept key positions with current clients.").

330 Nonetheless, we encourage firms to maintain adequate controls to ensure that former employees are not unduly influencing the audit engagement team.

331 Of course, once an employee of an accounting firm, the person would also be subject to all other independence requirements applicable to other firm members. For example, if the former audit client employee becomes a covered person, he or she could have no financial interest in the audit client. See Rule 2-01(c)(1).

332 The AICPA recommended that the rule apply to all professional employees of the accounting firm, not just to partners, shareholders, and principals. See AICPA Letter. We agree and, therefore, have modified the final rule to encompass this situation.

333 See, e.g., Deloitte & Touche Letter; Written Testimony of Dennis Paul Spackman, Chairman, National Association of State Boards of Accountancy

(Sept. 13, 2000) ("I am in full agreement with the provisions of the Commission's proposal [regarding] Business Relationships.").

334 See Codification § 602.02.g.

335 See Deloitte & Touche Letter ("Although we agree with the direction of [Rule 2-01(c)(3)], it provides no basis for prohibiting business relationships with beneficial owners of more than five percent of the equity securities of the audit client or any of its affiliates.").

336 Ernst & Young Letter; see also AICPA Letter ("Such sweeping new restrictions would dramatically constrict the parties with which accounting firms could engage, even though many such parties at most have only very attenuated ties to audit clients. . . . We view independence risks as extremely remote in such circumstances and, therefore, consider the reach of such provisions unnecessarily broad.").

337 See Codification § 602.02.g; Letter from Jonathan G. Katz, Secretary, SEC, to Duane R. Kulberg, Arthur Andersen & Co. (Feb. 14, 1989).

338 See, e.g., Deloitte & Touche Letter.

339 See infra Section IX; Codification § 602.02(g).

340 See AICPA Letter.

341 See Letter from Jonathan G. Katz, Secretary, SEC, to Duane R. Kulberg, Arthur Andersen & Co. (Feb. 14, 1989).

342 See, e.g., Proposing Release, Section III.D.1.(b)(i), (iv) (regarding bookkeeping and actuarial services, respectively). But see Proposing Release, Section III.D.1.(b)(ii) (regarding financial information systems).

343 See, e.g., Testimony of Barry Melancon, President and Chief Executive Officer, AICPA (Sept. 21, 2000).

344 See Testimony of Joseph F. Berardino, Managing Partner, Assurance and Business Advisory Services, Arthur Andersen LLP (Sept. 20, 2000) and Testimony of James E. Copeland, Chief Executive Officer, Deloitte & Touche LLP (Sept. 20, 2000) (responding to questions from Chairman Arthur Levitt, SEC, about whether they would be comfortable if our final rules on non-audit services paralleled the profession's own rules); see also Testimony of K. Michael Conaway, Presiding Officer, Texas State Board of Accountancy (Sept. 20, 2000).

345 See infra Section IV.D.4.b(x).

346 AICPA Code of Professional Conduct, ET § 101.05; Codification § 602.02.c.i.

347 Proposing Release, Section III.D.1(b)(i); Codification § 602.02.c.

348 See, e.g., Deloitte & Touche Letter; AICPA Letter.

349 See Ernst & Young Letter.

[350] For example, as part of the audit process, the auditor might propose adjustments that eventually are incorporated into the audit client's financial statements. See Deloitte & Touche Letter.

[351] AICPA Code of Professional Conduct, ET § 101.05.

[352] See, e.g., Deloitte & Touche Letter.

[353] Codification § 602.02.c.ii, Example 6.

[354] Codification § 602.02.c.iii.

[355] Proposing Release, note 160.

[356] Deloitte & Touche Letter; Ernst & Young Letter; PricewaterhouseCoopers Letter.

[357] There may be entities that are not large enough to maintain the capability in-house, yet there may not be reputable providers of these services where domestic companies' foreign affiliates are located or a reputable firm may not want to provide the services because they will generate only minimal fees. See Codification § 602.02.e.iii.

[358] Codification § 602.02.c.iii (requiring compliance with this condition, "so that an informed observer in the foreign location would have no cause to question the fact or appearance of independence").

[359] Codification § 602.02.c.iii.

[360] The Commission has determined to raise to $10,000 from $1,000 the dollar threshold in the Codification in light of the inflation since the provisions in the Codification were adopted.

[361] See generally, Arthur Andersen Letter; Deloitte & Touche Letter.

[362] See AICPA Code of Professional Conduct, ET § 101.05.

[363] Although we anticipate that accountants and their audit clients will usually seek to meet these conditions, we note certain points about paragraph (c)(4)(ii)(B) relevant to situations where these conditions are not met. First, by "significant," we refer to information that is reasonably likely to be material to the financial statements of the audit client. Since materiality determinations may not be final before financial statements are generated, an accounting firm may need to evaluate the general nature of the information rather than wait to evaluate system output during the period of the audit engagement. For example, without satisfying the conditions of paragraphs (c)(4)(ii)(B)(1)-(5), an accountant would not be independent of an audit client for which it designed an integrated Enterprise Resource Planning ("ERP") system. (An ERP system is designed to integrate all functions and departments in a company into one computer system that can serve the needs of each department.) In addition, without satisfying the conditions, a firm's independence would be impaired if it designed and implemented an accounts receivable/order management system that recorded and summarized sales that were material to the financial statements of the audit client. A firm's independence would not be impaired, however, if the accounting firm designed and implemented a

system for a foreign subsidiary whose financial condition and results of operations were not material to the financial statements of the audit client.

[364] Ernst & Young Letter; PricewaterhouseCoopers Letter.

[365] The ISB has identified threats to the independence of firms that perform appraisal and valuation services for audit clients. See ISB, Discussion Memorandum 99-3 "Appraisal and Valuation Services," at 7-9.

[366] See generally Codification § 602.02.c.

[367] See, e.g., Arthur Andersen Letter; Deloitte & Touche Letter; PricewaterhouseCoopers Letter.

[368] Of course, reference to financial statements includes results of operations, financial conditions and cash flows.

[369] AICPA Code of Professional Conduct, ET § 101.05 states that an auditor's independence would not be impaired in connection with appraisal and valuation services "when all significant matters of judgment are determined or approved by the client and the client is in a position to have an informed judgment on the results of the valuation."

[370] See, e.g., Arthur Andersen Letter.

[371] Deloitte & Touche Letter.

[372] We note in this regard, that if an acquisition individually, and when aggregated with other acquisitions reflected in the financial statements, is immaterial to the audit client's financial statements, then assisting in the allocation of the purchase price would not fall within the conditions of the rule and therefore would not be deemed to impair the auditor's independence.

[373] See, e.g., Deloitte & Touche Letter; Ernst & Young Letter; Letter of KPMG Europe (Sept. 22, 2000).

[374] Ernst & Young Letter.

[375] See e.g., Deloitte & Touche Letter; Letter of KPMG Europe (Sept. 22, 2000).

[376] See Letter from Lynn Turner, Chief Accountant, SEC, to Antonio Rosati, CONSOB (Aug. 24, 2000). In that letter, our Chief Accountant did not deem the auditor's independence to be impaired where there were certain agreed-upon procedures for the contribution-in-kind report and the accountant represented in the report that the report did not express an opinion on the fairness of the transaction, the value of the security, or the adequacy of consideration to shareholders. This letter is available on our website.

[377] SECPS Reference Manual ("SECPS Manual") § 1000.35.

[378] PricewaterhouseCooopers Letter; Ernst & Young Letter; see also Deloitte & Touche Letter.

379 SECPS Manual § 1000.35, at ¶ 5.

380 Although it addresses a different topic, accountants and registrants may refer to ISB, "Interpretation No. 99:1: Impact on Auditor Independence of Assisting Clients in the Implementation of FAS 133 (Derivatives)" for general guidance on what constitutes "assistance" as opposed to "performing" certain functions or services.

381 See SECPS Manual § 1000.35.

382 See Committee of Sponsoring Organizations of the Treadway Commission, Internal Control - Integrated Framework, at 7 (1992) (the "COSO Report").

383 Testimony of Robert E. Denham (July 26, 2000); see also Testimony of John Whitehead, retired Chairman, Goldman Sachs & Co. (Sept. 13, 2000) ("internal auditing is the function of management").

384 Testimony of Manuel H. Johnson, Public Member, ISB (July 26, 2000).

385 See AICPA Code of Professional Conduct, ET § 101.15 (Interpretation 101-13).

386 Testimony of John D. Hawke, Jr. (July 26, 2000). He also reported a trend among banks in favor of outsourcing internal audit work to the external auditor. He testified that "[o]f [the] 50 largest banks" within the jurisdiction of the OCC, "8 out-source their internal audit, and 7 of those 8 out-source to the same firm that does their external audit. That's a pretty good chunk of the largest banks." Id. In addition, Mr. Hawke reported that in a survey of the OCC banks in the Northeast region, one-third outsource their internal audit work and half of those banks outsource to their external auditor. Id.

387 In this study, companies with small, "mean-sized," and large internal audit departments were asked to indicate their level of agreement (on a scale of zero to five, with five being the strongest) with the following statement: "There is an independence problem if the external audit firm performs extended audit services (internal audit services) for the same firm for which it performs the annual financial statement audit." The level of agreement among respondents was between 3.7 and 4.0, "indicating a perception of an independence problem." Larry E. Rittenberg and Mark A Covaleski, The Outsourcing Dilemma: What's Best for Internal Auditing, at 68 and Exh. 4-4 (Institute of Internal Auditors Research Foundation 1997).

388 AICPA SAS No. 55, AU§ 319 (effective for audits on or after Jan. 1, 1990).

389 See, e.g., Testimony of John D. Hawke, Jr., Comptroller of the Currency (July 26, 2000) (noting concerns about the effect of the proposed rule on small banks); Testimony of Wayne A. Kolins, National Director of Assurance, BDO Seidman, LLP (Sept. 20, 2000).

390 These hardships could include, for example, difficulty in obtaining suitable professional services at a cost appropriate to the size of the business, or, for a small accounting firm, the loss of a substantial portion of its client base for either its audit or internal audit services.

[391] Using the $200 million threshold reasonably isolates companies that are relatively small themselves - approximately 54% of the 9,414 public reporting companies in the Standard & Poors Research Insight Compustat Database ("Compustat Database") - and has the effect of almost completely excepting smaller accounting firms. Approximately 85% of the public company audit clients (other than bank holding companies) of non-Big Five accounting firms have less than $200 million in assets. Of public company audit clients with more than $200 million in assets - the companies that would not trigger the exception - no more than 6.1% (again, excluding bank holding companies) are audited by non-Big Five firms. The source for these data is the Compustat Database, October 31, 2000. For further analysis, see infra Section V.B. (cost-benefit analysis).

[392] See, e.g., Testimony of Jacqueline Wagner (Sept. 13, 2000) (testifying for the Institute of Internal Auditors) ("The IIA believes that the total outsourcing of the internal auditing function to the organization's external auditing firm impairs that firm's independence."); Testimony of Dominick Esposito, Chief Executive Officer, Grant Thornton LLP (Sept. 13, 2000) ("I think if there is the entire internal audit department outsourced, it can present a conflict.").

[393] Testimony of Ray J. Groves (July 26, 2000).

[394] See AICPA Code of Professional Conduct, ET § 101.15 (Interpretation 101-13).

[395] Testimony of Barry Melancon, President and Chief Executive Officer (Sept. 13, 2000). Mr. Melancon also noted that "[t]here still has to be management responsibility for the overall internal audit function . . . we certainly agree that the ultimate responsibility for internal auditing, the management decision making, must [lie] with management, not with the auditor."

[396] When providing internal audit services to an audit client with $200 million or more in assets, the auditor must measure the internal audit services provided to the audit client in full-time employee hours. In order to remain independent, the auditor must ensure that it provides 40% or less of the total hours expended by the audit client, the auditor and anyone else on internal audit matters related to internal accounting controls, financial systems, and financial statements, and matters that impact the financial statements.

[397] In addition, performing procedures that generally are considered to be within the scope of the engagement for the audit of the audit client's financial statements, such as confirming accounts receivable and analyzing fluctuations in account balances, would not impair the accountant's independence, even if the extent of testing exceeds that required by GAAS. For example, if an accountant in normal circumstances would plan to observe ten percent of an audit client's inventory, but at the audit client's request the accountant observes 50% of inventory on hand, the accountant's independence would not be impaired.

[398] AICPA Code of Professional Conduct, ET § 101.15 (Interpretation 101-13).

[399] AICPA Code of Professional Conduct, ET § 191.206-207 (Interpretation 101-103).

[400] Former Rule 2-01(b), 17 C.F.R. 210.2-01(b); AICPA Code of Professional Conduct, ET § 101.02.

[401] See SECPS Manual § 1000.35 App. A; see also AICPA Code of Professional Conduct, ET § 101.05 (Interpretation 101-3) (deeming an auditor's independence impaired when the auditor negotiates employee compensation or benefits, or hires or terminates client employees).

[402] SECPS Manual § 1000.35 App. A.

[403] Id.

[404] Id.

[405] Id.; AICPA Code of Professional Conduct, ET § 101.05.

[406] Id.

[407] SECPS Manual § 1000.35 App. A

[408] See, e.g., Deloitte & Touche Letter; KPMG Letter; PricewaterhouseCoopers Letter; Ernst & Young Letter.

[409] See, e.g., KPMG Letter; Ernst & Young Letter.

[410] See, e.g., Deloitte & Touche Letter; Ernst & Young Letter.

[411] Former Rule 2-01(b), 17 CFR 210.2-01(b).

[412] Codification § 602.02.e.iii.

[413] See AICPA Code of Professional Conduct ET § 101.05.

[414] See, e.g., Ernst & Young Letter; PricewaterhouseCoopers Letter.

[415] See Arthur Andersen & Co., 1994 SEC No Act. LEXIS 617 (July 8, 1994) ("Andersen No-Action Letter") in which the staff stated it would not recommend enforcement action under the Investment Advisers Act where an accounting firm did not register as an investment adviser but an affiliated registered investment adviser provided investment advisory services. The staff permitted the affiliate to publish a newsletter with financial planning information, provided the newsletter does not recommend any specific industry sectors or securities, to identify categories of mutual funds that satisfy an advisory client's investment objectives, and to recommend two or more mutual funds in each category. When an advisory client wants more specific advice, the investment advisory affiliate accountant will provide a client with a list of two or more investment advisers or broker-dealers that meet certain predetermined criteria, provided that the accountant does not receive any fee or other economic benefit from the mutual funds, investment advisers or broker-dealers recommended. The advisory affiliate will disclose to advisory clients that the recommended mutual funds, investment advisers, or broker dealers

may include audit clients. See also Ernst & Young Letter (citing Andersen No-Action Letter).

[416] AICPA Code of Professional Conduct, ET § 101.05 (Interpretation 101-3).

[417] Id.

[418] Codification § 602.02.e.iii.

[419] See Arthur Andersen Letter (acknowledging that it is appropriate to prohibit accountants from recommending any specific securities to audit clients and from recommending audit clients' securities to non-audit clients).

[420] See AICPA Code of Professional Conduct, ET § 101.05, Interpretation 101-3, which states that an accountant's independence would not be impaired if that accountant assists in developing corporate strategies, assists in identifying or introducing the client to possible sources of capital that meet the client's specifications or criteria, assists in analyzing the effects of proposed transactions, assists in drafting an offering document or memorandum, or participates in transaction negotiations in an advisory capacity.

[421] Letter from Edmund Coulson, Chief Accountant, SEC, to Edward McGowen, Pannell Kerr Forster, at 2 (July 11, 1988) (discussing mergers and acquisition services, among others).

[422] See Ernst & Young Letter; PricewaterhouseCoopers Letter.

[423] See also ISB, "Discussion Memorandum 99-4: Legal Services" (Dec. 1999).

[424] See Proposing Release, Section III.D.1(b)(ix).

[425] Codification § 602.02.e.ii.

[426] Arthur Young, 465 U.S. at 819-20 n.15.

[427] American Bar Association Commission on Multidisciplinary Practice, Report to the House of Delegates, at 5 (July 2000) ("ABA Report") (available at www.ABAnet.org/cpr/mdpfinalrep2000.html).

[428] See Ernst & Young Letter; PricewaterhouseCoopers Letter; Arthur Andersen Letter.

[429] See, e.g., Va. Sup. Ct. R. 1A:4 (2000).

[430] See, e.g., Arthur Andersen Letter.

[431] See ABA Report, supra note 427.

[432] Id. at 5 (footnote omitted).

[433] See, e.g., PricewaterhouseCoopers Letter; Deloitte & Touche Letter.

[434] AICPA Code of Professional Conduct, ET § 101.202-101.203.

[435] See, e.g., Arthur Andersen Letter.

[436] AICPA Code of Professional Conduct, ET § 102.07 ("[I]n the performance of any professional service, a member shall comply with rule 102 [ET § 102.01], which requires maintaining objectivity and integrity and prohibits subordination of judgment to others . . . . Moreover, there is a possibility that some requested professional services involving client advocacy may appear to stretch the bounds of performance standards, may go beyond sound and reasonable professional practice, or may compromise credibility, and thereby pose an unacceptable risk of impairing the reputation of the member and his or her firm with respect to independence, integrity, and objectivity. In such circumstances, the member and the member's firm should consider whether it is appropriate to perform the services.").

[437] AICPA SAS No. 22, AU § 311.04b; AU § 9311.03.

[438] See, e.g., PricewaterhouseCoopers Letter; Deloitte & Touche Letter.

[439] AICPA Code of Professional Conduct, ET § 302.01.

[440] As Ray J. Groves, former Chairman and CEO, Ernst & Young testified, "It does not impair independence to reward a professional who excels in his or her performance, or who exceeds reasonable expectations." Written Testimony of Ray J Groves (July 26, 2000).

[441] See Letter from Lynn Turner, Chief Accountant, SEC, to Charles Bowsher, Chairman, POB (Dec. 9, 1999); see, e.g., In the Matter of PricewaterhouseCoopers, LLP, AAER No. 1098 (Jan. 14, 1999).

[442] See Letters from Lynn Turner, Chief Accountant, SEC, to Michael Conway, Chairman, SECPS Executive Committee (Nov. 30, 1998; Dec. 8, 1999; May 1, 2000).

[443] AICPA Letter; Deloitte & Touche Letter; KPMG Letter; Letter of Jodi L. McFall, CPA (Sept. 1, 2000); Letter of Electronic Data Systems (Sept. 11, 2000); Letter of William Tourville, CPA (Sept. 14, 2000); Letter of Gary Whitsell (Sept. 19, 2000).

[444] Letter of Thomas Graves (July 18, 2000); Letter of the FEE (Sept. 25, 2000).

[445] See Ernst & Young Letter.

[446] See, e.g., Ernst & Young Letter.

[447] Proposing Release, n.192.

[448] See Ernst & Young Letter (acknowledging that the requirement applies worldwide).

[449] See KPMG Letter; Letter of KPMG Europe (Sept. 22, 2000).

[450] GAAS already requires firms to have quality controls for their audit practices and refers auditors to the "Statements on Quality Control

Standards" ("SQCS") for guidance regarding the elements of those systems. AICPA SAS No. 25; AU § 161.

[451] We considered whether to use the number of firm professionals, instead of the number of SEC registrants, to determine which firms are required to implement the quality controls in Rule 2-01(d)(4) to qualify for the limited exception. See SECPS Manual § 1000.46. We use number of SEC registrants because we are particularly concerned with those firms that audit a large number of SEC registrants, regardless of the number of professionals, and because we can more easily verify the number of SEC registrants audited by a firm.

[452] Letter from Lynn Turner, Chief Accountant, SEC, to Michael Conway, Chairman, SECPS Executive Committee (Dec. 9, 1999).

[453] See, e.g., Letter of KPMG Europe (Sept. 22, 2000).

[454] See Ernst & Young Letter; PricewaterhouseCoopers Letter.

[455] See Ernst & Young Letter; PricewaterhouseCoopers Letter.

[456] Letter of KPMG Europe (Sept. 22, 2000).

[457] See Ernst & Young Letter; Letter of Ernst & Young, U.K. (Sept. 7, 2000); Letter of KPMG Europe (Sept. 22, 2000); Deloitte & Touche Letter.

[458] See Letter from Michael A. Conway, Chairman, SECPS Executive Committee, to the Managing Partners of the SECPS Member Firms (April 2000).

[459] SECPS Manual § 1000.46 (April 2000).

[460] Ernst & Young Letter (suggesting a three-year transition period); Letter of Ernst & Young U.K. (Sept. 7, 2000).

[461] AICPA Ethical Standard ET § 101.07 (grandfathering certain loans that existed as of January 1, 1992).

[462] See supra note 25.

[463] See Earnscliffe II, supra note 38, at 45, which states, "Most people sensed that the relationship between the auditor and auditee was appropriate, typically neither too close nor tension-ridden. The one area of greater concern had to do with the provision of non-audit services to audit clients, where participants felt unsettled and discomfited. Avoidance of this practice seemed preferred, but disclosure was seen as a helpful alternative step as well."

[464] The disclosure requirement pertains to the accounting firm that is the registrant's principal accountant. The principal accountant generally is the accounting firm that takes responsibility for the report on the financial statements of the registrant for each year presented. See SEC Division of Corporation Finance, "Accounting Disclosure Rules and Practices: An Overview," Topic Four, I.D. (Mar. 31, 2000).

[465] See proposed Rule 14a-101 Item 9(e)(4); Rule 10-01(d) of Regulation S-X and Item 310 of Regulation S-B, 17 C.F.R. 210.10-01, 228.310(b).

[466] Ernst & Young Letter.

[467] PricewaterhouseCoopers Letter; Ernst & Young Letter; Testimony of J. Michael Cook, former Chairman and Chief Executive Officer, Deloitte & Touche (July 26, 2000); Testimony of Philip D. Ameen, Chair, Committee on Corporate Reporting, FEI-CRR (Sept. 20, 2000).

[468] See supra Section IV.D.4.b(ii). The services described in Rule 2-01(c)(4)(ii)(B) relate to systems that aggregate source data underlying, or generate information significant to, the financial statements, which may be a particular concern to investors. See Earnscliffe I, supra note 65, at 24, which states, "Some felt that installing computer systems was not a problem . . . others argued that if the computer system had anything to do with the financial reporting systems . . . then the auditor would be in serious conflict." The required disclosure will permit investors to decide whether such services create independence concerns.

[469] See Earnscliffe I, supra note 65, at 26, which describes responses to a scenario when the annual audit fee was $1 million and the auditor performed computer system work for $10 million, which was 1% of the auditor's annual revenues, and states, "First off, the sheer size of the contract was seen as a potential perception challenge. Even though $10 million might be good value for the client, and only a tiny fraction of the audit firm's business, there was a sense of doubt that the firm would be willing to walk away from such a relationship, if that were necessary to protect the independence of the audit."

[470] Companies Act 1985, Part XI, Chapter V, Auditors, § 390B, "Remuneration of Auditors and Their Associates for Non-audit Work," and Regulations 1991, § 5, "Disclosure of Remuneration for Non-Audit Work." See generally Written Testimony of Graham Ward, Institute of Chartered Accountants of England and Wales ("ICAEW") (Sept. 13, 2000).

[471] Michael Firth, "The Provision of Nonaudit Services by Accounting Firms to their Audit Clients," Contemporary Accounting Research, at 6 (Summer 1997). Firth hypothesized that companies with potentially high agency costs (i.e., companies in which directors do not control management or which have a large amount of debt) would limit the non-audit services provided by their auditors because the appearance of a lack of auditor independence would increase their cost of capital. Firth's sample data came from the 500 largest British industrial, listed companies. Firth's findings were consistent with his hypothesis.

[472] See Arthur Andersen Letter.

[473] See Department of Trade and Industry, "A Framework of Independent Regulation for the Accounting Profession," ¶¶ 29, 35, 39, 44, and 46 (Nov. 1998).

[474] Testimony of Graham Ward, ICAEW (Sept. 13, 2000).

[475] ICI Letter.

476 We note that audit committees currently receive information about the auditor's provision of non-audit services under ISB Standard No. 1 and SECPS Manual § 1000.08. See ISB Standard No. 1, supra note 167; SECPS Manual § 1000.08 (requiring the auditor to report annually to the audit committee or board of directors (or its equivalent in a partnership) of SEC registered audit clients on the "total fees received from the client for management advisory services during the year under audit and a description of the types of such services rendered").

477 The O'Malley Panel has recommended that audit committees pre-approve non-audit services that exceed a threshold determined by the committee. This recommendation is consistent with the recommendations of the Blue Ribbon Committee regarding auditors' services. The Panel set forth factors for audit committees to consider in determining the appropriateness of a service. See O'Malley Panel Report, supra note 20, at ¶ 5.30.

478 The ISB cites threats to independence arising from these structures and identifies quality controls to ensure the independence of the auditors in these situations. See ISB, "Discussion Memorandum 99-2: Evolving Forms of Firm Structure and Organization," at 20 (Oct. 1999).

479 AICPA SAS No. 1, AU § 543 also sets forth guidance on when a principal auditor discloses and makes reference to another auditor who performs an audit of a component of the entity.

480 See, e.g., Testimony of Robert E. Denham, Member, ISB (July 26, 2000) (recommending that disclosure be put in footnotes to the financial statements or in the Form 10-K).

481 See, e.g., Letter of Peter C. Clapman, Senior Vice President and Chief Counsel, Investments, TIAA-CREF (Sept. 21, 2000).

482 See Item 9 of Schedule 14A. 17 CFR 240.14a-101.

483 15 U.S.C. § 78(d).

484 "Foreign private issuer" is defined in Securities Act Rule 405 (17 CFR 230.405) and Exchange Act Rule 3b-4 (17 CFR 240.3b-4).

485 See, e.g., KPMG Letter; Arthur Andersen Letter.

486 See Written Testimony of Wayne Kolins, National Director of Assurance, BDO Seidman, LLP (Sept. 20, 2000).

487 See, e.g., Letter of Fred M. Rock, CPA (Sept. 20, 2000); Letter of Centerprise Advisors, Inc. (Sept. 25, 2000).

488 See, e.g., Deloitte & Touche Letter; Testimony of Wayne A. Kolins, BDO Seidman, LLP (Sept. 20, 2000).

489 See Letter of Edmund Coulson, Chief Accountant, SEC, to Robert Mednick, Arthur Andersen (June 20, 1990).

490 Questions of attribution in this context have not been analyzed on the basis of "affiliation" in the past. Indeed, the term "affiliate of the accounting

firm" is not used in our current Rule 2-01 or in the Codification. The term was used in our proposed rule, along with the proposed definition of the term, to attempt to bring certainty to this issue. Since "affiliate" is defined in Rule 1-02 of Regulation S-X and we are eliminating the definition of "affiliate of the accounting firm," we have used the term "associated" instead of "affiliated" in our final rules to make clear that, consistent with the status quo, the entities treated as if they were the accounting firm will not be determined by reference to the definition of "affiliate" in Rule 1-02 of Regulation S-X. While the "control" relationships of Rule 1-02 may be adequate to warrant treating an entity as the accounting firm for independence purposes, Rule 1-02 does not set forth the exclusive circumstances in which an entity's interests will be imputed to the accounting firm in this context. In addition, we do not intend for the definition of "associated" used in any other context in the federal securities laws to apply to this term.

[491] See, e.g., Letter of Edmund Coulson, Chief Accountant, SEC, to Robert Mednick, Arthur Andersen (June 20, 1990); Letter of W. Scott Bayless, Assistant Chief Accountant, SEC, to Larry Edgerton, Elms, Faris & Co. (June 7, 1996); Letter of Lynn E. Turner, Chief Accountant, SEC, to Jeff Yabuki, American Express Financial Advisors (Nov. 2, 1998); Letter of Lynn E. Turner, Chief Accountant, SEC to Michael Gleespen, Century Business Services (Nov. 2, 1998); Letter of Lynn E. Turner, Chief Accountant, SEC, to Terry Putney, H&R Block Business Services (Nov. 2, 1998); Letter of Lynn E. Turner, Chief Accountant, SEC, to Michael Conway, KPMG Peat Marwick LLP (Jan. 7, 1999); Letter of Lynn E. Turner, Chief Accountant, SEC, to Nigel Buchanan, PricewaterhouseCoopers (July 26, 1999); Letter of Lynn E. Turner, Chief Accountant, SEC, to Kathryn A. Oberly, Esq., Ernst & Young (May 25, 2000); Letter of Lynn E. Turner, Chief Accountant, SEC, to Antonio Rosati, Director of Issuers Division, Commissione Nazionale per le Societa e la Borsa (August 24, 2000); Letter of Lynn E. Turner, Chief Accountant, SEC, to J. Terry Strange, KPMG (October 16, 2000); see also Codification § 602.02.b.ii, Ex. 8; 602.02.b.iv; 602.02.c.iii; 602.02.g, Ex. 5. Cf. SECPS Manual § 1000.45 (discussing application of SECPS rules to "foreign associated firm[s]"); AICPA Code of Professional Conduct, ET § 101.16 (Interpretation 101-14) (application of independence rules to alternative practice structures); AICPA Code of Professional Conduct, ET § 505.03 (application of independence rules to entities controlled by an accounting firm or its members). In addition, accounting firms entering into business transactions in which they acquire equity stakes in other companies will need to continue to consider whether they will have a direct or material indirect business relationship with, or a direct financial interest or material indirect financial interest in, any of their audit clients that are also clients of or enter into business relationships with or invest in or are invested in by that other company. See Letter of Lynn E. Turner, Chief Accountant, SEC, to Kathryn A. Oberly, Esq., Ernst & Young (May 25, 2000); Letter of Lynn E. Turner, Chief Accountant, SEC, to J. Terry Strange, KPMG (October 16, 2000).

[492] See AICPA Letter; Arthur Andersen Letter.

[493] See Deloitte & Touche Letter.

[494] See Codification § 602.02.b.iii (Ex. 1); 602.02.b.iv; 602.02.c.iii; 602.02.h (Ex. 9).

495 See APB No. 18.

496 See Letter of Stanley Keller, Esq., and Richard Rowe, Esq., ABA Committees on Federal Regulation of Securities Law and Accounting (Sept. 27, 2000).

497 See APB No. 18, at ¶ 17. Paragraph 17 of APB No. 18 also discusses a number of considerations that may affect the ability of an entity to have significant influence over an investee.

498 We have, however, narrowed the definition of "investment company complex" from the definition used in ISB Standard No. 2. See infra Section IV.H.11.

499 See Arthur Andersen Letter.

500 Rule 2-01(f)(5)(ii)(A).

501 Rule 2-01(f)(5)(ii)(B).

502 See, e.g., Deloitte & Touche Letter.

503 See, e.g., Deloitte & Touche Letter.

504 SECPS Manual § 1000.08; cf. AICPA Code of Professional Conduct, ET § 101.02.

505 See, e.g., Ernst & Young Letter ("We also would revise the definition of `audit and professional engagement period' in the Release . . . to codify the Commission staff's practice of only requiring the latest audited period in initial filings by foreign private issuers to be fully compliant with SEC independence rules.").

506 Arthur Young, 465 U.S. at 818.

507 See, e.g., PricewaterhouseCoopers Letter.

508 See, e.g., Deloitte & Touche Letter.

509 See Deloitte & Touche Letter.

510 AICPA SAS No. 22, AU § 311.046 and AUI 9311.03.

511 See, e.g., Deloitte & Touche Letter; Ernst & Young Letter.

512 See, e.g., Deloitte & Touche Letter; Ernst & Young Letter.

513 For a discussion of the definition of "office," see infra Section IV.H.12.

514 See Deloitte & Touche Letter.

515 For example, leased accounting personnel might consult with a professional employee participating in an audit and thereby become a member of the audit engagement team.

[516] See Written Testimony of Ronald Nielsen and Kathleen Chapman, Iowa Accountancy Examining Board (Sept. 20, 2000).

[517] ISB Standard No. 2, supra note 226.

[518] See, e.g., Deloitte & Touche Letter; AICPA Letter.

[519] See, e.g., Arthur Andersen Letter.

[520] See, e.g., Deloitte & Touche Letter; AICPA Letter.

[521] See AICPA Letter.

[522] The ISB Exposure Draft, cited in the AICPA Letter, states the following:

the identification of the relevant `office' or practice unit is based on the facts and circumstances, including the firm's operating structure, and requires judgment. In a traditional geographic practice office (one city location with one managing partner in charge of all operations - audit, tax, and consulting), that location should be considered to be the office. In addition, if there are smaller, nearby `satellite' offices managed under the primary city office, broadly sharing staff, etc., those locations should also be considered part of the primary office. On the other hand, many firms are now structured more on an industry specialization or line-of-service basis, and manage offices on that basis. For example, if a financial services group were a separate practice unit, and were operated that way with limited contact with personnel of other local units, that may represent a separate office for purposes of this standard. Substance should govern the office classification, and the expected regular personnel interactions and assigned reporting channels of an individual may well be more important than his or her physical location.

[523] While we discuss the costs and benefits to issuers separately from those accruing to investors, impacts on the issuers are also likely to flow to investors as owners of the issuers' securities.

[524] It has been suggested that the Proposing Release did not clearly specify the baseline from which the costs and benefits were being estimated. The following presentation clearly establishes the baseline: costs and benefits are compared to current regulations.

[525] See supra Section III.B.

[526] See Written Testimony of Jack Ciesielski, accounting analyst (Sept. 13, 2000) ("I think the real problem in attracting talent in the auditing profession is the share ownership restrictions placed on auditors. . . . The relaxation of share ownership constraints that are proposed in this document should allay most fears of future auditors.").

[527] See Rule 2-01(e)(1)(ii).

[528] The rules we adopt today are slightly more restrictive than current rules with respect to certain financial interests - such as credit cards and bank accounts - and employment relationships as they relate to covered persons on the audit engagement team. We do not anticipate that these changes will impose significant costs.

529 Other public accounting firms would have the flexibility to adopt a system to comply with the requirement in light of the nature and size of their practice. See SAS No. 25, AU § 161.03. This is in general conformity with GAAS, which states, "The nature and extent of a firm's quality control policies and procedures depend on factors such as its size, the degree of operating autonomy allowed its personnel and its practice offices, the nature of its practice, its organization, and appropriate cost-benefit considerations." See SAS No. 25, AU § 161.02.

530 Because the threshold for the limited exception is based on the number of audit clients rather than professionals, certain middle-tier firms, if they grow, may meet the threshold earlier than they would under current SECPS requirements. See SECPS Manual § 1000.46. We note that our rule does not require implementation of these systems, but rather leaves it to the discretion of the firm.

531 SAS No. 25, AU § 161 n.1.

532 AICPA Professional Standards: SQCS, QC § 20.09.

533 See "International Accounting Standards," Securities Act Rel. No. 7801 (Feb. 16, 2000) [65 FR 8,896]; Form 20-F, Item 8, "Financial Information," 17 CFR 249.220f.

534 See SECPS Manual § 1000.45.

535 See Letter from Michael A. Conway, Chairman, Executive Committee, SECPS, to the Managing Partners of SECPS Member Firms, April 2000 (available at www.aicpa.org).

536 See Romac International, 1999 Salary Survey and Career Navigator: Finance & Accounting (1999), which reports the median national public accounting salary to be $47,300 annually. Assuming a 2080-hour work year, we obtain $22.75 per hour. We increase our hourly estimate to $30 to allow for benefits and other overhead expenses.

537 See supra Sections IV.D.1, IV.D.2.

538 See supra Section III.B.

539 In the Proposing Release, the proscribed services included expert witness services. Expert witness services have been removed from the list of services that are per se incompatible with an auditor's independence.

540 Under the final rule, the term "internal audit services" does not include operational internal audit services unrelated to the internal accounting controls, financial systems, or financial statements. Additional discussion of the impact of this threshold appears in Section IV.D.4.b(v).

541 Throughout this section we round percentages to one decimal place. As a result some percentage combinations, when relevant, will not add to exactly 100.

542 Our purpose in using these data is to estimate the association between company size and the auditors classified as Big Five, second tier and smaller accounting firms. The Compustat Database has two limitations for

purposes of this estimate. First, the Compustat Database does not include all companies filing with the SEC. Second, we note that Compustat includes American Depository Receipts (ADRs). Some of the companies issuing ADRs and included on Compustat may not be required to file audited financial statements with the SEC. The data include 499 non-bank filers who issue ADRs; 405 are for companies with $200 million or more of assets; and 94 are companies with less than $200 million in assets. Only 57 of these ADR issuers are not audited by Big Five accounting firms.

The data also include 22 bank holding companies with $200 million or more of assets that have issued ADRs. The database contains information on approximately 9,414 registered companies including bank holding companies. Compustat applies set criteria for adding companies to the database. The criteria vary depending upon whether a company is domiciled in the U.S., Canada or abroad. The net effect of these criteria is that Compustat is heavily weighted toward larger companies, particularly, larger North American companies. If these criteria have the effect of excluding smaller companies that may have assets of less than $200 million, this analysis will overstate the proportion of companies that will be affected by the rule and the impact of the rule on smaller companies. See Compustat Database, October 31, 2000.

[543] The average revenue of companies with assets of $195 - $205 million is $209 million.

[544] See Testimony of Paul Volcker, former Chairman, Board of Governors of the Federal Reserve System (Sept. 13, 2000) ("I know that when . . . I was Chairman, there was still a question of whether banks had to be audited, and they are, of course, examined and many of the banks complain that it would be very costly and they didn't have the resources for decent internal auditing efforts. . . ."); see also Testimony of Laurence H. Meyer, Governor, Board of Governors of the Federal Reserve System (Sept. 13, 2000); Testimony of John D. Hawke, Jr., Comptroller of the Currency (July 26, 2000). Both indicated that their respective organizations have been concerned about internal audit outsourcing for some time. Neither organization has placed an absolute ban on internal audit outsourcing. However, both have provided guidance on the manner in which internal audit outsourcing is to be handled.

[545] Professional staff of the Office of the Chief Accountant obtained the names of bank holding company auditors by searching Commission 10-K filings contained in EDGAR. 10KWizard was utilized to search the EDGAR database.

[546] Only ten of the 91 bank companies with less than $200 million in assets were located in one of the top 35 U.S. cities by population. See Compustat Database, October 31, 2000.

[547] The Institute of Internal Auditors ("IIA") Global Auditing Information Network ("GAIN") cited by Larry E. Rittenberg and Mark A. Covaleski in their monograph, The Outsourcing Dilemma: What's Best for Internal Auditing for IIA (1997) ("Rittenberg") and Manufacturers Alliance, Survey of General Audit (2000) generally include large companies. According to Rittenberg, companies included in the IIA GAIN study are large, increasing the probability that the GAIN companies are Big Five clients. Only two of the companies responding to the Manufacturers Alliance survey used

accounting firms other than a Big Five firm as the primary external auditor. The Alliance survey reported a ten percentage point increase in the outsourcing of general audit tasks to the primary external auditor between 1995 and 2000. Of the companies using Big Five firms as their primary auditor, 42.5% indicated that they outsourced general audit work to their primary auditor. The survey also indicates that the portion of general audit needs that is outsourced remains fairly small, at less than 5% for 72.9% of the respondents.

[548] As noted above, our definition of internal audit is narrower than that used by Rittenberg and Covaleski.

[549] Rittenberg and Covaleski provide data that allows us to estimate the potential impact of the 40% limitation included in the rule. The Table below uses the information above to estimate the internal audit outsourcing and extended audit services that the external auditor can perform for the SEC registrant audit clients after the new rule is in effect. According to the IIA GAIN information in 1995 studied by Rittenberg and Covaleski, 35% of internal audit activities were classified as "operational." These activities can be fully outsourced under the rule. The remaining services were classified as follows: 17% compliance audit; 14% information systems; 26% financial audits; 8% other (unspecified). The rule will allow 40% of these services to be outsourced. Accordingly, under the rule, 61% of internal audit services could be outsourced.

In addition, the Manufacturers Alliance conducted its Survey of General Audit, 2000 and received responses from 106 companies of which 104 were audited by Big Five firms. It asked respondents how general audit time was allocated and received the following response: 40.2% control/compliance, 32.3% operational audit, 5.9% assisting external audit, 11.0% service requests, 3.4% M&A work and 7.1% other activities. While the categories are generally not the same as those used in the IIA GAIN reports, the operational audit component in both surveys is similar. On the other hand, control/compliance work is much higher for the Alliance survey respondents than the apparently similar category used in GAIN. This might be attributed to classification problems and/or the time period considered. However, in 1995 the Alliance survey reported an even higher control/compliance allocation at 46.9%. Further, the Alliance survey does not break out IT work specifically, making it difficult to compare the two survey results on this dimension. Alliance survey respondents did indicate that computer systems oriented work was growing rapidly (33%) or somewhat rapidly (59.4%). The Alliance survey reported a rise from 20.0% in 1995 to 32.3% in 2000 in the operational audit category, a category of internal auditing services not prohibited by the rule.

[550] See Letters from Commissioner Isaac C. Hunt, Jr., supra, note 212. Some commenters suggested that by requesting data on the costs and benefits of the rule, we asked the public to shoulder a burden rightfully belonging to the regulator. See, e.g., Arthur Andersen Letter. We do not suggest that any party was obligated to provide data in response to our requests for comments. On the other hand, where data are exclusively under the control of commenters, our rules cannot be criticized for any failure to take into account data to which we do not have access. Wherever possible, we relied on information supplied by interested parties and other public sources of information.

551 See Letter of Kim Johnson, General Counsel, The Public Employees Retirement Association of Colorado (September 1, 2000); Testimony of Allen Cleveland, New Hampshire Retirement System (Sept. 13, 2000); Testimony of John Biggs, Chairman, President and CEO of TIAA-CREF (July 26, 2000).

552 See Testimony of Kayla Gillan, General Counsel, CalPERS (Sept. 13, 2000).

553 See Testimony of Jay Eisenhofer, Partner, Grant & Eisenhofer (Sept. 13, 2000) ("Your rule, I believe, will cut down on fraud, cut down on auditor self-interest, and increase the reliability of financial statements.").

554 See, e.g., KPMG Letter.

555 See, e.g., Arthur Andersen Letter.

556 See, e.g., Deloitte & Touche Letter.

557 See, e.g., Testimony of Douglas Scrivner, General Counsel, Andersen Consulting (Sept. 20, 2000) ("It is important to note that audit firms do not provide consulting services to improve the quality of the audits, but rather for commercial considerations. A then CEO of one of the Big Five audit firms was quoted recently in Business Week saying `If I had to trade an auditing account for other business, I would do it.'").

558 Despite the mixed academic results and the difficulties in preparing unbiased survey results, it is clear that the perception of auditor independence is important to financial statement users and can be affected negatively by the extent and type of non-audit services provided by the auditor to audit clients.

Perception is difficult to establish definitively. A number of academics have provided evidence that perceptions are affected by the mix of audit and non-audit services provided to audit clients. The academic evidence is mixed and subject to alternative interpretation. Selected papers by academics include: M. Firth, "Perceptions of Auditor Independence and Official Ethical Guidelines," 55 Acct. Rev., at 451-466 (July 1980) ("Firth"); R.A. Shockley, "Perceptions of Auditors' Independence: An Empirical Analysis," 56 Acct. Rev., at 785-800 (October 1981) ("Shockley"); D.J. Lowe and K. Pany, "CPA Performance of Consulting Engagements with Audit Clients: Effects on Financial Statement Users' Perception and Decisions,"14 Auditing: J. of Prac. & Theory, at 35-53 (Fall 1995) ("Lowe 1995"); D.J. Lowe and K. Pany, "An Examination of the Effects of Type of Engagement Materiality, and Structure on CPA Consulting Engagements with Audit Clients," 10 Acct. Horizons, at 32-52 (December 1996) ("Lowe 1996"); J.G. Jenkins and K. Krawczyk, "Perception of the Relationship Between Nonaudit Services and Auditor Independence," North Carolina State University, manuscript (2000) ("Jenkins & Krawczyk").

Generally, Firth and Shockley found that financial statement users are more concerned than auditors about the independence problems associated with matters such as incentives to retain clients in a competitive environment and/or when non-audit services are sold to audit clients. More recently, Lowe (1995, 1996) found that loan officers and financial analysts appear to perceive little or no independence problem at low levels (1% of office revenue) of non-audit services, but did exhibit concern as the level of office revenues from non-audit services rose. Jenkins & Krawczyk studied three group's perceptions about auditor independence and the provision of non-audit services to audit clients. The Jenkins and Krawczyk study groups are Big Five CPA professionals, non-Big Five CPA professionals and a group labeled "general public," composed of business professionals and graduate business students. The CPA professionals, particularly those associated with the Big Five, generally felt that independence was not threatened and in some cases might be strengthened by the provision of non-audit services to audit clients. The "general public" was generally supportive of the provision of non-audit services, but less so than the other two groups.

Recent surveys of a variety of financial statement users demonstrate the existence of varying degrees of concern for auditor independence when offering non-audit services to audit clients. The story told by the surveys is admittedly complex. Virtually all of the surveys that have been submitted to the public record (Public Opinion Strategies, Brand Finance PLC, Earnscliffe, AIMR, Penn Schoen Survey, and Pace University) indicate some concern for auditor independence. The degree of concern may be, in part, a function of the timing of the surveys, the manner in which the subjects were queried, and the subject sample selection.

[559] Duquesne Poll, supra note 110. The surveyors asked several related questions of the subjects. First they asked, "And from what you've seen, read or heard, do you generally favor or oppose this SEC proposal?" This was immediately followed by, "And do you strongly favor/oppose or just somewhat favor/oppose the SEC proposal." In response to this question, 30% stated that they "Strongly Favor" and 34% that they "Somewhat Favor" the SEC proposal. The surveyors then provided a one paragraph narrative describing the auditor's responsibilities with respect to fair presentation of financial statements and a one paragraph narrative describing the SEC concerns about the potential conflict of interest auditors face when selling both audit and consulting services to the same client. The subjects were then asked to state whether they strongly/somewhat favor/oppose a position based on this information. At this point 49% stated that they "Strongly Favor" and 32% stated that they "Somewhat Favor" the SEC proposal.

[560] See Testimony of Mauricio Kohn, CFA, CMA, CFM, AIMR (Sept. 20, 2000).

[561] See Letter of Brand Finance PLC (June 13, 2000).

[562] See Testimony of Rajib Doogar (Sept. 13, 2000) ("Low audit credibility, in turn, will drive up costs of capital, affecting the well functioning of capital markets and indeed of the US economy as a whole.").

[563] See Letter of Charles C. Cox, Kenneth R. Cone, and Gustavo E. Bamberger, Lexecon Inc. (Sept. 25, 2000) ("Lexecon Letter").

[564] See, e.g., M.C. Jensen and W.H. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure," 3 J. of Fin. Econ, at 305-360 (1976); A.A. Alchian and H. Demsetz, "Production, Information Costs, and Economic Organization," 62 Am. Econ. Rev., at 777-795 (1972). This agency conflict grows out of the inability of investors to

perfectly control by contract managers' behavior. The problem is exacerbated if investors cannot monitor management's choices.

565 See M. H. Bazerman, K.P Morgan, and G.F. Loewenstein, "The Impossibility of Auditor Independence," 38 Sloan Mgt. Rev. 89-94 (Summer 1997); Testimony of Professor Max H. Bazerman, Northwestern University (July 26, 2000); Testimony of Professor George F. Loewenstein, Carnegie Mellon Institute (July 26, 2000); J.D. Beeler and J.E.Hunton, "Contingent Economic Rents: Insidious Threats to Auditor Independence," manuscript (2000); G. Trompeter, "The Effect of Partner Compensation Schemes and Generally Accepted Accounting Principles on Audit Partner Judgment," 13 Auditing: J. Prac. & Theory, at 56-68 (Fall 1994). Trompeter provides experimental evidence that compensation schemes can influence subject judgments. Trompeter finds that auditors whose rewards are based on local office revenues have a tendency to support management views more often than if their rewards are computed on the broader firm revenue base. In the latter case, loss of a local client does not necessarily lead to substantial individual reward losses. Trompeter addresses the incentives issue, one of the complex issues possibly leading to subtle biases in judgment. His results suggest a self-serving bias effects judgment. But see Testimony of Professor Urton Anderson, University of Texas (Sept. 21, 2000) and Professor Don N. Kleinmuntz, University of Illinois at Urbana-Champaign (Sept. 21, 2000) for arguments that the self-serving bias is overcome in practice by a variety of behavioral and institutional factors. See R.R. King, "An Experimental Investigation of Self-Serving Biases in an Auditing Trust Game," manuscript (2000).

566 See AICPA Practice Aid Series, Make Audits Pay: Leveraging the Audit into Consulting Services (1999). Furthermore, as a result of the rule, issuers may avoid marketing pressure from their auditors to purchase certain non-audit services.

567 See Testimony of John C. Whitehead, retired Chairman, Goldman Sachs & Co. (Sept. 13, 2000).

568 See Testimony of D. Bevis Longstreth, former SEC Commissioner and Member of the O'Malley Panel (Sept. 13, 2000).

569 See, e.g., Lexecon Letter.

570 See, e.g., Deloitte & Touche Letter.

571 See, e.g., KPMG Letter. See supra Section III.C.4, for a discussion of this comment. But see Testimony of J. Michael Cook, former Chairman and Chief Executive Officer, Deloitte & Touche (July 26, 2000) ("I agree with the Commission that the absence of `proof' does not justify inaction, particularly when such evidence cannot be expected to be demonstrable.").

572 See, e.g., Testimony of Richard Blumenthal, Attorney General, State of Connecticut (Sept. 20, 2000); Testimony of Robert Morgenthau, District Attorney for the County of New York (Sept. 13, 2000); Testimony of Charles R. Drott (Sept. 13, 2000).

573 See, e.g., Lexecon Letter.

[574] See, e.g., Lexecon Letter. The authors cite two studies that find accounting firms face significant costs when government regulators criticize auditors: M. Firth, "Auditor Reputation: The Impact of Critical Reports Issued by Government Inspectors," 21 Rand J. of Econ., at 374-387 (Autumn 1990) and L. R. Davis and D. T. Simon, "The Impact of SEC Disciplinary Actions on Audit Fees," 11 Auditing: J. of Prac. & Theory, at 58-68 (Spring 1992). In the former study, the loss of reputation in the U.K. manifested itself in lower market share for the largest accounting firms, while in the latter loss of reputation was related to a reduction in audit fees. We note that in both studies governmental oversight was responsible for making public the improper auditor behavior. It is not clear from this research that other economic forces were (or are) sufficiently strong to impose the costs to loss of reputation.

[575] See, e.g., Lexecon Letter.

[576] See Lexecon Letter for a discussion and bibliography on this point.

[577] See SECPS Manual §1000.45 (April 2000).

[578] See, e.g., Testimony of Dennis Paul Spackman, Chairman, National Association of State Boards of Accountancy (Sept. 13, 2000); Testimony of Paul Volcker, former Chairman, Board of Governors of the Federal Reserve System (Sept. 13, 2000).

[579] See Testimony of Rajib Doogar (Sept. 13, 2000).

[580] See, e.g., Lexecon Letter.

[581] See Testimony of Professor John C. Coffee, Jr., Columbia University (July 26, 2000).

[582] This effect can be observed in a simple present value calculation. Assuming future cash flows of $100 per period and a discount rate or required rate of return of 10%, the present value of the cash flows in perpetuity is $1,000. If the discount rate is reduced to 9%, a 10% change in the discount rate, the present value of the future cash flows is $1,111, an 11% change in the present value. This analysis ignores the possibility that a decrease in the discount rate can change the investment opportunity set and increase the per-period cash flows.

[583] While we recognize that the set of firms that may purchase such services may change from year to year, we have received no evidence to suggest that the fraction of companies that may actually purchase such services in any given year is different from our estimate.

[584] See GAO Report. Appendix B of the Proposing Release, Table 4 provides a 1999 comparable figure of 76.68%.

[585] See Compustat Database (October 31, 2000).

[586] This calculation is based on the aggregate value of U.S. equities markets of $16.1 trillion as of September 29, 2000 as reported by Wilshire Associates and an additional $4.3 trillion in corporate debt outstanding issued by U.S. firms as of June 30, 2000 as reported by the Board of

Governors of the Federal Reserve. Therefore the aggregate value of outstanding debt and equity securities is $20.4 trillion.

587 See "Accounting Wars," Bus. Wk., at 156-168 (Sept. 25, 2000).

588 See Testimony of Bill Patterson, Director, Office of Investments, AFL-CIO (Sept. 20, 2000) ("Now, the individual investor, I think their interest in the process is really catalyzed again around these high profile irregularities like Cendant, Sunbeam, Lucent, and Waste Management. I think these are warning shots to investors that this is a problem that has to be addressed.").

589 See Testimony of Frank Torres, Consumers Union (Sept. 20, 2000) ("I think American consumers, from my experience, don't like the idea that they might get had.").

590 See, e.g., Letter of Jack Ciesielski, accounting analyst (July 14, 2000); Letter of William V. Allen, Jr. (Aug. 22, 2000); Testimony of John Biggs, Chairman and CEO of TIAA-CREF (July 26, 2000); Testimony of Kayla J. Gillan, General Counsel, CalPERS (Sept. 13, 2000) ("A clear, simple and bright line [prohibition] standard will avoid this tendency [toward creative ways to avoid the rule], and moreover, I have not heard anyone suggest that there is an absence of qualified and cost effective alternatives to the auditor performing nonaudit consulting services to the same client.").

591 See, e.g., Lexecon Letter.

592 Some commenters suggested that the rule would impose additional costs on small businesses and accounting firms. The impact of the rule on small entities is discussed below in Section VI.

593 See, e.g., Arthur Andersen Letter; Deloitte & Touche Letter.

594 See Manufacturers Alliance, Survey of General Audits (2000). In a survey of its members, the Alliance found that just less than 96% of respondents outsourced less than 35% of the internal audit. This amount is within the 40% threshold allowed by the rule.

595 Memorandum to File No. S7-13-00 (September 23, 2000).

596 See Testimony of William D. Travis, Managing Partner, McGladrey and Pullen, LLP (Sept. 20, 2000). According to Mr. Travis' testimony, 85% of McGladrey and Pullen LLP's total revenues are attributable to accounting, auditing and tax. Therefore, only 15% is attributable to all consulting engagements. In addition the testimony indicates that approximately 50% of the firm's accounting and tax clients purchase audit services and that only 15% of its client base is made up of public companies. Mr. Travis also notes elsewhere in his testimony that "[t]he IT practice [] was part of what was sold to an affiliate of Block, so the consulting practice is owned entirely by Block." See also Compustat Database, October 31, 2000. Compustat lists only five companies with assets of $200 million or more as audited by McGladrey and Pullen, LLP.

597 Two studies in the 1980s documented that audit fees were generally greater, after controlling for other factors, for clients that also purchased non-audit services from the same public accounting firm. See Z. V.

Palmrose, "The effect of non-audit services on the pricing of audit services," 24 J. of Acct. Res., at 405-11 (Autumn 1986); D. A. Simunic, "Auditing, consulting, and auditor independence," 22 J. of Acct. Res., at 679-702 (Autumn 1984). Palmrose found that the positive relationship held for both incumbent and non-incumbent auditors, suggesting that synergies may not exist. Nevertheless, the authors of these studies concluded that this evidence was not inconsistent with the hypothesis that the joint provision of audit and non-audit services may give rise to "knowledge spillovers." More recent research documents that these higher fees are associated with increased audit effort (in labor hours). See L. R. Davis, David N. Ricchiute, and G. Trompeter, "Audit Effort, Audit Fees, and the Provision of Non-audit Services to Audit Clients," 68 Acct. Rev., at 135-50 (Jan. 1993). The results of the Davis study therefore cast further doubt on the knowledge spillover hypothesis.

Three recent studies also address the issue of synergies at least indirectly. See B. Arrunada, "The Provision of Non-Audit Services by Auditors: Let the Market Evolve and Decide," 19 Intl. Rev. of Law and Econ., at 513-31 (1999) ("Arrunada"); M. Ezzamel, D.R. Gwilliam and K.M. Holland, "Some Empirical Evidence from Publicly Quoted UK Companies on the Relationship Between the Pricing of Audit and Non-audit Services," 27 Acct. and Bus. Res., at 3-16 (1996) ("Ezzamel"); K. Pany and P. M. J. Reckers, "Auditor Performance of MAS: A Study of its Effects on Decisions and Perceptions," Acct. Horizons, at 31-38 (June 1988) ("Pany & Reckers"). Ezzamel in the U.K. observed a positive relationship between audit fees and non-audit fees. But the authors do not distinguish between competing explanations of the observed phenomenon. Pany & Reckers conducted an experimental study on U.S. loan officers. They did not find deterioration in the loan approval rate as consulting fees increased. But they did find limited evidence that providing MAS at a level of 90% of audit fees for a period of three years may present an independence perception problem among some financial analysts. They note that in 1988, levels of MAS fees as high as 90% of audit fees were uncommon. Arrunada states that after examining the effects of the provision of non-audit services on service cost, audit competition, service quality, and auditor independence, "[he] concludes that the provision of non-audit services reduces total costs, increases technical competence, and motivates more intense competition. Furthermore, it does not necessarily damage either auditor independence or the quality of non-audit services."

[598] See Testimony of Philip A. Laskawy, Chairman, Ernst & Young LLP (Sept. 20, 2000). Mr. Laskawy commented on this matter as it relates to information systems consulting:

We recently sold our practice in this area. We did so for a variety of reasons, but one reason certainly was that although we did not believe independence was actually impaired by this service, we could understand that particularly with large fees that sometimes are involved an appearance problem could be present. I might note that now that we have sold this practice we have not discovered that we are somehow enfeebled, unable to perform effective audits or to maintain top-notch audit and tax practices. In fact, we have found more the opposite to be true. Without a large consulting practice to manage we are now more targeted and more focused on our core audit and tax business, and our audit and tax partners feel as though they, and not the management consultants, are in the drivers seat at the firm. Moreover, from our clients' perspective, there actually may be an advantage in not having such a practice. We have had a greater string of wins in obtaining new audit clients since we sold our management consulting practice than we had at any time in recent history, four new Fortune 500 clients, including two Fortune 50 companies, just within the last six months.

See also Testimony of James J. Schiro, Chief Executive Officer, PricewaterhouseCoopers, before the Panel on Audit Effectiveness (July 10, 2000) ("[Our] restructuring will allow us to rededicate ourselves to our core principles."); Testimony of J. Terry Strange, Global Managing Partner, Audit, KPMG LLP, (July 26, 2000) ("In our view, the restructurings that are underway are driven by market forces, not regulatory considerations."); Testimony of Thomas Goodkind, CPA (Sept. 13, 2000) (responding to a question about his experiences relating to synergies and knowledge transfers between audit and non-audit staff, Goodkind replied, "In my experience, a transference of knowledge, I've rarely seen that in my experience."); Testimony of Douglas R. Carmichael (July 26, 2000) ("The counter argument that consulting improves audit quality is also unproven and does not provide a basis for eliminating the proposed restrictions."); Testimony of Douglas Scrivner, General Counsel, Andersen Consulting (Sept. 20, 2000) ("It is important to note that audit firms do not provide consulting services to improve the quality of the audits, but rather for commercial considerations.").

[599] See Public Accounting Report: Annual Survey of National Accounting Firms (2000) ("PAR").

[600] See Manufacturers Alliance, Survey of General Audit (2000). We use data from table 13 and table 66 to derive this ratio.

[601] Id. at table 16.

[602] Id. at table 73.

[603] Data are derived from PAR. The average growth rate in non-audit service revenues in 1999 was 21% and 9% for auditing and accounting services. Because there is uncertainty about whether individual firms classify internal audit outsourcing as consulting or assurance services, we choose the larger growth rate. In the current economy this may represent an optimistic growth rate.

[604] See Testimony of Professor Rick Antle, Yale University (July 26, 2000) ("I'll tell you now that as far as I know there's no systematic evidence as to the magnitude of these economies, just none that I know of."). See also Letter of Professor Rick Antle, Yale University (Sept. 25, 2000). Professor Antle provides analysis to estimate the aggregate cost of lost synergies. He estimates the value of the non-audit services as "the additional value of having the consulting done by the audit firm." He further estimates this value at $700 million, the gross margin attributable to all non-audit services provided to SEC audit clients in 1999. This number likely over-estimates the gross profits for these services in the future for two reasons: First, it includes revenues for non-audit services for the Big Five firms, two or three of which have sold or are committed to selling most of these practices. Second, the rule does not prohibit the purchase of all non-audit services by audit clients. In addition, Professor Antle estimates the aggregate social benefit of non-audit services purchased from any provider.

Because the rule does not prohibit the purchase of any of these services, this estimate is not relevant to the cost-benefit analysis.

605 Professor Antle's assumption about the value of synergies to the gross profit before partner compensation implies that the value of these synergies is on the order of 4% of non-audit revenues from SEC clients.

606 See also Testimony of Charles Cox, Kenneth R. Cone and Gustavo E. Bamberger, Lexecon, Inc. (Sept. 25, 2000). These commenters also estimate the aggregate cost of lost synergies on the order of 1%-2% of non-audit revenues from SEC clients.

607 See Testimony of Stephen G. Butler, Chairman and Chief Executive Officer, KPMG (Sept. 21, 2000). In response to a Commissioner's question about the source of non-audit service revenues, Mr. Butler commented that any statement attributing a percent of non-audit services to SEC audit clients for his firm would be difficult to interpret. Butler stated that "it is difficult to look at that sort of statistic because that's not a constant 20% that buys that service from us. It might be 20% of the number of our clients this year, it might be the same percentage next year, but it might be a totally different 20 percent."; Testimony of Robert K. Elliott, Chairman, AICPA (Sept. 21, 2000) ("[auditing is] . . . not an annuity, [but] it is more like an annuity than a consulting engagement which, when it's over, it's over.").

608 We assume that these costs may represent as much as 5% of the revenues from proscribed services purchased by each affected company. If as many as 10% of the purchasers of proscribed internal audit services from their auditor have contracts in excess of eighteen months and the entire $251.3 million represents revenues from proscribed services, the aggregate transition costs would be $1.3 million. Some may argue that transition costs are substantially higher, but we note that if transition costs are sufficiently high, economic theory suggests the service providers would be, on average, charging higher fees for the same level of service to the detriment of their clients. See, e.g., T. Nilssen, "Two Kinds of Consumer Switching Costs," 23 Rand J. of Econ., at 579-589 (Winter 1992).

609 See, e.g., Arthur Andersen Letter; Deloitte & Touche Letter.

610 See, e.g., Letter of Letter of W. Steve Albrecht, Professor and Associate Dean, Marriott School of Management, Brigham Young University (Aug. 25, 2000); Letter of Professor James Jiambalvo, University of Washington (Sept. 14, 2000); Written Testimony of Professor Peter Cappelli, Wharton School (Sept. 20, 2000).

611 See, e.g., Testimony of Joseph F. Berardino, Managing Partner, Assurance and Business Advisory Services, Arthur Andersen (July 26, 2000); Written Testimony of Stephen G. Butler, Chairman and Chief Executive Officer, KPMG (Sept. 13, 2000).

612 See Testimony of J. Michael Cook, former Chairman and Chief Executive Officer, Deloitte & Touche (July 26, 2000) ("A final assertion that quality will ultimately decline because the `new audit profession' will be unattractive to the best and brightest people. I cannot evaluate that possibility but would observe that the audit-dominated firms of the future that today's leaders express concerns about are in many respects

comparable to the firms that attracted them (and me) to the profession twenty or more years ago. Certainly much has changed in that time period, but I would expect the right leaders to be able to make such firms attractive once again.").

[613] See Salary Survey Fall 2000, National Association of Colleges and Employers, 2000. Recent starting salaries for accounting graduates are 23% lower than those for information systems, 24% for consulting and 9% for financial and treasury analysis; see also Testimony of Robert K. Elliot, Chairman, AICPA (Sept. 21, 2000); Testimony of Barry Melancon, President and Chief Executive Officer, AICPA (Sept. 21, 2000).

[614] See, e.g., Testimony of Douglas Scrivner, General Counsel, Andersen Consulting (Sept. 20, 2000) ("It is more likely that recruitment has been jeopardized by the actions of the accounting firms themselves. Some of the firms have diverted investment and resources out of the audit function and into non-audit services, thereby reducing the attractiveness of the audit function as a career path. They have created the very environment in which accounting majors look elsewhere and audit staff move over to the consulting side as quickly as they can."); see also O'Malley Panel Report, supra note 20, at ¶ 4.4 ("Focus group participants often indicated that not only clients, but also engagement partners and firm leaders, treat the audit negatively - as a commodity."). See generally the Taylor Research and Consulting Group, Inc., Final Quantitative Report (2000); Albrecht and R. Sack, Accounting Education: Charting the Course through a Perilous Future, at 23 (August 2000). AICPA statistics presented to the O'Malley Panel indicate that from 1992 to 1997 the number of students obtaining bachelor degrees declined by 14%, those obtaining finance degrees declined by 17%, those obtaining general business degrees declined by 8%, and those obtaining marketing degrees declined by 27%.

[615] See Digest of Educational Statistics, 1999.

[616] See, e.g., Written Testimony of Mauricio Kohn, CFA, CMA, CFM, AIMR (Sept. 20, 2000) (submitting survey); Letter of Mary Ellen Olivierio and Bernard Newman, Lubin School of Business, Pace University (Sept. 23, 2000).

[617] See Lexecon Letter; Letter of Brand Finance PLC (June 13, 2000).

[618] The Commission imposed a similar disclosure requirement when it issued ASR 250. As noted above, ASR 250 was withdrawn three years later. The rule prompted some academic research at the time. Three studies from the period and a current study are of particular interest: J. H. Scheiner and J.E. Kiger, "An Empirical Investigation of Auditor Involvement in Non-Audit Services," 20 J. of Acct. Res., at 482-496 (Autumn 1982) ("Scheiner & Kiger); J. H. Scheiner, "An Empirical Assessment of the Impact of SEC Nonaudit Service Disclosure Requirements on Independent Auditors and Their Clients," 22 J. of Acct. Res., at 789-797 (Autumn, 1984) ("Scheiner"); G. W. Glezen and J.A. Millar, "An Empirical Investigation of Stockholder Reaction to Disclosures Required by ASR No. 250," 23 J. of Acct. Res., at 859 - 870 (Autumn 1985); M. Ezzamel, D.R. Gwilliam and K. M. Holland, "Some Empirical Evidence from Publicly Quoted UK Companies on the Relationship Between the Pricing of Audit and Non-audit Services," 27 Acct. and Bus. Res., at 3-16 (1996) ("Ezzamel").

Scheiner and Glezen studied the impact of ASR 250 disclosure requirements on the provision of audit and non-audit services and concluded that the major accounting firms did not significantly reduce the amounts of services offered. Glezen compared stockholder approval of auditors before and after the issuance of ASR 250 and found no significant decline in the approval ratios across the three periods. These authors generally conclude that either independence is not important to stockholders, a conclusion they consider unlikely, or the level of non-audit services did not reach the level at which independence was perceived to be threatened. Scheiner allows that the firms in his study were not providing clients many of the services that fell within the disclosure rule. Scheiner and Kiger find evidence that the non-audit services provided to audit clients at that time generally "consisted of traditional accounting services -- primarily tax services. Less traditional services which are often questioned by critics of the accounting profession comprise only a small part of total non-audit services." They further state that at that time, "[t]he prohibition of non-accounting, non-audit services would not appear to have a substantial impact on firms because these services do not represent a large percentage of total revenues."

As we discussed in Section III.B., the level of non-audit services in general and non-audit services for audit clients in particular have increased substantially in recent years. Ezzamel found in the U.K. that substantial income was produced by non-audit services and that "the extent of voluntary disclosure of the breakdown on non-audit services was limited and the existing disclosure requirement allowed considerable variety in the manner in which non-audit services incurred or paid abroad were disclosed."

[619] ISB Standard No. 1, supra note 167. In addition, SAS No. 61 provides additional guidance on topics that an auditor should discuss with the audit committee (or board of directors if there is no such committee) of each registrant. AICPA SAS No. 61, AU § 380.

[620] SECPS Manual § 1000.08(i).

[621] In our Paperwork Reduction Act analysis in the Proposing Release, we estimate that approximately 9,892 respondents file proxy statements under Schedule 14A and approximately 253 respondents file information statements under Schedule 14C. We based the number of entities that would complete and file each of the forms on the actual number of filers during the 1998 fiscal year.

[622] See Deloitte & Touche Letter. Deloitte & Touche provided an estimate of 3-6 hours per filing for a small firm and 50-100 hours for a large firm, but provided no data to support this estimate.

[623] The ongoing figure is not adjusted for inflation or growth in consulting revenues beyond 2000. However, we note that there is a slowdown in the growth of these services. See, e.g., PAR, End of a Run: National Firms' Growth Rate Slowed In FY 99 (Mar. 31, 2000).

We note that the transition costs of $1.3 million may be incurred at any time over the eighteen-month transition period. We include this estimate in the first year only for ease of presentation.

[624] 5 U.S.C. § 603.

[625] 17 CFR 240.14a-101.

[626] See supra note 8.

[627] See supra notes 215, 216.

[628] Letter of Jim J. Tozzi, Member, Board of Advisors, Center for Regulatory Effectiveness (Aug. 30, 2000) ("Tozzi Letter").

[629] 17 CFR 230.157.

[630] 15 U.S.C. § 77c(b).

[631] 17 CFR 270.0-10.

[632] 13 CFR 121.201.

[633] Tozzi Letter.

[634] See supra notes 218, 219.

[635] See supra note 221.

[636] See, e.g., AICPA Letter.

[637] Id.; see also Letter of David E. Pertl, Senior Vice President and CFO, First Choice, Inc. (Sept. 18, 2000); Letter of Kelly Schwarzbeck, CPA, Alexander X. Kuhn & Co. (Aug. 22, 2000); Letter of Robert L. Bunting (Aug. 22, 2000).

[638] See, e.g., Letter of the California Chamber of Commerce (Sept. 15, 2000); Letter of Joseph C. King, CPA, Faulkner & King, PSC (Sept. 13, 2000).

[639] See, e.g., Letter of Landon J. Brazier, Knight Vale & Gregory (Aug. 31, 2000); Letter of Stephen Lange Ranzini, Chairman, CEO and President, University Bank (Sept. 9, 2000).

[640] See, e.g., Letter of Dean R. Heintz, CPA, Casey Peterson & Assoc., Ltd. (Aug. 8, 2000); Letter of Patrick J. Day, CPA (Aug. 10, 2000).

[641] Letter of Patrick J. Day, CPA (Aug. 10, 2000).

[642] See Testimony of Larry Gelfond, CPA, CVA, CFE, former President of the Colorado State Board of Accountancy (Sept. 13, 2000); Letter of John Mitchell, CPA (Aug. 14, 2000).

[643] See Public Accounting Report, Special Supplement: Annual Survey of National Accounting Firms - 2000 (March 31, 2000); Annual Reports to SECPS, Annual reports filed with AICPA Division for CPA firms; SECPS Reports, Reports prepared by the AICPA Division for CPA firms.

644 See Compustat Database, Oct. 31, 2000. The 85% figure excludes clients that are bank holding companies. For further analysis, see the cost-benefit analysis in Section V.B above.

645 See supra note 476.

646 See supra Section IV.G.

647 See, e.g., Letter of Donald G. Mantyla, CPA (Sept. 25, 2000).

648 Letter of Stanley Keller, Chair, Committee on Federal Regulation of Securities, American Bar Association (Sept. 27, 2000); Letter of Robert Bunting (Sept. 6, 2000); Letter of P. Gerard Sokoloski, CPA, President, NY State Society of Certified Public Accountants (Sept. 25, 2000).

649 44 U.S.C. 3501 et seq.

650 One commenter raised a number of issues related to OMB's processing and review of our submission. Because OMB has reviewed and approved our submission, we do not address these comments here.

651 See, e.g., Letter of Center for Regulatory Effectiveness: CRE Report Card on the SEC's Proposed Rule on Auditor Independence ("CRE Report Card").

652 See, e.g., Letter of Douglas R. Cox, Gibson, Dunn and Crutcher (Aug. 22, 2000) ("Cox Letter"). This commenter suggested, among other things, that the rule mandates disclosure of information that would appear irrelevant to the selection of auditors because a vote to ratify auditors is not required by the federal securities laws or many state laws. The commenter noted that the rule requires disclosure on Schedule 14C which does not ask investors to vote on any matter. Deloitte & Touche, in its comment letter, suggested that the Commission could minimize the burden imposed by the rule by requiring disclosure only when the stockholders vote on the approval or ratification of the company's accounting firm. Deloitte & Touche Letter. The disclosure rule serves a broader purpose than assisting shareholders in votes to ratify the selection of an auditor. The disclosure rule is one component of our auditor independence rules, the purpose of which is to promote the integrity of financial statements and promote investor confidence. Thus, the disclosure is aimed not only at a registrant's existing shareholders but at prospective shareholders as well.

653 Tozzi Letter.

654 CRE Report Card.

655 See Section IV.G for further discussion of the disclosure requirement, including discussion of comments received concerning that requirement.

656 As discussed in the Proposing Release (see Section II.C.4 and note 156 of this release), from 1978 to 1982, we required companies to disclose in their proxy statements all non-audit services provided by their auditors but later rescinded the requirement. Among other reasons, our review of proxy disclosures convinced us that accounting firms then, in contrast to now, were not providing extensive non-audit services to their audit clients. In addition, we noted that, even without the proxy statement requirement,

investors had access to useful data provided to and made public by the SECPS.

657 As noted above, the SECPS has stopped publishing information about audit firms' provision of non-audit services.

658 See supra Section IV.G.

659 See, e.g., Deloitte & Touche Letter; Cox Letter.

660 See, e.g., Deloitte & Touche Letter. Deloitte & Touche stated in its comment letter that it "is difficult to estimate the average hours without an empirical study," but suggested that disclosure would require approximately three to six hours for companies with basic reporting systems and approximately 50-100 hours for companies with more complex reporting systems. As discussed below, we have modified the disclosure requirement, and we do not agree that the required disclosure will create more than a minimal additional burden to companies already preparing Schedules 14A or 14C.

661 Cox Letter.

662 CRE Report Card; AICPA Letter.

663 See, e.g., Cox Letter.

664 Id.

665 See, e.g., CRE Report Card.

666 See Deloitte & Touche Letter.

667 We do not believe that the new disclosure requirement will cause registrants significant burdens associated with administrative tasks such as collecting, storing, and formatting the information, nor do we believe that compliance with the disclosure rule will require significant employee training.

668 The proposed rule required disclosure of each professional service during the most recent fiscal year. Under the proposed rule, a service did not have to be disclosed if the fee for that service was less than $50,000 or ten percent of that registrant's audit fee. Commenters suggested that these thresholds were too low, and would result in disclosures of insignificant services. As adopted, the rule does not require disclosure of each professional service.

669 As proposed, the rule would have required registrants to disclose whether the audit committee approved each disclosed non-audit service and considered the possible effect on the principal accountant's independence. As adopted, the rule requires disclosure of whether the audit committee considered whether the provision of the non-audit services by the principal accountant is compatible with maintaining the principal accountant's independence. We do not believe that this requirement imposes a significant burden.

[670] As noted above, audit committees currently receive information about the auditor's provision of non-audit services under ISB Standard No. 1 and SECPS Manual § 1000.08. See supra note 476.

[671] In its comment letter, the AICPA suggested that the proposed rule's definition of "affiliate of the accounting firm" created ambiguities that made the disclosure requirement potentially overbroad and burdensome. In response to commenters' concerns, we have removed the definition of "affiliate of the accounting firm" from the rule as adopted. Instead, the rule relies on existing guidance concerning when an entity is associated with the accounting firm. We believe that, with this modification, the disclosure requirement in the final rule is targeted to its purpose and is not unduly burdensome.

[672] 15 U.S.C. § 77b(b); 15 U.S.C. § 78c(f); 15 U.S.C. 80a-2(c).

[673] See, e.g., KPMG Letter.

[674] See supra Sections III.C.1, III.C.3.

[675] See supra Section IV.B.1.

[676] See, e.g., Arthur Andersen Letter.

[677] Cf. Testimony of Alfred M. King, Valuation Research Corporation (July 26, 2000).

[678] See supra Section V.B.2(c).

[679] Id.

[680] 15 U.S.C. § 78w(a)(2).

[681] See, e.g., Arthur Andersen Letter; Deloitte & Touche Letter.

[682] See Deloitte & Touche Letter. As discussed above, some firms had already split off, or announced the split-off of, their consulting practices prior to our Proposing Release. The rule does not dictate any particular business model for accounting firms. Rather, firms remain free to determine their own structure, consistent with the law.

[683] See, e.g., Testimony of Wayne A. Kolins, National Director of Assurance, BDO Seidman, LLP (Sept. 20, 2000). As discussed in more detail in this release, we have removed the definition of "affiliate of the accounting firm" from the rule as adopted. Instead, the rule relies on existing guidance concerning when an entity is associated with the accounting firm. We believe that this modification addresses commenters' concerns in this area.

[684] See id.

[685] See, e.g., Testimony of Larry Gelfond, CPA, CVA, CFE, Colorado Accountancy Board, September 13, 2000 ("I do not believe that [the rule] will in any way hinder our [small] firm. In many respects, it may even benefit our firm. . . . I look at this, frankly, as an opportunity, particularly in the internal audit functions to step in, and given our experience, to work with management and with their respective independent auditor, let's say a

Big Five firm, that this is an area that we can frankly look at as a new revenue generator.").

[686] See, e.g., AICPA Letter; Letter of David E. Pertl, Senior Vice President and CFO, First Choice, Inc. (Sept. 18, 2000); Letter of Kelly Schwarzbeck, CPA, Alexander X. Kuhn & Co. (Aug. 22, 2000); Letter of Robert L. Bunting (Sept. 6, 2000); Letter of Bruce C. Holbrook, Vice Chairman, Goodman & Company, LLP (July 25, 2000); Letter of William W. Traynham, CPA, President, Community Bankshares Inc. (Aug. 14, 2000).

[687] See, e.g., Letter of the California Chamber of Commerce (Sept. 15, 2000); Letter of Joseph C. King, CPA, Faulkner & King, PSC (Sept. 13, 2000).

[688] See, e.g., Letter of Jeffry T. Herbst (Sept. 11, 2000); Letter of Richard P. Thornton (Sept. 13, 2000); Letter of Marc J. Garofalo, Mayor, Derby, Conn. (Sept. 18, 2000).

[689] See Compustat Database, October 31, 2000. The 85% figure excludes clients that are bank holding companies. For further analysis, see supra Section V.B (cost-benefit analysis).

http://www.sec.gov/rules/final/33-7919.htm

U.S. Securities and Exchange Commission

Proposed Rule: Revision of the Commission's Auditor Independence Requirements

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 210 and 240

[Release Nos. 33-7870; 34-42994; 35-27193; IC-24549; IA-1884; File No. S7-13-00]

RIN 3235-AH91

Revision of the Commission's Auditor Independence Requirements

AGENCY: Securities and Exchange Commission

ACTION: Proposed rule

SUMMARY: The Securities and Exchange Commission ("SEC" or "Commission") is soliciting comment on proposed rule amendments regarding auditor independence. The proposals modernize the Commission's requirements by providing governing principles for determining whether an auditor is independent in light of: investments by auditors or their family members in audit clients, employment relationships between auditors or their family members and audit clients, and the scope of services provided by audit firms to their audit clients. The proposals would, among other things, significantly reduce the number of audit firm employees and their family members whose investments in audit clients are attributed to the auditor. They would also identify certain non-audit services that, if provided to an audit client, would impair an auditor's independence. The scope of services proposals would not extend to services provided to non-audit clients. The proposals also would provide a limited exception for accounting firms that have certain quality controls and satisfy other conditions. Finally, the proposals would require companies to disclose in their annual proxy statements certain information about, among other things, non-audit services provided by their auditors during the last fiscal year.

DATES: Comments are due on or before September 25, 2000.

ADDRESSES: Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549-0609. Comments also may be submitted electronically at the following e-mail address: rule-comments@sec.gov. Comment letters should refer to File No. S7-13-00; this file number should be included on the subject line if e-mail is used. All comment letters received will be available for public inspection and copying in the

Commission's Public Reference Room at the same address. Electronically submitted comments will be posted on the Commission's internet web site (http://www.sec.gov).[1]

FOR FURTHER INFORMATION CONTACT: John M. Morrissey, Deputy Chief Accountant, or W. Scott Bayless, Associate Chief Accountant, Office of the Chief Accountant, at (202) 942-4400, or with respect to questions about investment companies, John S. Capone, Chief Accountant, Division of Investment Management, at (202) 942-0590, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549-1103.

SUPPLEMENTARY INFORMATION: The Commission is proposing amendments to Rule 2-01 of Regulation S-X[2] and Item 9 of Schedule 14A[3] under the Securities Exchange Act of 1934 (the "Exchange Act").[4]

I. Executive Summary

Independent auditors have an important public trust.[5] Every day, millions of people invest their savings in our securities markets in reliance on financial statements prepared by public companies and audited by independent auditors.[6] These auditors, using Generally Accepted Auditing Standards ("GAAS"), examine issuers' financial statements and issue opinions about whether the financial statements, taken as a whole, are fairly presented in conformity with Generally Accepted Accounting Principles ("GAAP"). While an auditor's opinion does not guarantee the accuracy of financial statements, it furnishes investors with critical assurance that the financial statements have been subjected to a rigorous examination by an impartial and skilled professional and that investors can therefore rely on them. Providing that assurance to the public is the auditor's over-arching duty.[7]

Investors must be able to put their faith in issuers' financial statements. If investors do not believe that the auditor is truly independent from the issuer, they will derive little confidence from the auditor's opinion and will be far less likely to invest in the issuer's securities. Fostering investor confidence, therefore, requires not only that auditors actually be independent of their audit clients, but also that reasonable investors perceive them to be independent.

One of our missions is to promote investor confidence in the reliability and integrity of issuers' financial statements. To promote investor confidence, we must ensure that our auditor independence requirements remain relevant, effective, and fair in light of significant changes in the profession, structural reorganizations of accounting firms, and demographic changes in society. Some of the important developments in each of these areas since we last amended our auditor independence requirements in 1983[8] include the following:

- firms are becoming primarily business advisory service firms as they increase the number, revenues from, and types of non-audit services provided to audit clients,
- firms and their audit clients are entering into an increasing number of business relationships, such as strategic alliances, co-marketing arrangements, and joint ventures,

- firms are divesting significant portions of their consulting practices or restructuring their organizations,
- firms are offering ownership of parts of their practices to the public, including audit clients,
- firms are in need of increased capital to finance the growth of consulting practices, new technology, training, and large unfunded pension obligations,
- firms have merged, resulting in increased firm size, both domestically and internationally,
- firms have expanded into international networks, affiliating and marketing under a common name,
- non-CPA financial service firms have acquired accounting firms, and the acquirors previously have not been subject to the profession's independence, auditing, or quality control standards,
- firms' professional staffs have become more mobile, and geographical location has become less important due to advances in telecommunications and internet services, and
- audit clients are hiring an increasing number of firm partners, professional staff, and their spouses for high level management positions.

Having considered these and other developments and their effect on auditor independence, we are proposing rule amendments. The proposals start from the premise that investor confidence in auditor independence turns on whether auditors are in fact independent and appear to be independent. To strengthen the basis for that confidence, the proposals focus on those who can influence a particular audit. The proposals articulate four principles that would govern our determination of whether an accountant is independent of its audit client. Specifically, the proposals provide that an accountant is not independent whenever, during the audit and professional engagement period, the accountant: (i) has a mutual or conflicting interest with the audit client, (ii) audits the accountant's own work, (iii) functions as management or an employee of the audit client, or (iv) acts as an advocate for the audit client.

The proposals then describe certain relationships which, when considered in light of these principles, render an accountant not independent of an audit client. The relationships addressed by the proposals include, among others, the financial and employment relationships between auditors (or their family members) and audit clients, and relationships between auditors and audit clients where the auditors provide certain non-audit services to their audit clients.

Financial and Employment Relationships. Current requirements attribute to an auditor ownership of shares held by widely dispersed audit firm personnel and their families. In light of some of the developments described above, these rules may unnecessarily restrict investment and employment opportunities available to firm personnel and their families. The proposals shrink significantly the circle of firm personnel whose investments are imputed to the auditor. They also shrink the circle of family members and former firm personnel whose employment impairs an auditor's independence.

Non-Audit Services. We have become increasingly concerned that the dramatic increase in the nature, number, and monetary value of non-audit services that accounting firms provide to audit clients may affect their independence. Accordingly, the proposals specify certain non-audit services that, if provided by an accounting firm to an audit client, impair an auditor's independence in light of the four governing principles.

For example, the proposals provide that an accounting firm would not be independent from an audit client to which the firm provides valuation and appraisal services. Some accounting firms provide these services to audit clients,[9] even though the firm's auditors must independently question the value of the appraised asset in auditing the audit client's financial statements. As such, the auditor may have participated actively in the process of developing asset values that are reported to investors in financial statements. The auditor then is required to challenge those same numbers during the audit. In this dual role as auditor and consultant, the accountant both oversees and answers to management, raising serious conflict of interest questions. Will the auditor be diligent and objective in reviewing the accounting firm's valuation work? If, during the audit, the auditor identifies a problem with the valuation or appraisal, will that auditor bring the problem to management's attention? Perhaps more important, even if the auditor made unbiased decisions, would investors believe that the auditor had been objective?[10]

The proposals do not extend to all non-audit services provided to audit clients. Not all non-audit services pose the same risk to independence. The proposals reflect what we believe to be a reasonable differentiation among various non-audit services, as well as our preference for narrowly drawn rules.

Quality Controls. Accounting firms and the public benefit when firms have effective quality controls that ensure the independence of audit professionals. These controls protect the public and the firms, on whose audits the public relies. Public companies benefit as well, since they are able to access capital at a lower cost through our capital markets. Therefore, for accounting firms that have certain quality controls, we are proposing a limited exception from the independence rules for certain independence failures that are cured promptly after discovery. This exception should encourage firms to institute controls to ensure the independence of the firm's personnel.

Disclosure of Non-Audit Services. Investors should have enough information to enable them to evaluate the independence of a company's auditors. The proposed rules would bring the benefits of sunlight to the auditor independence area by requiring companies to disclose in their annual proxy statements certain information about, among other things, the non-audit services provided by their auditors and the participation of leased personnel in performing the company's annual audit.

II. The Need to Preserve Auditor Independence

A. The Securities Laws Give Independent Auditors A Vital Mission and Responsibility

Capital formation depends on the willingness of investors to invest in the securities of public companies. Investors are more likely to invest, and pricing is more likely to be efficient, the greater the assurance that the financial information disclosed by issuers is reliable.[11] Independent auditors play a key role in providing that assurance. Auditors follow specified procedures set forth in GAAS and express their opinion on whether the financial statements, taken as a whole, fairly reflect the financial position, results of operations, and cash flows of the company.[12] Based on the independent auditor's opinion, investors have reason to believe that financial statements are materially accurate, fair, and complete.

The federal securities laws, to a significant extent, make independent auditors "gatekeepers" to the public securities markets.[13] These laws require, or permit us to require, financial information filed with us to be certified (or audited) by independent public accountants.[14] Without an opinion from an independent auditor, the company cannot satisfy the statutory and regulatory requirements for audited financial statements and cannot sell its securities to the public.[15] The auditor is the only professional that a company must engage before making a public offering of securities and the only professional charged with the duty to act and report independently from management. Because it is the issuer's responsibility to file independently audited financial statements, if the auditor is not independent, the issuer's filings are deficient under the securities laws.

In the fiscal year ended September 30, 1999, 13,460 public companies filed annual reports with the Commission. In the same period, the aggregate dollar volume for public offerings filed with the Commission was $2.1 trillion. While our staff reviews a great many filings, it is not able to review in detail all of the financial statements filed with us. We therefore must rely heavily on the accounting profession to be primarily responsible for the integrity of the large volume of financial information that forms the cornerstone of our full disclosure system.[16]

In creating this system, Congress granted the accounting profession an important public trust. Congress considered creating a corps of government auditors to review and audit companies' financial statements. Congress also considered mandating federal licensing of auditors. Instead, Congress entrusted the accounting profession with the responsibility of auditing the financial statements of companies registered with the SEC.[17] In so doing, Congress gave the accounting profession both an enormously valuable franchise and a bedrock public responsibility.[18]

The Supreme Court has underscored the significant and unique role of the auditor. In United States v. Arthur Young & Co.,[19] the Court considered whether to extend to auditors certain confidentiality protections available to legal counsel representing a client and preparing for trial. The Court refused to extend the protections, citing principally the differences between the roles of counsel and auditor. A lawyer, the Court noted, is a confidential advisor and advocate with a duty to present the client's case in the most favorable light. In contrast, the Court stated that the "independent certified public accountant performs a different role. By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client ... [and] owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public."[20] According to the Court, "This `public watchdog' function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust."[21] The Court's words largely echoed those of Congress,[22] the Commission,[23] and the accounting profession.[24]

B. Independence in Fact and Appearance

To fulfill the important role assigned to the auditor, the auditor must approach each audit with professional skepticism and must have a willingness and freedom to decide issues in an unbiased and objective manner, even when the auditor's decisions may be against the interests of management of an audit client. According to a 1947 statement by the accounting profession, "The independent auditor is under a responsibility peculiar to his profession to maintain strict independence of attitude and judgment in planning and conducting his examination and in expressing his opinion on financial statements."[25] Further, the AICPA's SAS No. 1 requires that "in all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor...he must be without bias with respect to the client."[26]

Because a principal purpose of auditor independence is to provide assurance to investors, the accounting profession has long required independence not only in fact but also in appearance. SAS No. 1 states, "Public confidence would be impaired by evidence that independence was actually lacking, and it might also be impaired by the existence of circumstances which reasonable people might believe likely to influence independence."[27] Accordingly, "Independent auditors should not only be independent in fact; they should avoid situations that may lead outsiders to doubt their independence."[28]

The 1979 Report of the Public Oversight Board ("POB") echoes the point, noting that the appearance of independence is itself "a key ingredient to the value of the audit function, since users of audit reports must be able to rely on the independent auditor. If they perceive that there is a lack of independence, whether or not such a deficiency exists, much of that value is lost."[29] The Supreme Court made the same point in the Arthur Young decision:

The SEC requires the filing of audited financial statements in order to obviate the fear of loss from reliance on inaccurate information, thereby encouraging public investment in the Nation's industries. It is therefore not enough that financial statements be accurate; the public must also perceive them as being accurate. Public faith in the reliability of a corporation's financial statements depends upon the public perception of the outside auditor as an independent professional. . . . If investors were to view the auditor as an advocate for the corporate client, the value of the audit function itself might well be lost.[30]

Auditor independence involves assumptions about human behavior that cannot be easily verified.[31] While conflicts of interest are easily described, their actual impact on the "objectivity" of particular auditors can never be precisely known, because "objectivity," as the AICPA's professional standards note, "is a state of mind."[32]

For this reason, the appearance standard serves an important legal purpose. It supplements an inquiry into the auditor's actual, subjective state of mind with an objective test: whether reasonable persons, knowing all relevant circumstances, would perceive that an auditor is independent. As the words connote, the appearance standard confines the inquiry into what is apparent and does not require an inquiry into the auditor's actual state of mind. The appearance standard, it should be stressed, is not a matter of "public relations." It does not require the auditor to guess how persons with only a superficial understanding of the relevant facts would view his or her actions. Appearance is measured only with respect to reasonable persons knowing all the relevant facts and circumstances.

Independence rules also must be prophylactic.[33] Auditor independence requires auditors "to be alert to a number of rather subtle influences... [T] here is a considerable range of individual abilities within the profession; some accountants are strong enough and alert enough to control themselves under the most adverse and perhaps even the most subtle influences; others are not so fortunate."[34] Our task in this area is to identify and address the influences that reasonably could be expected to pose an unacceptable risk that an auditor would lose his or her objectivity or that reasonable persons would perceive a loss of objectivity.

C. The New Business Environment Calls for Modernized Rules

In recent years, there have been significant demographic changes, changes in the accounting profession, and changes in the business environment that have affected accounting firms. Some of the more significant changes that have drawn attention to our auditor independence requirements include the increase in dual-career families, an ever-increasing mobility among professionals, a broadening international presence of accounting firms, and the growth and profitability of non-audit services offered by accounting firms to audit clients. These changes have led us to re-evaluate whether our auditor independence requirements remain effective, relevant, and fair.

1. Financial and Employment Relationships

We propose to update the requirements regarding financial and employment relationships between auditors or their family members and audit clients.[35] The existing requirements, among other things, attribute to the auditor investments of the relatives of the auditor "in varying degrees depending on the closeness of the [family] relationship,"[36] regardless of the amount of the holdings. They also attribute to auditors the investments of all partners and many professional employees in the accounting firm, as well as their families. The existing attribution rules may be too restrictive, since traditional family structures have changed, family members are more dispersed, there is increased mobility of professional employees, and accounting firms themselves are expanding around the globe. Accordingly, our proposals narrow many of these requirements, while protecting investor confidence in the reliability of financial information.

The proposals similarly narrow existing restrictions on the employment of auditors' family members, former audit firm employees, and former audit client employees who leave companies to work in audit firms. For example, with respect to employment restrictions on auditor's relatives, the proposals liberalize our existing position in several significant respects. First, the proposals reduce the pool of people within audit firms whose independence is required for an independent audit. Second, the proposals identify specific positions, namely those in which a person is in a position to or does influence the audit client's financial records, that would impair an auditor's independence if held by the auditor's relative. Finally, under the proposals, only positions at an audit client held by the auditor's "close family members" affect the auditor's independence. These proposals liberalize our current position and the ISB's position as reflected in its recent Invitation to Comment.[37]

2. Scope of Services

(a) A Historical Perspective on the Provision of Non-Audit Services. In the 1970s, Congress seriously considered limiting the services independent public accountants could provide that were not directly related to accounting, even though at that time non-audit services did not constitute a large percentage of audit firms' businesses.[38] Although Congress did not take action, in 1979, the Chairman of the POB warned the public about dangers arising from the growth of non-audit services:

The [POB] believes that there is possibility of damage to the profession and the users of the profession's services in an uncontrolled expansion of MAS to audit clients. Investors and others need a public accounting profession that performs its primary function of auditing financial statements with both the fact and the appearance of competence and independence. Developments which detract from this will surely damage the professional status of CPA firms and lead to suspicions and doubts that will be detrimental to the continued reliance of the public upon the profession without further and more drastic governmental intrusion. [39]

Our staff considered these issues in a 1994 Staff Report.[40] The Staff Report noted that much of the growth in non-audit services until then could be attributed to services provided to parties other than audit clients.[41] Accordingly, the Staff Report concluded that no change in our rules or the federal securities laws was warranted at that time, but the staff promised to "continue to be alert to the development of problems of independence that may be caused by [non-audit services]."[42] The staff has kept a watchful eye on these matters.

Other industry observers also have followed developments in this area. After the Staff Report, there were at least three significant studies by the private sector and one by the General Accounting Office ("GAO"). These studies emphasized the continuing public concern regarding the objectivity and independence of auditors, particularly in light of the expansion of consulting and other non-audit services for audit clients. The Advisory Panel on Auditor Independence (also known as the Kirk Panel), in its September 1994 report, described the trend toward non-audit services as "worrisome," because:

[g]rowing reliance on nonaudit services has the potential to compromise the objectivity or independence of the auditor by diverting firm leadership away from the public responsibility associated with the independent audit function, by allocating disproportionate resources to other lines of business within the firm, and by seeing the audit function as necessary just to get the benefit of being considered objective and to serve as an entree to sell other services....[43]

Similarly, the AICPA Special Committee on Financial Reporting (also known as the Jenkins Committee), in its 1994 report, found that users of financial statements believed that non-audit service relationships could "erode auditor independence." The Report noted:

[Users] also are concerned that auditors may accept audit engagements at marginal profits to obtain more profitable consulting engagements. Those arrangements could motivate auditors to reduce the amount of audit work and to be reluctant to irritate management to protect the consulting relationship.[44]

Two years later, in 1996, GAO completed a thorough review of the accounting profession. In its report, GAO noted:

GAO . . . believes that questions of auditor independence will probably continue as long as the existing auditor/client relationship continues. This concern over auditor independence may become larger as accounting firms move to provide new services that go beyond traditional services. The accounting profession needs to be attentive to the concerns over independence in considering the appropriateness of new services to ensure that independence is not impaired and the auditor's traditional values of being objective and skeptical are not diminished.[45]

Most recently, in 1999, Earnscliffe conducted interviews to assess the perceptions of different audiences about auditor independence. In conclusion, Earnscliffe reported that, "Most [interviewees] felt that the evolution of accounting firms to multi-disciplinary business service consultancies represents a challenge to the ability of auditors to maintain the reality and the perception of independence...."[46]

Taken together, these studies suggest that important constituencies see a connection between the business scope of accounting firms and auditor independence.

(b) Recent Developments. The menu of services offered by the firms to audit clients has grown dramatically and continues to grow.[47] Attached to this release, for commenters' convenience, is a list of services that auditors provide to their audit and non-audit clients.[48] Companies appear to be turning to their auditors for performance of their internal audit, pension, financial, administrative, sales, data processing, and marketing functions, among others.[49]

U.S. revenues for management advisory and similar services[50] for the five largest public accounting firms amounted to more than $15 billion in 1999, based on amounts calculated from data published in the Public Accounting Report.[51] Revenues for these service lines are now estimated to constitute half of the total revenues for these firms.[52] In contrast, these service lines provided only 13 percent of total revenues in 1981.[53] From 1993 to 1999, the average annual growth rate for revenues from management advisory and similar services has been 26 percent; comparable growth rates have been 9 percent for audit, and 13 percent for tax services.[54]

For the largest firms, the growth in management advisory and similar services involves both audit clients and non-audit clients. For the largest public accounting firms, MAS fees from audit clients have increased significantly over the past two decades. In 1984, only one percent of audit clients of the eight largest public accounting firms paid MAS fees that exceeded the audit fee.[55] The percent of Big 5 audit clients that paid MAS fees in excess of audit fees did not exceed 1.5 percent until 1997.[56] In 1999, 4.6 percent of Big 5 audit clients paid MAS fees in excess of audit fees,[57] an increase of over 200% in two years. For the five largest public accounting firms, MAS fees received from audit clients amounted to ten percent of all revenues in 1999.[58] Almost three-fourths of audit clients purchased no MAS from their auditors in 1999. This means that purchases of MAS services by one-fourth of firm's audit clients account for ten percent of all firm revenues.[59] In addition, the magnitude of MAS fees received from SEC registrants appears to distinguish the five largest accounting firms from other firms. The MAS fees received by the approximately 800 accounting firms with 1,000 or fewer SEC registrants as audit clients represent approximately one percent or less of total fees on average.[60]

Certain transactions raise questions about auditor independence. Some smaller firms are consolidating their audit practices and seeking public investors in the resulting company.[61] Other firms are entering into agreements to sell all of their assets except their audit practices to established financial services companies. As part of these agreements, the financial services companies also hire the employees of the accounting firm, and then lease back the majority or all of the assets and audit personnel to the "shell" audit firm. These lease arrangements allow the financial service firm to pay the professional staff for "nonprofessional" services for the corporate organization as well as professional attest services rendered for the audit firm.[62]

In February 2000, Ernst & Young announced that it would sell its management-consulting business to Cap Gemini Group SA, a large and publicly-traded computer services company headquartered in France.[63] KPMG recently split off its consulting business into a separate corporation (KPMG Consulting, Inc.), sold preferred stock convertible to between 18.2% and 19.9% of its outstanding stock to Cisco Corporation, and announced its intention to sell additional shares to the public in an initial public offering.[64] PricewaterhouseCoopers has publicly announced its intention to re-structure its audit and consulting businesses along similar lines.[65]

Under certain circumstances, these transactions could lead to violations of the independence rules, since the financial interests and relationships of the newly formed consulting entities would be imputed to the auditing firms. At a minimum, these transactions could raise serious public policy issues by creating relationships between firms and shareholders, strategic investors, and companies providing services to audit clients. In the case of Ernst & Young, our Chief Accountant, by no-action letter, stated that the Office of the Chief Accountant would not assert that Ernst & Young's independence from an audit client has been impaired solely because that audit client is also a client of, enters into a business relationship with, or is invested in by Cap Gemini. That no-action relief was based on, among other things, Ernst & Young's representations that: (1) following the initial sale to Cap Gemini, Ernst & Young's equity interest would be reduced to zero within five years, (2) Ernst & Young would play no role in the corporate governance of the consulting company, and (3) Ernst & Young would not have any co-marketing arrangements with the new entity.[66]

(c) How Non-Audit Services Can Affect Auditor Independence. The dramatic expansion of non-audit services may fundamentally alter the relationships between auditors and their audit clients in two principal ways. First, as auditing becomes an ever-smaller portion of a firm's business with its audit clients, auditors become increasingly vulnerable to economic pressures from audit clients. Second, certain non-audit services, by their very nature, raise independence issues. These concerns, described more fully below, have led us to consider whether our rules should limit - or even completely bar - an auditor's provision of non-audit services to audit clients.

(i) Auditor Vulnerability to Economic Pressure From Audit Clients. Large non-audit engagements[67] may make it harder for auditors to be objective when examining their client's financial statements. Under any circumstances, it can be difficult for an auditor to make a judgment that works against the audit client's interest. Where making that judgment may imperil a range of service engagements of the firm, of which the audit is a fairly small part, it may be unrealistic to expect that an auditor can ignore completely what the firm stands to lose by the auditor's action.

Our concern is not just that an auditor will give in to a client. It is that, as auditors become involved in a broad array of business arrangements with their clients, they come to be seen by themselves, their firms, their clients, and investors less as exacting, skeptical professionals who must be satisfied before signing off on the financial statements, and more like any other service vendor who must satisfy the client to make the sale.[68]

An expanded menu of relationships with an audit client may also give rise to a mutuality of interest between the auditor and client. This would be a significant concern in any era, but it may be especially important in an era when many ventures go quickly from start-up to apparent success to failure. For example, an audit firm may agree to perform the audit of a start-up company for fees significantly below market rates for a few years, in anticipation of "recouping" such an investment in the client through a subsequent initial public offering or performance of consulting services.

We also have concerns about the effect on an accounting firm's internal culture when the firm is trying to be an audit client's vendor of choice. As non-audit services become more important to a firm, that firm may care less about auditing and more about expanding its service lines. The factors that drive a high quality audit, including the core values of the auditing profession, may diminish in importance to the firm, as will the influence of those firm members who exemplified those core values in their own professional careers.

There appears to be growing public concern about audit firms' increasing provision of various non-audit services, and skepticism that firm safeguards adequately protect the fact and appearance of independence. Earnscliffe reports that auditors, audit committee chairs, chief executive officers, analysts, and regulators all, to some degree, recognize the independence risks posed by multifaceted relationships between auditors and their audit clients.[69] A majority of the Earnscliffe respondents felt that internal firm safeguards "might ultimately be insufficient to sustain confidence in the independence of auditors." According to the Report, those respondents

. . . felt that the judgement of observers would turn on how the financial incentives and penalties were organized: if it appeared that a firm had more upside in bending to a client's pressures, then internal processes would only be of limited value. Not everyone felt that this was the perception today, rather they were offering the view that internal firm safeguards had limited prophylactic value if the scrutiny were to become more punishing.[70]

(ii) Independence Issues Inherent in the Nature of Certain Non-audit Services. Providing certain non-audit services to an audit client can lead an audit firm to have a mutual or conflicting interest with the client, audit its own work, advocate a position for the client, or function as an employee or management of the client.[71] Auditor independence concerns arise, for example, when a company hires its audit firm to perform valuations of in-process research and development.[72] When an auditor in effect, even if not in form, makes decisions for management, he or she functions as a member of the management team and may develop a "mutuality of interest" with the audit client. After all, a "consultant ...will be judged by the ultimate usefulness of his advice in bringing success to management's efforts. He has had a hand in shaping managerial decisions and will be judged by management on the same basis that the management itself will be judged. How then can he claim to be completely independent?"[73] The consultant is accountable to management, in contrast to the auditor, who must "acknowledge[] no master but the public."[74]

(d) Measuring Independence Impairments. Some argue that no empirical evidence justifies our concerns. They argue that there is no evidence that providing non-audit services in general - much less particular types of non-audit services - leads to false financial reporting. Without this evidence, the argument goes, the Commission should not take steps to protect auditor independence.

It is common sense, however, and confirmed by studies, that a person's decision changes when he or she has a stake in the outcome of that decision.[75] Furthermore, common sense dictates that the more someone - including an auditor - has at stake, the more likely his or her decision is to be affected.

Studies cannot always confirm what common sense makes clear. Except where an auditor accepts a payment to look the other way,[76] is found to have participated in a fraudulent scheme,[77] or admits to being biased, it is largely impossible to observe an auditor's state of mind or know whether an auditor's mind is "objective." It is even harder to measure the impact a particular financial arrangement has on the auditor's state of mind. And it is similarly impossible to tie a questionable state of mind to a wrong judgment, a failure to notice something important, a failure to seek important evidential matter, a failure to challenge a management assertion, or a failure to consider the quality - not just the acceptability - of a company's financial reporting.[78] This is particularly true because auditing misjudgments may often go unnoticed.[79] As the POB noted, "Specific evidence of loss of independence through MAS, a so-called smoking gun, is not likely to be available even if there is such a loss."[80]

Whatever the effect of non-audit service relationships on an auditor's conduct, there can be little question about the effect of these impairments on investor confidence. Gradual decreases in investor confidence may not be measurable, but their cumulative economic impact could not be more palpable. Investor confidence in the integrity of publicly available financial information is the cornerstone of our securities markets. That confidence is hard won and easily lost, and the Commission must act to protect it.

(e) Whether to Prohibit All Non-Audit Services. In developing these proposals, we considered whether independence is impaired whenever an auditor provides any non-audit service to an audit client, or whether certain non-audit services do not impair independence. We have tentatively concluded, pending public comment, that the better approach is to permit some significant non-audit services, though several factors weigh in favor of a blanket ban.

Prohibiting only some non-audit services does not address the increasing vulnerability of auditors to their audit clients and the corresponding link between the financial health of auditors and their clients. These concerns do not turn on the nature of the non-audit service involved, but arise simply because of the growing interdependence of auditor and client.

In addition, distinguishing between permissible and impermissible types of services raises difficult questions about services that do not fall squarely into precise categories. These questions will get only harder in the future as firms move to provide new and unforeseen services.

Finally, an approach that tries to distinguish between permissible and impermissible types of services depends heavily upon daily interpretations by the very firms the rules are intended to affect. In light of the powerful economic interests at stake, there is serious question whether it is fair or reasonable to expect accounting firms to evaluate the impact of new services on their own impartiality.

Despite these doubts, we believe that the measured approach we propose - establishing basic principles for evaluating any non-audit services' impact on independence, and identifying specific services that are plainly incompatible with independence - protects investor confidence in the audit process while allowing auditors to provide those services that are not reasonably viewed as creating a bias in the auditor. Our goal is to preclude non-audit services only to the extent necessary to protect the integrity and independence of the audit function. Of course, therefore, the proposals do not extend to services provided to non-audit clients.

3. Quality Controls

As accounting firms become more global and their business relationships with their audit clients become more complex, the need for quality controls to address independence becomes more apparent. Without strong quality controls, it may be difficult or impossible for an accounting firm to understand whether its independence may be impaired. For example, firms need quality controls to track whether the firm, or any covered person in the firm, has any direct investment in an audit client.

Our staff has stated that certain firms, particularly larger firms with public company clients, may lack sufficient worldwide quality controls.[81] The staff has urged certain firms to review existing quality controls and ensure that particular areas are covered.[82] Moreover, designing and implementing quality controls is not a one-time responsibility. We encourage accounting firms to continue to invest in state-of-the-art systems that can identify conflicts at an early stage to ensure a swift response. The speed of the response to a conflict, or potential conflict, is important to maintain public confidence in the self-regulatory process and the effectiveness of quality controls.[83]

We understand that many firms are already designing and implementing quality controls. We recently announced a voluntary compliance program, in which the Big 5 accounting firms agreed to report past violations of auditor independence rules.[84] In connection with the program, the firms also have agreed to design and implement quality controls specified by our Chief Accountant and have the POB issue public reports on the results of their efforts. The rules we propose today are intended to encourage firms to design and implement effective quality controls to address independence. Toward that end, the rules contain a limited exception for firms that have appropriate quality controls and meet other conditions.

4. Proxy Disclosure

From 1978 to 1982, we required companies to disclose in their proxy statements all non-audit services provided by their auditors.[85] We also required companies to include a statement of the percentage of the fees for all non-audit services compared to total audit fees, the percentage of the fee for each non-audit service compared to total audit fees, and a statement whether each non-audit service was considered and approved by the audit committee of the board of directors or by the board itself.[86]

In connection with the disclosure requirement, we published an interpretive release[87] describing certain factors that independent accountants, audit committees, boards of directors, and managements should consider in determining whether a company's independent accountant should be engaged to perform non-audit services. These factors included the auditor's dependence on non-audit fees, the possibility of the auditor supplanting management's role in making corporate decisions, the possibility of creating a situation where an auditor may be required to review its own work, and the relation of the non-audit activity to accounting and auditing skills.

Although our concerns regarding the provision of consulting and other non-audit services remained unchanged, we later determined to rescind the formal interpretive release[88] and the proxy disclosure requirement.[89] Among other reasons, our review of proxy disclosures convinced us that accounting firms were not providing extensive non-audit services to their audit clients. Our review of the 1979 and 1980 proxy disclosures of approximately 1,200 registrants showed that fees paid by audit clients for non-audit services generally constituted a relatively small fraction of registrants' audit fees.[90] In addition, we noted that, even without the proxy disclosure requirement, investors had access to useful data concerning the relative levels of audit and non-audit services provided by firms to their audit clients. In particular, we noted that summarized information regarding the relationship between MAS and audit fees was provided to the SECPS by member firms and was publicly available. We also concluded that the efforts of audit committees and the accounting profession to monitor firms' provision of non-audit services generally had been effective.

As discussed above, however, in recent years there has been a dramatic growth in the number of non-audit services provided to audit clients and the magnitude of fees paid for non-audit services.[91] Moreover, there may be less information available to investors about these services since the

SECPS has stopped publishing information about audit firms' provision of non-audit services. Further, information provided by the SECPS describes the mix of services provided by an accounting firm to all of its clients, while an investor generally is primarily interested in the services provided to an individual company. This information is not currently available.

Under circumstances where investors have less information about a matter that has become more important, we believe a disclosure requirement may once again prove useful to investors. Accordingly, we propose to reinstate a requirement that companies include in their proxy statements certain disclosures about non-audit services provided by their auditors during the last fiscal year. As we did while the requirement was in effect twenty years ago, we expect that both we and investors will learn from these disclosures and that they will have an impact on audit committees, investors, and accounting firms.[92] Disclosure may be particularly effective now that investors have unprecedented access to information about companies in which they invest. We believe that investors should have access to information regarding the company's auditors when making investment decisions and when voting to elect, approve, or ratify the selection of, the accounting firm as the principal auditor of a company's financial statements.

We also believe that audit committees, as well as management, should engage in active discussions of independence issues with the outside auditors. According to the Blue Ribbon Report, "If the audit committee is to effectively accomplish its task of overseeing the financial reporting process, it must rely, in part, on the work, guidance and judgment of the outside auditor. Integral to this reliance is the requirement that the outside auditors perform their service without being affected by economic or other interests that would call into question their objectivity and, accordingly, the reliability of their attestation."[93]

Recently, the ISB adopted ISB Standard No. 1, which requires each auditor to disclose in writing to its client's audit committee, all relationships between the auditor and the company that, in the auditor's judgment,[94] reasonably may be thought to bear on independence, and to discuss the auditor's independence with the audit committee.[95] Furthermore, we recently adopted new disclosure rules regarding audit committees and auditor reviews of interim financial information, in response to recommendations made by the Blue Ribbon Committee.[96] These new rules require that companies include in their proxy statements reports of their audit committees that state whether, among other things, the audit committees have received the written disclosures and the letter from the independent auditors required by ISB Standard No. 1,[97] and discussed with the auditors the auditors' independence. Our new requirements, and the new requirements of the ISB, the New York Stock Exchange, the National Association of Securities Dealers, Inc. and the American Stock Exchange[98] should encourage auditors, audit committees, and management to have robust and probing discussion of all issues that might affect investors' views of the auditor's independence.

D. The Need for a More Accessible Auditor Independence Framework

Currently, our auditor independence requirements are found in various Commission rules and interpretations. These have been supplemented over the years by staff letters, staff reports, and ethics rulings by the accounting profession.[99] Current Rule 2-01 of Regulation S-X sets forth the circumstances under which we will not recognize an accountant as independent.[100] Because Rule 2-01 does not address particular factual situations, we and our staff have issued interpretations of Rule 2-01 in response to public companies' questions about particular situations.[101] The proposed revisions to Rule 2-01 would consolidate and make more accessible the standards for auditor independence under the federal securities laws, reemphasize its importance, and provide a comprehensive framework for evaluating auditor independence. The proposed proxy disclosures, if adopted, should add to the body of knowledge regarding the provision of non-audit services.

The new rules should also assist the ISB in its work. In FRR No. 50,[102] we stated that we would look to the ISB to provide leadership in improving auditor independence requirements and in establishing and maintaining a body of independence standards applicable to auditors of public companies.[103] In the same manner, we previously have endorsed the establishment of the Financial Accounting Standards Board ("FASB").[104] Among other things, the ISB sets standards and its staff answers day-to-day inquiries regarding the application of our auditor independence requirements to specific situations confronting auditors and their clients.

The ISB has requested more guidance from us. For example, the ISB noted in ISB Standard No. 2,[105] the standard would not take effect until the SEC revises its rules on independence. Accordingly, our proposals and the attendant modifications to the Codification, if adopted, would enhance the ability of the ISB to make its standards effective. In addition, by providing a comprehensive framework, the new rules, if adopted, should assist the ISB in making future decisions regarding auditor independence matters.[106]

III. Discussion of Proposed Rules

A. Qualifications of Accountants

Section 2-01(a) would remain unchanged and require that in order to practice before the Commission an auditor must be in good standing and entitled to practice in the state of the auditor's residence or principal office. This requirement has existed since the Federal Trade Commission first adopted rules under the 1933 Act.[107] It acknowledges our deference to the states for the licensing of public and certified public accountants.

B. The General Standard for Auditor Independence

Proposed rule 2-01(b) sets forth the basic test of an auditor's independence. Under that test, we will not recognize as independent an accountant who, with respect to an audit client, is not, or would not be perceived by reasonable investors to be, capable of exercising objective and impartial judgment on all issues encompassed within the auditor's engagement.[108] The general standard in paragraph (b) recognizes that an auditor must be independent in fact and appearance. Appearance is measured by reference to reasonable investors knowing all the relevant circumstances. As noted above,[109] independence in fact and the appearance of independence are inseparable.

To make the general standard more specific, paragraph (b) identifies four governing principles for determining when an auditor is not independent. The four principles incorporate situations that we believe reasonable investors would agree impair an auditor's independence. They are when the auditor:

- has a mutual or conflicting interest with the audit client,[110]
- audits the accountant's own work,[111]
- functions as management or an employee of the audit client,[112] or
- acts as an advocate for the audit client.[113]

We believe these four basic principles provide a framework for analyzing auditor independence issues, in that actions inconsistent with one or more of these principles would result in a lack of auditor independence. We apply these principles in the remainder of the rules.

We request comment on the general standard and the four proposed principles. Do these four principles appropriately address the concept of auditor independence? If not, why not? Please describe any alternative formulation and why it is preferable. Some believe a basic principle of auditor independence is that the auditor will not subordinate his or her judgment to others.[114] Should this be included in the proposed principles? Are there additional principles that should be included, and, if so, what are they, and do they reflect an impairment of independence?

Should the concept of mutual or conflicting interests be limited to economic interests? Would that limitation reach areas such as employment of close family members by an audit client? What forms of activities engaged in by accountants involve auditing their own work? What forms of activities constitute advocacy? Are there situations in which an auditor may act as an advocate for the audit client that would not impair the auditor's independence? If so, what are these, and why would they not impair independence? For instance, the principle regarding advocacy is not intended to prevent the accounting firm from explaining or defending (in court, if necessary) its work in an audit. Should that principle be modified to make that explicit? If so, how? Should accounting firms be permitted to lobby for an audit client before Congress, state legislatures, regulatory agencies, or other similar bodies?

C. Specific Applications of the Independence Standard

Proposed rule 2-01(c) ties the general standard and four principles of paragraph (b) to specific applications.[115] It provides that an accountant is not independent under the standard of paragraph (b) if, during the audit and professional engagement period, the accountant has any of the financial, employment or business relationships with, provides certain non-audit services to, or receives a contingent fee from, the accountant's audit client or an affiliate of the audit client, as specified in paragraphs (c)(1) through (c)(5), or otherwise does not comply with the standard of paragraph (b). Paragraphs (c)(1) through (c)(5) address separately situations in which an accountant is not independent of an audit client because of: (i) a financial relationship, (ii) an employment relationship, (iii) a business relationship, (iv) the provision of non-audit services, or (v) the receipt of contingent fees.[116]

While paragraph (c) specifies a number of the relationships and other situations that might impair an auditor's independence, this list is not exhaustive. We cannot foresee all situations in which an auditor might lack independence. Accordingly, paragraph (c) includes a catch-all reference to any other situation in which an accountant "otherwise does not comply with the standard of paragraph (b) of this section."[117]

Auditor independence is more than a requirement imposed by the federal securities laws. Accountants have both a professional and ethical duty to remain independent of their audit clients,[118] including an obligation to "avoid situations that may lead outsiders to doubt their independence."[119] Accordingly, accountants may have to take steps to remain independent even if the steps are not specified in proposed rule 2-01.

In certain situations, the best course may be for the accountant to ask to be removed from the audit engagement. Neither we nor the profession's standards-setters can foresee every business or employment relationship, or investment that could affect the hundreds of decisions that an auditor must make during the course of an audit. On occasion, there may be a relationship, apart from those contemplated by any standard or rule, that has an important meaning to an individual accountant and could create, or be viewed as creating, a conflict with the accountant's duty to investors.[120] We therefore encourage accountants to seek to recuse themselves from any review, audit, or attest engagement if reasonable investors would view the accountant's ability to exercise objective and impartial judgment as compromised by <u>any</u> personal, financial, or business relationship, whether or not specifically discussed in the Commission's, the ISB's, or the profession's rules.

Paragraphs (b) and (c) require the accountant to be independent "during the audit and professional engagement period."[121] This term is defined in proposed rule 2-01(f)(6) to mean the period covered by any financial statements being audited or reviewed, and the period during which the auditor is engaged either to review or audit financial statements or to prepare a report filed with us, including at the date of the audit report.[122] The use of the word "during" in paragraphs (b) and (c) is intended to make clear that an accountant will lack independence if, for example, he or she is independent at the outset of the engagement but acquires a financial interest in the audit client during the engagement.

1. <u>Financial Relationships</u>

Proposed rule 2-01(c)(1) sets forth the general rule regarding financial relationships that impair independence and is substantially similar to current Rule 2-01(b). Both state that a direct or material indirect financial interest in an audit client will impair an auditor's independence with respect to that audit client. The remainder of paragraph (c) of the proposed rule provides a non-exclusive list of relationships in which an accountant has a direct or material indirect financial interest in an audit client and is, therefore, not independent. Accountants should not assume that financial interests not specifically described in (c)(i) through (c)(iv) do not impair independence.

(a) Investment in audit client. Proposed rule 2-01(c)(1)(i) provides that an accountant is not independent with respect to an audit client if the accounting firm, any covered person in the firm, or any immediate family member of any covered person has any direct investment in the audit client or in an affiliate of the audit client. Under current rules, the "direct financial interest" requirement prevents all partners in an accounting firm, all managers in the office performing the audit, and all persons on the engagement team, from having any financial interest in the audit client. This approach was intended to give effect to the principle of loyalty that the firm and all of its employees owe to public investors. It is based on the belief that the public generally perceives a firm as one entity in which individuals may have equal access to confidential client information, shared confidences, and common personal and financial interests.

Under the proposal, as under the current rules, the accounting firm (including its affiliates, such as its pension plan) cannot have a direct investment in an audit client and remain independent of that audit client. The proposal otherwise increases significantly the group of persons within the firm who can invest in an audit client without impairing the auditor's independence. Under proposed paragraph (c)(1)(i), the group of persons who cannot invest is limited to "covered persons in the firm" and their immediate family members. As explained in greater detail below, we define "covered persons" in proposed rule 2-01(f)(13) to include the "audit engagement team," those in the "chain of command," all other partners, principals, shareholders, or professional employees providing any professional service to the audit client or its affiliate, and any other partner, principal, or shareholder in an "office" that participates in a significant portion of the audit.[123] The proposal, like the current rule, would attribute all investments by a covered person's "immediate family members" -- that is, the covered person's spouse, spousal equivalent, and dependents -- to the covered person.[124]

Paragraph (c)(1)(i)(A) applies to any direct investment in an audit client "such as stocks, bonds, notes, options, or other securities." As the language of the rule makes clear, this is not an exclusive list of all covered ownership interests. In addition, as under current law, the rule cannot be avoided through indirect means. For instance, an accountant who cannot have a direct investment in the audit client by virtue of being a covered person in the firm, may not hold the investment through a corporation or as a member of an investment club.[125]

Under paragraph (c)(1)(i)(A), a direct investment in an affiliate of an audit client would be treated the same as an investment in the audit client. "Affiliate of the audit client" is defined in proposed rule 2-01(f)(5) to mean an entity that has significant influence over the audit client, or over which the audit client has significant influence.[126] Our concern is that, in both cases, there is a melding of financial interests and managerial functions of the entity and the audit client such that one can influence the accounting policies and financial transactions of the other. Once an audit client can exercise "significant influence" over the operating or financial policies of an entity, then under GAAP,[127] information from the financial statements of that entity will be reflected in the financial statements of the audit client. Similarly, if an entity can exercise influence over the audit client, information from the audit client's financial statements will be reflected in the entity's financial statements. In this case, the revenues and income of the audit client would directly affect the earnings of the entity in which the accountant has an investment.

Proposed rule 2-01(c)(1)(i)(A) applies only to a limited class of people, namely an accounting firm, as well as covered persons in the firm and members of their immediate families. Proposed rule 2-01(c)(1)(i)(B) applies to a larger class of people, including an accounting firm's partners, principals, shareholders, professional employees, and their immediate family members, the close family members of covered persons in the firm,[128] and any "group" of the foregoing persons.[129] Under proposed rule 2-01(c)(1)(i)(B), an accountant is not independent with respect to an audit client when any such person or group holds more than five percent of an audit client's outstanding voting securities or otherwise controls the audit client. We selected the five percent level, in part, because it triggers a separate filing with the Commission,[130] and therefore, in certain circumstances, the accountant will have an independent means of knowing the status of those persons' investments.

Proposed rule 2-01(c)(1)(i)(C) is a specialized application of the direct financial interest rule. It provides that an accountant is not independent when the accounting firm, any covered person in the firm, or any covered person's immediate family member serves as voting trustee of a trust or executor of an estate containing the securities of an audit client. In these positions, the firm or person typically makes investment decisions, or participates in making investment decisions, concerning the securities of the audit client. In this role, the firm or person typically has a fiduciary duty to preserve or maximize the value of the assets. We believe that this warrants treating the trustee or executor's interest as a direct financial interest in the audit client and deeming the auditor's independence impaired.

Proposed rule 2-01(c)(1)(i)(D) covers material indirect investments in an audit client. It describes the circumstances in which independence is impaired because of investments by the accounting firm, any covered person in the firm, any immediate family member of a covered person, or any group of these people in: (i) non-client entities that have an investment in an audit client ("non-client investors"), or (ii) companies in which an audit client also has invested ("common investees"). The current rule generally recognizes that these investments create a mutuality of interest if the auditor or the audit client owns more than five percent of the entity's equity securities.[131]

In both the "non-client investor" and "common investee" scenarios, an intermediary is placed between the auditor and the audit client. In one case, the auditor has invested in an entity that, in turn, has invested in the audit client. In the other, the auditor and the audit client are linked through a mutual financial interest in seeing their common investment grow and prosper. Because these financial ties are indirect, we believe that use of a materiality threshold continues to be appropriate. Accordingly, under the proposed rule, accounting firms, covered persons, and covered persons' immediate families can own up to five percent of an entity that invests in an audit client or of an investee in which an audit client also invests.[132]

It should be remembered, however, that should the "non-client investor" or the "common investee" become an affiliate of the audit client, then as described under paragraph (A) regarding direct investments, the auditor may not have any investment in the intermediary entity. For example, assume auditor A invests in non-client company B, which owns an equity interest in audit client C. A may own up to five percent of the equity of B without impairing its independence from C, provided B does not "significantly influence" or is not "significantly influenced" by C. As discussed above, if such significant influence exists, then B is an affiliate of C and, under paragraph (A) regarding direct investments, A may not invest in B without impairing its independence from C. Similarly, assume auditor A invests in non-client company Z, and audit client C also invests in company Z. A may own up to five percent of the equity of company Z without impairing its independence from C, provided Z does not "significantly influence" or is not "significantly influenced" by C.

Proposed rule 2-01(c)(1)(i)(D) does not make a distinction for an indirect investment in an audit client by an auditor through an investment company. As a result, an auditor would not be independent if the auditor owns more than 5% of the outstanding stock of an investment company and the investment company holds an investment in an audit client.[133] The proposed rule, however, does not impose a limit on the portion of an investee company's (including an investment company's) assets that may be invested in the audit client, assuming the auditor owns less than five percent of the investee company and the investee is not an affiliate of the audit client. For example, an operating company or an investment company (Company A) could have a significant portion of its assets invested in Company B, and an auditor could own up to five percent of Company A's stock and audit Company B, so long as B is not an affiliate of A.

We considered limiting the portion of an investee company's assets that could be invested in an audit client without impairing auditor independence. We request comment on whether there should be a limit on the portion of an investee's total assets that can be invested in an audit client without independence being impaired in addition to, or in place of, the proposed indirect investment test. If so, where should the limit be set? Would a 10% percent or 25% level be appropriate?

If we use that approach, should the rule for registered investment companies turn on their diversification status?[134] Limitations on material indirect investments in an audit client may be difficult for auditors to apply in practice when they invest in an investment company. Auditors have no easy way to determine how much of an investment company's assets are invested in an audit client or how much of an issuer's securities are owned by an investment company because many investment companies' portfolios change frequently. Because funds are required to disclose their diversification status in their registration statements, accountants could easily determine, by looking at a fund's registration statement, whether an investment in the fund by the accounting firm, a covered person in the firm or such person's immediate family might impair an accountant's independence under the rule. Should we permit an investment in any registered investment company that is "diversified" under the ICA, provided it is not part of the same investment company complex as an audit client?[135] Would this be one way to prevent inadvertent violations of the independence rules?

We solicit comment on all aspects of the financial interest rules in paragraph (c)(1)(i). In particular, would reasonable investors be concerned that investments of the sort described in this section would impair an auditor's independence? Should the restrictions on financial ownership interests apply to all partners (but not their immediate family or employees of the firm) of an audit firm, as the partners represent the partnership?

Is the five percent threshold for financial interest in an audit client by persons who do not influence the audit appropriate? For example, would reasonable investors perceive a firm's independence to be impaired if a partner or employee in an office that did not work on the audit, held four percent of the audit client? If the five percent threshold is not appropriate, what threshold is appropriate, and which individuals should be subject to the restriction?

Furthermore, is it appropriate to base the determination, as we do, on ownership of five percent or more of a company's equity securities? Should we be more specific and indicate whether to account for common and preferred shares, and voting and non-voting shares? If so, what types of shares should be included (i.e., voting shares only)? If the determination depends on ownership of outstanding voting shares, should all shares, regardless of the number of votes different classes of shares have, count the same?

Would reasonable investors perceive an accountant's independence to be impaired if any partner, shareholder, or professional employee of the accountant's firm has an investment in an audit client that is more than five percent of the individual's net worth, even if it represents less than five percent of the ownership of the audit client's equity securities?

Suppose that ABC Accounting Firm audits XYZ Corp. Partner A is a covered person in the firm for the XYZ audit. In the following situations, would a reasonable investor be concerned about the independence of the auditor:

(i) A grandchild of Partner A owns more than five percent of the equity of XYZ Corp;

(ii) Partner A's siblings each own four percent of the equity of XYZ Corp. The siblings do not act together in their investment activities in such a way as to constitute a group under the proposed definition of group;

(iii) Partner A's brother-in-law owns ten percent of the equity of XYZ Corp;

(iv) Partner A's sister-in-law owns 20 percent of the equity of XYZ Corp; or

(v) Five partners of ABC Accounting Firm, none of whom are covered persons and not acting as a "group," each own four percent of the equity of XYZ Corp.

Are there other persons whose investment in the XYZ Corp. may cause concern regarding the independence of Partner A?

We solicit comment on all aspects of the proposals regarding investments in audit clients in paragraph (c)(1)(i)(D). Do investments in an intermediary affect the auditor's independence when the intermediary has an investment in an audit client that an auditor could not have directly without impairing the auditor's independence? If the auditor has an investment greater than five percent in the intermediary, but the intermediary has an investment in the audit client that is less than five percent of the audit client, is the auditor's independence impaired? What if the intermediary's investment is less than five percent of the audit client but material to the auditor or intermediary?

Suppose that the pension fund of ABC Accounting Firm has a 4.9 percent ownership of DEF Corp. DEF is not an audit client of ABC. DEF in turn has a substantial investment in XYZ Corp., an audit client of ABC. DEF and XYZ are not affiliates. Would a reasonable investor perceive that the accountant's independence was impaired? Is five percent an appropriate threshold? Would a lower threshold enhance investor confidence in auditor independence? The proposed rule on material indirect investments includes investments by the accounting firm, any covered person in the firm or any of his or her immediate family members, or any group of such persons. Should other persons be included?

Suppose that the pension fund of ABC Accounting Firm has a 4.9 percent ownership of DEF Corp. DEF is not an audit client of ABC. XYZ Corp., an audit client of ABC, has a substantial investment in DEF, but XYZ and DEF are not affiliates. Would reasonable investors perceive that the accountant's independence was impaired? The proposed rule includes investments by the accounting firm, any covered person in the firm or any of his or her immediate family members, or any group of such persons. Should other persons be included? Are there any investments that you believe would impair an auditor's independence that the proposed rules permit? If so, what are they, and why do they raise independence concerns?

(b) Other financial interests. Proposed rule 2-01(c)(1)(ii) describes other financial interests of an auditor that would impair an auditor's independence with respect to an audit client because they create a debtor-creditor relationship or other commingling of the financial interests of the auditor and the audit client. In some situations (e.g., bank deposits or insurance), the continued viability of the audit client may be necessary for protection of the auditor's own assets or for the auditor to receive a benefit (e.g., insurance claim). These situations reasonably may be viewed as creating a self-interest that competes with the auditor's obligation to serve only investors' interests. We discuss several of these situations here.

(i) Loans/debtor-creditor relationships. The proposals provide that the accountant will not be independent when the accounting firm, or any covered person in the accounting firm, or any of the covered person's immediate family members has any loan (including any margin loan) to or from an audit client, the officers of an audit client or an affiliate of an audit client, the directors of an audit client or an affiliate of an audit client, or record or beneficial owners of more than five percent of the equity securities of an audit client or its affiliate. We considered adding to the proposal the AICPA's Ethics Ruling on loans to or from audit clients.[136] The ruling indicates that any loan would impair the auditor's independence, unless the loan was from a financial institution; acquired in accordance with that institution's normal lending procedures, terms and requirements; kept current as to all its terms; and, was: (1) an automobile loan or lease collateralized by the automobile; (2) a loan on the cash surrender value of an insurance policy; (3) a "passbook loan" collateralized by cash deposits at the same institution; or (4) credit cards or cash advances on checking accounts with an aggregate balance not paid of less than $5,000. We are proposing a more liberal approach since our proposal sets the credit card balance threshold at $10,000, permits a mortgage loan not obtained during the period of the audit or professional engagement, and because, unlike the

AICPA ruling, the proposed rule covers only the relatively small group of entities and people that could influence the audit.

We solicit comment on our approach to loans. Should we expand the rule to cover close family members as opposed to just immediate family members? For example, would a $1,000,000 home loan from an audit client to the auditor's brother-in-law be perceived as affecting the independence of the audit partner? Does the answer change if the loan is unsecured? Are there other categories of loans that should be excluded, similar to car loans? Are there circumstances under which a loan to or from an audit client would not impair an auditor's independence?

(ii) Savings and checking accounts. The proposals provide that an accountant will not be independent when the accounting firm, or any covered person in the accounting firm, or any of the covered person's immediate family members has any savings or checking account at a bank or savings and loan that is an audit client or its affiliate, if the account has a balance that exceeds the amount insured by the Federal Deposit Insurance Corporation ("FDIC"). Would reasonable investors perceive an accountant's independence to be impaired if an accountant or the accountant's immediate family member has any savings or checking account at an audit client or the audit client's affiliate? Would an accountant's independence be impaired if a covered person maintained a balance in a non-federally insured bank that is an audit client? Are there other institutions that are similar to a bank or savings and loan that should be included? Are any of the risks to independence mitigated by depository insurance similar to that provided by the FDIC? Why or why not? Would the financial condition of the bank or other depository institution affect reasonable investors' perceptions?

(iii) Broker-dealer accounts. The proposals provide that an accountant will not be independent when the accounting firm, or any covered person in the accounting firm, or any of the covered person's immediate family members has any brokerage or similar account maintained with a broker-dealer that is an audit client or an affiliate of an audit client if any such accounts include any asset other than cash or securities (within the meaning of "security" provided in the Securities Investor Protection Act ("SIPA")), or where the value of the assets in the accounts exceeds the amount that is subject to a Securities Investor Protection Corporation ("SIPC") advance for those accounts, under Section 9 of SIPA. Our proposal is rooted in a concern that, to the extent that the assets of an accountant (or covered persons or their family members) in a broker-dealer account are exposed to loss in the event of the broker-dealer's financial failure, the accountant has an interest in the financial condition of the broker-dealer.

When an accounting firm, a covered person, or a covered person's immediate family member maintains such accounts at an audit client, would reasonable investors perceive that auditor independence is impaired? Should covered persons be considered not independent if they have an account with a broker-dealer that is an audit client, regardless of whether the assets in the account are subject to a SIPC advance? Are there better ways to identify broker-dealer accounts that impair an auditor's independence? For example, the proposal's provision on loans and debtor-creditor relationships provides that a margin loan impairs an auditor's independence. Should the provision concerning broker-dealer accounts state that maintaining a margin account with a broker-dealer impairs an auditor's independence as to that broker-dealer, whether or not any margin debt exists? Are there other types of accounts that might be maintained with a broker-dealer that the rule should specifically identify as impairments to independence? If so, what types of accounts, and why do they impair, or appear to impair, independence?

Should the rule specifically address short positions, or the writing of options, in an account with a broker-dealer? If so, should the rule provide that those types of accounts, when held by the accounting firm, any covered person in the firm, or such person's immediate family member, impair independence as to the broker-dealer with whom the account is maintained?

Is it impractical for accountants (and covered persons and family members) to monitor whether the assets in their broker-dealer accounts are within the amounts subject to a SIPC advance? Are there preferable alternative formulations that would accomplish the goal of deeming independence to be impaired only in those situations where the accounts include assets that are exposed to loss in the event the broker-dealer fails? Or is that goal too narrow? Should the rule impose additional limits on accounts even though the assets in the accounts stay within the amounts subject to a SIPC advance? For example, an auditor might control several different types of accounts, each of which qualify for SIPC coverage. Should the rule impose some limit on the number or total assets of such accounts with a broker-dealer audit client? What should those limits be, and why?

Would it be preferable to provide that independence is impaired as to any broker-dealer audit client with whom the accountant (or covered person or covered person's family member) maintains any account, regardless of whether the account's assets are within the limits subject to a SIPC advance?

In addition to SIPC protection, broker-dealers sometimes purchase insurance from private insurers to protect customer assets. Should the rule take that type of insurance into account? If so, how?

(iv) Futures commission merchant accounts. The proposals provide that the accountant will not be independent when the accounting firm, or any covered person in the accounting firm, or any covered person's immediate family member has any futures, commodity, or similar account maintained with a futures commission merchant ("FCM") that is an audit client or an affiliate of the audit client. This proposal is rooted in a concern that, to the extent that the assets of an accountant (or covered persons or their family members) in an FCM account are exposed to loss in the event of the FCM's financial failure, the accountant has an interest in the financial condition of the FCM. We solicit comment on whether maintaining such accounts could impair, or would appear to reasonable investors to impair, an auditor's independence. Are there different types of FCM accounts or different types of assets maintained in FCM accounts that should be distinguished from each other for purposes of determining auditor independence? What distinctions should be made? Are there conditions under which an accountant (or covered person or covered person's family member) could maintain an account with an FCM but have no interest in the financial condition of the FCM? If so, what are those conditions? How, if at all, should the rule take those conditions into account?

(v) Credit cards. We are proposing that credit card balances of $10,000 or less owed by a firm, a covered person, or any covered person's immediate family member to an audit client or its affiliate, not be deemed to impair an auditor's independence. [137] We do not believe that a relatively minor credit card balance would create or appear to create a mutuality or conflict of interest with the lender-audit client. Furthermore, a strict prohibition of such accounts might unnecessarily affect a firm's ability to assign staff to provide short-term technical advice to the audit engagement team. Would reasonable investors perceive an accountant's independence to be impaired if a covered person held a credit card balance in excess of $10,000 with a lender that is an audit client? Is $10,000 an appropriate limit?

(vi) Insurance products. Proposed rule 2-01(c)(1)(ii)(F) provides that an auditor's independence is impaired whenever the accounting firm, any covered person in the firm, or any immediate family member of a covered person holds any individual insurance policy originally issued by an insurer that is an audit client or an affiliate of an audit client. Additionally, under the proposed rule, an auditor's independence is impaired if the audit firm obtains professional liability coverage from an audit client or its affiliate. Holding these policies creates a mutual interest in the continuing viability of the insurer.

We solicit comment on whether an accountant's independence is impaired, and on whether reasonable investors would perceive an accountant's independence to be impaired, if the accountant or a member of the accountant's immediate family originated an individual insurance policy with an insurance company that is an audit client or an affiliate of an audit client. Should the proposed rule cover all insurance policies, or be limited, such as to life insurance policies? Would an accounting firm's independence be impaired if the accounting firm acquired from an audit client insurance such as (i) insurance for litigation or indemnification losses, (ii) group health, or (iii) group life insurance policies? Should an accounting firm be permitted to purchase professional liability coverage through an audit client?

(vii) Investment companies. Proposed rule 2-01(c)(1)(ii)(G) sets forth the rule for investment by accounting firms, covered persons and covered persons' immediate family members in an investment company or a related entity. The proposed rule provides that an auditor is not independent if the auditor invests in any entity in an investment company complex if the audit client is also an entity included in that investment company complex. Proposed rule 2-01(f)(16) defines "investment company complex" as an investment company and its investment adviser or, if the company is a unit investment trust, its sponsor; any entity controlled by, under common control with, or controlling the investment adviser or sponsor, such as the distributor, administrator or transfer agent; and any investment company or an entity that would be an investment company but for the exclusions provided by section 3(c) of the ICA[138] that is advised by the same adviser or a related adviser, or sponsored by the same sponsor or related sponsor.

Proposed rule 2-01(c)(1)(ii)(G) makes clear that when an audit client is part of an investment company complex, the accountant must be independent of each entity in the complex. The proposed rule follows ISB Standard No. 2 on this point. Under ISB Standard No. 2, the firm and those in the firm who are in a position to influence an audit must be independent from each fund in the fund complex and each entity in the fund complex in order to be independent with respect to any fund or entity in the complex.[139]

In addition to the requirement that the auditor have no investment in any entity in the investment company complex, the auditor also must be independent with respect to its other relationships with entities within the complex. For example, an auditor could not be a director for an entity within an investment company complex while auditing an entity in the complex.

Should we follow the standard of ISB Standard No. 2 that an accountant must be independent of the entire investment company complex to be independent of any entity in that complex? Is this standard sufficiently clear and capable of implementation? If not, what modifications are needed? Does this standard have implications outside the area of investments (e.g., employment relationships, business relationships, or the provision of non-audit services) that go beyond what is necessary to safeguard independence?

Are there certain complex capital structures, such as master/feeder or fund of funds, that require specific clarification as to an auditor's independence when the auditor audits one or more entities in that structure? Are there any unique implications of applying the proposed independence rules to investment companies, investment advisers, sponsors of unit investment trusts, and affiliated or unaffiliated service providers? If so, what are they and how should they be addressed?

(c) Exceptions. Proposed rule 2-01(c)(1)(iii) would provide two limited exceptions to the financial relationship rules. These exceptions recognize that there are situations in which an accountant, by virtue of being given a gift of or inheriting a financial interest from a third party, or because the accounting firm has taken on a new audit client, may lack independence solely because of events beyond the accountant's control. In these circumstances, and provided the financial interest is promptly disposed of or the financial relationship is promptly terminated, we believe that reasonable investors would not necessarily perceive the accountant to be incapable of exercising objective and impartial judgment.

(i) Inheritance and gift. Proposed rule 2-01(c)(1)(iii)(A) provides that an accountant's independence will not be impaired if any person acquires a financial interest through an unsolicited gift or inheritance that would cause the accountant to be not independent under (c)(1)(i) or (c)(1)(ii), and the financial interest is disposed of as soon as practicable, but no longer than 30 days after the person has the right to dispose of such interest. We solicit comment on all aspects of the gift and inheritance exception. Does the exception capture all situations in which a person subject to the financial relationship rules might enter into a restricted financial relationship and yet not give rise to any independence concerns? Are there situations in which an accounting firm might have no option but to receive its fee in its audit client's stock as a result of a court settlement? If so, should there be an exception for these situations, and how would such an exception work? Does the rule provide affected persons with adequate means to "cure" the lack of independence? For example, should the rule expressly allow a covered person to recuse himself or herself from an engagement or the chain of command rather than disposing of the financial interest?

Would an accountant's independence be impaired if the covered person was restricted from disposing of the financial interest for an extended period? For example, suppose XYZ Corp. is the audit client of ABC Accounting Firm. Partner A is a covered person in the firm. Partner A becomes the beneficiary of a testamentary trust fund that includes $2 million in equity securities of XYZ Corp. This amount constitutes 40 percent of the amount of the trust, and 30 percent of Partner A's net worth. The terms of the trust fund prohibit disposing of the XYZ investment for a period of five years. Would a reasonable investor perceive ABC's independence to be impaired?

Assume the same facts as above, except that the securities are received directly by Partner A. Would placing those securities in a "blind trust" remedy the independence question? Can an individual be impartial if he or she knows what securities are held in the blind trust?

(ii) New audit engagement. Proposed rule 2-01(c)(1)(iii)(B) is designed to allow accounting firms to bid for and accept new audit engagements, even if a person has a financial interest that would cause the accountant to be not independent under the financial relationship rules. This exception is available to an accountant so long as the accountant did not audit the client's financial statements for the immediately preceding fiscal year, and the accountant was independent before the earlier of either accepting the engagement to provide audit, review, or attest services to the audit client; or commencing any audit, review, or attest procedures (including planning the audit of the client's financial statements).

The new audit engagement exception of proposed rule 2-01(c)(1)(iii)(B) is necessary because an auditor must be independent, not only during the period of the auditor's engagement, but also during the period covered by any financial statements being audited or reviewed. [140] Because of an existing financial relationship between an accounting firm or one of its employees and a company (that is not an audit client), an accounting firm may not be able to bid for or accept an audit engagement from the company without this exception. For example, where a firm's pension plan or a covered person in the firm owns the stock of a potential audit client during the period of the financial statements to be audited or reviewed, the accounting firm could not compete for the audit engagement but for this exception. This exception allows firms to bid for and accept engagements in these circumstances, provided they are otherwise independent of the audit client and they become independent of the audit client under the financial relationship rules before accepting the engagement or beginning any audit, review, or attest procedures.

We solicit comment on all aspects of the new audit engagement exception. Will the exception, as a practical matter, allow accounting firms to bid for and accept new audit engagements when they become available? Is the exception appropriate even though the auditor's independence would otherwise be considered impaired? Should the exception also extend to employment relationships, business relationships, or the provision of non-audit services? Does the existence of an employment relationship or the provision of non-audit services during the period covered by the financial statements raise independence concerns that cannot be "cured" before beginning the engagement in the same way that a financial relationship during this period can?

(d) Audit Clients' Financial Relationships. Proposed rule 2-01(c)(1)(iv) provides that an accountant is not independent when its audit client has invested, or otherwise has a financial interest in the accounting firm or an affiliate of the accounting firm.

(i) Investments by the audit client in the auditor. Under proposed rule 2-01 (c)(1)(iv)(A), an accountant's independence is impaired with respect to an audit client when the audit client or an affiliate of an audit client has, or has agreed to acquire, any direct investment in the accounting firm or its affiliate, whether in the form of stocks, bonds, notes, options, or other securities. This impairment occurs primarily for two reasons.

First, the accountant may be placed in the position of auditing the value of the securities of the accounting firm or its affiliates that are reflected as an asset in the financial statements of the audit client. This could result when an auditor in an accounting firm whose shares are held by the audit client must value the shares of that accounting firm held by the audit client for purposes of including that valuation in the audited financial statements.

Second, the accountant reasonably may be assumed to have a mutuality of financial interest with the owners of the firm and of the firm's affiliates, including an audit client-shareholder. The audit firm, as management, will be responsible to its shareholders, and one of the shareholders may be an audit client. Thus, there may be situations where a shareholder-audit client is in a position to influence the accountant because the accountant would owe a fiduciary responsibility to that audit client-shareholder and would be accountable to that audit client for the accounting firm's activities.[141] For example, an audit client-shareholder is legally entitled to receive certain notices, invoke "dissenters' rights," and nominate candidates for directors under most state corporation laws. Consequently, an accountant, as management, would have fiduciary obligations to an audit client-shareholder who, acting alone or in combination with other shareholders, may be in a position to exercise some measure of influence over the accountant.

Are there other situations in which an audit client could have a financial interest in the accounting firm that would impair independence? For example, would a reasonable investor perceive an accountant's independence to be impaired if the audit client's CEO held a substantial investment in the accounting firm? Would it make a difference if the investment was significant to the CEO's net worth? Should there be a maximum allowable investment by audit clients in their auditors? If so, what should the threshold be? Does it matter if the investment is material to the investor or one of its affiliates?

(ii) Underwriting. Few transactions are as significant to the financial health of a company, including an accounting firm, as the sale of its securities, whether in private or public offerings. In an offering, an underwriter either buys and then resells a company's securities or receives a commission for selling the services. In either circumstance, were an audit client to act as underwriter of an accounting firm's or its affiliate's securities, the audit client would assume the role of advocate or seller of the accounting firm's securities. Moreover, depending on the terms of the underwriting, the underwriter could for a time become a significant shareholder of the accounting firm. There also may be indemnification agreements that place the underwriter and auditor in adversarial positions.

Relying on an audit client to sell the accounting firm's securities plainly impairs independence. The accounting firm would have a direct interest in ensuring the underwriter's viability and credibility, either of which could be damaged as the result of an audit. Moreover, the auditor would have a clear incentive not to displease an audit client to which it had entrusted a critical financial transaction. Similar conflicts of interest may arise if an audit client or an affiliate of an audit client performs other financial services for an accounting firm or its affiliates, such as making a market in the accounting firm's or its affiliate's securities or issuing an analyst report concerning the securities of the accounting firm or its affiliate.

We request comment on whether we have addressed all situations in which the independence concerns arise because the audit client or its affiliate performs a financial service for the accounting firm or an affiliate? Are there financial services that an audit client or its affiliate could provide to its auditors or the accounting firm or its affiliate that would not raise these concerns? For example, would reasonable investors perceive an accountant's independence to be impaired if an audit client or an affiliate of an audit client made a market in the securities of the accounting firm or prepared and issued research reports on the accounting firm?

2. <u>Employment Relationships</u>

Proposed rule 2-01(c)(2) sets forth the employment relationships that impair an auditor's independence. This paragraph is based on the premise that when an accountant is either employed by an audit client, or has a close relative or former colleague employed in certain positions at an audit client, the accountant might not be capable of exercising the objective and impartial judgment that is the hallmark of independence.

As with the financial relationships provision, paragraph (c)(2) sets forth the general standard that an accountant is not independent if the accountant has an employment relationship with an audit client or an affiliate of an audit client. The proposed rule then provides a non-exclusive list of relationships that are inconsistent with the general rule of paragraph (c)(2). Again, accountants should not assume that all employment relationships not specifically described in (c)(2)(i) through (c)(2)(iv) do not impair independence. All non-specified employment relationships are subject to the general test of paragraphs (b) and (c)(2).

(a) <u>Employment at audit client of accountant</u>. Proposed rule 2-01(c)(2)(i) continues the principle set forth in current Rule 2-01(b) that to be independent, neither the accountant nor any member of his or her firm can be a director, officer, or employee of an audit client. The paragraph therefore provides that an accountant is not independent if any current partner, principal, shareholder, or professional employee of the accounting firm is employed by the audit client or an affiliate of an audit client, or serves as a member of the board of directors or similar management or governing body of the audit client or an affiliate of the audit client. In the most basic sense, the accountant cannot be employed by his or her audit client and be independent.

(b) <u>Employment at audit client of certain relatives of accountant</u>. Proposed rule 2-01(c)(2)(ii) specifies the family members of the auditor whose employment in certain positions by an audit client or its affiliate will impair the auditor's independence. For the employment category, the interests and relationships of a covered person's close family members -- that is, the covered person's spouse, spousal equivalent, dependents, parents, nondependent children, and siblings -- are attributed to the covered person in the firm. This stands in contrast to the investment category, where only the interests of the covered person's immediate family members (<u>i.e</u>., spouse, spousal equivalent, and dependents) are attributed to the covered person. We believe this distinction is justified because, while some close family members' investments may not be known to a covered person, the place and nature of such family members' employment should be obvious, and thus may affect the covered person's objectivity and impartiality.

We do not consider an audit client's employment of even a close family member, however, to impair an auditor's independence unless that family member is in a position to, or does, influence the preparers or the contents of the accounting records or financial statements of the audit client or its affiliate. The proposed rule uses the defined term "accounting or financial reporting oversight role" to describe the persons in this group. The term is defined in proposed rule 2-01(f)(3). To reduce uncertainty, the definition lists those positions that generally carry with them the type of influence about which we are concerned. These positions include: a member of the audit client's board of directors (or similar management or governing body), chief executive officer, president, chief financial officer, chief operating officer, general counsel, chief accounting officer, controller, director of internal audit, director of financial reporting, treasurer, vice president of marketing, or any equivalent position.

The proposed rule eliminates the so-called "five hundred mile rule." Under that rule, when a family member has an interest in or relationship with an audit client, consideration is given to whether the geographic separation of that family member from both the person in the firm and the conduct of the audit lessens the negative impact of that interest or relationship on the auditor's independence.[142] When an auditor's relative is not geographically distanced from the auditor and the audit, the auditor and his or her relatives are said to be in "closely linked business communities" and the auditor's independence is deemed to be impaired. However, considering whether family members are in "closely linked business communities" no longer seems relevant in today's world of instantaneous international communications and global securities markets. Accordingly, the proposal dispenses with this test of auditor independence.

We solicit comment on all aspects of proposed rule 2-01(c)(2)(ii). Does the proposal use an appropriate definition of what constitutes close family members whose employment by an audit client results in an impairment of an auditor's independence? If not, how should it be revised? Should the definition of close family member be expanded to include extended family relationships, such as in-laws? Would reasonable investors perceive an accountant's independence to be impaired if the audit client's CEO was the brother-in-law of a covered person? Would employment by an audit client of friends, neighbors, or other persons having emotional or financial ties with covered persons, but not within the definition of close family member, impair an accountant's independence?

Would reasonable investors perceive an accountant's independence to be impaired if a close family member of a covered person were employed by an audit client in a capacity that did not enable the family member to influence the preparers or contents of the accounting records or financial statements of the audit client or its affiliates? The ISB has suggested that independence is impaired if an immediate family member of a person on the audit engagement team is employed by the audit client in any position, or if a close family member holds a "key position" at an audit client.[143] Is the ISB's stricter position with respect to immediate family members necessary to ensure an auditor's independence?

Is the definition of the positions that may enable employees to influence the accounting records appropriate? Would independence be impaired by other employment positions held by close family members with an audit client, such as vice president of human resources, assistant controller, or manager of internal audit?

(c) Employment at audit client of former employee of accounting firm. Proposed rule 2-01(c)(2)(iii) describes the circumstances under which an auditor's independence will be impaired by an audit client's employment of a former partner, shareholder, principal, or professional employee of the accounting firm. When these persons retire or resign from accounting firms, it is not unusual for them to join the management of former audit clients or to become members of their boards of directors. Registrants and their shareholders may benefit from the former partner's accounting and financial reporting expertise. Investors and the public in general also may benefit when individuals on the board or in management can work effectively with the auditors, members of the audit committee, and management to provide informative financial statements and reports.

When these persons, however, assume positions with the firm's audit client and also remain linked in some fashion to the accounting firm, they could be in a position to influence the content of the audit client's accounting records and financial statements on the one hand, or the conduct of the audit, on the other. This is particularly true when the individual, while at the accounting firm, was in some way associated with the audit of the client. The perceived close association between a member of the board of directors or of senior management[144] may create the impression of a mutuality of interest.[145]

As accounting firm partners leave their firms and accept management positions with former audit clients, some have questioned whether these individuals compromised their independence in order to secure positions with audit clients.[146] Others have questioned the continuing personal relationships between the former partner and the individuals at the firm who audit the client's financial statements.[147] There is also the risk that the former partner's familiarity with the firm's audit process and the audit partners and employees of the firm will enable him or her to alter the outcome of the audit.[148]

As with the current requirements, the proposed rule recognizes that an auditor's independence with respect to an audit client may be impaired when former partners, shareholders, principals, or professional employees of the firm are employed in an accounting or financial reporting oversight role at the firm's audit client or an affiliate of the audit client. We are also proposing, however, that independence will not be impaired if certain steps are taken to disassociate the individual from the firm. Under the proposed rules, the former partner, shareholder, principal, or professional employee must not: (i) influence the firm's operations or financial policies, (ii) have a capital balance in the firm, or (iii) have a financial arrangement with the firm, other than a fully-funded, fixed payment retirement account.

The rule provides that, under certain conditions, use of a "rabbi trust" as a mechanism to make fixed retirement payments to a former partner or employee of the accounting firm would not impair an auditor's independence.[149] Specifically, under the proposed rule, use of a "rabbi trust" does not impair an auditor's independence as long as the amount owed to the individual is immaterial to the firm, the payments from the trust are fixed as to time and amount, and the chances of the firm entering bankruptcy or insolvency are remote.

We request comment on our approach in (c)(2)(iii). Should a former partner now employed by the audit client, be permitted to retain financial ties to the audit firm without impairing the independence of the auditor? What if the financial ties are material to the former auditor but not to the firm? Would reasonable investors perceive an accountant's independence to be impaired if a former employee of the accounting firm, who continued to hold a 401(k) investment with the accounting firm, became employed by the audit client? Does it matter if the former partner's position at the audit client is not one in which he or she will have influence over the company's audit, accounting records, or financial statements?

If an audit partner or other professional employee leaves an accounting firm and joins the audit client during the course of an audit, does this impair the accounting firm's independence? Should the rule depend on whether the person leaving the accounting firm is a senior partner within the firm, an audit manager with management responsibilities for the audit, or non-managerial audit staff?

Should we require a mandatory "cooling off" period for former partners and professional staff of an audit firm who join an audit client? Should registrants have to disclose on a timely basis if they hire a partner or other senior audit professional assigned to the company's audit.[150] If so, where should the disclosure appear?

(d) Employment at accounting firm of former employee of audit client. Proposed rule 2-01(c)(2)(iv) describes the circumstances under which employment of a former officer, director, or employee of an audit client or its affiliate as a partner, principal, or shareholder of the accounting firm will impair an auditor's independence. This provision, in a sense, mirrors the restrictions on employment by an audit client of former partners or employees of an accounting firm.

When the employee of an audit client joins an accounting firm, the independence rules must ensure that the former employee is not in a position to influence the audit of his or her former employer.[151] Participating in that audit might require the former employee to audit his or her own work. Accordingly, the rule provides that independence is impaired unless the former employee does not participate in and is not in a position to influence the audit of the financial statements of the audit client or its affiliate for any period during which he or she was employed by or associated with that audit client or its affiliate.

We solicit comment on whether additional or other procedures should be implemented when a former employee of an audit client joins the accounting firm? If so, what should they be? Should the rule also apply to professional employees of the accounting firm?

3. Business Relationships

Proposed rule 2-01(c)(3) describes the business relationships that impair an auditor's independence from an audit client. It continues the Codification's current standard that an auditor's independence with respect to an audit client is impaired when the accounting firm, or a covered person in the firm, has a direct or material indirect business relationship with an audit client, an affiliate of an audit client, or either of their officers, directors, or shareholders holding five percent or more of the audit client's equity securities.[152] As is true today, under proposed rule 2-01(c)(3), an accountant's independence is not impaired solely because the accountant has a business relationship with the audit client in which the accountant provides professional services to the audit client except for those specified in rule 2-01(c)(4) or acts as "a consumer in the ordinary course of business."

Because of recurring issues in this area, we have attempted to set forth in proposed rule 2-01(f)(11) a workable definition of "consumer in the ordinary course of business." In general, an accountant acts as a "consumer in the ordinary course of business" when the accountant buys "routine" products or services on the same terms and conditions that are available to the seller's other customers or clients.[153] An accountant is not acting as a "consumer" if it resells the client's products or services. Likewise, a purchase is not "in the ordinary course of business," nor is the product "routine," if it is significant to the firm or its employees. For example, an over-the-counter purchase of office supplies at customary prices would be considered in the ordinary course of business. Purchasing items other than on normal, customary terms, or acting as an agent, value-added reseller, or marketer of the client's products, however, would not be acting as a consumer in the ordinary course of business.

We considered whether to address each business relationship that would impair an auditor's independence. Because there are vast, varied, and constantly shifting types of business relationships, we determined not to attempt to identify all such business relationships. We have retained, however, a number of the examples currently found in the Codification to provide guidance on permissible and impermissible business relationships.[154]

We solicit comment on all aspects of paragraph (c)(3). Is the definition of "consumer in the ordinary course of business" appropriate? If not, how should it be modified? Should an auditor be allowed to resell its audit client's products? For example, should an auditor be allowed to act as a reseller of a client's software products to other clients of the auditor? Would the answer change if the sales to the auditor exceed some percentage of the client's revenues such as ten percent?

Should an auditor be permitted to enter into any of the following types of business relationships with an audit client without impairing independence, and why or why not: (i) strategic alliances such as joint marketing arrangements of the products or services of the audit client or auditor; (ii) joint ventures or other similar activities to develop or market new products or services; or (iii) prime/subcontractor relationships? Should any of these relationships be permitted if they do not result in the auditor and audit client sharing any revenues, costs or profits? Should any of these relationships be permitted if they do not result in any revenue, cost or profit sharing that is material to the audit partner, the audit firm, or the audit client?

Are there other business relationships that impair independence that the rules do not cover? Should we retain the "direct or material indirect business relationship" formulation or are there other formulations that would provide additional or more precise guidance? Should we adopt rules addressing particular business relationships based on the examples of direct and material indirect business relationships in the Codification?

In addition, we request comment on business relationships between other persons or entities related to the accountant that might affect the independence of the accountant. For example, suppose that XYZ Corp., an audit client of ABC Accounting Firm, manufactures coffee mugs. The spouse of Partner A, who is the partner in charge of the audit of XYZ, purchases coffee mugs from XYZ Corp., applies decorative logos, and sells the mugs to customers. The spouse purchases the mugs at a price that is below the normal selling price. Would a reasonable investor perceive that accountant's independence to be impaired?

D. Non-Audit Services

Historically, accounting firms have provided consulting and other non-audit services to their audit clients.[155] As noted elsewhere in this release, however, for many years consulting services for SEC registrants constituted a relatively minor portion of the firms' revenues.[156] In recent years, firms have expanded the scope of services they offer to audit and other clients.[157]

Current Rule 2-01 states that our independence requirements apply to "any professional employee involved in providing [on behalf of an accounting firm] any professional service" to an audit client. The current rule further states that in making independence determinations, we will consider "all relevant circumstances, including evidence bearing on all relationships between the accountant and [the client]."[158] Our independence requirements, therefore, apply to all persons at an accounting firm who provide non-audit services to audit clients, and we consider those services in making independence determinations. These principles remain unchanged in the rule proposal.

The proposed rules, like our current independence requirements, govern non-audit services provided by an accountant to an audit client during the audit and professional engagement period. They do not govern non-audit services when provided to persons other than audit clients. We request comment on this approach.

1. The Proposals

(a) General Rule. Proposed rule 2-01(c)(4) states the general rule that an auditor's independence is impaired if providing services to an audit client or its affiliate is inconsistent with the standard in proposed rule 2-01(b). The rule is derived from current Rule 2-01 and our releases that have been incorporated into the Codification. Proposed rule 2-01(c)(4) identifies certain services that are incompatible with the principles set forth in proposed rule 2-01(b), even when the audit client, by contract or otherwise, accepts ultimate responsibility for the work performed or for any decision made.

The rule does not provide an all-inclusive list of the services that are incompatible with proposed rule 2-01(b). Whether the provision of a non-audit service not specified in the proposed rule impairs an accountant's independence will be measured against the four general principles set forth in proposed rule 2-01(b). We request comment on whether there are any services listed in Appendix A that would raise independence concerns if provided by the accounting firm to the audit client? If so, what are they, and why do they raise independence concerns? Are there other non-audit services that are not on the list in Appendix A that raise independence concerns? If so, what are they, and why do they raise independence concerns?

We request comment on whether, if you are a registrant, your company, board of directors, or audit committee have a policy or practice of not hiring your independent auditors to provide non-audit services, other than income tax services. We request comment from registrants about what non-audit services you hire your auditor to provide, other than tax services.

We also request comment on whether allowing certain non-audit services to be provided to audit clients is a viable approach, or whether banning all non-audit services for audit clients is the only appropriate approach. Should such a ban exclude tax services?

(b) Specific Non-Audit Services that Impair Independence

(i) Bookkeeping or other services related to the audit client's accounting records or financial statements. Currently, an auditor's independence is impaired if the auditor provides bookkeeping services to an audit client or an audit client's affiliate.[159] Proposed rule 2-01(c)(4)(i)(A) continues that position. When an accounting firm provides bookkeeping services for an audit client, the auditor auditing that client's financial information may be auditing his or her accounting firm's work. If, during an audit, an auditor must audit the bookkeeping work performed by his or her accounting firm, it is questionable that the auditor could, or that reasonable investors would believe that the auditor could, remain objective and impartial. If the auditor found an error in the bookkeeping, the auditor could well be under pressure not to raise the issue with the client, if raising the issue could jeopardize the firm's contract with the client for bookkeeping services.

Because there may be bookkeeping tasks that do not involve financial information or that do not otherwise need to be considered in the audit, we have narrowed the definition to services involving maintaining or preparing the audit client's or its affiliate's accounting records or financial statements, or generating financial information to be disclosed by the audit client, or its affiliate, to the public.[160]

We request comment on whether performing bookkeeping or preparing financial records or statements for an audit client would impair, or would appear to reasonable investors to impair, an auditor's independence. If not, why not? Should the definition of bookkeeping be further clarified? If so, how? Does the definition cover all the bookkeeping services that would impair an accountant's independence?

(ii) Financial information systems design and implementation. Under the proposed rule, an accountant is not independent if the accountant designs or implements a hardware or software system that is or will be used to generate information that is significant to the audit client's financial statements taken as a whole. By "significant" we refer to information that is reasonably likely to be material to the financial statements of the audit client or its affiliate. Since materiality determinations cannot be made before financial statements are generated, the accounting firm by necessity will need to evaluate the general nature of the information rather than only system output during the period of the audit engagement. An accountant, for example, would not be independent of an audit client for which it designed an integrated Enterprise Resource Planning (ERP) system.[161]

Designing or implementing systems affecting the financial statements may create a mutual interest between the client and the accountant in the success of that system, supplant a fundamental business function, or result in the accountant auditing his or her own work. For example, if an auditor designs and installs a computer system that generates the financial records, and that system generates incorrect data, the accountant is placed in a position of having to report on its own work. When an accountant audits the accountant's own work, investors may perceive that the accountant will be unwilling to challenge the integrity and efficacy of the client's financial or accounting information collection systems that the accountant designed or implemented.

Our proposed rule would not, however, cover services in connection with the assessment, design, and implementation of internal accounting and risk management controls. Accountants often gain an understanding of their audit clients' systems of internal accounting controls. With this insight, auditors often become involved in diagnosing, assessing, and recommending to audit committees and management, ways in which their audit client's internal controls can be improved or strengthened. These services can be extremely valuable to companies, and they may also bring benefits to the performance of a quality audit, such as through increased knowledge of the audit client's business.

At the same time, we recognize that when an auditor designs and implements its audit client's internal accounting and risk management control systems, some might believe that the auditor will lack objectivity if called upon to audit financial statements that are derived at least in part from data from those systems. Testing of these controls is often an integral part of any audit of the financial statements of a company. Do such services result in the auditor auditing their own work? Would such services impair an auditor's independence if the auditor were required to issue an opinion on the effectiveness of the control systems that he or she designed or implemented?

We believe there is relatively little reason for concern about an audit firm's work on hardware or software systems that are unrelated to the audit client's financial statements or accounting records. Accordingly, our proposed rule does not prohibit an accounting firm from providing such services for non-financial or tax purposes where the results of the valuation do not have a direct impact on the financial statements.

We request comment on whether designing or implementing financial information systems poses a threat to an auditor's independence. Is an auditor's independence impaired when the auditor designs, selects or helps select, implements, or tests computer software and hardware systems that generate financial data used in or underlying the financial statements? Why or why not?

Whether a system is used to generate information that is "significant" to the audit client's financial statements may depend on the size of the engagement. Does the magnitude of the fees for such services make a difference? For example, if the auditor is hired to do a major new system design and implementation for which the fees will exceed the audit fee, is the auditor's independence impaired or would reasonable investors perceive the auditor's independence to be impaired? What if the consulting fees do not exceed the audit fee, but are significant in relation to the audit fee? What if the consulting fees are much larger than the audit fee?

Is having the audit committee pre-approve these computer systems consulting arrangements sufficient to monitor and ensure the auditor's independence? Why or why not? Would disclosure of such an arrangement make a difference? Why or why not?

Some believe that with the current pace of technological innovation, the quality of audits in the future will be even more dependent on internal controls over the electronic processing of information and data. If so, is auditor independence impaired if auditors are permitted to design and implement the systems that process the information and data, then audit these systems in the course of the audit engagement?

(iii) Appraisal or valuation services, fairness opinions, or contribution-in-kind reports. The proposals would provide that the auditor is not independent if the auditor provides appraisal or valuation services, fairness opinions or contribution-in-kind reports,[162] where there is a reasonable likelihood that the results will be audited by the auditor.[163] Appraisal and valuation services include any process of valuing assets, both tangible and intangible, or liabilities. They include valuing, among other things, in-process research and development, financial instruments, assets and liabilities acquired in a merger, and real estate. Fairness opinions and contribution-in-kind reports are opinions and reports in which the firm provides its opinion on the adequacy of consideration in a transaction. Providing these services to audit clients raises several auditor independence concerns. When it is time to audit the financial statements, the accountant could well end up reviewing his or her own work, including key assumptions or variables that underlie an entry in the financial statements.[164] Also, where the appraisal methodology involves projection of future results of operations and cash flows, the accountant that prepares the projection could have a mutuality of interest with the client in attaining forecast results. The auditor may feel constrained by the valuation and appraisal issued by the firm, and as a result, the auditor may be unable to evaluate skeptically and without bias the accuracy of that valuation or appraisal. Our proposals do not prohibit an accounting firm from providing such services for non-financial (e.g., tax) purposes.

We request comment on whether providing appraisal or valuation services and issuing fairness opinions or consideration-in-kind reports to audit clients would impair, or appear to reasonable investors to impair, an accountant's independence. Does providing valuation or appraisal services that are unrelated to the financial statements, such as for income tax purposes impair an accountant's independence?

Some believe that providing valuations and appraisals does not impair the auditor's independence when the amounts involved are likely to be immaterial to the financial statements that later would be reviewed by the auditor. Should we provide an exception in our rule to cover this situation? If so, would the auditor/consultant be able to determine in advance of the valuation work being performed whether amounts may be material to the financial statements currently and in the future?

Are there certain types of appraisal or valuation services, or certain instances in which they are provided, that do not raise auditor independence concerns? Are there circumstances in which an accounting firm may be required by law or regulation to provide such services, either in the United States or abroad? If so, please describe them. How should our rules address them?

(iv) Actuarial services. The SECPS defines actuarial services to include: (i) assisting management to develop appropriate methods, assumptions, and amounts for policy and loss reserves presented in financial reports, based on the company's history, current practice and future plans; (ii) assisting management in the conversion of financial statements from a statutory basis to one in conformity with GAAP; (iii) analyzing actuarial considerations and alternatives in federal income tax planning; and (iv) assisting management in the financial analyses of various matters, such as proposed new policies and business acquisitions.[165] Providing actuarial services may affect amounts reflected in an audit client's financial statements and result in an accountant auditing his or her own work.

The proposals, therefore, provide that the accountant is not independent if the auditor provides any advisory service involving the determination of policy reserves and related accounts for the audit client or its affiliate, unless the audit client uses its own actuaries or third-party actuaries to provide management with the primary actuarial capabilities. The SECPS already prohibits member accounting firms from providing certain actuarial services.

Does providing actuarial services to an audit client, such as the calculation of actuarial reserves or determining key actuarial assumptions, impair an auditor's independence? Sometimes auditors provide consulting services to their audit clients concerning employee benefit plans. While the consulting services may range from providing tax advice to complete development and ongoing administration of the plan and plan records, many of these services require computation of future benefit levels. Does providing such services impair an auditor's independence with respect to the audit client or the audit of the plan?

Auditors also sometimes prepare or assist an audit client in preparing its annual pension plan reports, from which the financial data are derived to be used in recording the appropriate pension plan information in the financial statements. Does providing this service for an audit client impair the independence of the auditor? Would the auditor's independence be impaired if management provided all of the significant data and key assumptions, and the auditor merely input these data into its computer model to generate the necessary information for the accounting records and financial statements?

Are there certain circumstances under which an accountant can provide actuarial services to an audit client without impairing independence? Have we appropriately described the actuarial services that give rise to independence concerns?

(v) Internal audit outsourcing. The line between performing management functions and performing an audit is not always clear. Our staff has received numerous questions about where to draw this line in general, and where to draw this line with respect to "internal audit outsourcing" in particular. Companies "outsource" internal audit functions by contracting with an outside source to perform all or part of their audits of internal controls. As emphasized by the Committee of Sponsoring Organizations ("COSO"), internal auditors play an important role in evaluating and monitoring a company's internal control system.[166] As a result, internal auditors are, in effect, part of a company's system of internal accounting control.

Since the external auditor generally will rely, at least to some extent, on the internal control system when conducting the audit of the financial statements,[167] the auditor would be relying on its own work performed as part of the internal controls and internal audit function. In essence, by outsourcing the internal audit function, the auditor assumes a responsibility of the company and becomes part of the company's control system, as opposed to providing consulting advice. Also, there may well be a mutuality of interest where management and the external auditor become partners in creating an internal control system and share the risk of loss if that system proves to be deficient.

Proposed rule 2-01(c)(4)(i)(E) provides that an auditor is not independent when the auditor performs certain internal audit services for an audit client or an affiliate. This does not include nonrecurring evaluations of discrete items or programs that are not in substance the outsourcing of the internal audit function. It also does not include operational internal audits unrelated to the internal accounting controls, financial systems, or financial statements.

In 1996, the Ethics Committee of the AICPA published a revised ruling concerning internal audit outsourcing.[168] It states that AICPA members may perform "extended audit services," including internal audit outsourcing services, provided the member or his or her firm does not act or appear to act in a capacity equivalent to a member of client management or as an employee. Under the ruling, an AICPA member may conduct "separate evaluations" of the effectiveness of a client's internal controls.[169] The client, however, among other things, must designate a competent member of management to: (i) be responsible for the internal audit function, (ii) determine the scope, risk, and frequency of internal audit activities, including those to be performed by the member, (iii) evaluate the findings and results arising from the internal audit activities, and (iv) evaluate the adequacy of the audit procedures performed and the findings resulting from performance of those procedures. The ruling also contains examples of activities that, if performed by the member, would be considered to impair that member's independence.[170] The staff has interpreted the language of this ruling narrowly: if the performance of internal audit work entails <u>any</u> managerial or employee function, audit independence is adversely affected.

As noted above, the proposal does not follow the AICPA because we believe performing an internal audit function results in the auditor assuming a management function and, during the audit, relying on a system that the auditor has helped to establish or maintain. We solicit comment on whether internal outsourcing would impair, or would appear to reasonable investors to impair, an auditor's independence. Does it impair an auditor's independence if the auditor does not outsource the internal audit function of the audit client, but rather performs individual audit projects for the client? Would it impair the auditor's independence if the auditor performs only operational audits that are unrelated to the internal controls, financial systems, or financial statements?

(vi) Management functions. Proposed rule 2-01(c)(4)(i)(F) provides that an accountant's independence is impaired with respect to an audit client for which the accountant acts, temporarily or permanently, as a director, officer, or employee of an audit client, or an affiliate of the audit client, or performs any decision-making, supervisory, or ongoing monitoring functions. This provision is consistent with the provisions of existing Rule 2-01(b).

We request comment on whether there are circumstances under which an accounting firm can perform or assume management functions or responsibilities for an audit client without impairing independence?

(vii) Human resources. Proposed rule 2-01(c)(4)(i)(G) provides that an auditor's independence is impaired with respect to an audit client when the auditor recruits, hires, or designs compensation packages for, officers, directors, or managers of the audit client or its affiliate. Under the proposed rule, an auditor's independence also is impaired when the auditor advises an audit client about its or its affiliate's management or organizational structure, when it develops employee evaluation programs, or conducts psychological or other formal testing of employees.[171]

Assisting management in human resource selection or development places the auditor in the position of having an interest in the success of the employees that the auditor has selected, tested, or evaluated. Accordingly, an auditor may be reluctant to suggest the possibility that those employees failed to perform their jobs appropriately, or at least reasonable investors might perceive the auditor to be reluctant, because doing so would require the auditor to acknowledge shortcomings in its human resource service. The auditor would also have other incentives not to report such employees' ineffectiveness, including that the auditor would identify and be identified with the recruited employees.

We request comment on whether providing human resource services would impair, or would appear to reasonable investors to impair, an auditor's independence. Are there any types of human resource and employee benefit services rendered that are included in Appendix A that do or do not impair an auditor's independence?

Is an auditor's independence impaired when the accounting firm does an executive search for an audit client? Would an auditor's independence be impaired if the auditor provided personnel hiring assistance for only non-executive or non-financial personnel?

Does it impair an auditor's independence if the auditor provides consultation with respect to the compensation arrangements of the company's executives? Is an auditor's independence impaired if the auditor outsources an audit client's human resource department or similar functions? Are there circumstances in which outsourcing these functions would not impair independence?

(viii) Broker-dealer, investment adviser or investment banking services. The proposed rule provides that an accountant is not independent if the accountant acts as a securities professional for an audit client or an affiliate of the audit client. Examples include serving as a broker-dealer, promoter, underwriter, investment adviser, or analyst of the audit client's or an affiliate of the audit client's securities; designing the audit client's or its affiliate's system for compliance with broker-dealer or investment adviser regulations; or recommending the purchase or sale of securities issued by an audit client or its affiliate. Our existing regulations take note of the mutuality of interest created by providing services of this type.[172] Selling - directly or indirectly - an audit client's securities is incompatible with the auditor's responsibility of assuring the public that the company's financial condition is fairly and accurately presented.

We solicit comment on whether providing these services would impair, or would appear to reasonable investors to impair, an auditor's independence. Are there situations in which an accountant could serve as a promoter or underwriter of an audit client's or an affiliate of an audit client's securities without impairing independence?

Broker-dealers often give advice and recommendations on investments and investment strategies. Investment advisers give similar advice. The value of that advice is measured principally by the performance of a customer's securities portfolio. When the customer is an audit client, the accountant has an interest in the value of the audit client's securities portfolio, even as the accountant values the portfolio as part of an audit.

When an accountant, in any capacity, recommends to anyone (including non-audit clients) that they buy or sell the securities of an audit client or an affiliate of the audit client, the accountant has an interest in whether those recommendations were correct. That interest could affect the audit of the client whose securities, or whose affiliate's securities, were recommended. For example, if an auditor uncovers an accounting error in a client's financial statements, and the auditor had, in an investment adviser capacity, recommended that client's securities to investment clients, the auditor performing the audit may be reluctant to recommend changes to the client's financial statements if the changes could negatively affect the value of the securities recommended by the auditor to its investment adviser clients. We solicit comment on whether recommending the purchase or sale of the securities of an audit client or an affiliate of an audit client would impair, or would appear to reasonable investors to impair, an auditor's independence. Will there be an independence impairment if the accountant's broker-dealer customers or investment adviser customers hold substantial positions in audit client securities, even though the accountant did not recommend those securities? We request comment on whether acting as a broker-dealer or an investment adviser for an audit client or an affiliate of an audit client would impair, or would appear to reasonable investors to impair, an auditor's independence.

An accountant acting as a securities analyst for an audit client or an affiliate of an audit client has a mutuality of interest with the audit client. An analyst often prepares research reports that are used to promote or market the securities of their client. In addition, an auditor may be placed in a conflict if the audit results in the auditor obtaining information that casts doubt on the analyst's opinion. We solicit comment on whether serving as a securities analyst for an audit client's or an affiliate of an audit client's securities would impair, or would appear to reasonable investors to impair, an auditor's independence. Are there circumstances in which an accountant could act as a securities analyst for an audit client's or an affiliate of an audit client's securities without impairing independence?

Independence issues also arise when an accountant designs an audit client's or an affiliate of an audit client's system for complying with broker-dealer or investment adviser regulations. To the extent that, during the performance of the audit, the auditor relies on the controls that are part of compliance systems designed by the accountant, the accountant will end up in the position of auditing its own work.

We solicit comment on whether designing an audit client's or an affiliate of an audit client's system for compliance with broker-dealer or investment adviser regulations would impair, or would appear to reasonable investors to impair, an auditor's independence. If an accountant has an audit client who is a broker-dealer or an investment adviser, and the accountant designs the client's system for regulatory compliance, will the financial audit necessarily encompass reviewing or auditing any aspect of that system or its performance?

We further solicit comment on the scope of the proposal. Are there other securities professional services that the rule should expressly identify as impairing independence?

(ix) Legal services. The proposed rule provides that an accountant is not independent of an audit client if the accountant provides any service to the audit client or its affiliates that, in the jurisdiction in which the service is provided, may be provided only by someone licensed to practice law. This proposal is consistent with current regulations, under which legal services are deemed to be incompatible with auditor independence.[173] A lawyer's core professional obligation is to advance clients' interests. Rules of professional conduct require the lawyer to "represent a client zealously and diligently within the bounds of the law."[174] The lawyer must "take whatever lawful and ethical measures are required to vindicate a client's cause or endeavor.... In the exercise of professional judgment, a lawyer should always act in a manner consistent with the best interests of the client."[175] Unlike an auditor, a lawyer takes basic direction from the client. In addition, a lawyer has a near absolute duty to safeguard the confidences of his or her client.[176] We have long maintained that an individual cannot be both a zealous legal advocate for management or the client-company, and maintain the objectivity and impartiality that are necessary for an audit. As noted above, the Supreme Court has agreed with our view. In Arthur Young, the Supreme Court emphasized, "If investors were to view the auditor as an advocate for the corporate client, the value of the audit function itself might well be lost."[177]

We recently reiterated our views in a settled enforcement action.[178] In addition, the staff wrote to the American Bar Association and to its Commission on Multidisciplinary Practices ("ABA Commission") explaining the impairment of auditor independence that is created when a firm provides both audit and legal services to an entity required to file audited financial statements with the SEC.[179] In its final report, the ABA Commission adopted this view. In discussing legal and attest services, the report states, "The Commission explicitly recognizes their incompatibility. It does not believe that a single entity should be allowed to provide legal and audit services to the same client."[180] We continue to believe that a fundamental conflict exists between the roles of an independent auditor and an attorney.[181]

We request comment on whether providing legal services to an audit client or an affiliate of an audit client would impair, or would appear to reasonable investors to impair, an auditor's independence. Are there any particular legal services that should be exempted from the rule? Does making the rule's application depend upon the jurisdiction in which the service is provided leave the rule subject to any significant uncertainty, or pose the prospect of any significant complexity or unfairness? Should there be any exception for legal services provided in foreign jurisdictions? If so, why?

(x) Expert services. The proposed rule states that an accountant's independence is impaired as to an audit client if the accountant renders or supports expert opinions for the audit client or an affiliate of the audit client in legal, administrative, or regulatory filings or proceedings ("expert services"). Clients retain experts to lend authority to their contentions in various proceedings by virtue of the expert's specialized knowledge and experience. The provision of expert services by the accountant creates, at the very least, the appearance that the accountant is acting as the client's advocate in pursuit of the client's interests. The appearance of advocacy (and the corresponding appearance of mutual interest) created by providing expert services is sufficient to deem the accountant's independence impaired.[182] Our proposals would not prohibit an auditor from testifying as a fact witness to its audit work for a particular audit client. In those instances, the auditor is merely providing a factual account of what he or she observed and the judgments he or she made.

We solicit comment on whether providing expert services on behalf of an audit client or an affiliate of an audit client would impair, or would appear to reasonable investors to impair, an auditor's independence. Are there circumstances in which providing audit clients with expert services in legal, administrative, or regulatory filings or proceedings should not be deemed to impair independence? We also solicit comment on whether an auditor should be permitted to serve as a non-testifying expert for an audit client in connection with a proceeding in which the auditor's work does not provide a basis for testimony by an expert

An auditor may provide an audit client a written report or "opinion" on the application of an accounting principle to a particular transaction in accordance with AU § 625. Such advice aids the audit client in determining the appropriate accounting for a transaction. However, an auditor may also provide such an opinion that is not used primarily by the audit client in the preparation of its financial statements, but rather to market a product to third parties. Does it impair the independence of the auditor when it issues an opinion on the application of an accounting principle that is used primarily to market a product to third parties?

(xi) Tax services. The proposed rule would not affect tax-related services provided by auditors to their audit clients. Tax services are unique, not only because there are detailed tax laws that must be consistently applied, but also because the Internal Revenue Service has discretion to audit any tax return. We do not think that the Congressional purpose for requiring independent audits is thwarted by an accountant providing traditional tax preparation services to an audit client or an affiliate of an audit client.

We are considering whether special considerations apply when the auditor provides a tax opinion for the use of a third party in connection with a business transaction between the audit client and the third party. The tax opinion may be vital in the audit client's efforts to induce the third party to enter into the transaction, particularly when the transaction is tax-driven. Under those circumstances, the auditor may be acting as an advocate for the audit client by actively promoting the client's interests.

We request comment on whether providing tax opinions, including tax opinions for tax shelters, to an audit client or an affiliate of an audit client under the circumstances described above would impair, or would appear to reasonable investors to impair, an auditor's independence. Should the rules provide that independence is impaired whenever the auditor provides any tax opinion or any tax opinion that will affect the audit client's financial statements? Does rendering a tax opinion to an audit client affect an auditor's independence considering an auditor must reach an opinion that the financial statements taken as a whole, including the tax accounts, are fairly presented? Are there circumstances in which providing audit clients with tax opinions should not be deemed to impair independence? Are there other tax-related services that if provided to an audit client, would impair, or would appear to reasonable investors to impair, an auditor's independence?

2. Alternatives

We are considering a number of alternatives concerning scope of services. We encourage public comment on each alternative. We may adopt a rule based on one or more of these alternatives instead of the proposed rule or in combination with the proposed rule.

As discussed above, some have suggested that auditors should be prohibited from providing any non-audit service to audit clients.[183] We are considering drawing this bright line. This approach may provide investors with the greatest assurance of an auditor's independence. Some believe that such an approach should contain an exception, referred to as an exclusionary rule, that would permit non-audit services to be provided if: (i) before any non-audit service is rendered to the audit client, the client's audit committee finds that special circumstances make it obvious that the best interests of the company and its shareholders will be served by retaining its audit firm or affiliate to render such non-audit service and that no other vendor of such service can serve those interests as well; (ii) a written copy of that finding is submitted promptly to the SEC and POB; and (iii) the company discloses such finding by the audit committee and the amount paid and expected to be paid to the audit firm or affiliate for such service in the company's next proxy statement for the election of directors.[184]

Is a complete break between audit and non-audit services necessary to give investors confidence that auditors will act without bias and with complete objectivity and independence? Would a complete break be useful for instilling such confidence in investors? Is the exclusionary rule a reasonable alternative to a prohibition on non-audit services? How should the exclusionary rule be modified?

We are also considering whether the rules should identify services that would not impair an auditor's independence. These would include services that are a natural outgrowth of the audit process, by building on information learned, and analyses conducted, during the audit. Examples might include business risk assessments, tax services, actuarial valuations of pension and other post-employment benefits or similar liabilities, consulting on the client's internal controls, and similar services. If we pursue this alternative, we might also include a provision stating that these services would nevertheless impair independence if they involved the auditor in making management decisions, operating the client's internal controls or information systems, marketing the client's products, or sharing risks or rewards with the client. We solicit comment on this alternative.

We are also considering whether the independence problems raised by expanded non-audit services can be avoided by structuring a firm to segregate its audit and non-audit businesses into separate autonomous units. Under this approach, the audit, income tax, and certain consulting practices, such as financial advisory and business risk management services, would be placed into an "audit entity." Information and computer technology services, e-commerce, business process reengineering, strategic planning, and other remaining consulting practices would be placed into a separate "consulting entity." Each entity would be managed by individuals not associated with the other entity. Both the audit entity and the consulting entity would be owned and to some extent governed by a common partnership or corporation ("holding entity"), whose board and management would be elected by the respective subsidiary entities. Partners of the audit entity and the consulting entity would own the holding entity.

The holding entity board of directors could be structured to give either entity - or neither - a majority of representatives on the board. The holding entity would retain certain rights, including the right to approve significant transactions, investment, borrowings, or business alliances. The audit and consulting entities would enter into agreements not to compete with each other. In addition, the holding entity, the audit entity, and the consulting entity might share similar, but not identical names, such as ABC Global, ABC LLP, and ABC Consulting, respectively. Partners in the audit entity and consulting entity might market the other entity's services.

In these arrangements, it is common that there would be some level of direct or indirect profit sharing between the audit and consulting entities. The amount of shared profits might depend on whether each met or fell below certain earnings targets. The impact of the profit sharing on an individual owner or partner in the audit or consulting entity would depend on his or her ownership interest in the respective entity. There could also be profit sharing between the audit entity and the consulting entity arising from investments made in other companies.

We request comment on whether such a structure would create a sufficient "firewall" between the audit entity and the consulting entity such that the auditor's independence would not be impaired with respect to any services provided by the consulting entity. Are there other ways to construct a firewall that should prevent the consulting entity from being considered an affiliate of the audit entity for purposes of determining the audit entity's independence? Would the independence of the audit entity be impaired if the consulting entity entered into business relationships, such as strategic marketing alliances, with an audit client of the audit entity? Would the independence of the audit entity be impaired if it continued to provide consulting services that generated revenues or profits that were material to the audit entity? Would the independence of the audit entity be impaired if the consulting entity acquired either material or immaterial investments in clients of the audit entity? Would the audit entity's independence be impaired if clients of the audit entity invested in the consulting entity?

We could require the audit entity and consulting entity to have completely separate management and financial operations, not to "co-brand" or use similar names or logos, not to share more than a de minimis amount of revenues or earnings (no organization's or partner's earnings would change by more than three percent annually), not to have an equity interest in each other, and not to be contractually or otherwise obligated to refer clients to one another. We request comment on whether any or all of these requirements would suffice to prevent impairments to the audit entity's independence resulting from activities or relationships of the consulting entity.

Under the auditing literature, an auditor is required to discuss matters that may affect the audit with personnel responsible for providing non-audit services to the client-company.[185] Does this requirement prevent the use of firewalls? Are investors harmed if communications between the audit and consulting entities are hindered? If communication is not hindered and there would remain a free flow of information between the audit and consulting entities, should we require other measures to assure independence of the auditors? If we were to pursue this alternative, are there other conditions that should be considered?

We are also considering an alternative that would provide that non-audit services impair independence only when the aggregate fees for those services surpass a certain level in relation to the audit fee. For example, we could adopt a rule stating that an auditor's independence would be impaired if the fees for all non-audit services (excluding tax services) during the most recent fiscal year, and the fiscal year in which the services would be provided, were or would be more than 25 percent of the fee for the audit of the client's financial statements. Does the size of the consulting fees relative to audit fees affect independence? Is the proposed fee comparison an appropriate measure by which to determine whether independence is impaired? If not, what level of non-audit service fees, relative to audit fees, should trigger an impairment of independence?

We also solicit comment on whether not to preclude certain non-audit services, but instead to require companies to disclose substantial information about all the non-audit services received from their auditors. Under this alternative, investors, and not regulators or other interested parties, would decide whether their perceptions of auditor independence were affected by the provision of non-audit services to audit clients. Is disclosure alone sufficient to preserve investor confidence in financial information? Can an impairment of auditor independence be avoided merely by disclosing it?

Several of the largest accounting firms have announced that they have sold, or intend to sell, certain non-audit service lines. We solicit comments relating to those developments and their bearing on this proposed rule. Will the economic forces that gave rise to these transactions cause all or most major accounting firms to divest all or a portion of their consulting service lines? Will economic forces cause those accounting firms that have divested certain consulting service lines to create similar service lines in the future?

3. Transition

We recognize that adoption of the proposed rules could require a registrant to decide between continuing to engage an auditing firm to audit its financial statements and continuing to engage that firm to provide certain non-audit services. It may not be feasible for the registrant and the auditor to cease all ongoing or scheduled non-audit engagements immediately. The company may need time to find a new provider of those services, to complete works in progress, and to provide for a smooth transition from one provider of services to another.

As a result, we propose to include a transition period of two years. Under the proposal, for the two years following the effective date of the rule, providing the non-audit services set forth in subsection (c)(4)(i) to an audit client or an affiliate of an audit client will not impair an accountant's independence from the audit client, if the following holds true: (i) the non-audit services are performed pursuant to a written contract in effect on or before the effective date of this rule; and (ii) performing those services would not impair the auditor's independence under pre-existing requirements of the Commission, the ISB, or the U.S. accounting profession. We believe that two years provides a reasonable time period for the auditor and the audit client to make the necessary elections and conform to the new rules.

We solicit comment on the proposed transition provisions. Do the proposed transition provisions allow an adequate period for implementation? Should the period be longer? If so, how long and why? Could the period reasonably be shorter? If so, what is the shortest transition period that we could reasonably adopt? Are there any conditions other than the two specified in the proposed rule that should be satisfied in order for the services specified in section 2-01(c)(4)(i) not to impair independence during the transition period? Should the condition described in section (c)(4)(ii)(A) -- that the non-audit services performed during the transition period be pursuant to a written contract in effect on or before the effective date of the rule --require that the contract be in writing?

E. Contingent Fees

Proposed rule 2-01(c)(5) provides that an accountant is not independent under the standard of paragraph (b) of the rule if the accountant provides any service to an audit client or an affiliate of an audit client for a contingent fee, or receives a contingent fee from an audit client or an affiliate of an audit client. Contingent fee arrangements will typically result in the auditor having a mutual interest with the client. If, for example, a firm arranged to receive an audit fee of $200,000, but half of that fee was contingent upon the audit client successfully completing an initial public offering within the following year, the auditor would have a mutual interest with the audit client in the success of the client's planned IPO, and in the continuing viability of the audit client. That mutuality of interest could influence the auditor's conduct of the audit.

A "value added" fee may be another example of a contingent fee arrangement that presents independence problems. An accounting firm might arrange to provide a non-audit service to a client for a "value added" fee, meaning that the amount of the fee will depend upon the additional value, profit, or other benefit recognized by the client because of the non-audit service. For example, an audit may undertake a study of certain types of a client's expenditures in order to identify greater amounts of qualifying expenses that would result in greater income tax credits. Fees for such services might be based on a percentage of the tax credits generated, a base fee plus a percentage of tax credits generated over a pre-determined base amount, or a base fee plus a "value added" amount to be added to the base fee.

The accounting firm will have an interest in a high valuation of the benefit to the client from the service that had been provided for a contingent fee. In the situation described above, the accounting firm's economic benefit will be greater if the tax credits are maximized, a position that is inconsistent with an auditor who would have to act independently in assessing the accuracy of the impact on the income tax accounts and financial statements of the tax credits.

Rule 302 of the profession's ethics rules states that an AICPA member may not receive a contingent fee for the performance of any service. The AICPA Rule further states:

[A] contingent fee is a fee established for the performance of any service pursuant to an arrangement in which no fee will be charged unless a specified finding or result is attained, or in which the amount of the fee is otherwise dependent upon the finding or result of such service. Solely for purposes of this rule, fees are not regarded as being contingent if fixed by courts or other public authorities, or, in tax matters, if determined based on the results of judicial proceedings or the findings of governmental agencies.[186]

Contingent fees are not specifically mentioned in our current regulations, though contingent fees are prohibited by the AICPA Rules.[187] In view of the increase in consulting activities and business relationships among accounting firms, their affiliates, and SEC registrants, however, we believe that it is advisable to state explicitly in the proposed rule that receiving contingent fees from an audit client impairs the auditor's independence.[188] Consistent with the AICPA Rule, however, our proposed definition of "contingent fees," in proposed rule 2-01(f)(12), contains an exception for fees that are fixed by courts or by federal, state, or local governments.

We solicit comment on whether contingent fee arrangements impair, or would appear to reasonable investors to impair, an auditor's independence. Are there circumstances in which, or particular types of services for which, a contingent fee arrangement would not impair independence?

We also solicit comments on whether our proposed definition of contingent fees is adequate. For example, an auditor might charge an audit client fees for professional services priced significantly below market price with the expectation of higher fees in connection with or after a securities offering. Though these arrangements may involve no legal obligations between the parties, they could have the same effect. Should our definition of "contingent fees" include fees that are substantially below the fair market value of the services provided? Are there fee arrangements, such as commissions, that are not included within the proposed definition but that should be included because they would impair an auditor's independence? Should the exception for fees fixed by courts or public authorities be deleted?

F. Quality Controls

Paragraph (d) of the proposed rules establishes a limited exception for accounting firms that maintain certain quality controls and satisfy certain conditions. We are proposing this exception to encourage accounting firms to adopt internal quality controls that ensure the independence of the firm's auditors. In addition, we are proposing this section so that accounting firms that have appropriate controls will not be deemed to lack independence when the particular auditor did not know, and was reasonable in not knowing, the circumstances giving rise to the impairment.

Notwithstanding attempts to maintain independence, we recognize that situations may arise where an accountant's independence inadvertently becomes impaired. A covered person's independence may be impaired, for example, because his or her family member made an investment in an audit client and the covered person was not aware of the investment. We propose, therefore, that in certain situations an accounting firm's independence will not be impaired if: (i) the covered person did not know, and was reasonable in not knowing, the circumstances that gave rise to the lack of independence;[189] (ii) the covered person's lack of independence was corrected promptly after the covered person or the accounting firm became aware of it; and (iii) the accounting firm maintains a quality control system that provides reasonable assurance that the accounting firm and its employees do not lack independence.

The third condition for the exception - a quality control system - is the first line of defense to guard against independence impairments with respect to a client. We understand that accounting firms vary significantly in size and in the nature of their practices, and we propose that the quality controls that the firm establishes be tailored to the firm's size and practice.

Proposed rule 2-01(d)(3)(i)-(vii) describe the elements of a quality control system that large accounting firms that audit public companies must have in place to qualify for the limited exception.[190] Many of these elements are set forth in a 1999 letter from our staff to the SECPS.[191] In the letter, the staff noted that the requirements reflect procedures that many accounting firms are implementing or already following. While the proposed rules would require only large firms to incorporate these elements in their control systems to qualify for the limited exception, we encourage all firms to adopt them and note that, depending on firm size and the nature of its practice, some of these elements may be essential to a quality control system. We discuss those elements here.[192]

1. Written Independence Policies and Procedures

The largest firm's independence policies and procedures must be reduced to writing. We expect that the policies and procedures would be comprehensive and would cover all professionals in the accounting firm and address all aspects of independence, including financial, employment, and business relationships, and fee arrangements.

2. Automated Systems

Large firms must have automated systems to identify financial relationships that may impair independence. We expect that these systems would provide a reasonable basis for tracking audit clients and financial investments by firm professionals. We anticipate that large firms will employ a sophisticated electronic system updated on a regular basis that would allow employees to post their investments to the system, and that would maintain a list of employee holdings and check them against a current list of clients. We propose to require these systems track only financial relationships.

3. Training

Large firm quality controls also must include annual or ongoing firm-wide training about auditor independence. This training should be designed to raise awareness and understanding of the applicable rules. Each professional in a large accounting firm should be able to demonstrate a minimum level of competence with respect to professional standards, legal requirements, and firm policies and procedures.

4. Internal Inspection and Testing

An internal inspection and testing program to monitor adherence to independence requirements is an important part of quality controls. To qualify for the limited exception, large firms must monitor compliance by their firm, their firm partners and their firm professional employees with the applicable independence rules of the profession, standard setters, and other regulatory bodies. This would entail procedures to audit, on a test basis, the completeness and accuracy of information submitted by employees and partners, and information in a client investment database. We expect that firms would have policies, procedures, and controls to monitor the investments of the firm itself and its pension and retirement plans, and any business arrangements with firm clients. We encourage firms to monitor compliance with their own policies and procedures as well.

5. Notice of Names of Senior Management Responsible for Independence

We also propose to require, with respect to large firms, that all firm members, officers, directors, and employees be notified of the name and title of the member of senior management responsible for compliance with the independence requirements. This would require firms to assign responsibility to members of senior management for ensuring compliance with the independence rules.

6. Prompt Reporting of Employment Negotiations

A firm professional would not be independent if he or she were to audit a client while simultaneously negotiating employment with that client. The quality control system of a large firm, therefore, would contain written policies and procedures to require firm professionals to report promptly to the firm as soon as they begin employment negotiations with an audit client. The large firm also would have appropriate procedures in place to remove any such professional from that audit client's engagement immediately and to review that professional's work related to that client.

7. Disciplinary Mechanism

Finally, we propose to require that large firms' quality control systems also have a disciplinary mechanism for enforcement.

We request comment on whether these are the appropriate elements of an effective quality control system. Are there other quality controls that should be required? For example, are these quality controls sufficient to address all situations where the audit firm leases personnel? Under the proposed rules, these procedures apply to those firms that have as clients 500 or more companies registered with us under section 12 of the Exchange Act. Is 500 the appropriate number? Is there another test that we should use to determine which firms must adhere to these procedures to qualify for the exception? We request comment on whether these are the appropriate controls on which to condition the exception, or whether other conditions would be appropriate.

The Big 5 firms are comprised of both U.S. and foreign members. Should these quality controls apply to both U.S. and the foreign firms? Do the foreign firms require a transitional or phase-in period? Should the exception also be provided to a firm that has adopted the specified quality controls, but did not know and was reasonable in not knowing that a partner or employee lacked independence, and the lack of independence was cured promptly after the firm became aware of it? Should the term "promptly" be defined in terms of a period of time?

G. "All Relevant Circumstances"

Proposed rule 2-01(e), reciting the standard currently found in current Rule 2-01(c), provides that we will look to all relevant circumstances in making independence determinations, including all relationships between the accountant and the audit client or its affiliates, and will not confine ourselves solely to the relationship between the audit client and the corporate entity whose name appears on the audit client's filing. Reasonable investors would consider all appropriate circumstances in evaluating an auditor's independence. Paragraph (e) of the proposed rule expresses this principle and makes clear that an independence determination cannot be based on an artificially limited set of the relevant facts.

We solicit comment on paragraph (e). Does paragraph (e) adequately capture the relevant circumstances for making an independence determination? Are there other considerations that should be expressly mentioned in this paragraph?

H. Proxy Disclosure Requirement

We are proposing to reinstate a proxy disclosure requirement. The proposed proxy disclosure requirement varies somewhat from the proxy disclosure requirement rescinded in 1982. Like the 1979-82 proxy disclosure requirement, the proposal would require companies to: (i) describe specifically each professional service provided by its auditor, and (ii) indicate whether the company's audit committee or, where no such committee exists, board of directors approved the service and considered the effect that the provision of each disclosed service could have on the auditor's independence.[193] We are proposing to require disclosure of the specific non-audit services provided by an auditor to an audit client because we believe that an investor needs the information to form a judgment about independence. We also believe that investors will be aided by disclosure as to whether the audit committee or board of directors considered this issue: Among other things, this information will enable investors to make judgments about whether their interests have been adequately considered by the audit committee or whether the investors should make further inquiry.

Unlike the earlier proxy disclosure requirement, the current proposal would require companies to disclose the fee paid for each non-audit service and the aggregate audit fee for the most recent fiscal year. Additional disclosures would be required only if a company's auditor leased or otherwise acquired from another entity the professionals it needed to perform a majority of the audit of the company's financial statements.

1. Disclosure of Fees

The proposal would generally require a company to disclose the fee paid for each non-audit service performed by its auditor and the fee charged for the annual audit. An exception to these general disclosure requirements is that issuers would not have to describe a non-audit service, nor disclose the fee for that service, if the fee was less than $50,000 or ten percent of the company's audit fee, whichever is smaller. We are proposing this exclusion to allow companies to avoid disclosure of de minimis items.

Earnscliffe asked respondents in its survey whether disclosure could potentially improve auditor independence. "A fair number of [respondents] advocated a requirement of full disclosure as a way to both deter an unhealthy relationship between auditor and client, and to inform investors of any risks related thereto."[194] Like the respondents surveyed, we believe that disclosure could have a positive impact on auditor independence.

We note that, in this area, the United Kingdom has long required disclosure of annual audit fees, and since 1989, it has required disclosure of fees for non-audit services provided by their auditors. "The [British] government believes that the publication of the existence of, and extent of, non-audit consultancy services provided to audit clients will enable shareholders, investors, and other parties to judge for themselves whether auditor independence is likely to be jeopardized."[195]

We request comment on whether the disclosure requirement will be useful to investors and enhance auditor independence. Will disclosure impede the ability of audit client's to obtain valuable non-audit services or have any negative affect? We also request comment on whether the disclosure regarding the approval of the audit committee should be made by the audit committee in its report under Item 306 of Regulation S-K. Is the information required to be disclosed appropriate or should other information be required? Should we require companies to disclose separately the fee paid for tax services? For example, should we require companies to disclose fees by a range in which they fall? Would the disclosure of audit and non-audit fees be more appropriate in Form 10-K (for example, for all companies or for those companies that are not required to prepare proxy statements or information statements) or footnotes to the financial statements, as done in the U.K.?

We further request comment on the exclusion for non-audit services that cost the lesser of $50,000 or ten percent of a company's annual audit fee. Should we set different levels for this de minimis exclusion? If so, what should these levels be? What is the appropriate scope of the exclusion? As proposed, the disclosure requirement applies only to the registrant. In the case of an investment company complex, should the rule extend beyond the registrant to require disclosure of all of the professional services that are provided to the investment company complex?

2. Leased Personnel

Under the proposal, a company would have to disclose if its principal auditor leased or otherwise acquired from another entity the personnel it needed to perform a majority of the audit of the company's financial statements. This disclosure requirement responds to the recent move by accounting firms to sell their non-audit practices to financial services companies. Often in these transactions, the partners and employees become employees of the financial services firm. The accounting firm in essence becomes a "shell" that then leases assets, namely professional auditors, back from those companies to complete audit engagements. In such an arrangement, audit professionals become full- or part-time employees of the financial services company, but work on audit engagements for their former accounting firm. They receive compensation from the financial services firm and in some situations from the accounting firm.[196] We believe that investors should be informed when individuals who have personal interests that may affect their objectivity are performing the bulk of the audit.[197]

We request comment on the proposal to require disclosure when the principal audit firm signing the audit opinion uses personnel from another entity to perform a majority of the work on the audit engagement.

I. Definitions

In this section of the release, we provide a more detailed explanation of those defined terms not discussed in the preceding sections. Proposed rule 2-01(f) provides definitions of certain terms used in rule 2-01. These definitions apply only to rule 2-01 and not to other sections of Regulation S-X. Rule 1-02 of Regulation S-X provides definitions of terms used in the remainder of Regulation S-X. Are the different scopes of the two sets of definitions sufficiently clear, or should we amend current Rule 1-02 to make it explicit?

1. "Accountant"

Proposed rule 2-01(f)(1) defines the term "accountant." The proposed rules are written in terms of an accountant's independence from the audit client. The definition of "accountant" set forth in Rule 2-01(f) includes the accounting firm in which the auditor practices and, accordingly, makes clear that an individual accountant's lack of independence may be attributed to the firm.

2. "Accounting Firm"

Proposed rule 2-01(f)(2) is the first of several definitions that are used to describe the entities or groups whose actions may cause an accountant to lack independence. The "accounting firm" includes the organization (whether organized as a partnership, corporation, limited liability company, or otherwise) that is engaged in the practice of public accounting or furnishing accountant's reports with respect to financial statements, reports, or other documents filed with the Commission, and all of the firm's divisions, subsidiaries, and departments. The definition also includes all "affiliates of the accounting firm," including its pension, retirement, investment, or similar plans. The definition of "affiliate of the accounting firm" is discussed below.

The "accounting firm" does not include individual partners or employees of the firm. For the purposes of these independence rules, we are proposing that a distinction be made between investments in which the "accounting firm" has the primary legal rights or obligations, and investments in which individual partners or employees have the primary legal rights or obligations.

3. "Affiliate of the Accounting Firm"

Proposed rule 2-01(f)(4) defines "affiliate of the accounting firm."[198] This definition attempts to capture those entities that are financially tied to or otherwise associated with the accounting firm enough to warrant being treated like the accounting firm for purposes of our independence requirements. While part of the definition draws on the definition of "affiliate" used in other areas of the securities laws, the definition is broader than those other provisions.

Proposed rule 2-01(f)(4)(i)(A) states that an "affiliate of the accounting firm" includes any person controlling, controlled by, or under common control with the firm, shareholders of more than five percent of the firm's voting securities (or similar interests entitling a person to vote), and entities five percent or more of whose securities (or similar interests entitling a person to vote) are owned by the firm. The rule also includes any officer, director, partner, or co-partner of any of the foregoing entities, or persons. This portion of the definition is based generally on the provisions in section 2(a)(3) of the ICA[199] and the definition of "affiliate" in Regulation S-X.[200]

We request comment on whether all investments and relationships of an affiliate of an accounting firm, as described in the preceding paragraph should be attributed to the audit firm for purposes of evaluating its independence from its audit clients. Should the answer depend upon the percentage of the accounting firm's securities (or similar voting interests) that the affiliate owns? If the latter, at what percentage of ownership should we draw the line beyond which independence is impaired, and, accordingly, draw the line by which we define "affiliate of the accounting firm?"

If the "affiliate" holding the ownership interest is an entity, should the definition of "affiliate of the accounting firm" also include any officer, director, partner, co-partner or shareholder of more than five percent of the voting securities of that entity? Does the proposed definition identify all persons that should be considered affiliates for purposes of determining impairments to independence?

Paragraphs (C) through (F) of proposed rule 2-01(f)(4)(i) describe those who are "affiliates of the accounting firm" because they are business partners of the accounting firm. In general, these include certain: (i) joint ventures in which the accounting firm participates, (ii) entities that provide non-audit services to the accounting firm's audit clients and with which the accounting firm has certain financial interests or relationships, and (iii) entities involved in "leasing" professional services to the accounting firm for their audits. The definition also includes all other entities with which the accounting firm is publicly associated in certain ways.[201]

The category of joint ventures and partnerships takes into account recent changes in accounting firms' structures and alliances with third parties. It generally would attribute to the auditor actions and interests of certain entities in joint ventures or partnerships in which the parties agree to share revenues, ownership interests, appreciation, or certain other shared economic benefits. The category is based on the notion that such agreements create a mutuality of interest between the auditor and its partner or shareholder because the revenue or profits accruing to each party depend, to some degree, on the efforts of each. Their interests are wedded.[202] Accordingly, under the proposals, the business partner's relationships with or interests in the accounting firm's audit clients would be attributed to the auditor.

The definition of "affiliate of an accounting firm" also includes any entity that provides non-audit services to an audit client, if the accounting firm has an equity interest in, shares revenues with, loans money to, or if any covered person has certain direct business relationships with, the consulting entity. Under these circumstances, the actions and investments of the consulting entity are fairly attributed to the accounting firm because the accounting firm's interest in the consulting entity creates a mutuality of interest in the promotion and success of the entity's consulting projects.

The proposed definition of "affiliate of the accounting firm" also attributes to the auditor the actions and interests of persons "co-branding" or using the same (or substantially the same) name or logo, cross-selling services, or using co-management. Where the auditor has taken steps to identify itself publicly with another person, the auditor shares, and will be perceived to share, a mutuality of interest with that other person.

Would the relationships described in the preceding three paragraphs impair, or appear to reasonable investors to impair, an auditor's independence? Are there any that should be excluded from the definition of "affiliate of the accounting firm" for purposes of determining impairments to independence?

The proposed definition of "affiliate of the accounting firm" also addresses the situation where full- or part-time employees of an entity other than the firm signing the audit report perform a majority of the audit engagement. The proposal provides that if an auditor "leases" personnel from an entity to perform audit procedures or prepare reports to be filed with the Commission, and the "leased" personnel perform a majority of the hours worked on the engagement, then the actions and interests of the "lessor," the lessor's board of directors, executive officers, persons with responsibility for management, quality control, or technical supervision over the leased personnel, and shareholders of five percent or more of the lessor's securities, are attributed to the audit firm. In these situations, we believe that this proposal strikes a balance between those entities and persons who reasonably could influence the auditor and the audit process, and those who may be associated with the lessor but have no real or perceived ability to influence the audit.

Would the relationships described in the preceding paragraph impair, or appear to reasonable investors to impair, an auditor's independence? Does the answer depend upon the percentage of the hours worked on the engagement that are attributable to leased personnel? If so, where should the line be drawn and why?

Finally, the proposed definition of "affiliate of the accounting firm" excludes persons whose sole business relationship with an accounting firm is to share certain services or facilities, such as a joint training facility or billing office, so long as neither the auditor nor the other person profits from the shared services. The latter restriction is necessary to assure that the auditor and audit client have not joined together in a profit-seeking venture.

We seek comment on the proposed definition of "affiliates of an accounting firm Should persons or entities other than those identified in the proposed rule be included as affiliates?

4. "Affiliate of the Audit Client"

Proposed rule 2-01(f)(5) defines "affiliate of an audit client" as any entity that has "significant influence" over the audit client, or any entity over which the audit client has significant influence. The definition thus makes clear that it covers both "upstream" and "downstream" affiliates of the audit client, including the audit client's corporate parent and subsidiary.

We use the term "significant influence" in the definition to signal that the "affiliates of an audit client" should be determined in light of the principles in Accounting Principles Board ("APB") Opinion No. 18.[203] APB No. 18 clarifies the term "significant influence." This accounting literature recognizes that "significant influence" can be exercised in several ways: representation on the board of directors; participation in key policy decisions; material inter-company transactions; interchange of personnel; or other means. APB No. 18 also recognizes that an important consideration is the extent of the equity investment, particularly in relation to the concentration of other investments. In order to provide a reasonable degree of uniformity in application of this standard, the Board concluded that,

[A]n investment (direct or indirect) of 20% or more of the voting stock of an investee should lead to a presumption that in the absence of evidence to the contrary an investor has the ability to exercise significant influence over an investee. Conversely, an investment of less than 20% of the voting stock of an investee should lead to a presumption that an investor does not have the ability to exercise significant influence unless such ability can be demonstrated.[204]

We believe that the "significant influence" test is appropriate because it results in the marriage of financial information between the audit client and the entity influenced by, or influencing, the financial or operating policies of the audit client, including those over which the audit client has control or that control the audit client. Should we, however, consider a different definition of an "affiliate of an audit client?" What other test would be appropriate? Rather than using a test that sets a presumption of influence at an equity investment of 20%, is a different investment threshold more appropriate? Should it be higher or lower, and why?

5. "Audit and Professional Engagement Period"

The proposed definition of "audit and professional engagement period" uses language from current Rule 2-01(b) and indicates that the auditor must be independent during the period covered by any financial statements being audited or reviewed (the "audit period"), and during the period that the auditor is engaged either to review or audit financial statements or to prepare a report (the "professional engagement period"). The proposed definition also provides that the "professional engagement period" begins when the auditor signs the initial engagement letter or begins review or audit procedures, whichever is earlier, and ends when the registrant or the accountant notifies the Commission that the registrant is no longer the accountant's audit client.

The proposed definition makes clear that we agree with the "auditor of record" notion described in AICPA Ethics Ruling 101-1. That ruling states:

The period of a professional engagement starts when the [AICPA] member begins to perform any professional services requiring independence for an enterprise, lasts for the entire duration of the professional relationship, which could cover many periods, and ends with the formal or informal notification of the termination of the professional relationship either by the member, by the enterprise, or by the issuance of a report, whichever is later. Accordingly, the professional engagement does not end with the issuance of a report and recommence with the signing of the following year's engagement.[205]

We solicit comment on the proposed definition. Does the proposed definition cover the appropriate period? Is the definition appropriate for all situations in which the professional engagement ends or do we need to provide an alternative definition for some types of registrants, such as foreign private issuers, or for certain types of engagements? Could this portion of the definition be made more specific by referring to Form 8-K or other Commission filings?

6. "Audit Client."

The term "audit client" is defined in proposed rule 2-01(f)(7) as the entity whose financial statements or other information is being audited, reviewed, or attested. This is how "audit client" is commonly used. Use of the term "audit client" in this rule in no way changes our position that the auditor "owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public."[206]

7. "Audit Engagement Team"

Proposed rule 2-01(f)(8) defines the term "audit engagement team." The "audit engagement team" includes the people in the accounting firm that are obviously in a position to influence the audit. Members of the "audit engagement team" are included within the category of "covered persons in the firm," which is the term used to indicate the persons in the firm subject to a number of the specific rules in paragraph (c) of proposed rule 2-01.

The "audit engagement team" includes all partners, principals, shareholders, and professional employees participating in an audit, review, or attestation engagement of an audit client, including those conducting concurring or second partner reviews, and all persons who consult, formally or informally, with others on the audit engagement team during the audit, review, or attestation engagement regarding technical or industry-specific issues, transactions, or events.

We solicit comment on this definition. Should any other persons be included on the audit engagement team? Should any of the persons included on the audit engagement team not be included?

Could the definition's inclusion of persons consulted on an audit create a disincentive for an auditor to seek, or for others to provide, assistance on an audit, and thereby adversely affect the quality of the audit? Is there a realistic possibility that auditors will be impeded significantly in their efforts to secure expert consulting assistance because experts would have to terminate any interest in the audit client before consulting? For example, XYZ Corp is an audit client of ABC Accounting Firm. Industry Expert A, who is not otherwise a covered person in the firm with respect to XYZ Corp, holds an investment in XYZ Corp. Accountant B, who is a covered person, seeks the advice of Industry Expert A. A declines to offer advice because liquidation of the investment would create adverse tax consequences. In situations like this, are there likely to be other industry experts in the firm without investments in the audit client that the accountant could consult? Should the definition of covered persons be limited to assure that all appropriate expertise is available for every audit engagement?

8. "Chain of Command"

Proposed rule 2-01(f)(9) defines the term "chain of command." This term is defined broadly to refer to the group of people in the accounting firm who, while not directly on the audit engagement team, are capable of influencing the audit process either through their oversight of the audit itself or through their influence over the members of the audit engagement team. Like the "audit engagement team," persons in the "chain of command" are included as "covered persons in the firm," and therefore are subject to a number of the specific rules in paragraph (c) of proposed rule 2-01.

Under the proposed definition, the "chain of command" includes all persons having any supervisory, management, quality control, compensation, or other oversight responsibility over either any member of the audit engagement team or over the conduct of the audit. It also includes all partners and managers who may review, determine, or influence the performance appraisal or compensation of any member of the audit engagement team and any other person in a position to influence the audit engagement team's decisions during the conduct of the audit, review, or attestation engagement.

We solicit comment on the definition. Should additional persons be included in the chain of command? Should prominent partners, principals or shareholders in the firm, such as a chairman, CEO, member of the governance board, office managing partner or managing partner of the national technical office always be considered to be in the chain of command? Should any of the persons included in the chain of command not be included? Specifically, is it appropriate to include managers in this group? Is the definition capable of being consistently applied under different accounting firms' management structures?

9. "Close family members"

Proposed rule 2-01(f)(10) defines "close family members" to mean a person's spouse, spousal equivalent, parent, dependent, nondependent child, and sibling. These terms should be understood in terms of contemporary family relationships. Accordingly, "spouse" means a husband or wife, whether by marriage or under common law; "spousal equivalent" means a cohabitant occupying a relationship generally equivalent to that of a spouse; "parent" means any biological, adoptive, or step parent; "dependent" means any person who received more than half of his or her support for the most recent calendar year from the relevant covered person; "child" means any person recognized by law as a child or step-child; and "sibling" means any person who has the same mother or father.

"Close family members" includes the persons separately defined as "immediate family members" (spouse, spousal equivalent, and dependent), and adds certain family members who may, as a general matter, be thought to have less regular, but not necessarily less close, contact with the covered person in question (parent, nondependent child, and sibling). One of our reasons for distinguishing the two groups is that the less immediate the family relationship to the covered person, the more substantial that family member's relationship to the audit client should be before we deem it to impair the auditor's independence.

We considered whether we should follow this approach further and further into a covered person's family, making impairment depend upon increasingly substantial relationships to the audit client the further removed the family member is from the covered person. The proposed definition of "close family members," for example, does not include in-laws.

We solicit comment on the proposed definition of "close family members." Should the definition include family members in addition to those proposed? Is the proposed definition too inclusive? Should we adopt some type of formula that would reach family members who are further removed from the covered person if those family members have substantial enough relationships to the audit client? How would such a formula work? Instead, are these situations appropriately handled under the general standards of paragraphs (b) and (c)(2) of the rule?

10. "Covered Persons in the Firm"

Proposed rule 2-01(f)(13) defines the term "covered persons in the firm." The term includes four basic groups: (i) the "audit engagement team;" (ii) the audit engagement team's "chain of command;" (iii) any other professional employee of the accounting firm who is, or during the audit client's most recent fiscal year was, involved in providing any professional service to the audit client, its parents, subsidiaries, or other affiliates; and (iv) all other professional employees from an "office" of the accounting firm that participates in a significant portion of the audit.

The "audit engagement team" and the "chain of command" are discussed above. We have also included as "covered persons in the firm" those professionals who provide consulting and non-audit services to the audit client. We did so because the auditing literature, quite appropriately, directs the audit engagement team to discuss certain matters with the firm personnel responsible for providing such services to that client.[207]

We have also included as "covered persons in the firm" all other professional employees from an "office" of the accounting firm that participates in a significant portion of the audit. (The definition of "office" is separately discussed below.) We included these people because we believe they are generally in a position to influence the audit. They are the ones most likely to interact with the audit engagement team on substantive matters and to exert influence over the audit engagement team by virtue of their physical proximity to, or relatively frequent contact with, the audit engagement team.

Nevertheless, under the proposal, an accounting firm employee in a distant part of the world, or even down the street, could own an audit client's securities, have a family member in a financial position at the client, or enter into a business relationship with a client without necessarily impairing the firm's independence from the audit client. We expect that many partners and employees who previously could not own securities issued by an audit client will be able to do so under the proposed rule. It should be noted that insider trading restrictions prohibit any partner, principal, shareholder, or employee of the firm, whether or not he or she performs any service for the client, from trading on any nonpublic information about that client.[208]

We believe that the lines drawn in the proposed rule provide a reasonable balance between those who may and those who may not be able to influence the audit process for a particular client. In general, all those who may have a connection with, or directly or indirectly influence, the audit have been included.

We solicit comment on the definition of "covered persons in the firm." Are there other persons in the firm who should be included, such as all partners? Are there persons included in the definition who should not be included? Is the concept of a "significant portion of the audit" sufficiently familiar to accountants to be a useful standard?

A person who is not a covered person at the time an audit engagement begins may be consulted about the audit as the engagement progresses. Once consulted, that person becomes a member of the audit engagement team and, therefore, a covered person in the firm. That person must dispose of any financial interest in the audit client completely and irrevocably before participating in any discussion with another covered person concerning the audit engagement. The proposal would not allow the person consulted to participate in a discussion about the audit engagement and then "cure" an independence impairment by later disposing of his or her financial interest in the audit client.

Likewise, a person may become a covered person by rotating on to an engagement or being promoted into the chain of command. In these situations, the person must also dispose of any financial interest in the audit client completely and irrevocably before becoming a covered person.

11. "Immediate Family Members"

Proposed rule 2-01(f)(15) defines "immediate family members" to mean a person's spouse, spousal equivalent, and dependent. These terms have the same meaning as they do in the definition of "close family members."

"Immediate family members" is a narrower group than "close family members." Again, part of our premise in distinguishing the two groups is that the less immediate the family relationship to the covered person, the more substantial that family member's relationship to the audit client should be before we deem it to impair the auditor's independence. By circumscribing the group of "immediately family members," we mean to identify those persons who have such regular and close contact with a "covered person," that it is fair, for independence purposes, to attribute to the covered person any financial and employment relationships that family member has with the audit client.

We solicit comments on the definition of "immediate family members." Should the definition include family members in addition to those proposed? Is the proposed definition too inclusive? Are there any qualifications that should be added to the definition, such as not including spouses who are separated from, and living apart from, the covered person?

12. "Investment Company Complex"

Proposed rule 2-01(f)(16) provides a definition of "investment company complex" that is loosely based on ISB Standard No. 2. ISB Standard No. 2 defines "mutual fund complex" to mean "[t]he mutual fund operation in its entirety, including all the funds, plus the sponsor, its ultimate parent company, and their subsidiaries."[209]

Our proposed rule defines "investment company complex" to include an investment company and its investment adviser, or if the company is a unit investment trust, its sponsor; any entity controlled by, under common control with, or controlling the investment adviser or sponsor of a unit investment trust, such as a distributor, fund administrator, or transfer agent; and any investment company or an entity that would be an investment company but for the exclusions provided by section 3(c) of the ICA and that is advised by the investment adviser or sponsored by the sponsor, or an entity that is controlled by, under common control with, or controlling the investment adviser or sponsor. The definition does not include sub-advisers whose role is primarily portfolio management and who provides services pursuant to a subcontract with, or are overseen by, an adviser in the complex. As proposed, an auditor generally would not be precluded from investing in other investment companies advised by an investment company audit client's sub-adviser. We request comment on whether the auditor of an investment company should be independent of other investment companies that have an adviser that is the sub-adviser of an audit client investment company. Sub-advisers are excluded only when their duties are limited to portfolio management. Should they be excluded only in this circumstance? Is the definition of sub-adviser clear and capable of implementation, or is another definition preferable?

As proposed, the definition would require an auditor to be independent of all companies that would be investment companies but for the exclusions set forth in section 3(c) of the ICA. Should the auditor of an investment company be independent of all investment type products (i.e., hedge funds, venture capital funds, commodity pools, real-estate pools) offered by the adviser or sponsor of the investment company?

The rule would preclude auditors of a unit investment trust from investing in other investment companies sponsored by the sponsor of the unit investment trust and any other entity in the same investment company complex. We have defined sponsor as the entity that establishes the unit investment trust. Is such a definition sufficiently clear and capable of implementation? If not, how should it be modified so as to be sufficiently clear?

We solicit comment on the proposed definition of "investment company complex." Does the definition include all entities that should be within the investment company complex? Does the definition include any entities that should not be included? For example, under the proposed rule, we focus on the integral role of an investment adviser in the investment company complex. But, for some fund groups, the principal underwriter or administrator plays a predominant role in organizing and managing the overall operations of the investment companies in the investment company complex. Should the auditors be independent of the administrator or principal underwriter? Should the auditors be independent of other fund groups who use the same principal underwriter or administrator?

13. "Office"

Proposed rule 2-01(f)(17) defines "office" to mean a distinct sub-group within an accounting firm, whether distinguished along geographic or practice lines. The term "office" is used in the rule to help delimit the persons who are considered "covered persons" and, therefore, plays a role in identifying those firm personnel who cannot have financial or employment relationships with a particular audit client or affiliate of an audit client without impairing the firm's independence.

We give "office" a meaning that does more than merely refer to a distinct physical location where the firm's personnel work. By "office" we mean to encompass any reasonably distinct sub-group within an accounting firm, whether constituted by formal organization or informal practice, where the personnel who make up the sub-group generally serve the same clients, work on the same matters, or work on the same categories of matters. In this sense, "office" may transcend physical boundaries, and it is possible that a firm may have a sub-group that constitutes an "office" even though the personnel making up that sub-group are stationed at various places around the country or the world.

At the same time, we intend for "office" also to include reference to a physical location. For this reason, "office" will generally include a distinct physical location where the firm's personnel work. We recognize, however, that in some cases thousands of firm personnel may work at a single, large physical location, but physical divisions may nonetheless effectively isolate different sub-groups of personnel from each other in ways that will warrant treating each sub-group as a separate "office" under the proposed definition.

We solicit comments on the proposed definition of "office." Does the definition provide a useful framework for identifying firm personnel who reasonably should be included within the definition of "covered persons?" Is there an alternative definition that would better serve the objective of identifying persons firm-wide whose geographic or professional proximity to the firm's work for a particular audit client suggests that their financial or employment relationships with that audit client should be deemed to impair the firm's independence? Should "office" be defined more narrowly, such as by limiting it to persons who work in the same physical location? To the extent that the definition does include physical location, should "office" be defined more strictly, by providing that all firm personnel working at the same physical or geographic location will, in all cases, constitute a single office?

J. Codification

As previously discussed, the Commission's current auditor independence requirements are found in various rules and interpretations. Section 600 of the Codification provides interpretations and guidance not otherwise available in the current rule. The proposed rule attempts to articulate clearly situations and circumstances, such as financial relationships, employment relationships, and non-audit services that impair auditor independence. Accordingly, we are proposing to delete interpretations included in the Codification that are reflected in, or that have been superseded by, the proposed rule.[210] The current Codification contains background information and interpretations that may continue to be useful in situations not specifically or definitively addressed in the proposed rule. Examples of these items concern business relationships, unpaid prior professional fees, indemnification by clients, and litigation.

Should the background information and other relevant items included in the Codification be maintained in their current form? Are there additional items that should be modified? Are there items that are proposed to be deleted but should be maintained in the Codification?

IV. General Request for Comments

We request comment on the proposals, other matters that may have an impact on the proposals, and your suggestions for additional changes. In addition, in considering whether to adopt rule amendments on auditor independence, the Commission will consider what effect, if any, its actions might have on the states and on state law. Specifically, the Commission will consider whether the rule amendments (i) could alter the relationships between federal and other authorities, (ii) require expenditures by state officials, or (iii) preempt state or local law. The Commission's rules affect only those auditors that perform audits for companies required to file financial statements and auditors' reports with the Commission, whereas state regulations often affect a much broader category of auditors and companies.

The Commission's proposals are not intended to alter the relationship between federal and state authorities. In general, states have patterned their regulations after those of the AICPA or the National Association of State Boards of Accountancy. Many state independence regulations may be more permissive, in some respects, than the Commission's current regulations. These differences would continue under the proposals. The proposals do not require state officials to undertake licensing regimes or otherwise make any financial outlays. Furthermore, our proposals would not affect the ability of the states to adopt different regulation in those areas they currently regulate. We solicit comment on whether the proposals would affect specific state laws or require any expenditures by state officials. We also request comment on whether or how these proposals would alter the relationship between federal and state authorities.

V. Cost-Benefit Analysis

We have identified certain costs and benefits of the proposals. We request comment on all aspects of this cost-benefit analysis, including identification of any additional costs or benefits of the proposed amendments. We encourage commenters to identify or supply relevant data concerning the costs or benefits of the proposed amendments.

A. Costs and Benefits of the Proposals Regarding Investments in and Employment Relationships with Audit Clients

The proposals clarify and, in some cases, eliminate, certain existing regulations under which an accountant's independence is impaired by fellow accounting firm employees or their family members having an investment in or holding a position at an audit client. As explained above,[211] changes in business practices and demographics, including an increase in dual-career families, may warrant a change in our auditor independence requirements to prevent them from unnecessarily restricting the employment and investment opportunities available to auditors and members of their families. To this end, the proposals take a more targeted approach and focus on those persons who are involved in or can influence an audit. In addition, the proposals create a limited exception for accounting firms that have quality controls that provide reasonable assurance of independence.

1. Benefits

We believe that our proposals on investment and employment restrictions provide several benefits. Eliminating certain investment and employment restrictions should benefit auditors and their families by permitting them a wider range of investment and employment opportunities. Currently, according to annual reports filed by accounting firms with the SECPS, the five largest audit firms employ approximately 115,000 professionals. Other public accounting firms that audit SEC registrants employ an estimated 5,000 to 25,000 professional staff. Our proposals would benefit these 120,000 to 140,000 accounting firm professional employees and their families by enabling them to invest in some public companies that, under the current rules, they cannot invest in without impairing the independence of the companies' auditors. In addition, under the proposals, unlike under current rules, family members of some audit firm employees could be employed by audit clients and their affiliates without impairing auditor independence.

Expanding the set of investment opportunities available to auditors and their family members may increase the return they can earn on their investments and improve their ability to reduce risk through diversification. Similarly, expanding the set of employment opportunities available to the family members of audit firm employees has the potential to increase their compensation. Finally, opening up the employment opportunities available to auditors and their family members increases their freedom of choice with respect to employment opportunities. This could improve the non-pecuniary, as well as financial, benefits of employment.

We request comment on the estimate of the number of individuals who are likely to benefit from the proposed amendments. Is a better estimate available? Is it possible to estimate the annual benefits to these individuals from having a wider range of investment choices? Is it possible to estimate the benefits that these individuals may achieve on an annual basis because of a wider range of employment choices? Would eliminating investment and employment regulations provide other benefits to these individuals? Are there other individuals who would benefit from the proposals regarding investment and employment relationships?

In addition to eliminating certain restrictions, the proposals clarify the independence requirements. Currently, these requirements are found in various Commission rules, Commission interpretations, staff letters and staff reports. The proposals consolidate the requirements. As a result, the proposals should provide clearer guidance to accountants and their families, issuers and their audit committees, regulators, courts, administrative law judges, and others. The proposals also put this guidance in an easily accessible format that should save these parties costs in ascertaining and complying with the regulations. Is it possible to quantify these benefits? Would additional parties be affected by the proposed clarification of our investment and employment restrictions?

Finally, the proposals encourage, but do not require, accounting firms to establish quality control systems that provide reasonable assurance that they are complying with our auditor independence requirements. The proposals do so by providing that an accounting firm's independence will not be impaired solely because one of its employees does not comply with the independence rules if, among other things, the firm has adequate independence quality controls in place.

GAAS already requires firms to have quality controls for their audit practices and refers auditors to the "Statements on Quality Control Standards" ("SQCS") for guidance regarding the elements of those systems.[212] SQCS No. 2 states that firms' controls should provide "reasonable assurance that personnel maintain independence (in fact and in appearance) in all required circumstances, perform all professional responsibilities with integrity, and maintain objectivity in discharging professional responsibilities."[213] In addition to requirements imposed by GAAS, public accounting firms that are SECPS members must comply with independence quality control membership requirements. Among other things, member firms with at least 7,500 professionals must implement an electronic tracking system by no later than December 31, 2000.[214] Our proposals, therefore, do not impose, even indirectly, a requirement for internal controls that does not already exist under GAAS and SECPS membership requirements.

The proposals, however, do clarify the GAAS requirement for firms with more than 500 SEC registrants as audit clients by identifying procedures that should be part of their quality control systems.[215] This aspect of the proposals could benefit the largest public accounting firms by reducing uncertainty about the required minimum characteristics of any quality control system they institute.

In addition, any public accounting firm implementing a quality control system in compliance with this limited exception should benefit because we would be narrowing the circumstances in which independence would be impaired. This aspect of the proposals also should provide investors with the assurance of improved quality control systems of any firms that implement them, and inform investors and others who rely on audited financial statements about the minimum characteristics of the quality control systems maintained by these accounting firms. This should reduce uncertainty among investors and increase investor confidence.

What methods are available to estimate the benefits that these accounting firms would receive from the limited exception and the reduced uncertainty about the minimum characteristics required for quality control systems? What methods are available to estimate the benefits to investors and others because of enhanced assurance that firms possess quality controls with minimum characteristics described in this section? Are there other benefits arising from the proposed amendment?

We request comment, including supporting data if available, on the benefits of the proposals regarding investment and employment relationships.

2. Costs

Modification of our investment and employment restrictions may require accounting firms, their employees, or others to incur transaction costs, such as one-time costs to modify existing systems that monitor investments and employment relationships, and training costs to make all professional staff aware of the revised rules. Is it possible to estimate these costs? Are there additional costs that would be borne by any individual or entity other than those identified?

As discussed above, the proposals provide an incentive - namely a limited exception from the auditor independence requirements - for accounting firms to establish quality controls. In the case of the largest firms, the proposals specify what we believe to be the minimum characteristics of these systems.[216] For the largest firms, implementing such a quality control system would likely entail costs to enhance or alter the firm's existing system. Because seeking the limited exception is elective, such costs will be assumed voluntarily, if at all, by accounting firms that decide that the benefits of this limited exception outweigh the cost of any incremental changes that are necessary to make their quality control systems meet the proposals' standards.

In addition, to minimize costs, we have tailored these quality control proposals in recognition of current industry requirements and practices. As noted above, under GAAS and, where applicable, under SECPS membership requirements, accounting firms must have a system of quality controls, including policies and procedures, to provide the firm with reasonable assurance that personnel maintain independence in all required circumstances.[217] Moreover, it is prudent business practice to maintain reasonable quality controls.[218] An accounting firm that chooses to upgrade its existing quality control system to comply with the limited exception should incur only the incremental costs of implementing any improvements beyond what is required by GAAS and SECPS membership requirements.

We seek comment, and supporting data if available, on these and any other costs of our investment and employment proposals, including the quality control proposals. Is it possible to quantify the initial costs accounting firms may incur to modify their quality control systems? Is it possible to quantify the incremental costs that may be incurred by the largest accounting firms that choose to put in place a quality control system that meets the specified criteria?

B. Costs and Benefits of Restricting Certain Non-Audit Services

As more fully described above,[219] there is increasing concern that the growth of non-audit services provided to audit clients affects the independence of auditors. If investors lose confidence in auditors' ability or willingness to provide an unbiased and impartial examination of companies' financial statements, then investors' trust in the reliability of publicly available financial information, and in the integrity of the securities markets, may be damaged.

Currently, accounting firms may not provide certain services to their audit clients without impairing their independence. Our proposals extend and clarify those restrictions by setting forth four basic principles that should be used to evaluate the effect of non-audit services on an auditor's independence, and by designating certain non-audit services that, if performed by an auditor for an SEC registrant that is an audit client, impair the auditor's independence.

Our proposals on the provision of non-audit services may affect four distinct groups: investors, issuers, public accounting firms, and other potential providers of non-audit services. The benefits and costs arising from the proposed amendments are examined for each group.

1. Benefits

(a) Investors. For the reasons explained above, the Commission believes that the proposals will enhance auditor independence and thereby enhance the reliability and credibility of financial statements of public companies.[220] We expect these benefits to inure primarily to investors who, if the proposals are adopted, should be able to review public companies' financial statements with greater assurance that reliance on the statements will lead to more informed investment decisions. We seek comment on whether it is possible to quantify the benefits of the proposals to investors, and if so, how.

(b) Issuers. Issuers may benefit from the proposed scope of services regulations in several respects. First, the proposals eliminate certain uncertainties as to when a registrant's auditor will not be recognized as independent. The proposals eliminate these uncertainties by setting forth not only four general principles by which to analyze non-audit services, but also by listing certain non-audit services as incompatible with the concept of auditor independence. Accordingly, in the future, issuers can know that if their auditor provides any of the listed services, the auditor will not be independent for purposes of Commission filings.

Second, if the proposals increase investor confidence in financial reporting and thereby encourage investment, they may facilitate capital formation. In such a scenario, issuers would be able to attract capital at lower rates of return, or in circumstances in which they currently cannot raise capital.

Finally, the proposals may increase the utility of annual audits to issuers. For example, by requiring issuers to obtain certain information technology services, such as implementation of an accounting information system that is used to generate data significant to the financial statements as a whole, from a vendor other than their auditor, the proposals should result in someone other than the non-audit services provider reviewing that system during the course of the audit. As a result, issuers may get an independent "second opinion" of the system from the audit. Furthermore, as a result of the proposals, issuers may avoid pressure from their auditors to purchase non-audit services.

(c) Other Consulting Firms. Consulting firms that do not engage in public accounting also may benefit from the proposals. Such consulting firms may receive revenue from certain consulting engagements that, but for our proposals, would have gone to the client's auditor. Moreover, to the extent that a registrant's auditor has advantages in competing to provide consulting services to an audit client by virtue of the auditor's personal relationships with officers of the audit client or increased awareness of potential consulting engagements through proximity to an audit client, our proposals may improve competition in the market for the provision of consulting services. This improved competition could benefit any consulting firm with comparative advantages in providing the necessary non-audit services.[221]

(d) Public Accounting Firms. We anticipate that the proposals will confer two primary benefits on public accounting firms. First, the proposals should clarify what non-audit services may be provided to an audit client without jeopardizing auditor independence. Second, the proposals could improve competition in the market for the provision of non-audit services by public accounting firms. Because the restrictions on providing non-audit services to an audit client would apply equally to all accounting firms, the overall impact of the proposed restrictions may be to re-distribute the restricted non-audit services among the public accounting firms.[222]

In addition, as noted above, a registrant's auditor may have advantages in competing to provide non-audit services to its audit client that are not based on the auditor's skill or cost advantages in providing that service. To the extent that such advantages exist, the proposals may improve competition in the market for non-audit services. If a public accounting firm has a comparative skill or cost advantage in providing a particular non-audit service, that public accounting firm may benefit from any enhanced competition because its comparative advantage over other public accounting firms in providing that service would be more likely to lead to non-audit assignments from other public accounting firms' audit clients. Might these enhancements to competition change the way accounting firms invest in various of their service lines? For example, might accounting firms begin to re-invest more heavily in their audit function?

We request comment, including supporting data, on the benefits of the proposals.

2. Costs

Our proposals on non-audit services may impose costs on issuers and public accounting firms. We request comment on whether these proposals may impose costs on other groups.

(a) Issuers. The proposed amendments have the effect of restricting issuers from purchasing certain non-audit services from their auditors. Currently, the five largest public accounting firms audit approximately 12,800 public companies. Other public accounting firms audit approximately 3,900 public companies. According to reports filed with the AICPA, of the 12,800 public companies audited by the so-called "Big 5," approximately 9,500 did not purchase any consulting services from their auditor in the most recently reported year. Of the approximately 3,900 registrants that are audited by other public accounting firms, approximately 3,100 did not purchase any consulting services from their auditor.

For the 12,600 registrants that did not purchase any consulting services from their auditor, the proposed amendments would not have affected their purchase of non-audit services in the most recently reported year. In the future, however, these registrants could be affected by the proposals insofar as the proposals reduce their flexibility in the purchase of non-audit services.

Of the approximately 4,100 registrants that were reported to have purchased non-audit services from their auditor, many may have purchased non-audit services that are not covered by the proposals. In the future, these issuers could continue to procure the same services from their auditor.

Issuers that purchased from their auditor non-audit services that are covered by the proposals, however, will have to look to other professional services firms, including other public accounting firms, to provide these services in the future. The fact that many issuers currently purchase non-audit services from firms other than their auditor suggests that there is a competitive market for non-audit services. Therefore, issuers who are precluded by the proposals from purchasing such services from their auditor likely will be able to purchase these services from other vendors. These issuers may incur costs from having to use a separate vendor, including the possible loss of any synergistic benefits of having a single provider of both audit and non-audit services. For example, they may incur costs locating a new vendor and developing a business relationship with that vendor.

We request comment on whether it is possible to quantify the costs arising from employing separate vendors for certain consulting services, and if so, how. We also request comment on the accuracy of the estimated number of issuers that would be affected by the proposed amendment. What percentage of SEC registrants use a competitive bidding process in selecting providers of non-audit services? What percentage "sole source" non-audit assignments? For issuers that currently acquire from their auditor non-audit services that are prohibited by the proposals, what is the additional cost of using a competitive bidding process to acquire non-audit services? Are there any benefits to the issuer of employing such a process? Under our proposed rule, how often, if at all, would an issuer be unable to find a vendor other than their auditor to provide a covered non-audit service on a comparable basis?

(b) Public Accounting Firms. Some public accounting firms provide a wide variety of services both to audit and non-audit clients. Our scope of services proposals are likely to affect these firms in several ways. The primary cost for these firms is that they individually may lose one source of revenue because they will no longer be able to sell certain non-audit services to their audit clients. Based on the accounting firms' SECPS reports, however, it appears that, on average, public accounting firms with fewer than 1,000 SEC registrants as clients earn less than 1% of their total fees from providing management consulting services to audit clients.[223]

The anticipated loss of revenue would primarily affect the Big 5 firms. Some members of the Big 5 provide extensive non-audit services to their audit clients. However, at least two of the Big 5 have recently sold or taken steps to separate their consulting practice from their audit practice. And, at least one other Big 5 firm has announced its intention to separate its consulting and its audit practices. In addition, the SECPS reports of the Big 5 show that almost 75% of their audit clients that are SEC registrants purchased no management consulting services from their auditor. Accordingly, the proposals appear likely to impose significant costs only on those members of the Big 5 that do not plan to separate their audit and non-audit practices (or at least that portion of their non-audit practice that provides those non-audit services listed in proposed rule 2-01(c)(4)).[224] Even then, because only about 25% of these firms' SEC audit clients buy non-audit services from their auditors, the proposals will only impose costs with respect to, at most, 25% of these firms' client relationships.

In addition, because our proposals would affect all auditors, the overall impact of the proposed restrictions may be merely to redistribute certain non-audit services among public accounting firms.[225] To the extent these services are only redistributed, there should be no net loss of revenue to public accounting firms as a whole.

We request comment on these costs and our estimates of the number of accounting firms and issuers that will be affected. Is it possible to quantify these costs? Is there any reason to believe the costs in the form of lost revenue will not be offset by equal benefits to other public accounting firms and other consulting firms?

A complete prohibition on accounting firms' providing any non-audit services could impose other, different costs on public accounting firms, such as depriving accounting firms of expertise they could have obtained from consulting activities that can be employed in audit engagements, preventing "synergies" from a better understanding of the client, and harming accounting firms' ability to recruit and retain employees. Our proposed rule does not ban accounting firms from providing all non-audit services, nor does it ban accounting firms from providing any non-audit services to entities other than their audit clients. It only adds certain non-audit services to those that accounting firms are already precluded from providing to a particular audit client if they wish to maintain independence from that audit client.

Nonetheless, we have considered whether our proposals are likely to impose any of these other costs on public accounting firms. For example, we have considered that the provision of non-audit services may enhance an auditor's expertise and thereby improve the efficiency or effectiveness of the audit. Our proposals would not preclude public accounting firms from developing or maintaining such expertise through consulting engagements, however. Under the proposals, public accounting firms could provide any non-audit service to clients that are not audit clients as to which they must be independent under the federal securities laws, and thereby develop or maintain their expertise. Moreover, to the extent that the effect of the proposals is merely to redistribute the provision of non-audit services among the public accounting firms, this redistribution may permit each of the firms to maintain its expertise in various of these services.

We request comment on whether our proposals on non-audit services would impose costs on accounting firms or others because accountants would have diminished expertise. If so, is it possible to quantify these costs? We also request comment on what effect, if any, reducing the pool of clients to which accounting firms can sell certain non-audit services will have on the firms' profit margins.

Our proposals also may affect what some contend are synergies (or "knowledge spillovers") that arise from providing non-audit services to an audit client. Research on enhanced efficiency or effectiveness of providing non-audit services to audit clients is inconclusive.[226] Anecdotal evidence that argues against knowledge spillovers is found in the recent sale or proposed sale of the consulting divisions of several large public accounting firms. If efficient and effective audits require the expertise that can be most efficiently maintained through the provision of consulting services to audit clients, these firms would be unlikely to sell their consulting practices. Thus, the sale of these consulting practices, coupled with the results of previous research, provide evidence that is inconsistent with the existence of synergies that would be negatively affected by our proposed amendments.

We seek comment on whether there are knowledge spillovers that would be lost under the proposals. If so, is there some means of quantifying this cost? Would knowledge spillovers be a concern for some or all of the non-audit services covered by our proposals? We also seek comment on whether there is evidence as to the mechanisms by which knowledge spillovers occur. For example, please provide an average of the number of hours billed on particular audit engagements by consulting personnel as a fraction of total audit hours and the number of hours of audit staff time billed for consulting services covered by the rule to an audit client of that staff member.

Finally, some accounting firms have suggested that their recruiting and employee retention would be affected if they could not provide non-audit services. According to this argument, employees or potential employees are more interested in joining accounting firms in which they will be able to engage in both audit and non-audit work, or at least have the option of engaging in both audit and non-audit work.

We seek comment on whether our proposals impose a cost of this type on accounting firms. Do a significant number of accounting firm employees engage in both: (i) audit activities, and (ii) non-audit activities that are prohibited as a result of our proposal, as part of their work? Have a significant number of accounting firm employees shifted from providing audit services to providing non-audit services that are covered by these proposals? Do the proposals significantly reduce the non-audit work available to professional audit staff? If so, how?[227]

C. Costs and Benefits of the Proposals to Add Disclosure Requirements

Our proposals require public companies, under certain circumstances, to disclose information about the non-audit services provided by their auditor, the fees for those services, and the audit fee. The proposals also require public companies to disclose, when relevant, that more than 50% of the audit was performed by personnel who are full- or part-time employees of an entity other than the audit firm.

The disclosure of non-audit services provided by a company's auditor is intended to allow investors to judge for themselves whether they believe that a particular service affects the independence of the auditor. Such disclosures have been provided in the United Kingdom for several years.

The disclosure regarding the usage of leased personnel to perform an audit is intended to allow investors to know when personnel of an entity, other than the audit firm, performed a majority of the audit so that investors can consider the independence of the other entity. Under such circumstances, the independence of the other entity and its personnel may be as relevant - if not more relevant - to auditor independence than the independence of the auditor itself.

1. Benefits

As discussed above,[228] there is growing concern about the impact of non-audit services on auditors' independence. In addition, as noted above, while the SECPS collects information on non-audit and audit fees from its member firms, it no longer publishes this information. Accordingly, such information is not readily available to, or easily accessible by, the investing public. Further, this information provides a description of service line activities by the public accounting firm for all of its clients, rather than for each audit client.

The proposals would remedy this situation. The proposed disclosure related to non-audit services provided by auditors to audit clients would give investors insight into the full relationship between a company and its auditor. In so doing, the proposed disclosure would replace uncertainty about the nature and scope of such relationships with facts about the services provided by the auditor to the company. This information may help shareholders decide, among other things, how to vote their proxies in selecting or ratifying management's selection of an auditor.

The disclosure regarding the auditor's use of another entity's employees to perform a majority of the audit work also provides important information to investors. Investors may need to know when a majority of the audit work is performed by persons who have financial, business, and personal interests in addition to, or different from, persons employed by the auditor. This disclosure is significant because it reveals when the "principal auditor" (the auditor performing a majority of the audit work) is an entity other than the firm signing the audit opinion.

We believe that the benefits of the proposed disclosure rules would include increased market efficiency due to improved information and transparency concerning the credibility and reliability of companies' financial disclosures. The value of these benefits is not readily quantifiable. We solicit comment, including supporting data if available, on the benefits of the proposed disclosure rule.

2. Costs

We believe that the proposed disclosure rule will impose relatively minor reporting costs on issuers. Generally, information about auditor independence is readily available to registrants. One basis for that information is ISB Standard No. 1, which requires auditors to report certain independence issues to the audit committees of their audit client-registrants.[229] In addition, the SECPS requires members to report annually to the audit committee, or similar body, the total fees received from the company for management advisory services during the year under audit, and a description of the types of such services rendered.[230] As a result, companies should have ready access to the information on fees paid to their auditor for non-audit services. The proposed disclosure requirement would merely require issuers to pass certain of this information on to shareholders.

For purposes of the Paperwork Reduction Act, we have estimated that our proposed disclosure rules would, on an annual basis, impose 2,473 additional burden hours on all Schedule 14A filers and 63 additional burden hours on all Schedule 14C filers, for an aggregate annual total of 2,536 additional burden hours.[231] That estimate is based on current burden hour estimates and the staff's experience with such filings. We further estimate that approximately 75% of the extra burden hours, or 1,902 hours, will be expended by companies' internal staff, and the remaining 25%, or 634 hours, by outside professional help.[232] These percentage estimates, which are based on current burden hour estimates and the staff's experience with such filings, reflect the time companies would spend preparing the additional disclosures in the proxy statement or information statement.

Assuming that the internal staff costs the company an average of about $85 per hour, the aggregate annual cost for internal staff assistance would amount to approximately $161,670. If we assume that the outside professional assistance would have an average cost of approximately $175 per hour, the aggregate annual paperwork cost would be approximately $110,950. The total annual costs would accordingly be about $272,620. We request comment on the reasonableness of these estimates and their underlying assumptions.

In addition, as noted above, some issuers would have to disclose the percentage of hours expended on the engagement by "leased" employees. We currently lack information on the number of issuers that would be affected by the proposed disclosures on "leased" employees. We expect, however, that this disclosure will be required only in rare situations where the firm has sold its non-attest practice to a financial services company and is leasing back its employees. In these situations, former employees of the firm become full- or part-time employees of the financial services company and are "leased" back to the accounting firm to perform audit work. This disclosure should not require any additional recordkeeping by the firm because the amount of hours performed on an audit by the lessor and by the "leased" personnel should be readily available from the firm's billing records. This information also should be readily available to the registrant because of the communications requirements under ISB Standard No. 1, as discussed above.

We seek comment on these and any other costs of the proposed disclosure rules. Are there any other potential costs we have not considered?

VI. Summary of Initial Regulatory Flexibility Analysis

The Commission has prepared an Initial Regulatory Flexibility Act Analysis ("IRFA") in accordance with the Regulatory Flexibility Act,[233] regarding the proposed amendments to Rule 2-01 of Regulation S-X and item 9 of Schedule 14A under the Exchange Act. The following summarizes the IRFA.

As discussed in greater detail in the IRFA and in other sections of this release, there have been significant changes in accounting firms, changes in the business environment, and demographic changes since we last amended our requirements regarding the independence of auditors of financial statements filed with us. The IRFA notes that we are re-evaluating whether our auditor independence requirements remain effective, relevant and fair. In this regard, we are proposing amendments to our current requirements to address investments by auditors or their family members in audit clients, employment of auditors' family members and former partners by audit clients, and the scope of services provided by audit firms to their SEC audit clients. The IRFA also discusses the proposed proxy disclosure requirements by public companies regarding non-audit services provided by their auditors.

The IRFA sets forth the statutory authority for the proposed rules. It also discusses small entities subject to the rules.[234] The IRFA states that approximately 2,500 Exchange Act reporting companies are small businesses and approximately 227 investment companies are small businesses. The IRFA also states that the Small Business Administration defines small business, for purposes of accounting firms, as those with under $6 million in annual revenues.[235] We cannot estimate the number of firms with less than $6 million in revenues.

The IRFA indicates that the proposed rules would affect two primary groups, auditors and registrants. The IRFA states that the rules could potentially affect auditors in three areas: investments and employment relationships; non-audit services; and quality controls. With regard to investments and employment relationships, the IRFA states that the proposed rules would liberalize certain restrictions on investments by, and employment opportunities available to, accountants and their families. In this sense, compliance requirements are being relaxed.

With regard to non-audit services, the IRFA states that the vast majority of SEC registrants are audited by one of the Big Five firms, which clearly are not small entities. The IRFA explains that we have data regarding the approximately 776 accounting firms with fewer than 20 SEC audit clients,[236] which would tend to be smaller accounting firms. As the IRFA explains, we do not believe that the proposed amendments regarding consulting and non-audit services would have a significant impact on a substantial number of small accounting firms.

With regard to quality controls, the IRFA explains that the proposed rules establish a limited exception for accounting firms that institute certain quality controls and satisfy other conditions. The proposed rules, therefore, encourage, but do not require, accounting firms to adopt quality controls that ensure the independence of the firms' auditors. The IRFA explains that GAAS already require firms to have quality controls over their audit practices, and the standards refer to the SQCS for guidance regarding the elements of those systems.[237]

The proposals, however, clarify the GAAS requirement for the quality controls of firms with more than 500 SEC audit clients by setting forth certain procedures that should be part of their quality controls. For firms with fewer than 500 SEC audit clients, a firm's quality control system should take into account the size and nature of the firm's practice. For smaller firms, therefore, the proposals incorporate GAAS requirements, but do not add new requirements.

The proposed proxy disclosure rule would require registrants to disclose certain information to shareholders regarding auditor independence and regarding fees for audit and non-audit services. The proposed rules also address situations where more than 50% of the audit is performed by personnel that are full or part-time employees of another entity.

We do not believe that the proposed proxy disclosure requirement would have a significant impact on a substantial number of small entities. These requirements would apply to small businesses only if they are otherwise subject to the proxy rules. We estimate the number of those entities to be no more than 2,700, including 227 investment companies. The proposed disclosures relate to only one item on the proxy statement, and the information should be readily available to registrants because of the requirements of ISB Standard No. 1. Finally, the proposals provide an exclusion from the disclosure requirements for de minimis items.

As explained in the IRFA, the Regulatory Flexibility Act directs us to consider significant alternatives that would accomplish the stated objective, while minimizing adverse impact on small entities. In that regard, we considered the following alternatives: (a) differing compliance or reporting requirements that take into account the resources of small entities; (b) the clarification, consolidation or simplification of compliance and reporting requirements under the rule for small entities; (c) use of performance rather than design standards; and (d) an exemption from the coverage of the proposed amendments for small entities.

As noted, because neither the proposals to modernize the independence rules for investments and employment relationships nor the proposed proxy disclosure requirements should have a significant economic impact on a substantial number of small entities, we did not make special provisions for small entities. Regarding the provision of non-audit services by accounting firms, including small accounting firms, we have, above, solicited comment on a number of alternative regulatory approaches. The IRFA states that because of the limited amount of non-audit services that small accounting firms provide to their SEC audit clients, we believe that the adoption of any of these alternatives would not have a significant impact on a substantial number of small businesses or small accounting firms.

The IRFA explains that the use of performance rather than design standards or providing an exemption from the coverage of the proposed amendments for small entities are not viable because it is not possible to design performance standards that would carry out our statutory mandate and we believe investors receive a significant benefit from knowing that an independent professional has examined the financial statements of a registrant, including a small registrant, with skepticism.

The IRFA includes information concerning the number of small entities that may be affected by the proposed amendments and the nature of the impact on those entities. We encourage the submission of comments with respect to any aspect of the IRFA. In particular, we seek comment on the number of small entities that would be affected by the proposed rules; the nature of the impact; how to quantify the number of small entities that would be affected; and how to quantify the impact of the proposed rules. Comment is specifically requested regarding the number of small accounting firms that might be affected by the proposed rules, and the effect, if any, that the proposed rules would have on those firms. Please describe the nature of any impact and provide empirical data supporting the extent of the impact. Such comments will be considered in the preparation of the Final Regulatory Flexibility Analysis, if the proposed amendments are adopted, and will be placed in the same public file as comments on the proposed amendments. A copy of the IRFA may be obtained by contacting Robert Burns, Chief Counsel, (202) 942-4400, at the Office of the Chief Accountant, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549-1103.

VII. Paperwork Reduction Act

Certain of the provisions in the proposed amendment to item 9 of Schedule 14A contain "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 (44 U.S.C. 3501 et seq.), and the Commission has submitted them to the Office of Management and Budget (OMB) for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. The collections of information are titled "Regulation 14A (Commission Rules 14a-1 through 14b-2 and Schedule 14A)" and "Regulation 14C (Commission Rules 14c-1 through 14c-7 and Schedule 14C)." An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number.

Regulation 14A (OMB Control No. 3235-0059) was adopted pursuant to section 14(a) of the Exchange Act[238] and prescribes information that a company must include in its proxy statement to ensure that shareholders are provided information that is material to their voting decisions. Regulation 14C (OMB Control No. 3235-0057) was adopted pursuant to section 14(c) of the Exchange Act[239] and prescribes information that a company must include in an information statement when a shareholder vote is to be held but proxies are not being solicited. Schedule 14C refers to Schedule 14A for the disclosure requirements related to the company's independent accountants.

The proxy disclosure requirements in section 14 of the Exchange Act apply to those entities that have securities registered with the Commission under section 12 of that Act. The likely respondents, therefore, include entities with more than 500 shareholders and more than $10 million in assets (section 12(g))[240] and entities with securities listed on a national exchange (section 12(b)).[241] Approximately 9,892 respondents file proxy statements under Schedule 14A and approximately 253 respondents file information statements under Schedule 14C. We based the number of entities that would complete and file each of the forms on the actual number of filers during the 1998 fiscal year.

We estimate that the total reporting burden for Schedule 14A is 179,144 hours, or approximately 18 hours per respondent. We estimate that the total reporting burden for Schedule 14C is 4,582 hours, or approximately 18 hours per respondent. These estimates include increases of 2,473 hours for Schedule 14A and 63 hours for Schedule 14C based on estimates that the proposed amendments will add one hour to the reporting burden of one-quarter of the respondents, and will not add to the burden of the other respondents. These increases are based on the fact that the information needed to make these disclosures should be readily available to the respondents and the fact that, based on information provided to the SECPS, approximately 75 percent of Commission registrants receive no non-audit services from the auditors of their financial statements and, accordingly, will not be required to make any disclosures under the proposed amendments.

We believe the proposed disclosure will bolster confidence in the securities markets by informing investors about: (i) non-audit relationships between the auditor and the audit client, and (ii) situations in which a majority of the audit work is performed by employees of an entity other than the principal audit firm signing the audit opinion. As discussed in other sections of this release, there is growing concern about the impact of non-audit services on auditors' independence. The disclosure will bring the benefit of sunshine to non-audit relationships and replace uncertainty about the nature and scope of such relationships with facts about the services provided by an auditor to each audit client. This information may be material to an investor's decision to vote on the selection or ratification of the auditor. The disclosure regarding the auditor's use of another entity's employees to perform a majority of the audit work also provides important information to investors. Investors may need to know when a majority of the audit work is performed by persons who have financial, business, and personal interests in addition to, or different from, persons employed directly by the auditor.

Compliance with the disclosure requirements is mandatory if the audit client is subject to the proxy or information disclosure requirements and either (i) the audit client has received non-audit services from the auditor of its financial statements, or (ii) the auditor used employees of another entity to perform a majority of the audit work. There would be no mandatory retention period for the information disclosed, and responses to the disclosure requirements will not be kept confidential.

Pursuant to 44 U.S.C. § 3506(c)(2)(B), the Commission solicits comments to: (i) evaluate whether the proposed collection of information is necessary for the proper performance of the functions of the agency, including whether the information will have practical utility, (ii) evaluate the accuracy of the Commission's estimate of the burden of the proposed collection of information, (iii) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected, and (iv) evaluate whether there are ways to minimize the burden of the collection of information on those who respond, including through the use of automated collection techniques or other forms of information technology.

Persons submitting comments on the collection of information requirements should direct the comments to OMB, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, DC 20503, and send a copy to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549, with reference to File No. S7-13-00. Requests for materials submitted to OMB by the Commission with regard to this collection of information should be in writing, refer to File No. S7-13-00, and be submitted to the Securities and Exchange Commission, Records Management, Office of Filings and Information Services. OMB is required to make a decision concerning the collection of information between 30 and 60 days after publication of this release. Consequently, a comment to OMB is assured of having its full effect if OMB receives it within 30 days of publication.

VIII. Consideration of Impact on the Economy, Burden on Competition, and Promotion of Efficiency, Competition, and Capital Formation

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996,[242] we are requesting information regarding the potential impact of the proposals on the economy on an annual basis. Commenters should provide empirical data to support their views.

Section 23(a)(2) of the Exchange Act requires us, when adopting rules under the Exchange Act, to consider the anti-competitive effects of any rule it adopts.[243] We expect that in some ways the proposals will increase competition by removing the accountant's competitive advantage in bidding on or otherwise obtaining non-audit work required by audit clients.[244] We request comment on any anti-competitive effects of the proposals.

In addition, Section 3(f) of the Exchange Act requires us, when engaging in rulemaking that requires us to consider or determine whether an action is necessary or appropriate in the public interest, to consider whether the action will promote efficiency, competition, and capital formation.[245] We believe that the proposals will increase investor confidence in the integrity of the audit process and in the audited financial information that they use daily to make investment and voting decisions. This increased sense of confidence should promote market efficiency and capital formation. The modernization of our rules should allow more accountants, and their families, to invest in a wider range of investment opportunities. According to information provided to the SECPS, over 100,000 individuals will have more freedom of choice in their financial investments. This should increase the efficiency of the markets. We request comment on these matters.

IX. Codification Update

The "Codification of Financial Reporting Policies" announced in Financial Reporting Release No. 1 (April 15, 1982) is proposed to be amended as follows:

1. By removing section 602.01.

2. By removing section 602.02.a.

3. By removing section 602.02.b.i.

4. By removing section 602.02.b.ii to remove examples 2, 3, 4, 7, 8, and 10, and redesignate examples 5, 6, and 9 as examples 2, 3, and 4.

5. By removing section 602.02.b.iii.

6. By amending section 602.02.b.iv to remove the first three introductory paragraphs.

7. By amending section 602.02.c.i to remove the last two paragraphs.

8. By amending section 602.02.c.ii to remove examples 1, 2, 3, 4, 5, 7, 8, and 9 and redesignate example 6 as example 1.

9. By amending section 602.02.d to remove the two introductory paragraphs, remove examples 2, 3, 4, 5, 6, and 7, and redesignate example 8 as example 2.

10. By removing section 602.02.e.ii.

11. By removing section 602.02.e.iii.

12. By amending section 602.02.f to remove the introductory paragraph, remove examples 1, 2, 3, 4, and 5, and redesignate examples 6 and 7 as examples 1 and 2.

13. By amending section 602.02.g to remove examples 5, 15, 18, 19, and 22 and remove examples 6, 7, 8, 9, 10, 11, 12, 13, 14, 16, 17, 20, 21, 23, and 24 as examples 5, 6, 7, 8, 9, 10, 11, 12, 13, 14, 15, 16, 17, 18, and 19, respectively.

14. By removing section 602.02.h.

15. By adding section 602.01, captioned "Discussion of Rule 2-01," to include the text in the adopting release that discusses the final rules, which, if the proposed rules are adopted, would be substantially similar to topic III of this release.

16. By amending section 602.02 to redesignate sections 602.02.b.ii, 602.02.b.iv, 602.02.b.v, 602.02.c.i, 602.02.c.ii, 602.02.c.iii, 602.02.d, 602.02.e.i, 602.02.e.iv, 602.02.f, 602.02.g, 602.02.i.i, and 602.02.i.ii as sections 602.02.a.i, 602.02.a.ii, 602.02.a.iii, 602.02.b.i, 602.02.b.ii, 602.02.b.iii, 602.02.c, 602.02.d.i, 602.02.d.ii, 602.02.e, 602.02.f, 602.02.g.i, and 602.02.g.ii, respectively.

The Codification is a separate publication of the Commission. It will not be published in the Code of Federal Regulations.

X. Statutory Bases and Text of Amendments

We are proposing amendments to Rule 2-01 of Regulation S-X and Item 9 of Schedule 14A under the authority set forth in Schedule A and Sections 19 and 28 of the Securities Act, Sections 3, 10A, 12, 13, 14, 17, 23 and 36 of the Exchange Act, Sections 5, 10, 14, and 20 of the Public Utility Holding Company Act of 1935, Sections 8, 30, and 38 of the Investment Company Act of 1940, and Sections 203 and 211 of the Investment Advisers Act of 1940.

List of Subjects

17 CFR Part 210

Accountants, Accounting.

17 CFR Part 240

Reporting and recordkeeping requirements, Securities.

Text of Amendments

In accordance with the foregoing, Title 17, Chapter II of the Code of Federal Regulations is proposed to be amended as follows:

PART 210 - FORM AND CONTENT OF AND REQUIREMENTS FOR FINANCIAL STATEMENTS, SECURITIES ACT OF 1933, SECURITIES EXCHANGE ACT OF 1934, PUBLIC UTILITY HOLDING COMPANY ACT OF 1935, INVESTMENT COMPANY ACT OF 1940, AND ENERGY POLICY AND CONSERVATION ACT OF 1975

1. The authority citation for Part 210 continues to read as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 77z-2, 77aa(25), 77aa(26), 78j-1, 78l, 78m, 78n, 78o(d), 78u-5, 78w(a), 78ll(d), 79e(b), 79j(a), 79n, 79t(a), 80a-8, 80a-20, 80a-29, 80a-30, 80a-37(a), unless otherwise noted.

2. By amending § 210.2-01 by revising paragraphs (b) and (c) and adding paragraphs (d), (e) and (f) to read as follows:

§ 210.2-01 Qualifications of accountants.

(a) * * *

(b) The Commission will not recognize an accountant as independent, with respect to an audit client, if the accountant is not, or would not be perceived by reasonable investors to be, capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement. Under this standard, an accountant is not independent whenever, during the audit and professional engagement period, the accountant:

(1) Has a mutual or conflicting interest with the audit client;

(2) Audits the accountant's own work;

(3) Functions as management or an employee of the audit client; or

(4) Acts as an advocate for the audit client.

(c) An accountant is not independent under the standard of paragraph (b) of this section if, during the audit and professional engagement period, the accountant has any of the financial, employment or business relationships with, provides any of the non-audit services to, or receives a contingent fee from, the accountant's audit client or an affiliate of the audit client, as specified in paragraphs (c)(1) through (c)(5) of this section, or otherwise does not comply with the standard of paragraph (b) of this section.

(1) Financial relationships. An accountant is not independent under the standard of paragraph (b) of this section if the accountant has a direct financial interest or a material indirect financial interest in the accountant's audit client, such as the financial relationships specified in this paragraph (c)(1).

(i) Investment in audit client. An accountant is not independent when:

(A) The accounting firm, any covered person in the firm, or any of his or her immediate family members, has any direct investment in an audit client or an affiliate of an audit client, such as stocks, bonds, notes, options, or other securities.

(B) Any partner, principal, shareholder, or professional employee of the accounting firm, any of his or her immediate family members, any close family member of a covered person in the firm, or any group of the above persons has filed a Schedule 13D or 13G with the Commission indicating beneficial ownership of more than five percent of an audit client's equity securities, or otherwise controls an audit client.

(C) The accounting firm, any covered person in the firm, or any of his or her immediate family members, serves as voting trustee of a trust or executor of an estate containing the securities of an audit client.

(D) The accounting firm, any covered person in the firm, any of his or her immediate family members, or any group of the above persons has any material indirect investment in an audit client, including:

(1) Ownership of more than five percent of an entity that has an ownership interest in the audit client; or

(2) Ownership of more than five percent of an entity of which the audit client has an ownership interest.

(ii) Other financial interests in audit client. An accountant is not independent when the accounting firm, any covered person in the firm, or any of his or her immediate family members has:

(A) Loans/debtor-creditor relationship. Any loan (including any margin loan) to or from an audit client, an affiliate of an audit client, or an audit client's or an affiliate of an audit client's officers, directors, or record or beneficial owners of more than five percent of the audit client's or affiliate's equity securities, except for the following loans obtained from a financial institution under its normal lending procedures, terms and requirements:

(1) Automobile loans and leases collateralized by the automobile;

(2) Loans fully collateralized by the cash surrender value of an insurance policy;

(3) Loans fully collateralized by cash deposits at the same financial institution; and

(4) A mortgage loan collateralized by the accountant's primary residence provided the loan was not obtained while the borrower was a covered person in the firm or an immediate family member of a covered person in the firm.

(B) Savings and checking accounts. Any savings, checking or similar account at a bank, savings and loan or similar institution that is an audit client or an affiliate of an audit client, if the account has a balance that exceeds the amount insured by the Federal Deposit Insurance Corporation or any similar insurer.

(C) Broker-dealer accounts. Any brokerage or similar accounts maintained with a broker-dealer that is an audit client or an affiliate of the audit client, if:

(1) Any such accounts include any asset other than cash or securities (within the meaning of "security" provided in the Securities Investor Protection Act); or

(2) The value of assets in the accounts exceeds the amount that is subject to a Securities Investor Protection Corporation advance, for those accounts, under Section 9 of the Securities Investor Protection Act.

(D) Futures commission merchant accounts. Any futures, commodity, or similar account maintained with a futures commission merchant that is an audit client or an affiliate of the audit client.

(E) Credit cards. Any credit card balance in excess of $10,000 owed to a lender that is an audit client or an affiliate of an audit client.

(F) Insurance products. Any individual policy or professional liability policy originally issued by an insurer that is an audit client or an affiliate of an audit client.

(G) Investment companies. Any investment in any entity in an investment company complex if the audit client is also an entity in the same investment company complex. When the audit client is an entity that is part of an investment company complex, the accountant must be independent of each entity in the investment company complex.

(iii) Exceptions. Notwithstanding paragraphs (c)(1)(i) and (c)(1)(ii) of this section, the accountant will not be deemed not independent if:

(A) Inheritance and gift. Any person acquires a financial interest through an unsolicited gift or inheritance that would cause an accountant to be not independent under paragraphs (c)(1)(i) or (c)(1)(ii) of this section, and the financial interest is disposed of as soon as practicable, but no longer than 30 days after the person has the right to dispose of the financial interest.

(B) New audit engagement. Any person has a financial interest that would cause an accountant to be not independent under paragraphs (c)(1)(i) or (c)(1)(ii) of this section, and:

(1) The accountant did not audit the client's financial statements for the immediately preceding fiscal year; and

(2) The accountant is independent under paragraphs (c)(1)(i) and (c)(1)(ii) of this section before the earlier of:

(i) Accepting the engagement to provide audit, review, or attest services to the audit client; or

(ii) Commencing any audit, review or attest procedures (including planning the audit of the client's financial statements).

(iv) Audit clients' financial relationships. An accountant is not independent when:

(A) Investments by the audit client in the auditor. An audit client or an affiliate of an audit client has, or has agreed to acquire, any direct investment in the accounting firm or its affiliate, such as stocks, bonds, notes, options, or other securities.

(B) Underwriting**.** An audit client or an affiliate of an audit client, including a broker-dealer or other entity**,** performs any service for the accounting firm related to underwriting, offering, making a market in, marketing, promoting, or selling securities issued by the accounting firm, or issues an analyst report concerning the securities of the accounting firm.

(2) Employment relationships. An accountant is not independent under the standard of paragraph (b) of this section if the accountant has an employment relationship with an audit client or an affiliate of an audit client, such as the employment relationships specified in this paragraph (c)(2). An accountant is not independent when:

(i) Employment at audit client of accountant. A current partner, principal, shareholder, or professional employee of the accounting firm is employed by the audit client or an affiliate of an audit client or serves as a member of the board of directors or similar management or governing body of the audit client or an affiliate of the audit client.

(ii) Employment at audit client of certain relatives of accountant. A close family member of a covered person in the firm is in an accounting or financial reporting oversight role at an audit client or an affiliate of an audit client, or was in such a role during any period covered by an audit for which the covered person in the firm is a covered person.

(iii) Employment at audit client of former employee of accounting firm. A former partner, shareholder, principal, or professional employee of an accounting firm is in an accounting or financial reporting oversight role at an audit client or an affiliate of an audit client, unless the individual:

(A) Does not influence the accounting firm's operations or financial policies;

(B) Has no capital balances in the accounting firm; and

(C) Has no financial arrangement with the accounting firm other than one providing for regular payment of a fixed dollar amount (which is not dependent on the revenues, profits, or earnings of the firm) pursuant to a fully funded retirement plan or rabbi trust.

(iv) Employment at accounting firm of former employee of audit client. A former officer, director, or employee of an audit client or an affiliate of an audit client becomes a partner, shareholder, or principal of the accounting firm, unless the individual does not participate in, and is not in a position to influence, the audit of the financial statements of the audit client or an affiliate of the audit client covering any period during which he or she was employed by or associated with that audit client or an affiliate of the audit client.

(3) Business relationships. An accountant is not independent under the standard of paragraph (b) of this section if the accounting firm or any covered person in the firm has any direct or material indirect business relationship with an audit client, an affiliate of an audit client, or with an audit client's or an affiliate of an audit client's officers, directors, or record or beneficial owners of more than five percent of the audit client's or affiliate's equity securities. The relationships described in this paragraph do not include a relationship in which the accounting firm or covered person in the firm provides professional services or is a consumer in the ordinary course of business,

(4) Non-audit services. (i) Even if the audit client accepts ultimate responsibility for the work that is performed or decisions that are made, an accountant is not independent under the standard of paragraph (b) of this section when the accountant provides certain non-audit services to an audit client or an affiliate of an audit client, such as:

(A) Bookkeeping or other services related to the audit client's accounting records or financial statements. Any service involving:

(1) Maintaining or preparing the audit client's or an affiliate of the audit client's accounting records;

(2) Preparing the audit client's or an affiliate of the audit client's financial statements; or

(3) Generating financial information to be disclosed by the audit client or an affiliate of the audit client to the public.

(B) Financial information systems design and implementation. Designing or implementing a hardware or software system used to generate information that is significant to the audit client's financial statements taken as a whole, not including services an accountant performs in connection with the assessment, design, and implementation of internal accounting controls and risk management controls.

(C) Appraisal or valuation services, fairness opinions, or contribution-in-kind reports. Any appraisal or valuation service for an audit client or an affiliate of an audit client, or any service involving a fairness opinion or contribution-in-kind report where it is reasonably likely that, in performing an audit in accordance with generally accepted auditing standards, the results will be audited by the accountant.

(D) Actuarial services. Any advisory service involving the determination of policy reserves and related accounts for the audit client or an affiliate of an audit client, unless the audit client or its affiliate uses its own actuaries or third-party actuaries to provide management with the primary actuarial capabilities.

(E) Internal audit outsourcing. Internal audit services for an audit client or an affiliate of an audit client, not including nonrecurring evaluations of discrete items or programs and operational internal audits unrelated to the internal accounting controls, financial systems, or financial statements.

(F) Management functions. Acting, temporarily or permanently, as a director, officer, or employee of an audit client or an affiliate of an audit client, or performing any decision-making, supervisory, or ongoing monitoring function for the audit client or affiliate of the audit client.

(G) Human resources. Recruiting, hiring, or designing compensation packages for officers, directors, or managers of the audit client or an affiliate of the audit client; advising about the audit client's or affiliate of the audit client's management or organizational structure; developing employee evaluation programs; or conducting psychological or other formal testing of employees.

(H) Broker-dealer, investment adviser, or investment banking services. Acting as a securities professional, such as a broker-dealer, promoter, underwriter, analyst of the audit client's or an affiliate of the audit client's securities, investment adviser, or in any capacity recommending the purchase or sale of an audit client's or an affiliate of an audit client's securities, or designing the audit client or an affiliate of the audit client's system to comply with broker-dealer or investment adviser regulations.

(I) Legal services. Providing any service to an audit client or an affiliate of an audit client that, in the jurisdiction in which the service is provided, could be provided only by someone licensed to practice law.

(J) Expert services. Rendering or supporting expert opinions for an audit client or an affiliate of an audit client in legal, administrative, or regulatory filings or proceedings.

(ii) Transition. Until [insert date two years from the effective date of this section], providing to an audit client or an affiliate of an audit client the non-audit services set forth in paragraph (c)(4)(i) of this section will not impair an accountant's independence with respect to the audit client if:

(A) The non-audit services are performed pursuant to a written contract in effect on or before [insert the effective date of this section]; and

(B) Performing those services did not impair the auditor's independence under pre-existing requirements of the Commission, the Independence Standards Board, or the accounting profession in the United States.

(5) Contingent fees. An accountant is not independent under the standard of paragraph (b) of this section if the accountant provides any service to an audit client or an affiliate of an audit client for a contingent fee, or receives a contingent fee from an audit client or an affiliate of an audit client.

(d) Quality controls. An accounting firm's independence will not be impaired solely because a covered person in the firm is not independent of an audit client provided:

(1) The covered person did not know, and was reasonable in not knowing, of the circumstances giving rise to the lack of independence;

(2) The covered person's lack of independence was corrected promptly after the covered person or accounting firm became aware of it; and

(3) The accounting firm has a quality control system in place that provides reasonable assurance, taking into account the size and nature of the accounting firm's practice, that the accounting firm and its employees do not lack independence. For an accounting firm that annually provides audit, review, or attest services to more than 500 companies with a class of securities registered with the Commission under section 12 of the Securities Exchange Act of 1934, a quality control system will not provide such reasonable assurance unless it has at least the following features:

(i) Written independence policies and procedures;

(ii) An automated system to identify financial relationships that might impair the accountant's independence;

(iii) An annual or on-going firm-wide training program about auditor independence;

(iv) An annual internal inspection and testing program to monitor adherence to independence requirements;

(v) Notification to all firm members, officers, directors, and employees of the name and title of the member of senior management responsible for compliance with auditor independence requirements;

(vi) Written policies and procedures requiring all firm professionals to report promptly to the firm when they are engaged in employment negotiations with an audit client, and requiring the firm to remove immediately any such professional from that audit client's engagement and to review promptly all work the professional performed related to that audit client's engagement; and

(vii) A disciplinary mechanism to ensure compliance with this section.

(e) In determining whether an accountant is independent, the Commission will consider all relevant circumstances, including all relationships between the accountant and the audit client or the affiliates of the audit client, and not just those relating to reports filed with the Commission.

(f) Definitions of terms. For purposes of this section:

(1) Accountant, as used in paragraphs (b) through (e) of this section, means a certified public accountant or public accountant performing services in connection with an engagement for which independence is required. References to the accountant include any accounting firm with which the certified public accountant or public accountant is affiliated.

(2) Accounting firm means the organization (whether it is a sole proprietorship, incorporated association, partnership, corporation, limited liability company, limited liability partnership, or other legal entity) that is engaged in the practice of public accounting or furnishing accountant's reports with respect to financial statements, reports, or other documents filed with the Commission, and all departments, divisions, parents, subsidiaries, and affiliates of the accounting firm, including its pension, retirement, investment or similar plans.

(3) Accounting or financial reporting oversight role means that the person is in a position to, or does influence the contents of the accounting records or financial statements or anyone who prepares them, such as when the person is a member of the board of directors or similar management or governing body, chief executive officer, president, chief financial officer, chief operating officer, general counsel, chief accounting officer, controller, director of internal audit, director of financial reporting, treasurer, vice president of marketing, or any equivalent position.

(4) Affiliate of the accounting firm. (i) "Affiliate of the accounting firm" means:

(A) Any person directly or indirectly controlling, controlled by, or under common control with the accounting firm, including:

(1) Any person or entity directly or indirectly owning, controlling, or holding the power to vote five percent or more of the accounting firm's outstanding voting securities, partnership units, or other interest entitling a person to vote; and

(2) Any person or entity five percent or more of whose outstanding voting securities, partnership units, or other interest entitling a person to vote are directly or indirectly owned, controlled, or held by the accounting firm;

(B) Any officer, director, partner, copartner, or shareholder of more than five percent of the voting securities of a person described in paragraph (f)(4)(A) of this section;

(C) Any joint venture, partnership, or other undertaking in which the accounting firm participates and in which the parties agree to any form of shared benefits, including any form of shared revenue, income, or equity appreciation;

(D) Any entity that provides non-audit or other professional services to one or more of the accounting firm's audit clients, and in which the accounting firm has any equity interest in, has loaned funds to, or shares revenues with, or with which the accounting firm or any covered person in the firm has any direct business relationship;

(E) All persons and entities with which the accounting firm is publicly associated by co-branding; using the accounting firm's name, initials, or logo; cross-selling services; or using co-management; and

(F) If the accounting firm leases, or otherwise routinely acquires on a temporary or continuous basis, the services of personnel employed full- or part-time by another party (the "lessor") and the leased personnel perform a majority of the hours worked on the engagement or supporting the accountant's reports filed with the Commission, the lessor and the lessor's board of directors, executive officers, and all persons with management, supervisory, compensation, or other oversight responsibility for the leased personnel, and shareholders of five percent or more of the lessor's equity securities.

(ii) "Affiliate of the accounting firm" does not include parties that share with an accounting firm training facilities, technical knowledge, databases, or billing facilities but that have no other business or financial relationship with the accounting firm, provided that the accounting firm pays a reasonably proportionate and fair share of the costs and expenses associated with such items, and the party charges all participants no more than the costs and expenses incurred to operate or maintain the shared facility or database.

(5) Affiliate of the audit client means an entity that has significant influence over the audit client, or over which the audit client has significant influence, including the audit client's parent and subsidiary.

(6) Audit and professional engagement period includes both:

(i) The period covered by any financial statements being audited or reviewed (the "audit period"); and

(ii) The period of the engagement to audit or review the client's financial statements or to prepare a report filed with the Commission (the "professional engagement period").

(A) The professional engagement period begins when the accountant either signs an initial engagement letter (or other agreement to review or audit a client's financial statements), or begins review or audit procedures, whichever is earlier; and

(B) The professional engagement period ends when the client or the accountant notifies the Commission that the client is no longer that accountant's audit client.

(7) Audit client means the entity whose financial statements or other information is being audited, reviewed, or attested.

(8) Audit engagement team means all partners, principals, shareholders, and professional employees participating in an audit, review, or attestation engagement of an audit client, including those conducting concurring or second partner reviews and all persons who consult, formally or informally, with others on the audit engagement team during the audit, review, or attestation engagement regarding technical or industry-specific issues, transactions, or events.

(9) Chain of command means all persons having any supervisory, management, quality control, compensation, or other oversight responsibility over either any member of the audit engagement team or over the conduct of the audit. The "chain of command" includes all partners, principals, shareholders, and managers who may review, determine, or influence the performance appraisal or compensation of any member of the audit engagement team and any other person in a position to influence the audit engagement team's decisions during the conduct of the audit, review, or attestation engagement.

(10) Close family members means a person's spouse, spousal equivalent, parent, dependent, nondependent child, and sibling.

(11) Consumer in the ordinary course of business means a purchaser of routine products or services on the same terms and conditions that are available to the seller's other customers or clients, as long as the purchaser does not resell the product or service or receive a commission or other fee for selling the product or service.

(12) Contingent fee means any fee where payment, or the amount of the fee paid or due, is contingent, in whole or in part, on the result, including the value added, of any transaction or event, other than completion of the

work or delivery of the product giving rise to the fee. A fee is not a "contingent fee" if it is fixed by a court or by any federal, state, or local governmental agency.

(13) Covered persons in the firm means the following partners, principals, shareholders, and employees of an accounting firm:

(i) The "audit engagement team;"

(ii) The "chain of command;"

(iii) Any other partner, principal, shareholder, or professional employee of the accounting firm who is, or during the audit client's most recent fiscal year was, involved in providing any professional service to the audit client or an affiliate of the audit client; and

(iv) Any other partner, principal, or shareholder from an "office" of the accounting firm that participates in a significant portion of the audit.

(14) Group means when two or more persons act together for the purposes of acquiring, holding, voting, or disposing of securities of a registrant.

(15) Immediate family members means a person's spouse, spousal equivalent, and dependent.

(16) Investment company complex. (i) "Investment company complex" includes:

(A) An investment company and its investment adviser or sponsor;

(B) Any entity controlled by, under common control with or controlling the investment adviser or sponsor in paragraph (f)(16)(A) of this section; or

(C) Any investment company or entity that would be an investment company but for the exclusions provided by section 3(c) of the Investment Company Act of 1940 (15 U.S.C. § 80a-3(c)) that has an investment adviser or sponsor included in this definition by either paragraphs (f)(16)(A) or (f)(16)(B) of this section.

(ii) An investment adviser, for purposes of this definition, does not include a sub-adviser whose role is primarily portfolio management and is subcontracted with or overseen by another investment adviser.

(iii) Sponsor, for purposes of this definition, is an entity that establishes a unit investment trust.

(17) Office means a distinct sub-group within an accounting firm, whether distinguished along geographic or practice lines.

(18) Rabbi trust means an irrevocable trust whose assets are not accessible to the accounting firm until all benefit obligations have been met, but are subject to the claims of creditors in bankruptcy or insolvency.

PART 240 - GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

3. The authority citation for Part 240 continues to read, in part, as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78f, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78u-5, 78w, 78x, 78ll(d), 78mm, 79q, 79t, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4 and 80b-11, unless otherwise noted.

* * * * *

4. By amending § 240.14a-101 to add paragraph (e) to Item 9 to read as follows:

§ 240.14a-101 Schedule 14A Information required in proxy statement.

* * * * *

Item 9. Independent public accountants. * * *

* * * * *

(e)(1) Describe each professional service provided during the most recent fiscal year by the independent public or certified public accountant (as defined in Article 2 of Regulation S-X, 17 CFR 210.2-01) that is the registrant's principal accountant. A service does not have to be disclosed if the fee for that service was, is, or will be less than the lesser of $50,000 or 10 percent of the fee for the audit of the registrant's annual financial statements.

Instruction to paragraph (e)(1). Specifically describe each service. Broad general categories such as "tax matters" or "management advisory services" or "management consulting services" are not sufficient.

(2) Indicate whether, before each disclosed professional service was rendered, the audit committee of the board of directors, or if there is no such committee then the board of directors, approved the service and considered the possible effect of the service on the principal accountant's independence.

(3) Disclose the fee for each disclosed professional service.

(4) Disclose the aggregate fee for the audit of the registrant's financial statements for the fiscal year most recently completed and for the reviews of the financial statements included in the registrant's Forms 10-Q (17 CFR 249.308a) or 10-QSB (17 CFR 249.308b) for that fiscal year.

(5) If greater than 50 percent, disclose the percentage of the hours expended on the principal auditor's engagement to audit the registrant's financial statements for the most recent

fiscal year that were attributed to work performed by persons other than the principal accountant's full-time, permanent employees.

* * * * *

By the Commission.

Jonathan G. Katz
Secretary

Dated: June 30, 2000

Note: Appendices A, B, and C to the preamble will not appear in the Code of Federal Regulations.

APPENDIX A

Services offered by Professional Accounting Firms

Accounting and Auditing Services

1. Year-end audit. This may include assisting the client in calculating the amount of the income taxes owed, valuing stock options and other stock compensation arrangements under FAS 123, and drafting and typing up the financial statements.
2. Review of interim (monthly, quarterly) financial statements.
3. Compilation of financial statements.
4. Bookkeeping services (some firms offer this as a computer bookkeeping service).
5. Valuations of derivatives at fair market value for accounting purposes.
6. Assistance in preparation of and review of filings with the SEC, including initial public offerings.
7. Underwriter comfort letters for SEC and non-SEC filings.
8. Audit of Management's Discussion and Analysis in SEC filings.
9. Agreed upon procedures engagement (the client and auditor agree to procedures the auditor is to perform with respect to tasks such as testing a royalty arrangement or compliance with a loan agreement, and the auditor then issues a report on his or her findings).
10. Audit or review of financial forecasts or projections. This includes such documents included in offering memoranda.
11. Providing advice on how to interpret new accounting pronouncements, including providing sample journal entries.
12. Audits of financial statements of pension plan financial statements.
13. Director examinations of financial institutions.
14. CPA WebTrust - an engagement to review the security of a company's website that is conducting electronic commerce over the internet.
15. Assisting international companies in conforming their financial reporting to U.S. financial reporting practices (GAAP conversions).
16. Technical opinions on accounting matters to clients of other accounting firms.

Business Controls

1. Ethics and Responsible Business Practices - a service that helps clients address the sources of internal wrongdoing and eliminate barriers to responsible business practices.

2. Evaluation, design and implementation of internal accounting and financial reporting controls, policies and procedures.
3. Evaluation, design and implementation of management and business controls over various business functions such as management reporting systems, research and development, etc.
4. Examinations of internal controls.
5. Business Fraud and Investigation Services - helps companies identify, manage and minimize integrity risks, such as suspected management or alleged employee fraud.

Tax Services

1. Preparation of federal and state individual income tax returns.
2. Preparation of federal and state corporation tax returns.
3. Individual and corporate tax planning (including federal, state, and local taxes).
4. Personal financial planning for individuals including client employees and executives.
5. Income tax planning for executives including employee compensation and benefit plans (see below).
6. Investment planning.
7. Programs for planning for college.
8. Retirement planning programs.
9. Estate planning including preparation of wills, trusts, etc.
10. Representation of clients in tax negotiations and disputes with the IRS.
11. Review of property tax assessments.
12. Succession planning.
13. Serve as or provide tax advice to executors and trustees.
14. Tax credit reviews to determine maximum allowable credits (e.g., research and development credits).
15. Trade and customs services - ensures compliance with trade laws and regulations while trying to avoid, reduce, or defer overall customs duties.
16. Transfer pricing studies and evaluation, documentation, and modification of existing policies.
17. Valuation services.
18. VAT Services.

Financial Services

1. Treasury management services including design, development and implementation of policies and procedures.
2. Credit management services including design, development and implementation of credit policies and procedures.
3. Design and structuring of financial instruments.
4. Assisting investment banking firms with the design of financial instruments and financing transactions.
5. Assistance with finding/identifying equity parties or financing parties.
6. Identification and selection of banks.
7. Assistance with or preparation of financing and loan applications.
8. Loan review services.
9. Regulatory advisory services.

Information Systems Technology

1. Selection of new hardware and software systems. This may include activities such as performing a "needs analysis," preparation of a request for proposals, and overseeing, assistance with, or performance of demonstrations.
2. Implementation of new hardware and software systems. This may include:
   - Full on-site team to perform all implementation services.
   - Project administration of another consulting team.
   - Development of necessary manual and computer control systems.
   - Providing necessary computer programmers.
   - Software design and programming.
   - Ongoing support functions.
3. Consulting on Y2K issues such as:
   - Inventory of Y2K system problems.
   - Development of Y2K remediation program.
4. Development of IT management and/or strategic plans.
5. Evaluation and selection of telephone systems.
6. Business continuity planning and information security services.
7. Application controls consulting.
8. Electronic commerce services.

9. Reporting on the processing of transactions by service organizations.

Employment Benefit Programs

1. 1. Designing and developing employee compensation programs including:
    - Stock option programs.
    - Retirement plans.
    - Executive compensation arrangements.
    - Deferred compensation and bonus arrangements.

Business Reengineering

1. Benchmarking of best practices including business and financial reporting practices.
2. Reengineering of business processes including:
    - Manufacturing processes.
    - Research and development processes.
    - Review of spending levels (e.g., for general and administrative expenses).
    - Plant layout design.
3. Review of manual processes that feed into computerized information systems.
4. Staff reduction programs.

Outsourcing

Outsourcing of such client functions as:

1. Information systems. This may include outsourcing the management or the entire data processing and information systems group.
    1. Internal audit function.
    2. Tax department.
    3. Office of the Chief Financial Officer.
    4. Accounting department.
    5. Human resource department.
    6. Risk management function.

Corporate Finance

1. Deal due diligence.
2. Candidate targeting.

3. Preparation of offering memorandums.
4. Lead advisor for private placements
5. Merger transaction advice on:
    - Structuring of transactions.
    - Tax implementations.
    - Sourcing capital.
    - Preparation of pro forma financial statements and projections.
    - Reengineering acquired businesses.
    - Cost reduction and synergistic studies.
6. Appraisal and valuation of targets assets, including receivables, inventories, property, plant and equipment, intangible assets and in-process research and development.
7. Fairness opinions.
8. In some foreign jurisdictions, the firms act as stock transfer agents.
9. "Turnaround" business advisors.

Marketing and Distribution

1. Evaluation of marketing and distribution channels.
2. Development of marketing and distribution channel plans and consulting on the implementation of such plans.

Legal Services

1. Corporate and commercial legal services to national and international companies worldwide.
2. Assistance to law departments and general counsel to enhance and measure performance.

Litigation Support

1. Case management.
2. Expert accounting and financial reporting witnesses.
3. Damages experts and witnesses.
4. Environmental litigation experts.
5. Securities litigation experts.
6. Antitrust services.
7. Construction disputes.
8. Service of detailed data to provide cost-effective, proactive strategies and solutions to complex business disputes.

Other

1. Government Contract Consulting - helps companies understand and address business risks associated with negotiating, contracting with, and performing under contracts for the sale of goods or services with U.S. federal, state, local and foreign governments.
2. Advise government entities that are privatizing on commercialization, restructuring, competition, changing organization attitudes, customer satisfaction and policy adjustment; provides other grant-aided work in emerging markets.
3. Real Estate - provides advice about increasing the profitability of real estate assets through the acquisition, development, management and disposition of single assets or portfolios of properties. Services also include strategic planning, consolidation studies, surplus property planning, valuations, and outsourcing consulting.
4. Services for middle-sized companies - includes cash management, payroll needs, business relocation services, and shareholder meetings.
5. Insolvency/executory services - acting as receivers, liquidators, bankruptcy trustees, or advisors to debtor or creditor groups.
6. Specific services for health insurers and other health care organizations.

APPENDIX B

Table 1
Estimated U.S. Revenues for Big 5/Big 6 Public Accounting Firms
Source: PAR

	1999	1998	1997	1996	1995	1994	1993
Total	$30,616	$25,917	$20,492	$17,305	$15,051	$13,291	$12,162
Estimated revenue mix by service line							
A&A	30%	30%	33%	36%	38%	44%	45%
Tax	19%	19%	20%	20%	20%	20%	22%
MCS & Other	51%	51%	47%	44%	42%	36%	32%
Estimated revenue by service line							
A&A	$9,150	$7,812	$6,738	$6,195	$5,762	$5,823	$5,485
Tax	$5,764	$4,871	$4,110	$3,477	$2,968	$2,673	$2,714
MCS & Other	$15,702	$13,234	$9,618	$7,633	$6,321	$4,796	$3,856
Compound growth rate of estimated U.S. revenues from 1993 to 1999							
A&A	9%						
Tax	13%						
MCS & Other	26%						

Table 2
Composition of Big 5 (Big 6/Big 8) U.S. Revenues by Service
Source: PAR, Annual Reports to SECPS, and SECPS Reports

Year	A&A		Tax		MCS & Other	
	Average	Median	Average	Median	Average	Median
1981	NA	NA	NA	NA	15%	13%
1984	NA	NA	NA	NA	16%	14%
1986	NA	NA	NA	NA	18%	18%
1988	55%	57%	23%	23%	22%	20%
1993	46%	51%	23%	22%	30%	27%
1994	45%	51%	20%	21%	34%	28%
1995	40%	43%	20%	20%	40%	35%
1996	37%	40%	21%	22%	42%	39%
1997	34%	36%	21%	21%	45%	42%
1998	31%	34%	20%	19%	49%	47%
1999	31%	33%	19%	18%	50%	49%

NA indicates that item is not reported or not available

Abbreviations of service lines:
A&A - accounting and auditing
MCS & Other - management consulting services and other non-audit, non-tax services

Table 3
Range of MCS Fees to Audit Fees for SEC Audit Clients of Big 5 (Big 6/Big 8) Firms
Source: Annual Reports to SECPS and SECPS Reports

Year	# clients	0%	1-25%	26-50%	51-100%	> 100%	>50%	>25%
1984	10,110	NA	NA	NA	NA	1.0%	NA	NA
1986	11,439	NA	NA	1.9%	1.2%	1.2%	2.5%	4.4%
1988	10,386	75.4%	19.1%	2.4%	1.6%	1.4%	3.1%	5.5%
1989	11,164	77.3%	17.0%	2.5%	1.8%	1.5%	3.2%	5.7%
1990	11,277	81.2%	13.5%	2.4%	1.5%	1.3%	2.8%	5.2%
1991	11,520	83.4%	12.5%	1.9%	1.4%	0.8%	2.2%	4.1%
1992	11,809	79.2%	16.5%	2.1%	1.1%	1.1%	2.2%	4.3%
1993	12,362	83.8%	11.5%	2.2%	1.3%	1.2%	2.5%	4.7%
1994	12,841	82.6%	12.5%	2.1%	1.4%	1.3%	2.8%	4.9%
1995	12,793	81.8%	13.4%	2.3%	1.2%	1.2%	2.4%	4.7%
1996	11,755	77.8%	16.1%	2.6%	1.9%	1.5%	3.4%	6.1%
1997	11,846	78.1%	14.8%	2.9%	2.1%	2.1%	4.2%	7.1%

1998	12,348	73.6%	16.5%	3.6%	3.1%	3.2%	6.4%	10.0%
1999	12,769	74.3%	14.3%	3.7%	3.0%	4.6%	7.6%	11.3%

NA indicates that item is not reported or not available

Table 4
MCS Activity for Public Accounting Firms Based on Number of SEC Audit Clients
For Most Recent Reporting Year
Source: SECPS Report

# clients	# firms	Average number of SEC clients	Average MCS fees from SEC clients to total fees	Average MCS fees from SEC clients to total MCS fees
> 1000	5	2554	10.0%	22.8%
100 - 1000	3	314	1.0%	3.6%
20-99	20	36	1.0%	9.9%
3 - 19	258	6	.9%	7.4%
2	167	2	.5%	3.3%
1	351	1	.4%	5.0%

Information sources:
PAR - Public Accounting Report, "Special Supplement: Annual Survey of National Accounting Firms - 2000, March 31, 2000.
Annual Reports to SECPS - Annual reports filed with the AICPA Division for CPA Firms SECPS member public accounting firms
SECPS Reports - Reports prepared by the AICPA Division for CPA Firms

APPENDIX C

Footnotes

1 We do not edit personal, identifying information, such as names or e-mail addresses, from electronic submissions. Submit only information you wish to make publicly available.

2 17 CFR 210.2-01.

3 17 CFR 240.14a-101.

4 15 U.S.C. § 78a et seq.

5 This release uses the terms "independent auditor," "auditor," "independent public accountant," "accountant," and "independent accountant" interchangeably to refer to any independent certified or independent public accountant who performs an audit of or reviews a public company's financial statements or whose report or opinion is filed with the Commission in accordance with the federal securities laws or the Commission's regulations.

6

Public companies must have their annual financial statements audited by independent public accountants. See, e.g., Items 25 and 26 of Schedule A to the Securities Act of 1933 (the "1933 Act"), 15 U.S.C. § 77aa(25) and (26) that expressly require that financial statements be audited by independent public or certified accountants. Public companies also must have their quarterly reports reviewed by independent accountants. See, e.g., Article 10 of Regulation S-X, 17 CFR 210.10-01(d).

7 The profession's principles of professional conduct state, "Members should accept the obligation to act in a way that will serve the public interest, honor the public trust, and demonstrate commitment to professionalism." American Institute of Certified Public Accountants ("AICPA") Professional Standards: Code of Professional Conduct ("AICPA Code of Professional Conduct"), ET § 53.

8 Financial Reporting Release ("FRR") No. 10 (Feb. 25, 1983).

9 See Independence Standards Board ("ISB"), "Discussion Memorandum 99-3: Appraisal and Valuation Services," at 2-3 (Sept. 1999). The ISB was formed in 1997 to establish auditor independence standards applicable to audit and other attestation reports that are filed with us. Copies of standards issued by the ISB can be obtained from the ISB's web site at www.cpaindependence.org.

10 As Statement on Auditing Standards No. 1 states, "...an independent auditor auditing a company of which he was also a director might be intellectually honest, but it is unlikely that the public would accept him as independent since he would be in effect auditing decisions which he had a part in making. Likewise, an auditor with a substantial financial interest in a company might be unbiased in expressing his opinion on the financial statements of the company, but the public would be reluctant to believe that he was unbiased." AICPA Codification of Statements on Auditing Standards ("SAS") No. 1, AU § 220.03. Indeed, a recent survey suggests that the complexity of the financial and business relationships between accounting firms and audit clients could diminish investors' confidence in the objectivity of auditors. In the 1999 study sponsored by the ISB, Earnscliffe Research & Communications found that many individuals interviewed believed that pressures on auditors have been increasing and are becoming problematic, and that "auditors are developing a stronger interest in their relationship with management, perhaps at the expense of their responsibilities to shareholders." See Earnscliffe Research & Communications ("Earnscliffe"), Report to the United States Independence Standards Board: Research into Perceptions of Auditor Independence and Objectivity, at 9 (Nov. 1999) ("Earnscliffe Report").

11 See generally Codification of Financial Reporting Policies (the "Codification") § 601.01 ("[a]n investor's willingness to commit his capital to an impersonal market is dependent on the availability of accurate, material and timely information regarding the corporations in which he has invested or proposes to invest").

12 The opinion of the auditor appears in a report that must include the word "independent." See AICPA SAS No. 58, AU § 508.08.

13 Steven M. H. Wallman, "The Future of Accounting and Disclosure in an Evolving World: The Need for Dramatic Change," Accounting Horizons, at 81 (Sept. 1995).

14 For example, Items 25 and 26 of Schedule A to the 1933 Act, 15 U.S.C. 77aa(25) and (26), and Section 17(e) of the Exchange Act, 15 U.S.C. § 78q, expressly require that financial statements be audited by independent public or certified accountants. Sections 12(b)(1)(J) and (K) and 13(a)(2) of the Exchange Act, 15 U.S.C. §§ 78l and 78m, Sections 5(b)(H) and (I), 10(a)(1)(G), and 14 of the Public Utility Holding Company Act of 1935 ("PUHCA"), 15 U.S.C. §§ 79e (b), 79j, and 79n, Sections 8(b)(5) and 30(e) and (g) of the Investment Company Act of 1940 ("ICA"), 15 U.S.C. §§ 80a-8 and 80a-29, and Section 203(c)(1)(D) of the Investment Advisers Act of 1940 ("Advisers Act"), 15 U.S.C. § 80b-3(c)(1), authorize the Commission to require the filing of financial statements that have been audited by independent accountants. Under this authority, the Commission has required that certain financial statements be audited by independent accountants. See, e.g., Article 3 of Regulation S-X, 17 CFR 210.3-01 et seq. In addition, public companies must have their quarterly reports reviewed by independent accountants. Article 10 of Regulation S-X, 17 CFR 210.10-01(d) and Item 310(b) of Regulation S-B, 17 CFR 228.310(b). The federal securities laws also grant the Commission the authority to define the term "independent." Section 19(a) of the 1933 Act, 15 U.S.C. § 77s(a), Section 3(b) of the Exchange Act, 15 U.S.C. § 78c(b), Section 20(a) of PUHCA, 15 U.S.C. § 79t(a), and Section 38(a) of the ICA, 15 U.S.C. § 80a-37(a), grant the Commission the authority to define accounting, technical, and trade terms used in each Act.

15 "An `unqualified opinion' states that the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the entity in conformity with generally accepted accounting principles." AICPA SAS No. 58, AU § 508.10.

16 This regulatory regime has been recognized by the courts. See, e.g., Touche Ross & Co. v. SEC, 609 F.2d 570, 580-81 (2d Cir. 1979).

17 Hearings on S. 875 Before the Senate Comm. on Banking and Currency, 73d Cong., 1st Sess. 55-60 (1933) ("1933 Senate Hearings"). During one hearing, Col. A. H. Carter, then president of the New York State Society of Certified Public Accountants, stressed the fact that outside accounting firms would be independent of management. During this discussion, Col. Carter, in differentiating between controllers employed by companies and independent accountants, stated, "the public accountant audits the controller's accountant." Senator Barkley then asked, "Who audits you?" Col. Carter's oft-quoted reply was, "Our conscience." Id at 58.

18 Payment of fees by the company to the auditor for performance of the audit and issuance of the auditor's opinion on the company's financial statements often is cited as a fundamental issue in the area of auditor independence. This fee structure was inherent in the decision by Congress in 1933 to have private sector auditors, rather than government employees, audit public companies. Id. Rather than being a reason for liberalization of the independence regulations, this payment structure should be a cause for exercising greater care by

both companies and auditors in maintaining the auditor's independence. The National Association of Securities Dealers, Inc. ("NASD"), the New York Stock Exchange ("NYSE"), and the American Stock Exchange ("AMEX") recently addressed this issue by changing their company listing standards to make it clear that the auditor is ultimately accountable to the board of directors and the audit committee, as opposed to management, and that the audit committee and the board of directors have the ultimate authority and responsibility to select, evaluate and, when appropriate, replace the auditor. See Order Approving Proposed Rule Change by the NASD, Exchange Act Rel. No. 42231, File No. SR-NASD-99-48 (Dec. 14, 1999); Order Approving Proposed Rule Change by the NYSE, Exchange Act Rel. No. 42233, File No. SR-NYSE-99-39 (Dec.14, 1999); and Order Approving Proposed Rule Change by the AMEX, Exchange Act Rel. No. 42232, File No. SR-Amex-99-38 (Dec. 14, 1999).

19 465 U.S. 805 (1984).

20 Id. at 817-18.

21 Id. at 818.

22 See, e.g., Subcomm. on Oversight and Investigations of the House Comm. on Interstate and Foreign Commerce, 94th Cong., 2d Sess., Federal Regulation and Regulatory Reform 35 (Subcomm. Print 1976) (also known as the Moss Report).

23 See, e.g., "Relationships Between Registrants and Independent Accountants," Accounting Series Release ("ASR") No. 296 (Aug. 20, 1981). See also Office of the Chief Accountant of the U.S. Securities and Exchange Commission, Staff Report on Auditor Independence (Mar. 1994) ("Staff Report") for a detailed discussion of: (1) the background and need for auditor independence, (2) the current rules and interpretations of the Commission, the AICPA, and other nations, and (3) recent and proposed changes in those rules and interpretations.

24 See, e.g., AICPA SAS No. 1, AU § 220.03.

25 The Council of American Institute of Accountants adopted an official statement on independence that was published in The Journal of Accountancy in July 1947.

26 AICPA SAS No. 1, AU § 220.01-02.

27 Id. at AU § 220.03.

28 Id.

29 POB, Scope of Services by CPA Firms, at 27 (Mar. 1979) ("1979 POB Report") (quoting A. Arens and J. Loebbecke, Auditing: An Integrated Approach (Prentice-Hall 1976)).

30 Arthur Young, supra note 19, at 819 n.15 (emphasis in original).

31 The Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees noted with respect to independent

directors that, even absent objective verification, "... common sense dictates that a director without any financial, family, or other material personal ties to management is more likely to be able to evaluate objectively the propriety of management's accounting, internal control and reporting practices." The Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (the "Blue Ribbon Committee"), Report and Recommendations, at 22 (1999) (the "Blue Ribbon Report"). Copies of the Blue Ribbon Report are available at www.nyse.com or www.nasd.com.

32 Article IV of the AICPA's Code of Professional Conduct provides, "Objectivity is a state of mind, a quality that lends value to a member's services. It is a distinguishing feature of the profession. The principle of objectivity imposes the obligation to be impartial, intellectually honest, and free of conflicts of interest. Independence precludes relationships that may appear to impair a member's objectivity in rendering attestation services." AICPA Code of Professional Conduct, ET § 55.01.

33 Earnscliffe reports that "[w]hile some believe that perceptions of the independence of auditors is already suffering some corrosion, more people take the view that damage is inevitable in the future if greater precautions are not taken to protect the perception of independence." Earnscliffe Report, supra note 10, at 46.

34 R. K. Mautz and Hussein A. Sharaf, The Philosophy of Auditing, at 223 (Am. Acct. Ass'n 1961).

35 See illustrations in Appendix C of how some of the proposed rules would apply. They are provided for illustrative purposes only and necessarily exclude certain important details set forth in the proposed rules.

36 Codification § 602.02.h.

37 See ISB, "Invitation to Comment 99-1: Family Relationships Between the Auditor and the Audit Client" (July 1999).

38 See Report on Improving the Accountability of Publicly Owned Corporations and Their Auditors, Subcomm. on Reports, Accounting and Management of the Senate Comm. on Governmental Affairs, 95th Cong., 1st Sess. (Comm. Print Nov. 1977). In the Report, the Subcommittee stated that it "agrees with the Cohen commission and many others that the accounting profession must improve its procedures for assuring independence in view of the public's needs and expectations. Several activities of independent auditors have raised questions. Among them are public advocacy on behalf of a client, receiving gifts and discounts from clients, and maintaining relationships which detract from the appearance of arm's-length dealings with clients. Such activities are not appropriate." Id. at 16. The subcommittee also stated that "[t]he best policy ... is to require that independent auditors of publicly owned corporations perform only services directly related to accounting. Non-accounting management services ... should be discontinued." Id. at 16-17.

In a letter to Harold Williams, Chairman, SEC, Senator Thomas F. Eagleton, Chairman, Subcomm. on Governmental Efficiency and the District of Columbia, of the Senate Comm. on Governmental Affairs, recommended that "[t]here must be a requirement that independent auditors of publicly owned corporations perform only services directly related to accounting." Letter from Senator Thomas F. Eagleton to Harold Williams, dated Apr. 6, 1978 (reprinted in Securities and Exchange Commission Report to Congress on the Accounting Profession and the Commission's Oversight Role (July 1978)).

39 Letter from John J. McCloy, Chairman, POB (former Chairman of the Board of Chase Manhattan Bank and former President of The World Bank), to Walter E. Hanson, Chairman, Executive Committee, SEC Practice Section ("SECPS"), dated March 9, 1979, at 2.

40 Staff Report, supra note 23, at 27-34. Between 1979 and 1981, public companies were required to disclose in their proxy statements certain information about non-audit services provided by their auditors. See infra Section II.C.4. (discussing these disclosure requirements). In the late 1980s, several of the large public accounting firms filed a petition with us seeking to enter into joint ventures, limited partnership agreements, and other similar arrangements with audit clients. See Letter from Jonathan G. Katz, Secretary, SEC, to Duane R. Kullberg, Arthur Andersen & Co., dated Feb. 14, 1989 (denying the petition). In 1990, the staff stated that if certain conditions were met, it would not object to Arthur Andersen & Co.'s conclusion that certain business relationships between Andersen Consulting and audit clients of Arthur Andersen & Co. may be considered indirect business relationships. See Letter from Edmund Coulson, Chief Accountant, SEC, to Robert Mednick, Arthur Andersen & Co., dated June 20, 1990.

41 Staff Report, supra note 23, at 33. See infra notes 47-67 and accompanying text (showing dramatic increase in nature, number, and dollar amount of non-audit services provided to audit clients since the issuance of the Staff Report).

42 Staff Report, supra note 23, at 34.

43 Advisory Panel on Auditor Independence, Report to the Public Oversight Board of the SEC Practice Section, AICPA: Strengthening the Professionalism of the Independent Auditor, at 9 (Sept. 13, 1994).

44 Special Committee on Financial Reporting, AICPA, Improving Business Reporting--A Customer Focus: Meeting the Information Needs of Investors and Creditors, at 104 (1994).

45 GAO, THE ACCOUNTING PROFESSION - Major Issues: Progress and Concerns, at 8 (GAO/AIMD-96-98, Sept. 1996) (the "GAO Report").

46 Earnscliffe Report, supra note 10, at 46.

47 Some firms are seeking to provide expanded services through joint ventures with audit clients or their affiliates. As noted above, as early as 1988, large public accounting firms were looking to enter into joint ventures, limited partnership agreements, and other similar arrangements with audit clients. See Letter from Jonathan G. Katz to Duane R. Kullberg, supra note 40.

[48] See Appendix A. The list was prepared by the ISB. See ISB, "Discussion Memorandum 99-2: Evolving Forms of Firm Structure and Organization" (Oct. 1999). Although the list is long, it is not comprehensive. Commentators may wish to review accounting firms' web sites and other sources for additional information about the services being provided by accounting firms.

[49] See, e.g., "KPMG spies rapid growth in `shared services'," Accounting Today, at 12 (June 3-16, 1996); "KPMG Restructures to Reposition Outsourcing," Public Accounting Report, at 1 (May 15, 1996).

[50] Management advisory services ("MAS") are a subset of non-audit services.

[51] See Table 1 in Appendix B. The underlying data are reported in "Special Supplement: Annual Survey of National Accounting Firms - 2000," Public Accounting Report (Mar. 31, 2000).

[52] See Tables 1 and 2 in Appendix B.

[53] See Table 2 in Appendix B.

[54] See Table 1 in Appendix B.

[55] See Table 3 in Appendix B.

[56] See Table 3 in Appendix B.

[57] See Table 3 in Appendix B.

[58] See Table 4 in Appendix B.

[59] See Table 3 in Appendix B. Taken together, the data from tables 1, 3, and 4 indicate that in 1999 more than 12,700 clients of the five largest public accounting firms paid approximately $9.150 billion for accounting and auditing services. During that same period, approximately 3,300 of those companies that are SEC registrants paid approximately $3.062 billion for MAS and similar non-audit services.

[60] See Table 4 in Appendix B.

[61] See, e.g., Rick Telberg, "Anybody can do it! says small-firm consolidator," Accounting Today, at 5 (Jan. 4-24, 1999).

[62] "Done Deal: HRB acquires M&P for $240 million cash, pension obligation," Public Accounting Report, at 1 (July 15, 1999); "AmEx and Checkers Close The Deal," Public Accounting Report, at 1 (Mar. 31, 1997).

[63] "Cap Gemini and Ernst & Young Have Agreed to Terms for the Acquisition of Ernst & Young Consulting" (Feb. 29, 2000) (press release of Ernst & Young) (available at www.ey.com).

[64] KPMG Consulting, Inc., Form S-1, filed May 5, 2000.

[65] Diane B. Henriques, "Auditing Firm Plans to Split Its Businesses," N.Y. Times, Feb. 18, 2000, at C8.

[66] Letter from Lynn E. Turner, Chief Accountant, SEC, to Kathryn A. Oberly, Esq., Ernst & Young, dated May 25, 2000 (available at www.sec.gov).

[67] In 1999, Big 5 accounting firms received higher fees for MAS and other consulting services than for audits from approximately 600 audit clients. See Table 3 in Appendix B.

[68] Earnscliffe reports, "The large majority of interviewees in each segment (including auditors) have sensed that in recent years accounting firms have lost their preoccupation with audits, and become much more preoccupied with growing new areas of consulting revenue. Many felt that within firms, the psychic and financial rewards were tilted heavily towards the consulting side, and that auditors who wanted to be well compensated and respected by peers, needed to support the growth of non-audit functions. This perception was even shared by a fair number of auditors. . . ." Earnscliffe Report, supra note 10, at 14.

See also Statement of PricewaterhouseCoopers, "In essence, we have become an organisation trying to follow two missions at the same time. One goal has been to assure financial market integrity and provide investor protection. The other has been to help clients succeed by guiding them through complex, large-scale business transformations. One goal demands objectivity and independence. The other demands a direct interest in our clients' success." Wall St. J., Feb. 22, 2000, at A17.

[69] Earnscliffe Report, supra note 10, at 28, 37-41.

[70] Id. at 20. Regarding the lack of effective safeguards, see generally "Report of the Internal Investigation of Independence Issues at PricewaterhouseCoopers LLP" (Jan. 6, 2000) (available on our web site, www.sec.gov. See also Letters from Lynn Turner, Chief Accountant, SEC, to Michael Conway, Chairman, SECPS Executive Committee, dated Nov. 30, 1998 and May 1, 2000.

[71] See generally Paul M. Clikeman, "Auditor Independence: Continuing Controversy," Ohio CPA J. (Apr.-June 1998); Mautz and Sharaf, supra note 34, at Ch. 8.

[72] See infra Section III.D.1.(b) (regarding the types of services that raise independence concerns).

[73] Mautz and H. Sharaf, supra note 34, at 222.

[74] Gary John Previts, The Scope of CPA Services 33 (John Wiley & Sons, 1985) (citing Charles Reckitt, The Public Accountant (Philadelphia 1900)).

[75] See Max H. Bazerman, Kimberly P. Morgan, and George F. Loewenstein, "The Impossibility of Auditor Independence," Sloan Management Review, at 89-94 (Summer 1997) (reviewing empirical research showing that "[w]hen people are called on to make impartial judgments, those judgments are likely to be unconsciously and powerfully biased in a manner that is commensurate with the judge's selfinterest," and concluding that, despite their best

intentions, "there is good reason to believe that auditors will unknowingly misrepresent facts and will unknowingly subordinate their judgment due to cognitive limitations"); see also Robert A Prentice, "The SEC and MDP: Implications of the Self-Serving Bias for Independent Auditing," Ohio St. L.J. (Fall 2000) (forthcoming).

76 See, e.g., SEC v. Jose Gomez, Accounting and Auditing Enforcement Release ("AAER") No. 57 (May 8, 1985).

77 See, e.g., SEC v. Christopher Bagdasarian and Sam White, AAER No. 825 (Sept. 26, 1996).

78 See AICPA SAS No. 90, AU § 380.11. Independence lapses perhaps are most likely to affect this gray area, where the answers are more a matter of judgment than of bright-line rule, and where judgments are out of the public view.

79 Of course, all of these factors make it equally impossible to demonstrate empirically that an auditor's economic interests do not adversely affect the quality of the audit.

80 1979 POB Report, supra note 29, at 34 n.103. As the POB noted, "[T]he Board recognizes that the nonexistence of such evidence does not necessarily mean that there have not been instances where independence may have been impaired. Not all situations where an auditor's objectivity is compromised will result in a lawsuit." Id. at 35.

81 See Letter from Lynn Turner, Chief Accountant, SEC, to Charles Bowsher, Chairman, POB, dated Dec. 9, 1999; see, e.g., In the Matter of PricewaterhouseCoopers, LLP, AAER No. 1098 (Jan. 14, 1999).

82 See Letters from Lynn Turner, Chief Accountant, SEC, to Michael Conway, supra note 70.

83 See id.

84 SEC Press Release, "All Big 5 Accounting Firms Agree to Participate in Voluntary Program to Address Independence Violations; Safe Harbor Provided for Certain Violations" (June 7, 2000).

85 For a concise discussion of the Commission's previous rulemaking efforts in this area, see Staff Report, supra note 23, at 27-34.

86 "Disclosure of Relationships with Independent Public Accountants," ASR No. 250 (June 29, 1978). Prior to the implementation of this disclosure requirement, a private commission established by the AICPA (The Commission on Auditor's Responsibilities, known as the "Cohen Commission") reviewed the performance of non-audit services by auditors. The Cohen Commission found that outside of executive search and placement services, there was no evidence that the performance of such services compromised auditor independence. In spite of this finding, the Cohen Commission urged the accounting profession to take steps to diminish the concerns of a "significant minority" and recommended that the performance of non-audit services be evaluated by audit committees or boards of directors, and that registrants or auditors appropriately disclose such

services. The Commission on Auditors' Responsibilities, AICPA, Report, Conclusions, and Recommendations, at 100-04 (1978).

87 "Scope of Services by Independent Accountants," ASR No. 264 (June 14, 1979).

88 In withdrawing the interpretive release, we reaffirmed our views regarding the need for caution in the provision of non-audit services:

Although the Commission's views expressed in [the interpretive release] are unchanged and registrants and accountants must continue to carefully evaluate their relationships to ensure that the public maintains confidence in the integrity of financial reporting, the Commission is withdrawing that release because it may confuse independent accountants, audit committees and others who are trying to evaluate services performed or to be performed by the accountants. Moreover, the Commission believes it has achieved its objective in issuing [the interpretive release]. Accountants and their self-regulatory structure, audit committees, boards of directors and managements are aware of the Commission's views on accountants' independence and should be sensitive to the possible impact on independence of nonaudit services performed by accountants. The Commission believes it should be able to rely on these persons to ensure adequate consideration of the impact on accountants' independence of nonaudit services because they share the responsibility to assure that the public maintains confidence in the independence of accountants.

ASR No. 296, supra note 23.

89 "Rescission of Certain Accounting Series Releases and Adoption of Amendments to Certain Rules of Regulation S-X Relating to Disclosure of Maturities of Long-Term Obligations," ASR No. 297 (Aug. 20, 1981).

90 ASR No. 296, supra note 23.

91 See supra Section II.C.; see also Appendix B.

92 The effect of the proposed disclosure would be similar to disclosure of management's discussion and analysis of financial condition and results of operations. See Item 303 of Regulation S-K, 17 CFR 229.303.

93 Blue Ribbon Report, supra note 31, at 40.

94 In a letter to the SECPS, ISB Chairman William Allen clarified the use of the auditor's judgment under the standard. He stated:

[I]n asking itself whether a fact or relationship is material in this setting the auditor may not rely on its professional judgment that such fact or relationship does not constitute an impairment of independence. Rather the auditor is to ask, in its informed good faith view, whether the members of the audit committee who represent reasonable investors, would regard the fact in question as bearing upon the board's judgment of auditor independence.

Letter from William T. Allen, Chairman, ISB, to Mr. Michael A. Conway, Chairman, Executive Committee, SECPS, dated Feb. 8, 1999. We believe that Chairman Allen's interpretation is appropriate.

95 ISB Standard No. 1, "Independence Discussions with Audit Committees" (Jan. 1999).

96 "Audit Committee Disclosure," Exchange Act Rel. No. 42266 (Dec. 22, 1999). Companies also should note the requirement to disclose interests and relationships with its auditors under Item 509 of Regulation S-K, 17 CFR 229.509, and Item 509 of Regulation S-B, 17 CFR 228.509.

97 ISB Standard No. 1, supra note 95.

98 Orders Approving Proposed Rule Changes by AMEX, NASD, and NYSE, supra note 18.

99 We have brought a number of enforcement cases in which we charged auditors with violations of the independence rules. See, e.g., In the Matter of Pricewaterhouse Coopers, LLP, AAER No. 1098 (Jan. 14, 1999); In the Matter of Moore Stephens, et al., AAER No. 1135 (May 19, 1999).

100 Rule 2-01 states:

(a) The Commission will not recognize any person as a certified public accountant who is not duly registered and in good standing as such under the laws of the place of his residence or principal office. The Commission will not recognize any person as a public accountant who is not in good standing and entitled to practice as such under the laws of the place of his residence or principal office.

(b) The Commission will not recognize any certified public accountant or public accountant as independent who is not in fact independent. For example, an accountant will be considered not independent with respect to any person or any of its parents, its subsidiaries, or other affiliates (1) in which, during the period of his professional engagement to examine the financial statements being reported on or at the date of his report, he, his firm, or a member of his firm had, or was committed to acquire, any direct financial interest or any material indirect financial interest; (2) with which, during the period of his professional engagement to examine the financial statements being reported on, at the date of his report or during the period covered by the financial statements, he, his firm, or a member of his firm was connected as a promoter, underwriter, voting trustee, director, officer, or employee. A firm's independence will not be deemed to be affected adversely where a former officer or employee of a particular person is employed by or becomes a partner, shareholder or other principal in the firm and such individual has completely disassociated himself from the person and its affiliates and does not participate in auditing financial statements of the person or its affiliates covering any period of his employment by the person. For the purposes of § 210.2-01(b), the term "member" means (i) all partners, shareholders, and other principals in the firm, (ii) any professional employee involved in providing any professional service to the person, its parents, subsidiaries, or other affiliates, and

(iii) any professional employee having managerial responsibilities and located in the engagement office or other office of the firm which participates in a significant portion of the audit.

(c) In determining whether an accountant may in fact be not independent with respect to a particular person, the Commission will give appropriate consideration to all relevant circumstances, including evidence bearing on all relationships between the accountant and that person or any affiliate thereof, and will not confine itself to the relationships existing in connection with the filing of reports with the Commission.

17 CFR 210.2-01.

101 Many of the interpretations are reprinted in Section 600 of the Codification. These interpretations include selected text from FRRs that explain the background, provide interpretive guidance for disclosure rules that promote auditor independence, and describe examples in which the staff and the Commission made a determination about a particular auditor's independence. Although the Commission updates the Codification to include the text from releases as rules are amended, the examples in the Codification have not been revised since 1983. See FRR No. 10, supra note 8. Since 1982, instead of waiting until there are a sufficient number of interpretations to warrant a Commission release that would amend the Codification, the Commission staff has placed its independence interpretive letters in a file where they are immediately available to the public. See FRR No. 33 (Oct. 17, 1988) and FRR No. 4 (Oct. 14, 1982).

102 FRR No. 50 (Feb. 18, 1998).

103 In FRR No. 50, however, we said that we were not abdicating our responsibilities in this area and that our existing authority regarding auditor independence was not affected. ISB standards and interpretations do not take precedence over our regulations or interpretations. As a result, if an ISB standard conflicts in any way with our rules or interpretations, the ISB standard or interpretation does not take effect unless or until we amend our existing regulation. See FRR 50, at 7 n.10.

104 See ASR No. 150 (Dec. 20, 1973) (recognizing establishment of the FASB); ASR No. 280 (Sept. 2, 1980) (commenting on FASB's role in establishing and improving accounting principles).

105 ISB Standard No. 2, "Certain Independence Implications of Audits of Mutual Funds and Related Entities," at 2 ¶ 5 (Dec. 1999).

106 See generally FRR No. 50, supra note 102 (regarding SEC's endorsement of ISB); ISB, "Discussion Memorandum 00-1: A Conceptual Framework for Auditor Independence," at 1 (Feb. 2000) (regarding the purposes of a conceptual framework).

107 Federal Trade Commission, Rules and Regulations Under the Securities Act of 1933, art. 14 (July 6, 1933).

108

Cf. Staff Report, supra note 23, at 12-16. See also SEC, Tenth Annual Report of the Securities and Exchange Commission, at 205-207 (1944), which states:

> [T]he Commission has found an accountant to be lacking in independence with respect to a particular registrant if the relationships which exist between the accountant and the client are such as to create a reasonable doubt as to whether the accountant will or can have an impartial and objective judgment on the questions confronting him.

109 See supra Section II.B.

110 See, e.g., Codification §§ 601.01 & 601.04.

111 See, e.g., Codification § 602.02.c.i.

112 See, e.g., Rule 2-01(b), 17 CFR 210.2-01(b); Codification § 602.02.d.

113 See, e.g., Arthur Young, supra note 19, at 819 n.15 (1984); Codification §§ 602.02.e.i and ii.

114 See AICPA Code of Professional Conduct, ET § 102.01 (regarding integrity and objectivity).

115 See illustrations in Appendix C, supra note 35.

116 A number of the specified situations are based on examples in the current Codification and the AICPA and SESPS membership rules.

117 We anticipate that the ISB and, when appropriate, our staff, will continue to implement and apply these principles to new and evolving transactions and events in the future.

118 See AICPA SAS No. 1, AU § 220.03; AICPA Code of Professional Conduct, ET § 101. Of course, accountants also have to comply with applicable state law on independence. Id.

119 AICPA SAS No. 1, AU § 220.03.

120 Cf. AUSA Life Ins. Co. v. Ernst & Young, 206 F.3d 202 (2d Cir. 2000) (noting "E&Y's failure lay in the seeming spinelessness" of the audit engagement partner and that "[p]art of the problem was undoubtedly the close personal relationship between" that partner and the company's chief executive officer, a former co-partner in the firm) (quoting 991 F. Supp. 234, 248 (S.D.N.Y. 1997) (district court opinion)).

121 AICPA Code of Professional Conduct, ET § 101.02 (as revised Feb. 28, 1998).

122 Proposed rule 2-01(f)(6) states that the engagement period ends when the registrant or accountant notifies the Commission that the registrant is no longer the accountant's audit client. This notice typically would occur when the registrant files with the Commission a Form 8-K with disclosures under Item 4 "Changes in Registrant's Certifying Accountant." In some cases, however, a Form 8-K would

not be required, such as when the registrant is a foreign private issuer or when the audited financial statements of a non-reporting company are filed upon its acquisition by a public company. Notification to the Commission in these cases would occur by the filing of the next audited financial statements of the foreign private issuer or the successor corporation. Registrants or auditors in these situations, however, may provide earlier notice to the Commission on Form 6-K or other appropriate means.

123 See infra Section III.I.10. for a complete discussion of the term "covered persons in the firm."

124 See infra Section III.I.11. for a complete discussion of the term "immediate family members."

125 Compare Codification § 602.02.b.ii (Example 1); cf. infra Section III.C.1.(a). (regarding indirect investments).

126 We recognize that this definition of affiliate is different from the current definition in Rule 1-02. We believe, however, that the revised definition is appropriate in the context of our proposals in this release.

127 Accounting Principles Board ("APB") Opinion No. 18, "The Equity Method of Accounting for Investments in Common Stock," at ¶ 17 (1971).

128 See infra Section III.I.9. for a complete discussion of the term "close family members."

129 "Group" is defined in proposed rule 2-01(f)(14) to mean when two or more persons act together for the purposes of acquiring, holding, voting, or disposing of securities of a registrant. This definition is based on Exchange Act Rule 13d-5(b)(1).

130 Schedules 13D and 13G, 17 CFR 240.13d-1. Schedules 13D and 13G are intended to alert the market to accumulations of a public company's securities that might indicate a potential change of control of the company.

131 Codification § 602.02.b.iii. We have used the term "material" in our proposed rules in the sense that it has been used in our current independence rules. See, e.g., ASR No. 79 (Apr. 8, 1958). This should not be confused with the meaning of the term "material" in other federal securities law contexts. See Staff Accounting Bulletin No. 99 (Aug. 13, 1999).

132 Paragraph (c)(1)(i)(D)(1) and (2) refer to "ownership" of an entity. Ownership interest is determined based on the form of organization. For example, for a corporation, ownership is based on ownership of a class of voting securities. For a partnership, ownership is based on ownership of a partnership interest or unit.

133 Also, an auditor would not be able to invest in an investment company if the investment company is an affiliate of the audit client. See proposed rule 2-01(c)(1)(i)(A).

134 Generally, a diversified management investment company is a company that with respect to 75% of its total assets may not invest

more than 5% of its total assets in a single issuer and may not own more than 10% of the outstanding securities of a single issuer. See Section 5(b)(1) of the ICA, 15 U.S.C. § 80a-5(b).

135 See infra Section III.I.12. for a discussion of the "investment company complex" definition.

136 See AICPA Code of Professional Conduct, ET §§ 101.02, 101.07 (Ethics Rulings 101-1-A-4, 101-5).

137 See proposed rule 2-01(c)(1)(ii)(E).

138 Section 3(c) of the ICA excludes from the ICA certain companies that otherwise would be investment companies. 15 U.S.C. § 80a-3(c). These companies include, among others, hedge funds and real estate pools.

139 ISB Standard No. 2, "Certain Independence Implications of Audits of Mutual Funds and Related Entities," at ¶ 3 (Dec. 1999).

140 See supra Section III.C.

141 See Letter from POB to ISB, dated Jan. 12, 2000 ("[p]ublic ownership in an audit firm or in its parent or in an entity that effectively has control of the audit firm would add another form of allegiance and accountability to those identified by the Supreme Court - a form of allegiance that in our opinion will be viewed as detracting from, if not conflicting with, the auditor's `public responsibility'").

142 See generally Codification § 602.02.h.

143 ISB, Invitation to Comment 99-1, supra note 37, at 9.

144 See generally AUSA Life Ins. Co. v. Ernst & Young, supra note 120.

145 See Auditing Standards Division, AICPA, "Audit Risk Alert - 1994, General Update on Economic, Accounting, and Auditing Matters," at 35 (1994).

A few litigation cases suggest auditors need to be more cautious in dealing with former coworkers employed by a client. None of these cases involved collusion or an intentional lack of objectivity. Nevertheless, if a close relationship previously existed between the auditor and a former colleague now employed by a client, the auditor must guard against being too trusting in his or her acceptance of representations about the entity's financial statements. Otherwise, the auditor may rely too heavily on the word of a former associate, overlooking that a common interest no longer exists.

146 See Paul M. Clikeman, "Close revolving door between auditors, clients," Accounting Today, at 20 (July 8-28, 1996). Cf. In the Matter of Richard A. Knight, AAER No. 764 (Feb. 27, 1996) (individual allegedly learned of accounting misstatements while he was engagement partner for firm conducting audit and resigned to become registrant's executive vice president and chief financial officer).

147 See, e.g., AUSA Life Ins. Co. v. Ernst & Young, supra note 120; AICPA Board of Directors, Meeting the Financial Reporting Needs of the Future: A Public Commitment From the Public Accounting Profession, at 4 (June 1993) ("AICPA Board Report"); see also Staff Report, supra note 23, at 51-52; In addressing an example of this problem, the court in Lincoln S&L v. Wall, 743 F. Supp. 901, 917 n.23 (D.D.C. 1990) wrote:

Atchison, who was in charge of the Arthur Young audit of Lincoln, left Arthur Young to assume a high paying position with Lincoln. This certainly raises questions about Arthur Young's independence. Here a person in charge of the Lincoln audit resigned from the accounting firm and immediately became an employee of Lincoln. This practice of "changing sides" should certainly be examined by the accounting profession's standard setting authorities as to the impact such a practice has on an accountant's independence. It would seem that some "cooling off period" perhaps, one to two years, would not be unreasonable before a senior official on an audit can be employed by the client.

148 In response to these and other concerns, the AICPA Board of Directors suggested in 1993 that we prohibit a public company from hiring the partner responsible for the audits of that company's financial statements for a minimum of one year after the partner ceases to serve that company. See AICPA Board Report, supra note 147, at 4. Our staff has indicated, however, that, if implemented, this suggestion would take the form of the firm's independence being impaired for one year from the date the individual left the audit engagement, rather than as a prohibition on hiring the former partner. Staff Report, supra note 23, at 52 n.146. See also Committee of Sponsoring Organizations of the Treadway Commission ("COSO"), "Fraudulent Financial Reporting: 1987-1997: An Analysis of U.S. Public Companies," at 21 (1999) (finding, with respect to companies where there was fraudulent financial reporting, that among 44 companies for which there was information available on their CFO's background, 11 percent of the companies' CFOs had previous experience with the companies' audit firms immediately prior to joining the company).

149 To avoid adverse tax consequences to the individual, accounting firms often settle their retirement obligations to former partners by fully funding a "rabbi trust" from which payments will be made to the individual. As defined by proposed rule 2-01(f)(18), a "rabbi trust" is an irrevocable trust whose assets are not available to the firm until all benefit obligations have been met but are subject to claims of the firm's creditors in bankruptcy or insolvency.

150 See Letter from Association for Investment Management and Research to Arthur Siegel, Executive Director, ISB, dated Feb. 29, 2000, at 4 ("AIMR Letter").

151 Of course, once an employee of an accounting firm, the person would also be subject to all other independence requirements applicable to other firm members. For example, if the former audit client employee becomes a covered person, he or she could have no financial interest in the audit client. See proposed rule 2-01(c)(1)(i)(A).

152 See Codification § 602.02.g. As under the current business relationship standard, the term "business relationships" does not encompass sales of professional services by the accounting firm to a company.

153 The definition of "consumer in the ordinary course of business" does not include situations in which an accountant sells, rather than purchases, the audit client's products or services.

154 See infra Section IX.

155 Consulting services differ fundamentally from the CPA's function of attesting to the assertions of other parties. In an attest service, the practitioner expresses a conclusion about the reliability of a written assertion that is the responsibility of another party, the asserter. In a consulting service, the practitioner develops the findings, conclusions, and recommendations presented. The nature and scope of work is determined solely by the agreement between the practitioner and the client. Generally, the work is performed only for the use and benefit of the client.

AICPA Professional Standards: Consulting Services - Definitions and Standards, CS § 100.02./TD>

156 See supra Section II.C; see also Appendix B.

157 See Appendix A.

158 Rule 2-01(c).

159 Codification § 602.02.c.i.

160 As noted in section 602.c.iii of the Codification, we determined not to raise questions of independence solely because a foreign office of, or a foreign firm associated with, a domestic accounting firm performs limited, routine, or ministerial bookkeeping services for a foreign division, subsidiary or investee of a domestic registrant which is a client of that firm. The Commission stated that a comparison of the fees for the bookkeeping services and the audit should provide a fair test for determining the significance of the work to the registrant and the accountant and, indirectly, the possible effect on the firm's independence. Accordingly, the Commission limited the fees for such services to the greater of $1,000 or one percent of the total audit fee for the registrant. The Commission continues to recognize the need for relief in this area and has therefore retained this section of the Codification.

161 This includes designing or implementing such a system for an affiliate of the audit of client, if the system is used to generate information that is significant to the audit client's financial statements taken as a whole.

162 Contribution-in-kind reports in certain foreign countries require the auditor to express an opinion on the fairness of a transaction, the value of a security, or the adequacy of consideration to shareholders.

163

The ISB has identified threats to the independence of firms that perform appraisal and valuation services for audit clients. See ISB, Discussion Memorandum 99-3, supra note 9, at 7-9 (Sept. 1999).

164 See generally Codification § 602.02.c.

165 See SECPS, Organizational Structure and Functions of the SECPS of the AICPA Division for CPA Firms, at § 1000.35 (June 1997) ("SECPS Manual").

166 See also Committee of Sponsoring Organizations of the Treadway Commission ("COSO"), Internal Control - Integrated Framework, at 7 (1992) (the "COSO Report").

167 AICPA SAS No. 55, AU § 319 (effective for audits on or after Jan. 1, 1990).

168 AICPA Code of Professional Conduct, ET § 101.15 (Omnibus Proposal of Professional Ethics Division Interpretations and Rulings (June 1996)).

169 COSO Report, supra note 166, discussed what constitutes an acceptable internal control system. Monitoring, according to the report, has two parts: ongoing monitoring activities and separate evaluations. The first is a management function, and the second is not.

"Ongoing monitoring" occurs in the course of operations, and includes regular management and supervisory activities. Id. at 3. Ongoing monitoring procedures are built into the normal recurring operations of an entity. Id. at 72. Separate evaluations, on the other hand, are not conducted on a continuing basis. The scope and frequency of separate evaluations depend primarily on management's assessments of the effectiveness of the ongoing monitoring procedures and the amount of information necessary for management to have reasonable assurance about the effectiveness of the internal control system. Id. at 3, 71.

The COSO Report defines certain tasks for management related to separate evaluations, including deciding on scope; analyzing control evaluation work by internal auditors; prioritizing high risk areas; considering the scope, time-frame, methodology, tools, input to be used, and means of reporting findings; reviewing findings; and ensuring follow-up actions are taken. Id. at 76.

170 Supra note 168. These examples include the performance of ongoing monitoring activities that affect the execution of transactions or ensure that transactions are properly executed, accounted for, or both; and the performance of routine activities in connection with the client's operating or production processes that are equivalent to those of an ongoing compliance or quality control function.

171 This proposal is consistent with SECPS Manual §1000.35, supra note 165.

172 Rule 2-01(b), 17 CFR 210.2-01(b); Codification § 602.02.e.iii. These regulations indicate that activities such as recommending securities, soliciting customers, and executing orders provide investors with

sufficient reason to question the auditor's ability to be impartial and objective.

173 Codification § 602.02.e.ii.

174 See, e.g., D.C. Rules of Professional Conduct, Rule 1.3(a).

175 Id. at cmts. 1, 5.

176 Id. at Rule 1.6.

177 Arthur Young, supra note 19, at 819-20 n.15.

178 In the Matter of Charles Falk, AAER No. 1134 (May 19, 1999) (formally disciplining an attorney/accountant who gave legal advice to an audit client of another partner in his accounting firm).

179 Letter from Harvey J. Goldschmid, Lynn E. Turner, and Richard H. Walker, SEC, to Philip S. Anderson, President, American Bar Association, dated July 12, 1999; Letter from Lynn E. Turner, Chief Accountant, SEC, to Sherwin P. Simmons, Chair, Commission on Multidisciplinary Practice, dated Jan. 22, 1999. Except with respect to the matter of auditor independence, we have not taken a position on the development of multidisciplinary practices.

180 American Bar Association Commission on Multidisciplinary Practice, Report to the House of Delegates, at 5 (July 2000) (footnote omitted). The report is available at www.ABAnet.org/cpr/mdpfinalrep2000.html.

181 See also ISB, "Discussion Memorandum 99-4: Legal Services" (Dec. 1999).

182 Existing auditor independence regulations recognize the problem posed by expert services. See Codification §§ 601.01 & 602.02.e. Moreover, in connection with its report on auditor independence, the GAO cited a congressional staff report issued in 1977 that "raised concerns involving situations where accountants testify before public bodies advocating positions that are favorable to their clients." GAO Report, supra note 45, at 47. That congressional study related to auditing firms' testimony before Congress on oil and gas pricing issues and stated, "Conflicts of interest occur when `Big Eight' firms influence governmental authorities on matters which affect their corporate clients." Subcomm. on Reports, Accounting and Management of the Senate Comm. on Government Operations, "The Accounting Establishment: A Staff Study," 95th Cong., 1st Sess., Doc. No. 95-34, at 67 (1977).

183 See supra note 38; The Panel on Audit Effectiveness ("O'Malley Panel"), Report and Recommendations: Exposure Draft, at ch. 5, p. 9 (May 31, 2000) ("O'Malley Report"). A copy of the O'Malley Report is available at www.pobauditpanel.org.

184 Id. at 10.

185 AICPA SAS No. 22, AU § 311.04b and AUI § 9311.03.

186 AICPA Code of Professional Conduct, ET § 302.01.

187 Under our current Codification, however, a contingent fee might constitute a financial interest in an audit client. For example, Codification § 602.02.b.v. states in part:

> If fees for audit and other professional services are owed to an accountant for an extended period of time and become material in relation to the fee expected to be charged for a current audit, there may be a question concerning the accountant's independence with regard to the current audit because the accountant may appear to have a direct interest in the results of operations of the client. Generally, prior year audit and other unpaid fees should be paid before a current audit engagement is commenced in order for the accountant to be deemed independent with respect to the current audit. (Emphasis added.)

188 The staff has become aware of an increasing number of situations where firms are sharing with their consulting clients the risk that the firm's advice will add value to the project or transaction. In such situations, the firms are paid through contingent fees or similar arrangements, or payments to the firm may be deferred until contemplated transactions occur or benefits from the project begin to be realized. If the consulting client is also an audit client, however, these payment mechanisms would be considered to be contingent fees and impair the firm's audit independence.

189 The exception does not apply to situations where the covered person was aware of the circumstances but did not know that the circumstances impaired the covered person's independence.

190 Under the proposed rule, these procedures apply to those firms that have as clients 500 or more companies that have a class of securities registered with us under Section 12 of the Exchange Act, 15 U.S.C. § 78l.

191 See Letters from Lynn Turner to Michael Conway, supra note 70. The SECPS adopted independence quality control membership requirements in April 2000.

192 The quality control policies and procedures would consist of policies and procedures for the accounting firm. Proposed rule 2-01(d)(3)(i). Under the proposed rules, the term accounting firm includes affiliates of the firm. Proposed rule 2-01(f)(2). The definition of affiliate of the accounting firm would include, among other things, all persons and entities with which the firm is publicly associated by co-branding or using the firm's name, initials, or logo. Proposed rule 2-01(f)(4)(E). One effect of this provision, therefore, is that the term accounting firm would include all of the firm's affiliates worldwide. We expect that the written policies and procedures, therefore, would apply to the firm and its affiliates worldwide. See Letters from Lynn Turner to Michael Conway, supra note 70.

193 The O'Malley Panel has recommended that audit committees pre-approve non-audit services that exceed a threshold determined by the committee. This recommendation is consistent with the recommendations of the Blue Ribbon Committee regarding auditors' services. The Panel set forth factors for audit committees to consider

in determining the appropriateness of a service. See O'Malley Report, supra note 183, at ch. 5, pp. 7-8.

194 Earnscliffe Report, supra note 10, at 33.

195 Michael Firth, "The Provision of Nonaudit Services by Accounting Firms to their Audit Clients," Contemporary Accounting Research, at 6 (Summer 1997). Firth hypothesized that companies with potentially high agency costs (i.e., companies in which directors do not control management or which have a large amount of debt) would limit the non-audit services provided by their auditors because the appearance of a lack of auditor independence would increase their cost of capital. Firth's findings were consistent with his hypothesis.

196 The ISB cites threats to independence arising from these structures and identifies quality controls to ensure the independence of the auditors in these situations. See ISB, "Discussion Memorandum 99-2: Evolving Forms of Firm Structure and Organization," at 20 (Oct. 1999).

197 AICPA SAS No. 1, AU § 543 also sets forth guidance on when a principal auditor discloses and makes reference to another auditor who performs an audit of a component of the entity.

198 As noted above, the definitions used in the rest of Regulation S-X, including the definition of "affiliate," would not apply to proposed Rule 2-01.

199 15 U.S.C. § 80a-2(a)(3).

200 17 CFR 210.1-02(b).

201 There is also an exception from the definition of "affiliate of the accounting firm" for certain persons or entities with which the accounting firm shares services, such as training or billing facilities. Proposed rule 2-01(f)(4)(ii).

202 See generally, Letter from Jonathan G. Katz to Duane R. Kullberg, supra note 40, at 4.

203 APB Opinion No. 18, "The Equity Method of Accounting for Investments in Common Stock" (Mar. 1971).

204 Id. ¶ 17.

205 AICPA Code of Professional Conduct, ET § 101.02.

206 Arthur Young, supra note 19, at 818.

207 AICPA SAS No. 22, supra note 185.

208 See "Selective Disclosure and Insider Trading," Securities Act Rel. No. 7787 (Dec. 20, 1999). As discussed in footnote 109 of that release, an individual working at an accounting firm may be liable for insider trading for misappropriating information about a client, even if he or she did not perform services for that client.

209 ISB Standard No. 2, supra note 139.

210 The Codification in its entirety remains in effect until any final rule is adopted.

211 See supra Section II.

212 AICPA SAS No. 25, AU § 161, n. 1.

213 AICPA Professional Standards: SQCS, QC § 20.09.

214 Letter from Michael A. Conway, Chairman, Executive Committee, SECPS, to the Managing Partners of SECPS Member Firms, dated April 2000 (available at www.aicpa.org).

215 The specified criteria for a quality control system only apply to the largest accounting firms. For other firms, the proposal states that a firm's quality control system should take into account the size and nature of the firm's practice. Again, this is in general conformity with GAAS, which states, "The nature and extent of a firm's quality control policies and procedures depend on factors such as its size, the degree of operating autonomy allowed its personnel and its practice offices, the nature of its practice, its organization, and appropriate cost-benefit considerations." AICPA SAS 25, AU § 161.02.

216 Other public accounting firms would have the flexibility to adopt a system to comply with the proposed requirement in light of the nature and size of their practice.

217 AICPA SQCS, QC § 20; AICPA SAS No. 25, AU § 161.

218 Some firms are already developing or improving quality control systems. At least one Big 5 accounting firm has begun the process of installing a computerized tracking system that monitors employee investments. See Elizabeth MacDonald, "Top Accounting Industry Group Sets Conflict-of-Interest Compliance Rules," Wall St. J., Feb. 2, 2000, at B2.

219 See supra Section II.C.

220 See supra Section III.D.1.

221 This would also benefit the issuers that contract for these non-audit services.

222 As noted above, some of this work may be re-distributed to consulting firms that do not engage in public accounting.

223 Of course, these firms and other firms that do not currently earn any such revenues would be precluded from earning such revenues in the future from the covered non-audit services.

224 Public accounting firms that are separating their consulting practices would be affected if they subsequently determined to re-acquire or recreate consulting practices that included these listed services.

225 Of course, as noted above, some of the non-audit services now provided by auditors may be redistributed to consulting firms that are not engaged in public accounting.

226

Two studies in the 1980s documented that audit fees were generally greater, after controlling for other factors, for clients that also purchased nonaudit services from the same public accounting firm. See Zoe-Vonna Palmrose, "The effect of nonaudit services on the pricing of audit services," Journal of Accounting Research, at 405-11 (Autumn 1986); Dan A. Simunic, "Auditing, consulting, and auditor independence," Journal of Accounting Research, at 679-702 (Autumn 1984). The authors of these studies nonetheless concluded that this evidence was consistent with the hypothesis that the joint provision of audit and nonaudit services may give rise to "knowledge spillovers" (i.e. enhanced efficiency or effectiveness). More recent research documents that these higher fees are associated with increased audit effort (in labor hours). See Larry R. Davis, David N. Ricchiute, and Greg Trompeter, "Audit Effort, Audit Fees, and the Provision of Nonaudit Services to Audit Clients," Accounting Review, at 135-50 (Jan. 1993). The results of the Davis et al. study therefore cast doubt on the knowledge spillover hypothesis.

227 This argument also assumes that accounting firms will not be engaged in both audit and nonaudit work. Our proposals, of course, do not prevent accounting firms from continuing to provide any nonaudit services to companies other than their audit clients.

228 See supra Section II.C.

229 ISB Standard No. 1, supra note 95. In addition, SAS No. 61 provides additional guidance on topics that an auditor should discuss with the audit committee (or board of directors if there is no such committee) of each registrant. AICPA SAS No. 61, AU § 380.

230 SECPS Manual, supra note 165, at § 1000.08(i).

231 Approximately 9,892 respondents file proxy statements under Schedule 14A and approximately 253 respondents file information statements under Schedule 14C. We based the number of entities that would complete and file each of the forms on the actual number of filers during the 1998 fiscal year.

232 These assumptions are based on the staff's experience with these filings. We believe that a company's internal staff will typically carry most of the burden of preparing the proposed additional disclosures, and will consult with outside professionals only on specific issues that the company may periodically encounter in preparing the proxy statement or information statement.

233 5 U.S.C. § 603.

234 For the purposes of this analysis, the Commission has defined "small business" in Securities Act Rule 157 as any entity whose total assets on the last day of its most recent fiscal year were $5 million or less and is engaged, or proposes to engage, in small business financing. 17 CFR 230.157. A registrant is considered to be engaged, or to propose to engage, in small business financing under this rule if it is conducting, or proposes to conduct, an offering of securities which does not exceed the dollar limitation prescribed by Section 3(b) of the Securities Act. 15 U.S.C. § 77c(b). The Commission also has defined small business in Rule 0-10 of the Investment Company Act

as an investment company that has assets of $50 million or less as of the end of its most recent fiscal year. 17 CFR 270.0-10.

235 13 CFR 121.201.

236 "Special Supplement: Annual Survey of National Accounting Firms - 2000," Public Accounting Report (March 31, 2000); Annual Reports to SECPS, Annual reports filed with AICPA Division for CPA firms; SECPS Reports, Reports prepared by the AICPA Division for CPA firms.

237 AICPA SAS No. 25, AU § 161 n.1.

238 15 U.S.C. § 78n(a).

239 15 U.S.C § 78n(c).

240 15 U.S.C. § 78l(g).

241 15 U.S.C. § 78l(b).

242 Pub. L. No. 104-121, tit. II, 110 Stat. 857 (1996).

243 15 U.S.C. § 78w(aa)(2).

244 See supra Section V. for a discussion of this issue.

245 15 U.S.C. § 78c(f).

http://www.sec.gov/rules/proposed/34-42994.htm

Home | Previous Page

Modified:07/17/2000

Home | Previous Page

U.S. Securities and Exchange Commission

Webmaster Note: Correction to Final Regulations is now available.

SECURITIES AND EXCHANGE COMMISSION

17 CFR PARTS 210, 240, 249 and 274

[RELEASE NO. 33-8183; 34-47265; 35-27642; IC-25915; IA-2103, FR-68, File No. S7-49-02]

RIN 3235-AI73

Strengthening the Commission's Requirements Regarding Auditor Independence

Agency: Securities and Exchange Commission

Action: Final rule

Summary: The Securities and Exchange Commission ("SEC" or "Commission") is adopting amendments to its existing requirements regarding auditor independence to enhance the independence of accountants that audit and review financial statements and prepare attestation reports filed with the Commission. The final rules recognize the critical role played by audit committees in the financial reporting process and the unique position of audit committees in assuring auditor independence. Consistent with the direction of Section 208(a) of the Sarbanes-Oxley Act of 2002, we are adopting rules to: revise the Commission's regulations related to the non-audit services that, if provided to an audit client, would impair an accounting firm's independence; require that an issuer's audit committee pre-approve all audit and non-audit services provided to the issuer by the auditor of an issuer's financial statements; prohibit certain partners on the audit engagement team from providing audit services to the issuer for more than five or seven consecutive years, depending on the partner's involvement in the audit, except that certain small accounting firms may be exempted from this requirement; prohibit an accounting firm from auditing an issuer's financial statements if certain members of management of that issuer had been members of the accounting firm's audit engagement team within the one-year period preceding the commencement of audit procedures; require that the auditor of an issuer's financial statements report certain matters to the issuer's audit committee, including "critical" accounting policies used by the issuer; and require disclosures to investors of information related to audit and non-audit services provided by, and fees paid to, the auditor of the issuer's financial statements. In addition, under the final rules, an accountant would not be independent from an audit client if an audit partner received compensation based on selling engagements to that client for services other than audit, review and attest services.

As described further in the release, these rules also will have an impact on foreign accounting firms that conduct audits of foreign subsidiaries and affiliates of U.S. issuers, as well as of foreign private issuers. Many of the modifications to the proposed rules, such as those limiting the scope of partner rotation and personnel subject to the "cooling off period," have the added benefit of addressing particular concerns raised about the international implications of these requirements. Moreover, additional time is being afforded to foreign accounting firms with respect to compliance with rotation requirements. The release also provides guidance on the provision of non-audit services by foreign accounting firms, including the treatment of legal services and tax services.

Dates: *Effective Date:* May 6, 2003. *Transition Dates:* Provided the following relationships did not impair the accountant's independence under pre-existing requirements of the Commission, the Independence Standards Board, or the accounting profession in the United States, an accountant's independence will not be deemed to be impaired:

(1) By employment relationships described in § 210.2-01(c)(2)(iii)(B) that commenced at the issuer prior to May 6, 2003;

(2) By compensation earned or received, as described in § 210.2-01(c)(8), during the accounting firm's fiscal year that includes May 6, 2003;

(3) Until May 6, 2004 by the provision of services described in § 210.2-01(c)(4) *provided* those services are pursuant to contracts in existence on May 6, 2003

(4) Until May 6, 2003 by the provision of services that have not been pre-approved by an audit committee as required in § 210.2-01(c)(7);

(5) An accountant's independence will not be deemed to be impaired until the first day of the issuer's fiscal year beginning after May 6, 2003 by a "lead" partner and other audit partner (other than the "concurring" partner) providing services in excess of those permitted under §210.2-01(c)(6); and

(6) An accountant's independence will not be deemed to be impaired until the first day of the issuer's fiscal year beginning after May 6, 2004 by a "concurring" partner providing services in excess of those permitted under §210.2-01(c)(6).

For the purposes of calculating periods of service under § 210.2-01(c)(6):

(1) For the "lead" and "concurring" partner, the period of service includes time previously served as the "lead" or "concurring" partner prior to May 6, 2003; and

(2) For audit partners other than the "lead" partner or "concurring" partner, and for audit partners in foreign firms, the period of service does not include time served on the audit engagement team prior to the first day of issuer's fiscal year beginning on or after May 6, 2003.

For Further Information Contact: Samuel L. Burke, Associate Chief Accountant, Paul Munter, Academic Fellow, or Robert E. Burns, Chief Counsel, at (202) 942-4400, Office of the Chief Accountant, or, with respect to questions about investment companies, Brian D. Bullard, Chief Accountant, at (202) 942-0590, Division of Investment Management, U.S. Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549.

Supplementary Information: We are adding Rule 2-07 to Regulation S-X,[1] amending Rule 2-01 of Regulation S-X,[2] amending Item 9 of Regulation S-K,[3] amending Forms 10-K, 10-KSB, 20-F and 40-F,[4] amending Form N-CSR[5] and adding new Exchange Act Rule 10A-2.[6]

I. Introduction and Background

On July 30, 2002, the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley Act" or "the Act") was enacted.[7] Title II of the Sarbanes-Oxley Act, entitled "Auditor Independence," requires the Commission to adopt, by January 26, 2003, final rules under which certain non-audit services will be prohibited, conflict of interest standards will be strengthened, auditor partner rotation and second partner review requirements will be strengthened, and the relationship between the independent auditor and the audit committee will be clarified and enhanced.

We are adopting amendments to our current rules regarding auditor independence.[8] The final rules advance our important policy goal of protecting the millions of people who invest in our securities markets in reliance on financial statements that are prepared by public companies and other issuers and that, as required by Congress, are audited by independent auditors. We believe the final rules strike a reasonable balance among commenters' differing views about the proposals while achieving our important public policy goals.[9]

As directed by the Sarbanes-Oxley Act, the rules focus on key aspects of auditor independence: the provision of certain non-audit services, the unique ability and responsibility of the audit committee to insulate the auditor from the pressures that may be exerted by management, the potential conflict of interest that can be created when a former member of the audit engagement team accepts a key management position with the audit client, and the need for effective communications between the auditor and audit committee. In addition, under the final rules, an accountant would not be independent from an audit client if any audit partner received compensation based directly on selling engagements to that client for services other than audit, review and attest services.

Title II of the Sarbanes-Oxley Act adds new subsections (g) through (l) to Section 10A of the Securities Exchange Act of 1934 as follows:

- Section 201 adds sub-section (g), which specifies that a number of non-audit services are prohibited. Many of these services were previously prohibited by the Commission's independence standards adopted in November 2000 (with some exceptions and qualifications).[10] The rules we are adopting amend the Commission's existing rules on auditor independence and clarify the meaning and scope of the prohibited services under the Sarbanes-Oxley Act.

- Section 201 also adds sub-section (h), which requires that non-audit services that are not prohibited under the Sarbanes-Oxley Act and the Commission's rules be subject to pre-approval by the registrant's audit committee. These rules specify the requirements for obtaining such pre-approval from the registrant's audit committee.

- Section 202 adds sub-section (i), which requires an audit committee to pre-approve allowable non-audit services and specifies certain exceptions to the requirement to obtain pre-approval. These rules specify the requirements of the registrant's audit committee for pre-approving non-audit services by the auditor of the registrant's financial statements.

- Section 203 adds sub-section (j), which establishes mandatory rotation of the lead partner and the concurring partner every five years. These rules expand the number of engagement personnel covered by the rotation requirement and clarify the "time out" period.

- Section 204 adds sub-section (k), which requires that the auditor report on a timely basis certain information to the audit committee. In particular, the Sarbanes-Oxley Act requires that the auditor report to the audit committee on a timely basis (a) all critical accounting policies used by the registrant, (b) alternative accounting treatments that have been discussed with management along with the potential ramifications of using those alternatives, and (c) other written communications provided by the auditor to management, including a schedule of unadjusted audit differences.[11] These rules strengthen the relationship between the audit committee and the auditor.

- Section 206 adds sub-section (l) addressing certain conflict of interest provisions. The Sarbanes-Oxley Act prohibits an accounting firm from performing audit services for a registrant if certain key members of management have recently been employed in an audit capacity by the audit firm. These rules clarify which members of management are covered by these conflict of interest rules.

In addition, under the final rules, an accountant would not be independent of an audit client if an audit partner received compensation based on selling engagements to that client for services other than audit, review and attest services.

As noted above, the rules establish and clarify the important roles and responsibilities of registrant audit committees as well as the registrant's independent accountant.[12]

We have adopted a separate rule under Exchange Act Section 10A (17 CFR 240.10A-2) to implement Section 3(b)(1) of the Sarbanes-Oxley Act and clarify that our rules implementing Title II of Sarbanes-Oxley not only define conduct that impairs independence but also constitute separate violations under the Exchange Act. We have otherwise adopted rules (except for the proxy disclosure changes) as part of Regulation S-X, and placed them among the current auditor independence provisions.

II. Discussion of Rules

A. Conflicts of Interest Resulting from Employment Relationships

The Commission's previous rules deem an accounting firm to be not independent with respect to an audit client if a former partner, principal, shareholder, or professional employee of an accounting firm[13] accepts employment with a client if he or she has a continuing financial interest in the accounting firm or is in a position to influence the firm's operations or financial policies. These rules renumber, but do not otherwise change, that existing requirement.

Consistent with Section 206 of the Sarbanes-Oxley Act, we are adding a restriction on employment with audit clients by former employees of the accounting firm. The Act specifies that an accounting firm cannot perform an audit for a registrant:

> [i]f a chief executive officer, controller, chief financial officer, chief accounting officer, or any person serving in an equivalent position for the issuer, was employed by that registered independent public accounting firm and *participated in any capacity in the audit* of that issuer during the 1-year period preceding the date of the initiation of the audit.[14]
>
> (emphasis added)

Thus, the Act requires a "cooling off" period of one year before a member of the audit engagement team can begin working for the registrant in certain key positions. Based on the provisions of the Act, we proposed that the employment of former audit engagement team[15] members of an accounting firm in a financial reporting oversight role[16] at an audit client would cause the accounting firm not to be independent with respect to that registrant if they were members of the audit engagement team within one year prior to the commencement of procedures for the current audit engagement. The rules that we proposed would have applied to employment relationships entered into between "audit engagement team" members and their "audit clients."[17]

The concept of a "cooling-off" period before an auditor can take a position at the audit client was previously considered by the Independence Standards Board.[18] In considering a cooling-off period, the Independence Standards Board noted that a mandated cooling-off period for partners and professional staff might create a greater appearance of independence between the accounting firm and the registrant.[19] Ultimately, however, the Independence Standards Board provided for an alternative to a cooling-off period. The Independence Standards Board concluded that:

> An audit firm's independence is impaired with respect to an audit client that employs a former firm professional who could, by reason of his or her knowledge of and relationships with the audit firm, adversely influence the quality or effectiveness of the audit, unless the firm has taken steps that effectively eliminate such risk.[20]

Independence Standards Board's Standard No. 3 specifically notes that additional caution is warranted when it has been less than one year since the professional disassociated him or herself from the firm.[21] The provisions of the Sarbanes-Oxley Act reflect the view that the passage of time is an additional safeguard to reduce the perceived loss of independence for the audit firm caused by the acceptance of employment by a member of the engagement team with an audit client.

Some commenters[22] stated that the rule should apply only to partners on the audit engagement team. However, we believe that the Act is clear that the cooling off period should apply more broadly. Additionally, our proposal would have applied to relationships between members of the audit engagement team and the audit client. Some commenters[23] believe that extending the requirement to the audit client was too broad. In some situations (such as certain affiliate companies), it could be difficult for the accounting firm and its audit clients to monitor and, in some cases, control the employment relationship.

Our proposed rule did not make a distinction based on the number of hours of audit, review, or attest services provided in determining who would be subject to this rule. The Act refers to individuals who "participated in any capacity in the audit." Commenters[24] noted that not all members of the audit engagement team, as that term is currently defined, necessarily participate in a meaningful audit capacity.

As discussed both in our proposing release and in this release, the term "financial reporting oversight role" refers to any individual who has direct responsibility for oversight over those who prepare the registrant's financial statements and related information (e.g., management's discussion and analysis) that are included in filings with the Commission. Some commenters[25] stated that the final rule only should apply to the four named positions in the Act (e.g., chief executive officer, controller, chief financial officer, chief accounting officer). Other commenters,[26] however, agreed with the Commission's approach of using the concept of financial reporting oversight role.

In response to the issues raised by commenters,[27] we are requiring that when the lead partner, the concurring partner, or any other member of the audit engagement team[28] who provides more than ten hours of audit, review or attest services for the issuer accepts a position with the issuer in a financial reporting oversight role within the one year period preceding the commencement of audit procedures for the year that included employment by the issuer of the former member of the audit engagement team, the accounting firm is not independent with respect to that registrant. Our rule applies to all members of the audit engagement team unless specifically exempted, as discussed later in this section of the release.

We agree with the commenters[29] who noted that extending the requirement to the "audit client" might be difficult to monitor because of the potentially broad scope of that defined term--particularly in situations where a member of the audit engagement team begins employment with an affiliate of the audit client.[30] Accordingly, the rules that we are adopting apply to employment relationships entered into between members of the audit engagement team and the "issuer."[31]

The Commission recognizes that, in certain instances, there are individuals who meet the definition of engagement team members while spending a relatively small amount of time on audit-related matters of the issuer. For example, a staff member may be asked to spend one day of time to observe inventory. While the input may have been important to resolving specific aspects of the audit, the staff member likely has not had significant interaction with the audit engagement team or management of the issuer. However, it is likely that those who spent more than a de minimis amount of time on the engagement team did participate in a meaningful audit capacity. Because of their roles in the engagement, the lead and concurring partner always should participate in a meaningful audit capacity, regardless of the number of hours spent on the engagement.

In order to provide useful guidance, our rule on conflicts of interest resulting from employment relationships specifies that, other than the lead and concurring partner, an individual[32] must provide more than ten hours of service during the annual audit period[33] as a member of the engagement team to have participated in an audit capacity. The Commission previously has considered a threshold based on the number of hours of service and, based on our experience, concluded that use of ten hours of service to the client constitutes a reasonable basis for distinguishing whether there has been participation on the audit.[34]

The Commission has determined that using the "financial reporting oversight role" is a better test for the scope of the provision than the four particular officers named in the Act. As discussed in the definitions section of this release, the term financial reporting oversight role is not a new concept. Furthermore, in addition to naming four specific positions, the Act also states that the cooling off period applies to "any person serving in an equivalent position for the issuer." Because issuers do not use uniform titles nor do all named positions (*e.g* ., controller) have uniform duties among all issuers, we believe that a more complete definition of the applicable positions is needed. Furthermore, the term financial reporting oversight role captures other key positions, such as members of the board of directors, who may have significant interaction with the audit engagement team.

While the rule is intended to apply broadly to members of the audit engagement team, we recognize the need to provide accommodations for certain unique situations. In addition to the exemption discussed previously for those who provided ten or fewer hours of audit, review, or attest services, the final rule provides an exception for conflicts that are created through merger or acquisition. Some commenters[35] noted that an individual may have complied fully with the rule and, subsequent to his or her beginning employment with an issuer, the issuer merged with or was acquired by another entity resulting in he or she becoming a person in a financial reporting oversight role of the combined entity and the combined entity being audited by the individual's previous employer. In such a situation, unless the employment was taken in contemplation of the combination, the individual or the issuer could not be expected to know that his or her employment decision would result in a conflict. Thus, as long as the audit committee is aware of this conflict, the audit firm would continue to be independent under these rules.

Further, we recognize that other unusual situations that may arise. For example, some commenters[36] have stated that in certain foreign jurisdiction it may be extremely difficult or costly to comply with these requirements. Accordingly, we have provided an additional exemption for emergency or unusual circumstances which we anticipate being invoked very rarely. However, in order for a company to avail itself of this exemption, the audit committee[37] must determine that doing so is in the best interests of investors.

Some commenters[38] stated that determining the time period of the prohibition would be difficult to apply as proposed. We recognize the difficulties when there is, potentially, a different applicable date for each member of the engagement team. For that reason, our final rule adopts a uniform date for all members of the engagement team.

For purposes of this rule, audit procedures are deemed to have commenced for the current audit engagement period the day after the prior year's periodic annual report (*e.g* ., Form 10-K, 10-KSB, 20-F or 40-F) is filed with the Commission. The audit engagement period for the current year is deemed to conclude the day the current year's periodic annual report (for example, Form 10-K, 10-KSB, 20-F or 40-F) is filed with the Commission.

To illustrate the application of this rule, assume that Issuer A's Forms 10-K are filed on March 15, 2003, April 5, 2004, March 10, 2005, and March 30, 2006. Issuer A is a calendar-year reporting entity. The audit engagement periods would be deemed to commence and end:

Annual Period	Engagement Period Commences	Engagement Period Ends
2003	March 16, 2003	April 5, 2004
2004	April 6, 2004	March 10, 2005
2005	March 11, 2005	March 30, 2006

If audit engagement person B provided audit, review or attest services for Issuer A *at any time* during the 2003 engagement period (March 16, 2003 - April 5, 2004), and he or she begins employment with Issuer A in a financial reporting oversight role prior to March 11, 2005, the accounting firm would be deemed to be not independent with respect to Issuer A. For example, if person B last performed audit, review or attest services for Issue A on March 24, 2003 and he or she began employment with Issuer A in a financial reporting oversight role prior to March 11, 2005, the accounting firm would be deemed to be not independent with respect to Issuer A. Likewise, if person B provided audit, review or attest services for Issuer A at any time during the 2004 engagement period (April 6, 2004 - March 10, 2005) and he or she began employment with Issuer A in a financial reporting oversight role prior to March 31, 2006, the accounting firm would be deemed to be not independent with respect to Issuer A.

The Act specifies that the cooling off period must be one year. Under our rules, the prohibition would require that the accounting firm has completed one annual audit[39] subsequent to when an individual was a member of the audit engagement team. As previously discussed, the measurement period is based upon the dates the issuer filed its annual financial information with the Commission.

With respect to investment companies, we proposed that the employment of a former audit engagement team member in a financial reporting oversight role at any entity in the same investment company complex during the one year period after the completion of the last audit would impair the independence of the accounting firm with respect to the audit client. The proposed rule was designed to prevent a former audit engagement team member from taking a position in an investment company complex where they could influence the preparation of the financial statements or the conduct of the audit.

Several commenters[40] suggested this requirement was too broad and could have unintended consequences, such as preventing a former audit engagement team member on an investment company audit engagement from taking a financial reporting position at an entity in the investment company complex whose operations are unrelated to the investment company. Some commenters[41] acknowledged, however, that it was in investors' interests to prevent audit engagement team members from leaving the firm and assuming a financial reporting oversight role at an entity in the investment company complex that had responsibility for the financial reporting or operations of the investment company audit client. One commenter[42] suggested the rule should not apply to positions at service providers solely because they are in the investment company complex.

Due to the unique structure of investment companies, where the normal operating activities, including activities related to the preparation of financial statements, are provided by outside service providers, we believe the rules need to extend beyond the investment company itself. After considering the comments, we agree, however, that the reach of the rule as proposed was too broad and have determined to tailor the scope of the rule with respect to investment companies to those situations where independence could be impaired. As adopted, an accounting firm would not be independent if a former audit engagement team member is employed in a financial reporting oversight role with not only the registered investment company, but also with any entity in the same investment company complex that is responsible for the financial reporting or operations of the registered investment company or any other registered investment company in the same investment company complex. The adopted rule prohibits employment in positions at an investment company complex that would allow a former audit engagement team member to bring undue influence over the audit process of an investment company. The rule recognizes that certain positions exist at an entity in the investment company complex that would be considered financial reporting or oversight positions but those positions have no direct influence in the financial reporting or operations of an investment company in the investment company complex. In these instances, we believe tailoring the focus of this rule will not harm investor interests.

We recognize the need to provide for orderly transition. We believe it would be unfair to expect those who began employment before the effective date of these rules to be asked to sever those employment relationships. Accordingly, these rules are effective for employment relationships with the issuer that commence after the effective date of these rules.

B. Scope of Services Provided by Auditors

Section 201(a) of the Sarbanes-Oxley Act adds new Section 10A(g) to the Securities Exchange Act of 1934. Except as discussed below, this section states that it shall be unlawful for a registered public accounting firm that performs an audit of an issuer's financial statements (and any person associated with such a firm) to provide to that issuer, contemporaneously with the audit, any non-audit services, including the nine categories of services set forth in the Act. Additionally, the Act provides that the provision of "any non-audit service, including tax services, that is not described" as a prohibited service, can be provided by the auditor without impairing the auditor's independence "only if" the service has been pre-approved by the issuer's audit committee. The nine categories of prohibited non-audit services included in the Act are:

- Bookkeeping or other services related to the accounting records or financial statements of the audit client;

- Financial information systems design and implementation;
- Appraisal or valuation services, fairness opinions, or contribution-in-kind reports;
- Actuarial services;
- Internal audit outsourcing services;
- Management functions or human resources;
- Broker or dealer, investment adviser, or investment banking services;
- Legal services and expert services unrelated to the audit; and
- Any other service that the Board[43] determines, by regulation, is impermissible.

The Commission's principles of independence with respect to services provided by auditors are largely predicated on three basic principles, violations of which would impair the auditor's independence: (1) an auditor cannot function in the role of management, (2) an auditor cannot audit his or her own work, and (3) an auditor cannot serve in an advocacy role for his or her client.[44]

Some commenters[45] stated that the Commission should prohibit the audit firm from performing most, if not all, non-audit services. Others commenters[46] supported a less strict approach. Consistent with our proposing release,[47] we are adopting rules related to the scope of services that independent accountants can provide to their audit clients. In adopting these rules, the Commission is clarifying the scope of the prohibited services. The prohibited services contained in these rules only apply to non-audit services provided by independent accountants to their audit clients. These rules do not limit the scope of non-audit services provided by an accounting firm to a non-audit client. Under the Act, the responsibility falls on the audit committee to pre-approve all audit and non-audit services provided by the accountant.

Recognizing that audit clients may need a period of time to exit existing contracts our rules provide that until [insert date 12 months after the effective date of these amendments to § 210.2-01] the provision of services described in § 210.2-01(c)(4) will not impair an accountant's independence *provided* those services are pursuant to contracts in existence on [insert 90 days after publication in the Federal Register].[48]

1. Bookkeeping or Other Services Related Accounting Records or Financial Statements of the Audit Client

Previously, an auditor's independence was impaired if the auditor provided bookkeeping services to an audit client, except in limited situations, such as in an emergency or where the services are provided in a foreign jurisdiction and certain conditions were met. The current Rule 2-01(c)(4)(i) continues the prohibition on bookkeeping, but we have eliminated the limited situations where bookkeeping services could have been provided under the previous rules.

Some commenters[49] suggested that bookkeeping services should be permitted, especially under the previous exceptions. However, our independence rules are predicated on the three basic principles enumerated earlier. One of those principles is that an auditor cannot audit his or her own work and maintain his or her independence. When an accounting firm provides bookkeeping services for an audit client, the firm may be put in the position of later auditing the accounting firm's own work. If, during an audit, an accountant must audit the bookkeeping work performed by his or her accounting firm, it is questionable that the accountant could, or that a reasonable investor would believe that the accountant could, remain objective and impartial. If the accountant found an error in the bookkeeping, the accountant could well be under pressure not to raise the issue with the client if raising the issue could jeopardize the firm's contract with the client for bookkeeping services or result in heightened litigation risk for the firm. In addition, keeping the books is a management function, which also is prohibited.[50]

Accordingly, we are adopting rules stating that all bookkeeping services would cause the auditor to lack independence unless it is reasonable to conclude that the results will not be subject to audit procedures. We proposed to prohibit bookkeeping services unless it was "reasonably likely that such services would not be subject to audit procedures." Our final rules make clear the presumption to emphasize the responsibility the accounting firm has in making a determination that the bookkeeping services will not be subject to audit procedures.

The rules utilize the previous definition of bookkeeping or other services, which focuses on the provision of services involving: (1) maintaining or preparing the audit client's accounting records, (2) preparing financial statements that are filed with the Commission or the information that forms the basis of financial statements filed with the Commission, or (3) preparing or originating source data underlying the audit client's financial statements. Our experience with this definition demonstrates that the concept of bookkeeping and other services is well understood in practice.

We understand that accountants sometimes are asked to prepare statutory financial statements for foreign companies, and these are not filed with us. Consistent with the Commission's previous rules, an accountant's independence would be impaired where the accountant prepared the statutory financial statements if those statements form the basis of the financial statements that are filed with us. Under these circumstances, an accountant or accounting firm who has prepared the statutory financial statements of an audit client is put in the position of auditing its own work when auditing the resultant U.S. GAAP financial statements.

With respect to the prohibitions on (1) bookkeeping; (2) financial information systems design and implementation; (3) appraisal, valuation, fairness opinions, or contribution-in-kind reports; (4) actuarial; and (5) internal audit outsourcing, the rules state that the service may not be provided "unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client's financial statements."[51] As proposed, for bookkeeping, appraisal or valuation, and actuarial services, the provision was "where it is reasonably likely that the results of these services will be subject to audit procedures during an audit of the audit client's financial statements" while for the other two services, there was no such wording. We have added the new wording to all five services to provide consistency in application. Additionally, the change from "reasonably likely . . ." to "unless it is reasonable to conclude" is intended to narrow the circumstances in which that condition can be invoked to justify the provision of such services.[52]

2. Financial Information Systems Design and Implementation

Currently, Paragraph (c)(4)(ii) identifies certain information technology services that, if provided to an audit client, impair the accountant's independence. The proposed rules identified information technology services that would impair the auditor's independence. Under Paragraph (c)(4)(ii)(A) of the proposed rule, an accountant would not be independent if the accountant directly or indirectly operates or supervises the operation of the audit client's information system or manages the audit client's local area network or information system. Further, Paragraph (c)(4)(ii)(B) of the proposed rule provided that an accountant is *not* deemed independent if the accountant designs or implements a hardware or software system that aggregates source data underlying the financial statements or generates information that is significant to the audit client's financial statements taken as a whole. These services were deemed to impair an accountant's independence under our previous rules.

Some commenters[53] suggested that the Commission's rules should include a dollar threshold limit or other qualifying language. Others[54] suggested that the Commission should clarify that the prohibition on designing and implementing systems would include selecting and testing a client's financial information system. Commenters[55] also believe that the Commission should clarify that recommendations for improvements in the systems should be permitted.

The Commission is adopting rules, consistent with our previous rules, that prohibited the accounting firm from providing any service related to the audit client's information system, unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client's financial statements. These rules do not preclude an accounting firm from working on hardware or software systems that are unrelated to the audit client's financial statements or accounting records as long as those services are pre-approved by the audit committee.

As noted above, the rule prohibits the accountant from designing or implementing a hardware or software system that aggregates source data or generates information that is "significant" to the financial statements taken as a whole. In this context, information would be "significant" if it is reasonably likely to be material to the financial statements of the audit client. Since materiality determinations may not be complete before financial statements are generated, the audit client and accounting firm by necessity will need to evaluate the general nature of the information as well as system output during the period of the audit engagement. An accountant, for example, would not be independent of an audit client for which it designed an integrated Enterprise Resource Planning ("ERP") or similar system since the system would serve as the basis for the audit client's financial reporting system.

Designing, implementing, or operating systems affecting the financial statements may place the accountant in a management role, or result in the accountant auditing his or her own work or attesting to the effectiveness of internal control systems designed or implemented by that accountant.[56] For example, if an auditor designs or installs a computer system that generates the financial records, and that system generates incorrect data, the accountant is placed in a position of having to report on his or her firms' own work. Investors may perceive that the accountant would be unwilling to challenge the integrity and efficacy of the client's financial or accounting information collection systems that the accountant designed or installed.

However, this prohibition does not preclude the accountant from evaluating the internal controls of a system as it is being designed, implemented or operated either as part of an audit or attest service and making recommendations to management. Likewise, the accountant would not be precluded from making recommendations on internal control matters to management or other service providers in conjunction with the design and installation of a system by another service provider.

3. Appraisal or Valuation Services, Fairness Opinions, or Contribution-in-Kind Reports

The Commission's previous independence rules stated that an accountant is deemed to lack independence when providing appraisal or valuation services, fairness opinions, or contribution-in-kind reports for audit clients. However, the previous rules contained certain exemptions that we proposed to eliminate.[57] The proposals provided that the auditor is not independent if the auditor provides appraisal or valuation services, or contribution-in-kind reports,[58] where it is reasonably likely that the results of the service will not be subject to audit procedures by the auditor because the auditor is in a position of auditing his or her own work. Additionally, an accountant was not independent under the proposal if he or she provided a fairness opinion because to do so requires the accountant to function as a part of management and may require the accountant to audit the results of his or her own work.

Appraisal and valuation services include any process of valuing assets, both tangible and intangible, or liabilities. They include valuing, among other things, in-process research and development, financial instruments, assets and liabilities acquired in a merger, and real estate. Fairness opinions and contribution-in-kind reports are opinions and reports in which the firm provides its opinion on the adequacy of consideration in a transaction.

Some commenters[59] believe that our proposed prohibitions were appropriate and others would be even more restrictive.[60] Other commenters,[61] however, believe that certain valuation services should be permissible.

We continue to believe that providing these services to audit clients raises several independence concerns. When it is time to audit the financial statements, it is likely that the accountant would review his or her own work, including key assumptions or variables that underlie an entry in the financial statements. Also, if the appraisal methodology involves a projection of future results of operations and cash flows, some[62] believe that the accountant that prepares the projection may be unable to evaluate skeptically and without bias the accuracy of that valuation or appraisal. Accordingly, the rules we are adopting prohibit the accountant from providing any appraisal service, valuation service or any service involving a fairness opinion or contribution-in-kind report for an audit client, unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client's financial statements.

Our rules do not prohibit an accounting firm from providing such services for non-financial reporting (*e.g* ., transfer pricing studies, cost segregation studies, and other tax-only valuations) purposes. Also, the rule does not prohibit an accounting firm from utilizing its own valuation specialist to review the work performed by the audit client itself or an independent, third-party specialist employed by the audit client, provided the audit client or the client's specialist (and not the specialist used by the accounting firm) provides the technical expertise that the client uses in determining the required amounts recorded in the client financial statements. In those instances the accountant will not be auditing his or her own work because a third party or the audit client is the source of the financial information subject to the audit. Additionally, the quality of the audit may be improved where specialists are utilized in such situations.

Some commenters[63] believe that a strict application of these rules related to contribution-in-kind reports may create conflicts in certain foreign jurisdictions. We are sensitive to these issues and, as we have done in the past,[64] we will continue to work with other regulatory agencies.

4. Actuarial Services

The previous rules generally bar auditors only from providing actuarial services related to insurance company policy reserves and related accounts. Our proposal provided that the accountant is not independent if the auditor provides any actuarial service involving the amounts recorded in the financial statements and related accounts for the audit client where it is reasonably likely that the results of these services will be subject to audit procedures during an audit of the audit client's financial statements because providing these services may cause an accountant later to audit his or her own work. Additionally, accountants providing these services assume a key management task. In addition, actuarially-oriented advisory services may affect amounts reflected in some company's financial statements.

Some commenters[65] agreed with our proposed prohibition of actuarial services. Others,[66] however, believe that some types of actuarial services should be permitted.

Consistent with our proposal, we continue to believe that when the accountant provides actuarial services for the client, he or she is placed in a position of auditing his or her own work. Accordingly, the rules we are adopting prohibit an accountant from providing to an audit client any actuarially-oriented advisory service involving the determination of amounts recorded in the financial statements and related accounts for the audit client other than assisting a client in understanding the methods, models, assumptions, and inputs used in computing an amount, unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client's financial statements.

As can be seen, however, we believe that it is appropriate to advise the client on the appropriate actuarial methods and assumptions that will be used in the actuarial valuations. It is not appropriate for the accountant to provide the actuarial valuations for the audit client.

The rules also provide that the accountant may utilize his or her own actuaries to assist in conducting the audit provided the audit client uses its own actuaries or third-party actuaries to provide management with its actuarial capabilities.

5. Internal Audit Outsourcing

Our previous rules on internal audit outsourcing allowed a company to outsource part of its internal audit function to the independent audit firm subject to certain exemptions. For example, smaller businesses were exempt from the internal audit outsourcing prohibition because there had been concerns about the potentially disproportionate impact on such companies.

Some companies "outsource" internal audit functions by contracting with an outside source to perform, among other things, all or part of their audits of internal controls. As emphasized by the Committee of Sponsoring Organizations ("COSO"), internal auditors play an important role in evaluating and monitoring a company's internal control system.[67] As a result, some argue that internal auditors are, in effect, part of a company's system of internal accounting control.[68]

Since the external auditor typically will rely, at least to some extent, on the existence of an internal audit function and consider its impact on the internal control system when conducting the audit of the financial statements,[69] the accountant may be placed in the position of auditing his or her firm as part of the internal control system. In other words, if the internal audit function is outsourced to an accountant, the accountant assumes a management responsibility and becomes part of the company's control system. Our proposed rule provided that an accountant is not independent when the accountant performs internal audit services related to the internal accounting controls, financial systems, or financial statements, for an audit client.

Some commenters[70] agreed with the proposed rule. While some commenters[71] believed that our rule should contain exemptions for smaller companies, others[72] did not. Some commenters[73] believed that the final rule should include a "reasonably likely to be subject to audit procedures" provision similar to other prohibited services (*e.g* ., bookkeeping). Still other commenters[74] suggested that the Commission should clarify that services provided in conjunction with an audit or attest service are permissible.

The rules we are adopting prohibit the accountant from providing to the audit client internal audit outsourcing services. This prohibition would include any internal audit service that has been outsourced by the audit client that relates to the audit client's internal accounting controls, financial systems, or financial statements unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client's financial statements.

During the conduct of the audit in accordance with generally accepted auditing standards ("GAAS") or when providing attest services related to internal controls, the auditor evaluates the company's internal controls and, as a result, may make recommendations for improvements to the controls. Doing so is a part of the accountant's responsibilities under GAAS or applicable attestation standards and, therefore, does not constitute an internal audit outsourcing engagement.

Along those lines, this prohibition on "outsourcing" does not preclude engaging the accountant to perform nonrecurring evaluations of discrete items or other programs that are not in substance the outsourcing of the internal audit function. For example, the company may engage the accountant, subject to the audit committee pre-approval requirements, to conduct "agreed-upon procedures" engagements[75] related to the company's internal controls, since management takes responsibility for the scope and assertions in those engagements. The prohibition also does not preclude the accountant from performing operational internal audits unrelated to the internal accounting controls, financial systems, or financial statements.

6. Management Functions.

In our proposal, we did not propose any significant change to our previous rule on management functions. Some commenters[76] suggested that we clarify that evaluations of and recommendations for improvements in a company's systems or controls does not constitute a management function.

Consistent with our proposal, the final rules prohibit the accountant from acting, temporarily or permanently, as a director, officer, or employee of an audit client, or performing any decision-making, supervisory, or ongoing monitoring function for the audit client.

We believe, however, that services in connection with the assessment of internal accounting and risk management controls, as well as providing recommendations for improvements, do not impair an accountant's independence. Accountants must gain an understanding of their audit clients' systems of internal controls when conducting an audit in accordance with GAAS.[77] With this insight, accountants often become involved in diagnosing, assessing, and recommending to audit committees and management ways in which their audit client's internal controls can be improved or strengthened.[78] The resulting improvements in the audit client's controls not only result in improved financial reporting to investors but also can facilitate the performance of high quality audits. For these reasons, we are continuing to allow accountants to assess the effectiveness of an audit client's internal controls and to recommend improvements in the design and implementation of internal controls and risk management controls.

As discussed in the previous section on financial information systems design and implementation, when an accountant designs and implements its audit client's internal accounting and risk management control systems, some believe that the accountant will lack objectivity if called upon to audit financial statements that are derived, at least in part, from data from those systems or to report on those controls or on management's assessment of those controls. As such, we believe that designing and implementing internal accounting and risk management controls is fundamentally different from obtaining an understanding of the controls and testing the operation of the controls which is an integral part of any audit of the financial statements of a company. Likewise, design and implementation of these controls involves decision-making and, therefore, is different from recommending improvements in the internal accounting and risk management controls of an audit client (which is permissible, if pre-approved by the audit committee).

For example, management could engage a third-party service provider to design and implement an inventory control system. In the course of that engagement, the third-party service provider might ask the accountant to make recommendations on internal control and accounting system components that have been included in the system being designed. Providing such recommendations to the third-party service provider would not place the independent accountant in the role of management.

Because of this fundamental difference, we believe that designing and implementing internal accounting and risk management controls impairs the accountant's independence because it places the accountant in the role of management. Conversely, obtaining an understanding of, assessing effectiveness of, and recommending improvements to the internal accounting and risk management controls is fundamental to the audit process and does not impair the accountant's independence. Furthermore, the accountant may be engaged by the company, subject to the audit committee pre-approval requirements, to conduct an agreed-upon procedures engagement[79] related to the company's internal controls or to provide attest services related to the company's internal controls without impairing his or her independence.

7. Human Resources

Our previous rules deem an accountant to lack independence when performing certain human resources functions, and we did not propose any significant change to those rules. Many commenters[80] agreed that the accountant should be prohibited from providing certain human resources functions for audit clients.

Consistent with our proposal, these rules provide that an accountant's independence is impaired with respect to an audit client when the accountant searches for or seeks out prospective candidates for managerial, executive or director positions; acts as negotiator on the audit client's behalf, such as determining position, status, compensation, fringe benefits, or other conditions of employment; or undertakes reference checks of prospective candidates. Under the rule, an accountant's independence also is impaired when the accountant engages in psychological testing, or other formal testing or evaluation programs, or recommends or advises the audit client to hire a specific candidate for a specific job.

Assisting management in human resource selection or development places the accountant in the position of having an interest in the success of the employees that the accountant has selected, tested, or evaluated. Accordingly, observers may perceive that an accountant would be reluctant to suggest the possibility that those employees failed to perform their jobs appropriately, or at least reasonable investors might perceive the accountant to be reluctant, because doing so would require the accountant to acknowledge shortcomings in its human resource service. The accountant also might have other incentives not to report such employees' ineffectiveness, including that the accountant would identify and be identified with the recruited employees.

8. Broker-Dealer, Investment Adviser Or Investment Banking Services

Our previous rules deem an accountant to lack independence when performing brokerage or investment advising services for an audit client.[81] We are adopting rules that add serving as an unregistered broker-dealer[82] to our rules that prohibit serving as a promoter or underwriter, making investment decisions on behalf of the audit client or otherwise having discretionary authority over an audit client's investments, or executing a transaction to buy or sell an audit client's investment, or having custody of assets of the audit client. The rule is substantially the same as the Commission's previous rule related to the provision of these types of services to audit clients. We are including unregistered broker-dealers within the rules because the nature of the threat to independence is unchanged whether the entity is or is not a registered broker-dealer.

Selling - directly or indirectly - an audit client's securities is incompatible with the accountant's responsibility of assuring the public that the company's financial condition is fairly presented. When an accountant, in any capacity, recommends to anyone (including non-audit clients) that they buy or sell the securities of an audit client or an affiliate of the audit client, the accountant has an interest in whether those recommendations were correct. That interest could affect the audit of the client whose securities, or whose affiliate's securities, were recommended. These concepts are echoed in the "simple principles" included in the legislative history to the Sarbanes-Oxley Act.[83] In such a situation, if an accountant uncovers an accounting error in a client's financial statements, and the accountant, in an investment adviser capacity, had recommended that client's securities to investment clients, the accountant performing the audit may be reluctant to recommend changes to the client's financial statements if the changes could negatively affect the value of the securities recommended by the accountant to its investment adviser clients.

Broker-dealers[84] often give advice and recommendations on investments and investment strategies. The value of that advice is measured principally by the performance of a customer's securities portfolio. When the customer is an audit client, the accountant has an interest in the value of the audit client's securities portfolio, even as the accountant must determine whether management has properly valued the portfolio as part of an audit. Thus, the accountant would be placed in a position of auditing his or her own work. Furthermore, the accountant is placed in a position of acting as an advocate on behalf of the client.

9. Legal Services

Our previous rule stated that an accountant is deemed to lack independence when he or she provides legal services to an audit client. The proposed rule provided that an accountant was not independent of an audit client if the accountant provides any service to the audit client that, under circumstances in which the service is provided, could be provided only by someone licensed, admitted or otherwise qualified to practice law in the jurisdiction in which the service is provided.

We believe that a lawyer's core professional obligation is to advance clients' interests. Rules of professional conduct in the U.S. require the lawyer to "represent a client zealously and diligently within the bounds of the law."[85] The lawyer must "take whatever lawful and ethical measures are required to vindicate a client's cause or endeavor. . . . In the exercise of professional judgment, a lawyer should always act in a manner consistent with the best interests of the client."[86] We have long maintained that an individual cannot be both a zealous legal advocate for management or the client company, and maintain the objectivity and impartiality that are necessary for an audit.[87] The Supreme Court has agreed with our view. In *United States v. Arthur Young* , the Supreme Court emphasized, "If investors were to view the accountant as an advocate for the corporate client, the value of the audit function itself might well be lost."[88]

Some commenters[89] believed that the prohibition on legal services should apply to all registrants, regardless of their jurisdiction. Others believed that certain accommodations should be made for foreign jurisdictions[90] or for routine or ministerial duties.[91]

The rules we are adopting are consistent with our proposal. Accordingly, an accountant is prohibited from providing to an audit client any service that, under circumstances in which the service is provided, could be provided only by someone licensed, admitted, or otherwise qualified to practice law in the jurisdiction in which the service is provided.

We recognize that there may be implications for some foreign registrants from this rule. For example, we understand that in some jurisdictions it is mandatory that someone licensed to practice law perform tax work, and that an accounting firm providing such services, therefore, would be deemed to be providing legal services. As a general matter, our rules are not intended to prohibit foreign accounting firms from providing services that an accounting firm in the United States may provide. In determining whether or not a service would impair the accountant's independence solely because the service is labeled a legal service in a foreign jurisdiction, the Commission will consider whether the provision of the service would be prohibited in the United States as well as in the foreign jurisdiction.

Evaluating and determining whether services are permissible may require a comprehensive analysis of the facts and circumstances. We are, however, sensitive to these issues and, as we have done in the past,[92] we encourage accounting firms and foreign regulators to consult with the staff to address these issues.

10. Expert Services

The Sarbanes-Oxley Act includes expert services in the list of non-audit services an accountant is prohibited from performing for an audit client. As discussed earlier, the legislative history related to expert services is focused on the accountant's role when serving in an advocacy capacity.

Some commenters[93] believed that the prohibition on expert services should be limited to instances of public advocacy or public adversarial proceedings and should not extend to situations where the accountant is advising a client or its counsel on technical matters apart from a public proceeding. Other commenters[94] believed a distinction exists between serving as an expert witness and serving as a fact witness in a proceeding. Additionally, many commenters[95] simply raised concerns over the lack of clarity of the term "expert" indicating that, as proposed, the meaning of the term is unclear.

Clients retain experts to lend authority to their contentions in various proceedings by virtue of the expert's specialized knowledge and experience. In situations involving advocacy, the provision of expert services by the accountant makes the accountant part of the "team" that has been assembled to advance or defend the client's interests.[96] The appearance of advocacy created by providing such expert services is sufficient to deem the accountant's independence impaired. The prohibition on providing "expert" services included in this rule covers engagements that are intended to result in the accounting firm's specialized knowledge, experience and expertise being used to support the audit client's positions in various adversarial proceedings.[97]

The rules we are adopting prohibit an accountant from providing expert opinions or other services to an audit client, or a legal representative of an audit client, for the purpose of advocating that audit client's interests in litigation or regulatory, or administrative investigations or proceedings. For example, under this rule an auditor's independence would be impaired if the auditor were engaged to provide forensic accounting services to the audit client's legal representative in connection with the defense of an investigation by the Commission's Division of Enforcement. Additionally, an accountant's independence would be impaired if the audit client's legal counsel, in order to acquire the requisite expertise, engaged the accountant to provide such services in connection with a litigation, proceeding or investigation.[98]

Our rules do not, however, preclude an audit committee or, at its direction, its legal counsel, from engaging the accountant to perform internal investigations or fact finding engagements. These types of engagements may include, among others, forensic or other fact-finding work that results in the issuance of a report to the audit client. The involvement by the accountant in this capacity generally requires performing procedures that are consistent with, but more detailed or more comprehensive than, those required by GAAS. Performing such procedures is consistent with the role of the independent auditor and should improve audit quality. If, subsequent to the completion of such an engagement,[99] a proceeding or investigation is initiated, the accountant may allow its work product to be utilized by the audit client and its legal counsel without impairing the accountant's independence. The accountant, however, may not then provide additional services, but may provide factual accounts or testimony about the work performed.

Accordingly, our rules would not prohibit an accountant from assisting the audit committee[100] in fulfilling its responsibilities to conduct its own investigation of a potential accounting impropriety.[101] For example, if the audit committee is concerned about the accuracy of the inventory accounts at a subsidiary, it may engage the auditor to conduct a thorough inspection and analysis of those accounts, the physical inventory at the subsidiary, and related matters without impairing the auditor's independence.

We recognize that auditors have obligations under Section 10A of the Exchange Act and GAAS[102] to search for fraud that is material to an issuer's financial statements and to make sure the audit committee and others are informed of their findings. Auditors should conduct these procedures whether they become aware of a potential illegal act as a result of audit, review or attestation procedures they have performed or as a result of the audit committee expressing concerns about a part of the company's operations or compliance with the company's financial reporting system. In these situations, we believe that the auditor may conduct the procedures, with the approval of the audit committee, and provide the reports that the auditor deems appropriate. Should litigation arise or an investigation commence during the time period that the auditors are conducting such procedures, we would not deem the completion of these procedures to be prohibited expert services so long as the auditor remains in control of his or her work and that work does not become subject to the direction or influence of legal counsel for the issuer.

Furthermore, under this rule, an accountant's independence will not be deemed to be impaired if, in an investigation or proceeding, an accountant provides factual accounts or testimony describing work it performed. Further, an accountant's independence will not be deemed to be impaired if an accountant explains the positions taken or conclusions reached during the performance of any service provided by the accountant for the audit client.

11. Tax Services

Since the Commission issued its auditor independence proposal, there has been considerable debate regarding whether an accountant's provision of tax services for an audit client can impair the accountant's independence. Tax services are unique among non-audit services for a variety of reasons. Detailed tax laws must be consistently applied, and the Internal Revenue Service has discretion to audit any tax return. Additionally, accounting firms have historically provided a broad range of tax services to their audit clients.[103]

In the proposing release, we suggested that in determining whether a given tax service should be allowed, the audit committee should be mindful of the three basic principles. In response, some commenters[104] indicated that asking audit committees to evaluate the provision of tax services by the accountant in light of the three basic principles would significantly alter the Commission's historic position related to tax services. Other commenters raised significant clarity and certainty issues. Some commenters[105] that urged clarity would, for example, prohibit accountants from providing any tax services to audit clients. Other commenters[106] believed that accountants should be permitted to provide only certain types of tax services to their audit clients.[107] Some commenters[108] believed that allowing the accountant to perform tax services both enhances the quality of the audit and provides greater independent oversight over the provision of tax services than would occur if a non-audit firm were engaged to provide these services. Additionally, one commenter's research suggests that higher levels of tax services fees are associated with substantially lower instances of financial restatements.[109]

The Commission reiterates its long-standing position that an accounting firm can provide tax services to its audit clients without impairing the firm's independence. Accordingly, accountants may continue to provide tax services such as tax compliance, tax planning, and tax advice to audit clients, subject to the normal audit committee pre-approval requirements under 2-01(c)(7). Additionally, the rules we are adopting require registrants to disclose the amount of fees paid to the accounting firm for tax services. The rules are consistent with the Act which states that:

> A registered public accounting firm may engage in any non-audit service, *including tax services* , that is not described in any of paragraphs (1) through (9) of subsection (g) for an audit client, only if the activity is approved in advance by the audit committee of the issuer.[110] (Emphasis added)

Nonetheless, merely labeling a service as a "tax service" will not necessarily eliminate its potential to impair independence under Rule 2-01(b).[111] Audit committees and accountants should understand that providing certain tax services to an audit client would, as described below, or could, in certain circumstances, impair the independence of the accountant. Specifically, accountants would impair their independence by representing an audit client before a tax court, district court, or federal court of claims. In addition, audit committees also should scrutinize carefully the retention of an accountant in a transaction initially recommended by the accountant, the sole business purpose of which may be tax avoidance and the tax treatment of which may be not supported in the Internal Revenue Code and related regulations.[112]

C. Partner Rotation

For 25 years, partner rotation has been a component of quality control processes for a vast majority of the accounting firms that audit SEC registrants.[113] The judgment about who should be subject to rotation and how long the partner(s) should remain on the engagement prior to rotating involves balancing the need to bring a "fresh look" to the audit engagement with the need to maintain continuity and audit quality.

The Sarbanes-Oxley Act requires rotation of certain audit partners on a five-year basis in order to continue to provide audit services for a registrant. Section 203 of the Sarbanes-Oxley Act of 2002 specifies that:

> It shall be unlawful for a registered public accounting firm to provide audit services to an issuer if the lead (or coordinating) audit partner (having primary responsibility for the audit), or the audit partner responsible for reviewing the audit, has performed audit services for that issuer in each of the 5 previous fiscal years of that issuer.

Section 301 of the Sarbanes-Oxley Act specifies that the Commission is to direct the national securities exchanges and associations to adopt company listing standards stating that the company's audit committee has the responsibility for appointment, compensation, and oversight of the work of the company's audit firm.[114] In that capacity, the audit committee has the responsibility for evaluating and determining that the audit engagement team has the competence necessary to conduct the audit engagement in accordance with GAAS. Additionally, the accountant is required to conduct the audit in accordance with GAAS.[115]

In particular, the third general standard requires that the accountant exercise due professional care in the conduct of the audit.[116] In order to exercise due professional care, it is necessary to ensure that the engagement is properly staffed with individuals competent to understand the unique issues relevant to that audit. Additionally, the accounting profession's quality control standards require that the firm have processes in place to ensure that appropriate personnel are assigned to each audit engagement.[117]

In our proposing release, we proposed that all partners on the audit engagement team, with the exception of certain "technical services" or "national office" partners and those serving on significant subsidiaries as defined in 1-02(w) of Regulation S-X, be subject to rotation after five years and that after rotation, they would be subject to a five year time-out before they could return to that engagement. Furthermore, the proposed rules would have applied the partner rotation requirements at the audit client[118] level.

Some commenters[119] have suggested that the fresh look can only be accomplished by requiring mandatory rotation of audit firms. In contrast, others[120] expressed the concern that the loss of continuity and audit competence created by mandatory firm rotation creates an even greater risk to audit quality. The issue of mandatory audit firm rotation as an effective means of safeguarding auditor independence has been debated for many years. Several different groups, including appointed commissions, professional organizations, and academics, have researched and analyzed the issue of audit firm rotation.[121] The results of those efforts have raised many of the same concerns as our commenters which the Commission considered in this rule-making. This issue will continue to be monitored by the Commission and others. As directed by Section 207 of the Sarbanes-Oxley Act, the issue of mandatory firm rotation is a matter requiring further study.[122]

1. Rotation of the Lead and Concurring Partner

Under the current requirements of the profession, the balance between the need for a fresh look with concerns about loss of continuity and competence is accomplished by requiring the lead partner to rotate off the audit engagement of SEC registrants after seven years with a two year time out period.[123] However, some commenters[124] believed that extending the partner rotation requirements to other audit partners would be a better balance of the need for a fresh look with concerns about continuity and competence.

These commenters' views are consistent with the provisions of the Sarbanes-Oxley Act, which clearly specify that, at a minimum, two partners be subject to rotation: the lead audit partner and the concurring partner. Furthermore, the Act specifies a five-year period prior to rotation rather than the current seven-year period specified in the membership requirements of the SECPS.[125] While the Act specified that these two partners were subject to rotation after five years, the Act is silent with regard to the time out period. One approach to the partner rotation rules could have been to preclude the partner from returning to the audit client after he or she rotates off to that engagement. Many commenters,[126] however, believed that the time out should be shorter than in our proposal. Other commenters[127] did not object to or even agreed with the five-year time out period for the lead and concurring partners.

The Commission is adopting rules to require the lead and concurring partners to rotate after five years and, upon rotation, be subject to a five-year "time out" period. Because of the importance of achieving a fresh look to the independence of the audit function, we believe that a five-year time out period is appropriate for these two partners.

2. Additional Partner Rotation

Clearly, the lead partner and the concurring partner perform critical functions that affect the conduct and effectiveness of the engagement. However, in many larger engagements, the engagement team will include more than just the lead partner and the concurring partner. Often, those other partners on the engagement team play a significant role in the conduct of the audit and maintaining ongoing relationships with the audit client.

Our proposal would have applied the same rotation requirements to all partners on the audit engagement team with the exception of certain "national office" technical partners and those who did not work on significant subsidiaries as defined in Rule 1-02(w) of Regulation S-X. Some commenters[128] believed that the rotation requirements should be at or extend beyond our proposal level to include, for example, "national office" or "technical" partners[129] or other audit engagement team members below the level of partner.[130] Other commenters,[131] however, believed that extending the rotation requirements beyond the two partners named in the Act could potentially harm audit quality and could impose additional costs on registrants. For example, one commenter[132] indicated that the proposed rotation requirements would cause the firm to have to rotate 181 partners in 88 countries for one large multi-national client. Another commenter[133] estimated that more than 250 partners in 80 countries would be subject to the rotation requirements under the proposed rules. Additionally, some commenters stated that the additional costs that accounting firms would incur to rotate and, in many cases, relocate audit partners would have to be passed on to registrants.

While other commenters[134] agreed with the concept of extending the partner rotation requirements beyond the two partners named in the Act, they suggested that the final rules should not apply as broadly as the Commission had proposed. One commenter suggested that assessing the "right cut" in identifying partners for rotation was a balance between the responsibility for final decisions on accounting and financial reporting issues affecting the financial statements and the level of the relationship with management.[135]

Commenters[136] noted that applying the rotation requirements too deeply could threaten the quality of the audit in certain situations. For example, in certain countries there may be a limited pool of audit partners who are familiar with U.S. GAAP and GAAS. In certain "specialty" areas, there may be a limited number of "specialty" partners available to service the client.[137]

In certain industries there may be limited industry expertise. Also, by applying the rotation requirements more deeply, firms might have a difficult time grooming another partner to both have sufficient knowledge of the industry and the client and have sufficient time remaining prior to rotation when the lead partner or concurring partner must rotate. Also, some commenters[138] noted that applying the proposed rotation requirements to specialty partners could impact audit quality.

We believe that the partner rotation requirements must strike a balance between the need to achieve a fresh look on the engagement and a need for the audit engagement team to be composed of competent accountants. We believe that a proper balance is one that weighs the responsibility for decisions on accounting and financial reporting issues impacting the financial statements with the level of the relationship with senior management of the client. Such a balancing clearly would include the lead (high on both dimensions) and concurring partners (high on responsibility for final decisions, somewhat lower on level of relationship with management). In addition to that, the lead partner at significant operating units has a high involvement with senior management and, for significant operations, responsibility for decisions on accounting matters that affect the financial statements. Likewise, other audit partners at the parent or issuer have a high involvement with senior management and some responsibility for accounting matters to be included in the financial statements.

In contrast, partners at smaller operating units and "specialty" partners typically have a low level of involvement with senior management and the responsibility for the overall presentation in the financial statements is relatively low.

Nonetheless, the Commission is sensitive to the impact that its proposed rotation requirements would have on audit competence in certain instances as well as costs to registrants. Consistent with this approach, we believe that the proper balance is achieved by extending the partner rotation requirements beyond the lead and concurring partner but less deeply than we proposed. In response to the concerns of commenters that our proposed rules went too deep, thus imposing significant costs on registrants and accountants as well as creating potential concerns of audit quality, the rules we are adopting will subject a smaller number of partners to the rotation requirement. Accordingly, we are adopting rules that apply the partner rotation requirements to "audit partners" which is a new term defined in these rules.

In addition to the lead and concurring partners, "audit partners" include partners on the audit engagement team who have responsibility for decision-making on significant auditing, accounting, and reporting matters that affect the financial statements or who maintain regular contact with management and the audit committee. In particular, audit partners would include all those who serve the client at the issuer or parent level, other than specialty partners. Further, the lead partner on subsidiaries of the issuer whose assets or revenues constitute 20% or more of the consolidated assets or revenues are included within the definition of "audit partner."

Thus, the term audit partner does not extend to all partners on the audit engagement team. For example, partners serving on subsidiaries which constitute less than 20% of the assets and revenues of the issuer would not be audit partners as we have defined that term and, thus, would not be subject to rotation. Likewise, partners on subsidiaries above the 20% threshold, other than the lead partner on those subsidiaries, are not subject to rotation.[139]

Audit partners also would exclude "specialty" partners because they typically do not have significant interaction with management on an ongoing basis regarding significant audit, accounting, and reporting matters. It is the lead partner (who is subject to rotation) who has the ultimate responsibility for the audit. We believe that this addresses the concern that many commenters expressed regarding certain "specialty" partners.

We believe that defining the term "audit partners" as the basis for defining those partners who are subject to the rotation requirements is responsive to the concerns expressed by some commenters of the problems that would be created by applying the rotation requirements deeper in the firm. Accordingly, we believe that this requirement establishes an appropriate balance between the need for a fresh look with the difficulties encountered in certain locations where the pool of available talent is limited.

In many cases, registrants have complex business transactions and other situations which may require that the engagement team consult with the accounting firm's national office or others on technical issues. Consistent with our proposal, partners assigned to "national office" duties (which can include technical accounting and auditing--whether at a local or national level--as well as centralized quality control functions) who may be consulted on specific accounting issues related to a client are not audit partners even though they may periodically consult on client matters.[140] While these partners play an important role in the audit process, they serve, primarily, as a technical resource for members of the audit team. Because these partners are not involved in the audit *per se* and do not routinely interact or develop relationships with the audit client, we do not believe that it is necessary to rotate the involvement of these personnel.

3. Rotation Period for Partners Other Than The Lead and Concurring Partners

Some commenters[141] believed that a different rotation period should be provided to partners other than the lead and concurring partners. In particular, if other partners subject to the rotation requirements had a longer period before they were required to rotate, firms would be better able to establish appropriate transition plans from one lead or concurring partner to the next. The longer rotation period for the other partners would allow them to spend time on the engagement team to learn about the business and the industry before having the ultimate responsibility for the engagement.

In response to these concerns, the rules we are adopting require partners subject to the rotation requirements, other than the lead and concurring partner, to rotate after no more than seven years and to be subject to a two-year time-out. In this way, a partner could serve either as the lead partner on a significant subsidiary or as an "audit partner" at the parent or issuer level for a period of time (e.g., two years) prior to becoming the lead or concurring partner on the engagement and still be able to serve in that lead or concurring role for five years.[142]

In conducting its oversight review of registered public accounting firms, we expect that the Public Company Accounting Oversight Board ("the Board") will monitor the impact of these rules on audit quality and independence.

4. Small Business/Small Firm Considerations

Many commenters[143] stated that if the rotation requirements were applied to smaller firms, many smaller firms would be unable to provide audit services to their public clients and would be forced to give up their public clients. Many commenters[144] suggested that this would result in those clients incurring greater costs such as from having to identify a new accounting firm, from the need to familiarize accountants with the client firm's industry and business practices and from the resulting reduction in competition among firms.[145] As we noted in the proposal, we are sensitive to the impact of our rules on smaller business and smaller firms.

Commenters[146] made a number of suggestions about how to accommodate the needs of smaller issuers and smaller firms including: (1) exempting the firms based on criteria such as number of partners, number of SEC clients, firm revenue, or number of professional personnel and (2) exempting accountants of smaller issuers as measured by revenue, assets, market capitalization, or profitability.

The existing professional standards on partner rotation contain an exemption for firms with fewer than five audit clients and fewer than ten partners.[147] We recognize the need to consider the impact of our rules on smaller businesses and smaller firms. While we believe it is appropriate to codify that exemption, we remain concerned about the quality of audits of all registrants. Accordingly, in order for audit firms with fewer than five audit clients that are issuers[148] and fewer than ten partners to qualify for the exemption from partner rotation, the Board must conduct a review of all of the firm's engagements subject to the rule at least once every three years. This special review should focus on the overall quality of the audit and, in particular, the independence and competence of the key personnel on the audit engagement teams.

5. Investment Companies

Under the proposed rule, a partner performing audit, review, or attestation services for any entity in the investment company complex could only do so if they had not served five consecutive years on any entity in the same investment company complex. The rotation requirement would have extended not only to the audit partners, but also those specialized partners, such as tax partners, that work on significant aspects of the audit. Those partners affected by the rotation requirement would have had to remain completely off any engagements in the investment company complex for a period of five years before they could again audit the investment company.

Commenters[149] raised significant concerns in the application of the proposed rule to investment companies. Two commenters[150] were concerned with the prohibition of partners who had served five consecutive years at a service provider or other non-investment company entity in the investment company complex from serving on the audit of a registered investment company in the same investment company complex without first observing the five year "time out" period.[151] One commenter[152] was concerned with the prohibition against partners who had served five consecutive years at an unregistered fund from serving on the audit of a registered investment company in the same investment company complex without first observing the five year "time out" period. One commenter[153] emphasized the financial reporting personnel and accounting control systems used by investment companies are different from those used for other entities in the investment company complex. As a result, the rotation of an audit partner from a non-registered investment company entity in the investment company complex to a registered investment company would provide a "fresh look" at the accounting control systems and the financial reporting process. In addition, due to the structure of the investment company complex organizations, the rotated partner typically would not be dealing with the same individuals in management or on the audit committee that they might have dealt with previously as the audit partner on an entity in the investment company complex.

We believe that the rotation requirements with regard to investment companies should prohibit the rotation of partners between different investment companies in the same investment company complex. We do not believe, however, that it is necessary for the rule to prohibit accountants from rotating to other entities in the investment company complex. Consequently, the rule, as adopted, will not allow audit partners to satisfy the partner rotation requirements by rotating between investment companies in the same investment company complex. The individual required to rotate and the applicable periods for rotation and "time-out" from the audit client will be applied in the same manner to investment companies as to other issuers. Lead and concurring partners will be required to rotate after a total of five consecutive years in either role. At a minimum, all audit partners that audit investment companies will be required to rotate after a total of seven years of consecutive service on any of the investment companies in the same investment company complex. Lead and concurring partners will be required to observe a "time out" period for five years before returning to the investment company and all other audit partners are be subject to a two year "time out" period.

The unique structure of investment company complexes allows for many different fiscal year-ends within the same investment company complex. In order to allow a partner to serve the total number of allowable periods on any one investment company audit in the complex, while still requiring partners to rotate off an investment company complex at the end of their specific periods, we have defined consecutive years of service for investment companies. A consecutive year of service for audit partners includes all fiscal year-end audits of investment companies in the same investment company complex that are performed in a continuous 12-month period. This would allow audit partners auditing multiple investment companies in the same investment company complex to audit each investment company for five or seven complete fiscal years, as appropriate.

6. Effective Date and Transition

In order to allow firms to establish an orderly transition of their audit engagement teams, the Commission is establishing transition provisions related to the partner rotation requirements. Since the lead partner was previously subject to rotation requirements, these rotation requirements should not impose a significant incremental burden on accounting firms. Accordingly, the rotation requirements applicable to the lead partner are effective for the first fiscal year ending after the effective date of these rules. Furthermore, in determining when the lead partner must rotate, time served in the capacity of lead partner prior to the effective date of these rules is included. For example, for a lead partner serving a calendar year audit client, if 2003 was that partner's fifth, sixth or seventh year as lead partner for that audit client, he or she would be able to complete the current year's audit and he or she must rotate off for the 2004 engagement.

The other partners subject to these rotation requirements were not previously subject to rotation. Accordingly, we believe that some additional transition is needed for these partners. In order to maintain continuity on the engagement, firms will need to stagger the rotation of partners. This is especially critical for the lead and concurring partners. As a consequence, to facilitate the process of staggering the rotation of the lead and concurring partners, the rotation requirements for the concurring partner are effective as of the end of the second fiscal year after the effective date of the rules. Therefore, a concurring partner for a calendar year audit client for which 2003 was his or her fourth or greater year in that role,[154] he or she would be able to serve in that capacity for the 2004 audit before being subject to rotation.

Since the other partners covered by these rules were neither identified in the Act nor previously subject to rotation requirements, we believe, consistent with many commenters, that a longer transition period is warranted. Accordingly, for other partners, the rules are effective as of the beginning of the first fiscal year after the effective date of these rules. However, in determining the time served, that first fiscal year will constitute the first year of service for such partners. For example, for a lead partner on a significant subsidiary with a calendar year reporting period, 2004 would constitute the first year in the seven year rotation period, regardless of how many years he or she had previously served in that capacity.

Finally, we recognize that in many foreign jurisdictions partners previously were not subject to rotation requirements. Accordingly, for all partners with foreign accounting firms who are subject to rotation requirements, the rules are effective as of the beginning of the first fiscal year after the effective date of these rules. Likewise, in determining the time served, that first fiscal year will constitute the first year of service for such partners. Thus, for a partner from a foreign firm who is serving as the lead partner for an issuer with a calendar year, 2004 would constitute the first year of the five year rotation period for that partner, without regard to the number of years he or she had previously served in that capacity.

D. Audit Committee Administration of the Engagement

Historically, management has retained the accounting firm, negotiated the audit fee, and contracted with the accounting firm for other services. Our proposed rules, however, recognized the critical role that audit committees can play in the financial reporting process and in helping accountants maintain their independence from audit clients. An effective audit committee may enhance the accountant's independence by, among other things, providing a forum apart from management where the accountants may discuss their concerns. It may facilitate communications among the board of directors, management, internal auditors and independent accountants. An audit committee also may enhance auditor independence from management by appointing, compensating and overseeing the work of the independent accountants.

In that light, Section 202 of the Sarbanes-Oxley Act requires that audit committees pre-approve the services--both audit and permitted non-audit--of the accounting firm.

Specifically, our proposed rules would have required the audit committee to approve the engagement of the independent accountant to audit the issuer and its subsidiary's financial statements and have ongoing communications with the accountant. The proposals also would have required that the audit committee pre-approve all permissible non-audit services and all audit, review or attest engagements required under the securities laws either:

- before the accountant is engaged by the audit client to provide services other than audit, review or attest services, the audit client's audit committee expressly approve the particular engagement; or

- any such engagement be entered into pursuant to detailed pre-approval policies and procedures established by the audit committee and the audit committee be informed on a timely basis of each service.

Finally, consistent with the provisions of the Act, under our proposals, audit committees could apply a de minimis exception to the pre-approval requirements in certain circumstances.

Some commenters[155] believed that the pre-approval alternatives stated above, coupled with the disclosure of fees based on the pre-approval practices conveyed an impression that one method of pre-approval was preferable. Other commenters[156] stated that it was uncertain whether audit committees could use policies and procedures as the basis for pre-approving audit services.

The rules we are adopting are intended to clarify that, to the extent permitted by the Sarbanes-Oxley Act,[157] the audit committee may pre-approve audit and non-audit services based on policies and procedures and that explicit approval and approval based on policies and procedures are equally acceptable. As discussed later in this release, we have revised the proposed disclosures to match our conclusions about pre-approval processes.

Accordingly, the final rules require that the audit committee pre-approve all permissible non-audit services and all audit, review or attest engagements required under the securities laws. The rules require that before the accountant is engaged by the issuer or its subsidiaries, or the registered investment company or its subsidiaries, to render the service, the engagement is:

- approved by the issuer's or registered investment company's audit committee; or

- entered into pursuant to pre-approval policies and procedures established by the audit committee of the issuer or registered investment company, provided the policies and procedures are detailed as to the particular service, the audit committee is informed

> of each service, and such policies and procedures do not include delegation of the audit committee's responsibilities to management.

As provided in the Sarbanes-Oxley Act, the rules recognize audit services to be broader than those services required to perform an audit pursuant to GAAS. For example, the Act identifies services related to the issuance of comfort letters and services related to statutory audits required for insurance companies for purposes of state law as audit services.[158] We recognize that domestically and internationally there are various requirements for statutory audits. These rules recognize this fact; accordingly, such engagements are viewed as audit services in the context of these rules.

Furthermore, audit services also would include services performed to fulfill the accountant's responsibility under GAAS. For example, in some situations, a tax partner may be involved in reviewing the tax accrual that appears in the company's financial statements. Since that is a necessary part of the audit process, that activity constitutes an audit service. Likewise, complex accounting issues may require that the firm engage in consultation with "national office" or other technical reviewers to reach an audit judgment. Whether or not the firm separately charges for that consultation, the activity constitutes an audit service since it is a necessary procedure used by the accountant in reaching an opinion on the financial statements.

This would contrast with a situation where a registrant is evaluating a proposed transaction and asks the independent accountant to evaluate the accounting for the proposed transaction. After research and consultation, the accounting firm provides an answer to the registrant and bills for those services. In considering the nature of the services, these services would not be considered to be audit services.

These rules require that the audit committee pre-approve all services. In doing so, the Act permits the audit committee to establish policies and procedures for pre-approval provided they are detailed as to the particular service and designed to safeguard the continued independence of the accountant. For example, the Sarbanes-Oxley Act allows for one or more audit committee members who are independent board directors to pre-approve the service. Decisions made by the designated audit committee members must be reported to the full audit committee at each of its scheduled meetings.[159]

Consistent with the Sarbanes-Oxley Act, our rules also reflect a de minimis exception solely related to the provision of non-audit services for an issuer. This exception waives the pre-approval requirements for non-audit services provided that: (1) all such services do not aggregate to more than five percent of total revenues paid by the audit client to its accountant in the fiscal year when services are provided, (2) were not recognized as non-audit services at the time of the engagement, and (3) are promptly brought to the attention of audit committee and approved prior to the completion of the audit by the audit committee or one or more designated representatives. Lastly, as further discussed later in this release, the audit committee's policies for pre-approvals of services should be disclosed by registrants in periodic annual reports.

As noted earlier, the proposed rules provided two alternatives related to pre-approval of permissible non-audit services as well as all audit, review, or attest engagements required under the securities laws: either pre-approval before the accountant is engaged to provide the services or the engagement is entered into pursuant to detailed pre-approval policies and procedures established by the audit committee, with the audit committee informed on a timely basis of each service. In response to issues raised by commenters, the final rule has been modified to remove the appearance of an implicit preference of one alternative over another.

With respect to investment companies, the proposed rule would have required pre-approval not only of the non-auditing services provided to the investment company, but also require pre-approval by the investment company's audit committee of the non-auditing services provided to the investment company's investment adviser and any entity controlling, controlled by, or under common control with the investment adviser that provides services to the investment company.

Commenters[160] expressed concern over the breadth of this proposed rule and the unintended consequences of the pre-approval process. Commenters[161] observed that an auditor could provide a non-audit service to an entity in an investment company complex that would require the pre-approval of multiple audit committees. Some commenters[162] indicated investment company complexes often have more than one audit committee for the various investment companies in the complex. Additionally, the other entities in the complex, themselves, will often have their own audit committees. As proposed, the rule would require not only the audit committee of the entity engaging the auditor to provide the non-audit service to pre-approve the use of the accountant, but also would require each audit committee of an investment company registrant in the complex to pre-approve the use of the accountant. This would ultimately result in each investment company audit committee having veto power over all non-audit services provided to the complex even if those services did not relate directly to the financial reporting or operations of the investment company. One commenter[163] expressed concern over the burden this would place on the investment company's audit committee. Other commenters[164] expressed concern with whether the members of the audit committee would be capable of evaluating the appropriateness of services provided to entities unrelated to the investment company's operations or financial reporting.

Commenters[165] suggested the rule should require the audit committee of the investment company to only pre-approve those audit and non-audit services provided directly to the investment company. One commenter[166] suggested the rule should require the audit committee of the investment company to pre-approve those audit and non-audit services that relate to the operations of the investment company.

After considering the comments, we believe modifying the approach by requiring the pre-approval of non-audit services to only those provided to the investment company directly, as suggested by several of the commenters, would not be consistent with the spirit or intent of the Sarbanes-Oxley Act. To address the commenters' concerns, but preserve the intent of the legislation, the rules as adopted would limit the investment company's audit committee pre-approval responsibility to those services provided directly to the investment company and those services provided to an entity in the investment company complex where the nature of the services provided have a direct impact on the operations or financial reporting of the investment company. The final rules would allow the investment company's audit committee to assess and determine before the work is conducted the impact that the services might reasonably have on the investment company accountant's independence as it relates to the audits of the investment company's financial statements. In addition, in response to one commenter's[167] suggestion concerning the non-audit services that should be disclosed, we have clarified the entities that provide services to the investment company that must be pre-approved. As adopted only the service providers that provide "ongoing" services to the investment company must have their non-audit services pre-approved. Thus, the final rules would limit the number of instances where pre-approval would be sought from multiple audit committees in the complex.

Although it may not be practical or feasible for the investment company audit committee to pre-approve all services provided to the investment company complex, we continue to believe the audit committee should be aware of all services the accountant is providing to entities in the investment company complex. One commenter[168] agreed with this position suggesting non-audit services be disclosed quarterly. As a result, we are adopting a requirement in the rule that the accountant disclose to the audit committee all services provided to the investment company complex, including the fees associated with those services.

The de minimis exception that was proposed would have calculated the percentage threshold based on the total revenues paid to the investment company's accountant by the investment company, its investment adviser and any entity controlling, controlled by, or under common control with the investment adviser that provided services to the investment company. We asked for comment on the appropriate methodology for calculating the de minimis exception. One commenter[169] suggested it would be unfair to determine the calculation of the de minimis exception based on the total fees paid to the accountant by the investment company because the resulting threshold would be so low; the practical effect would be no de minimis exception for investment companies. Therefore, the commenter suggested the threshold should coincide with the scope of the pre-approval requirement. We agree with the commenter and believe that the calculation of the de minimis exception should not relate solely to the level of services provided to the investment company. We have modified the proposed rule to determine the threshold based on the services provided to the investment company complex that were subject to the pre-approval requirements for the investment company's audit committee.

The proposed rules would require the audit committee to pre-approve all audit, review, and attest reports required under the securities laws. 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. We requested comment on who should approve the selection of the accountant of the investment company, for example, the independent directors, the audit committee or both. One commenter[170] stated that the audit committee should select the accountant and the independent directors should ratify the selection, thereby retaining the independent directors as the ultimate decision making authority with respect to accountant selection. After consideration of these matters, we have determined to adopt the rules as proposed.

Also, as discussed later in this release, these provisions are supplemented as a result of the proxy disclosure requirements. We believe that disclosure of the procedures the audit committee uses to pre-approve audit services, as well as the disclosure of all non-audit services by category, including those meeting the de minimis exception stated above, will provide investors valuable information that may be used to evaluate the relationships that exist between the accountant and the audit client.

These rules apply to all audit, review, and attest services and non-audit services that are entered into after the effective date of these rules. For arrangements for non-audit services entered into prior to the effective date of these rules--regardless of whether or not they were pre-approved by the audit committee--the accounting firm will have 12 months from the effective date of these rules to complete these services. For example, an engagement to provide non-audit services that was entered into in December 2002, which may or may not be complete by the effective date of these rules, is not subject to these rules, but must be completed within 12 months of the effective date of these rules. We believe these transition provisions will permit an orderly completion of existing engagements and permit accountants and audit committees adequate time to prepare to implement the new rules.

E. Compensation

We understand that some accounting firms offer their professionals cash bonuses and other financial incentives to sell products or services, other than audit, review, or attest services, to their audit clients. Such compensation arrangements may create a financial or other self-interest that could constitute a threat to the accountant's objectivity.[171] These arrangements also may detract from audit quality by incentivizing the audit partner to focus on selling non-audit services rather than providing high quality audit services.

We also question whether a reasonable investor with full knowledge of such incentive programs would believe that the accountant could function with the independence and objectivity that is necessary for him or her to maintain, both in fact and in appearance. We are concerned that an accountant might be viewed as compromising accounting judgments in order not to jeopardize the potential for increased income from the act of selling non-audit services to the audit client. Because of this concern, we proposed that an accountant's independence would be deemed to have been impaired when he or she is compensated for selling or performing non-audit services for an audit client. Our proposed rule limited such compensation, direct or otherwise, that could be provided to any audit engagement team partner.

Commenters expressed two primary concerns with the proposals. First,[172] because the compensation was not directly related to sales activities, the operation of the rule would have been difficult given the size and nature of some firms' national and global operations. For example, read literally as proposed, a partner's compensation could not include a proportionate share of the accounting firm's overall profits, because some of those profits would be derived from the provision of non-audit services by other firm personnel. Second, some commenters[173] observed that the provisions were perceived to be overly broad because, as proposed, they would have applied to partners who provide specialized services and would have prevented them from being rewarded for selling or performing services in their area of expertise. For example, under the proposal an audit partner could be rewarded for selling audit, review or attest services; however, tax partners could not be rewarded for selling additional tax services to audit clients if they were members of the audit engagement team. That is, audit partners could be rewarded for selling within their own discipline, but tax partners could not.

We are addressing these concerns by clarifying that the compensation concerns exist where the audit partner's compensation is based on the act of selling non-audit services and specifying that the rule applies to audit partners. As described more fully in our discussion of definitions, the term audit partner refers to the lead and concurring partners and other partners on the audit engagement team who have responsibility for decision-making on significant auditing, accounting, and reporting matters that affect the financial statements or who maintain regular contact with management or the audit committee. In particular, audit partners, other than specialty partners, would include all audit partners serving the client at the issuer or parent.[174] Further, the lead partner on subsidiaries of the issuer whose assets or revenues constitute 20% or more of the consolidated assets or revenues are included within the definition of audit partner. Conceivably, "compensation" could include any form of cash or other assets distributed to the audit partner, including any income or benefit based on an evaluation of the partner's performance.

This rule prohibits accounting firms from establishing an audit partner's compensation or allocation of partnership "units" based on the sale[175] of non-audit services to the partner's audit clients.[176] This provision also reinforces the position that accountants at the partner level should be viewed as skilled professionals and not as conduits for the sale of non-audit services to the audit partner's individual clients. This provision recognizes and focuses on the need for independence of the most senior members of the engagement team. However, this rule does not preclude an audit partner from sharing in the profits of the audit practice and those of the overall firm.[177] And, an audit partner's evaluation could take into account a number of factors directly or indirectly related to selling services to an audit client.[178]

Accordingly, we are amending the auditor independence rules to address the practice of accountants being compensated by their firms for selling non-audit products and services to their audit clients.[179] The new rule would provide that an accountant is not independent if, at any point during the audit and professional engagement period,[180] any audit partner,[181] other than specialty partners,[182] earns or receives compensation[183] based on selling engagements to that audit client, to provide any services,[184] other than audit, review, or attest services.

The lead partner is responsible for managing not only the audit engagement but also the client relationship. The lead partner is in a position to identify potential services that could benefit the audit client. Furthermore, because of the lead partner's frequent interaction with management, he or she has the opportunity to "pitch" those services to management. Thus, the lead partner relationship with management has been used by some as a conduit to sell non-audit services to the audit client.[185]

In contrast, partners at smaller operating units and "specialty" partners typically have a low level of involvement with senior management and the responsibility for the overall presentation in the financial statements is relatively low.

The application of these rules allows partners to be compensated for selling services with their discipline. Thus, just as an audit partner can be compensated for selling audit and audit-related services, so, too, can a tax partner be compensated for selling tax services. A specialty partner receiving compensation for selling within his or her discipline does not create the same threat to independence as when an audit partner is compensated for selling those non-audit services because the lead partner retains overall responsibility for the conduct of the audit. Additionally, there is a concurring partner who reviews the work on the audit engagement team. Finally, specialty partners have limited relationships with management in the context of their activities as a member of the audit engagement team.

The rules that we are adopting mitigate the concerns that an audit partner might be viewed as compromising audit judgments in order not to jeopardize the potential for selling non-audit services. These rules do not specifically address the provision of compensation to other audit engagement team members for directly selling non-audit services. We believe that, however, the other audit engagement team members will perform in a fashion that is consistent with the direction and tone set by the audit partners. Nonetheless, as it pre-approves non-audit services an audit committee may wish to consider whether, in the company's particular circumstances, compensating a senior staff member on the audit engagement team based on his or her success in selling the service to the company compromises that individual's or the firm's independence.

Further, in conducting its oversight review of registered public accounting firms, we expect that the Board will monitor the impact of these rules on audit quality and independence.

With respect to investment companies, the proposed rule on compensation would have prohibited all partners, principals and shareholders of an accounting firm that are members of the audit engagement team from being compensated for selling non-audit services to a registered investment company audit client or any other entity in the investment company complex. One commenter[186] suggested the rule on partner compensation for investment companies should apply only to the selling of non-audit services to the investment company itself and not to other entities in the investment company complex. We disagree and continue to believe a partner on a registered investment company audit should not be directly compensated for selling non-audit services to other entities in the investment company complex, for example, the investment company's investment adviser. Thus, we have not made changes to this aspect of the rule.

We understand that because of the seasonal nature of accounting firms that many firms have fiscal periods that end in the April to September time frame. In recognition of this fact and understanding that individuals may be operating in the current period under an established set of performance goals, the provisions of this paragraph will be effective in the fiscal periods of the accounting firm that commence after the effective date of these rules. Further, recognizing that the application of this rule could have a disproportionate economic impact on small firms, we are exempting firms with fewer than five audit clients that are issuers[187] and fewer than ten partners from the provisions of this requirement.

F. Definitions

The rules that the Commission is adopting impact various parties involved in the audit and financial reporting process of issuers. To more clearly identify those parties, we have revised and added to the definitions in Rule 2-01(f) of Regulation S-X. This section discusses those definitions.

1. Accountant

The term "accountant" previously was defined under the rules of the Commission as a "certified public accountant or public accountant performing services in connection with an engagement for which independence is required."[188] We have added to the definition the phrase, "registered public accounting firm." Under the provisions of the Sarbanes-Oxley Act, public accounting firms must register with the Board in order to prepare or issue, or to participate in the preparation or issuance of, any audit report with respect to any issuer. [189] Thus, the term "registered public accounting firm" refers to a firm that has registered with the Board in accordance with the requirements of the Sarbanes-Oxley Act.

2. Accounting Role

Under the previous rules of the Commission, "accounting role or financial reporting oversight role" was a defined term. However, because the rules requiring a cooling-off period for employment at the issuer relate only to those performing a financial reporting oversight role, the Commission has separated the definition of "accounting role" from that of "financial reporting oversight role." The term "accounting role" refers to a role where a person can or does exercise more than minimal influence over the contents of the accounting records or over any person who prepares the accounting records. All persons in a "financial reporting oversight role" (defined below) also are in an "accounting role." Persons in an accounting role include individuals in clerical positions responsible for accounting records (e.g., payroll, accounts payable, accounts receivable, purchasing, sales) as well as those who report to individuals in financial reporting oversight roles (e.g., assistant controller, assistant treasurer, manager of internal audit, manager of financial reporting).

3. Financial Reporting Oversight Role

The term "financial reporting oversight role" refers to a role in which an individual has direct responsibility for or oversight of those who prepare the registrant's financial statements and related information (e.g., management discussion and analysis), which will be included in a registrant's document filed with the Commission. As noted above, "accounting role and financial reporting oversight role" previously was one definition. In order to subject the appropriate individuals to certain portions of these rules, we have bifurcated the definitions.

4. Audit Committee

Section 205 of the Sarbanes-Oxley Act defines an audit committee as:

> A committee (or equivalent body) established by and amongst the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer.

The Act further stipulates that if no such committee exists, then the audit committee is the entire board of directors. For purposes of these independence rules, the Commission is adopting the same meaning for audit committee as used in the Act.

The audit committee serves as an important body, serving the interests of investors, to help ensure that the registrant and its accountants fulfill their responsibilities under the securities laws. Because the definition of an audit committee can include the entire board of directors if no such committee of the board exists, these rules do not require registrants to establish audit committees. Likewise, the auditor independence rules do not require that the committee be composed of independent members of the board.[190]

Some entities do not have boards of directors and therefore do not have audit committees. For example, some limited liability companies and limited partnerships that do not have a corporate general partner may not have an oversight body that is the equivalent of an audit committee. We are not exempting these entities from the requirements. Rather, such issuers should look through each general partner of the successive limited partnerships until a corporate general partner or an individual general partner is reached. With respect to a corporate general partner, the registrant should look to the audit committee of the corporate general partner or to the full board of directors as fulfilling the role of the audit committee. With respect to an individual general partner, the registrant should look to the individual as fulfilling the role of the audit committee.

We are, however, exempting asset-backed issuers[191] and unit investment trusts[192] from this requirement. Because of the nature of these entities, such issuers are subject to substantially different reporting requirements. Most significantly, asset-backed issuers are not required to file financial statements like other companies. Similarly, unit investment trusts are not required to provide shareholder reports containing audited financial statements. Also, such entities typically are passively managed pools of assets. Therefore, we are not applying the requirements related to audit committees in this release to such entities.

5. Audit Engagement Team

As discussed earlier in this release, the cooling off period applies to members of the audit engagement team. As used in this release, the term audit engagement team means all partners (or person in an equivalent position) and professional employees participating in an audit, review, or attestation engagement of an audit client. Included within the audit engagement team would be partners and all other persons who consult with other members of the engagement team during the audit, review, or attestation engagement regarding technical or industry-specific issues, transactions, or events.

6. Audit Partner

The term audit partner is an integral part of the rules we are adopting related to partner compensation and partner rotation. In each case, the affected parties are audit partners. As used in this rule, the term audit partner means a partner (or person in an equivalent position) who is a member of the audit engagement team (as defined above) who has responsibility for decision-making on significant auditing, accounting, and reporting matters that affect the financial statements or who maintains regular contact with management and the audit committee.

The term audit partner would include the lead and concurring partners, partners such as relationship partners who serve the client at the issuer or parent level, other than a partner who consults with others on the audit engagement team during the audit, review, or attestation engagement regarding technical or industry-specific issues, transactions, or events, and the lead partner on subsidiaries of the issuer whose assets or revenues constitute 20% or more of the consolidated assets or revenues of the issuer.[193]

G. Communication with Audit Committees

Auditors are required by GAAS to communicate certain matters to the audit committee. In particular, GAAS require that the accountant should determine that the audit committee is informed about matters such as:

- Auditor's responsibility under GAAS,
- Significant accounting policies,
- Methods used to account for significant unusual transactions,
- Effects of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus,
- Process used by management in formulating particularly sensitive accounting estimates and the basis for the auditor's conclusions regarding the reasonableness of those estimates,
- Material audit adjustments proposed and immaterial adjustments not recorded by management,
- Auditor's judgments about the quality of the company's accounting principles,
- Auditor's responsibility for other information in documents containing audited financial statements,
- Auditor's views about significant matters that were the subject of consultation between management and other accountants,
- Major issues discussed with management prior to retention,
- Difficulties with management encountered in performing the audit, and

- Disagreements with management over the application of accounting principles, the basis for management's accounting estimates, and the disclosures in the financial statements.[194]

Accountants are required under GAAS to provide these communications in a timely manner but not necessarily before the issuance of the audit report.[195] Accountants also may communicate with audit committees on matters in addition to those specifically required by GAAS, including auditing issues, engagement letters, management representation letters, internal controls, auditor independence, and others.

Section 204 of the Sarbanes-Oxley Act directs the Commission to issue rules requiring timely reporting of specific information by accountants to audit committees. In response to the Act, we proposed amending Regulation S-X to require each public accounting firm registered with the Board that audits an issuer's financial statements to report, prior to the filing of such report with the Commission, to the issuer or registered investment company's audit committee: (1) all critical accounting policies and practices used by the issuer or registered investment company, (2) all alternative accounting treatments of financial information within generally accepted accounting principles ("GAAP") that have been discussed with management, including the ramifications of the use of such alternative treatments and disclosures and the treatment preferred by the accounting firm, and (3) other material written communications between the accounting firm and management of the issuer or registered investment company.

Some commenters[196] believe that these communications should be the responsibility of management alone. Others,[197] however, believe that both the accountant and management should share the responsibility for informing the audit committee about such matters. While we understand that management has the primary responsibility for the information contained in the financial statements, since the accounting firm is retained by the audit committee, we share the view reflected in Section 205 of the Sarbanes-Oxley Act and current auditing standards, that the accounting firm has a responsibility to communicate certain information to the audit committee. As discussed below, we are adopting rules requiring that certain information be communicated by the independent accountant to the audit committee. Some commenters[198] believe that the Commission should require that these communications be in writing. Others,[199] however, disagree. We have not required that the communication be in writing. We would expect, however, that such communications would be documented by the accountant and the audit committee. We believe that many of these communications currently are being made as accountants fulfill their responsibilities under GAAS and the securities laws.[200]

In describing the role and responsibilities of the audit committee, Warren Buffett has stated that:

> Their function . . . is to hold the auditor's feet to the fire. And, I suggest . . . the audit committee ask [questions] of the auditors [including]: if the auditor were solely responsible for preparation of the company's financial statements, would they have been prepared in any way differently than the manner selected by management? They should inquire as to both material and non-material differences. If the auditor would have done anything differently

> than management, then explanations should be made of management's argument and the auditor's response.[201]

Requiring that the accountants communicate information to the audit committee will aid the audit committee in fulfilling its responsibilities.

1. Critical Accounting Policies and Practices

Consistent with our proposal, we are establishing rules requiring communication by accountants to audit committees of all critical accounting policies and practices.[202] In December 2001, we issued cautionary advice regarding each issuer disclosing in the Management's Discussion and Analysis[203] section of its annual report those accounting policies that management believes are most critical to the preparation of the issuer's financial statements.[204] The cautionary advice indicated that "critical" accounting policies are those that are both most important to the portrayal of the company's financial condition and results and require management's most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain.[205] As part of that cautionary advice, we stated:

> Prior to finalizing and filing annual reports, audit committees should review the selection, application and disclosure of critical accounting policies. Consistent with auditing standards, audit committees should be apprised of the evaluative criteria used by management in their selection of the accounting principles and methods. Proactive discussions between the audit committee and the company's senior management and auditor about critical accounting policies are appropriate.[206]

In May 2002, the Commission proposed rules to require disclosures that would enhance investors' understanding of the application of companies' critical accounting policies.[207] The May 2002 proposed rules cover (1) accounting estimates a company makes in applying its accounting policies and (2) the initial adoption by a company of an accounting policy that has a material impact on its financial presentation. Under the first part of those proposed rules, a "critical accounting estimate" is defined as an accounting estimate recognized in the financial statements (1) that requires the registrant to make assumptions about matters that are highly uncertain at the time the accounting estimate is made and (2) for which different estimates that the company reasonably could have used in the current period, or changes in the accounting estimate that are reasonably likely to occur from period to period, would have a material impact on the presentation of the registrant's financial condition, changes in financial condition or results of operations. The May 2002 proposed rules outline certain disclosures that a company would be required to make about its critical accounting estimates. In addition, under the second part of the May 2002 proposed rules, a company would be required to make certain disclosures about its initial adoption of accounting policies, including the choices the company had among accounting principles.

Accountants and issuers should read and refer to the December 2001 Cautionary Guidance to determine the types of matters that should be communicated to the audit committee under this rule. We are not requiring that those discussions follow a specific form or manner, but we expect, at a minimum, that the discussion of critical accounting estimates and the selection of initial accounting policies will include the reasons why estimates or policies meeting the criteria in the Guidance are or are not considered critical and how current and anticipated future events impact those determinations. In addition, we anticipate that the communications regarding critical accounting policies will include an assessment of management's disclosures along with any significant proposed modifications by the accountants that were not included.

2. Alternative Accounting Treatments

We recognize that the complexity of financial transactions results in accounting answers that are often the subject of significant debate between management and the accountants. Some commenters[208] to the proposed rules suggested that this rule be restricted to material accounting alternatives. These commenters indicated that restricting these communications will assist audit committee members by focusing their attention on important accounting alternatives. One commenter[209] believes that only alternative treatments under GAAP that were the subject of serious consideration and debate by the accountant and management should be communicated to the audit committee.

We understand the concerns expressed and, accordingly, we have clarified the final rule. Providing audit committees with information on material accounting alternatives is consistent with the objectives of the Act and will minimize the risk that audit committee members will be distracted from material accounting policy matters by the numerous discussions between the accountant and management on the application of accounting principles to relatively small transaction or events. Therefore, these rules require communication, either orally or in writing, by accountants to audit committees of all alternative treatments within GAAP for policies and practices related to material items that have been discussed with management, including the ramifications of the use of such alternative treatments and disclosures and the treatment preferred by the accounting firm. This rule is intended to cover recognition, measurement, and disclosure considerations related to the accounting for specific transactions as well as general accounting policies.

We believe that communications regarding specific transactions should identify, at a minimum, the underlying facts, financial statement accounts impacted, and applicability of existing corporate accounting policies to the transaction. In addition, if the accounting treatment proposed does not comply with existing corporate accounting policies, or if an existing corporate accounting policy is not applicable, then an explanation of why the existing policy was not appropriate or applicable and the basis for the selection of the alternative policy should be discussed. Regardless of whether the accounting policy selected preexists or is new, the entire range of alternatives available under GAAP that were discussed by management and the accountants should be communicated along with the reasons for not selecting those alternatives. If the accounting treatment selected is not, in the accountant's view, the preferred method, we expect that the reasons why the accountant's preferred method was not selected by management also will be discussed.

Communications regarding general accounting policies should focus on the initial selection of and changes in significant accounting policies, as required by GAAS,[210] and should include the impact of management's judgments and accounting estimates, as well as the accountant's judgments about the quality of the entity's accounting principles. The discussion of general accounting policies should include the range of alternatives available under GAAP that were discussed by management and the accountants along with the reasons for selecting the chosen policy. If an existing accounting policy is being modified, then the reasons for the change also should be communicated. If the accounting policy selected is not the accountant's preferred policy, then we expect the discussions to include the reasons why the accountant considered one policy to be preferred but that policy was not selected by management.

The separate discussion of critical accounting policies and practices is not considered a substitute for communications regarding general accounting policies, since the discussion about critical accounting policies and practices might not encompass any new or changed general accounting policies and practices. Likewise, this discussion of general accounting policies and practices is not intended to dilute the communications related to critical accounting policies and practices, since the issues affecting critical accounting policies and practices, such as sensitivities of assumptions and others, may be tailored specifically to events in the current year, and the selection of general accounting policies and practices should consider a broad range of transactions over time.

3. Other Material Written Communications

We understand written communications between accountants and management range from formal documents, such as engagement letters, to informal correspondence, such as administrative items. We also acknowledge that historically not all forms of written communications provided to management have been provided to the audit committee. Our rule is intended to implement Section 205 of the Sarbanes-Oxley Act, which clarified the substance of information that should be provided by accountants to audit committees to facilitate accountant and management oversight by those committees.

The Sarbanes-Oxley Act specifically cites the management letter and schedules of unadjusted differences as examples of material written communications to be provided to audit committees. Examples of additional written communications that we expect will be considered material to an issuer include:

- Management representation letter;[211]
- Reports on observations and recommendations on internal controls;[212]
- Schedule of unadjusted audit differences,[213] and a listing of adjustments and reclassifications not recorded, if any;
- Engagement letter;[214] and
- Independence letter.[215]

These examples are not exhaustive, and accountants are encouraged to critically consider what additional written communications should be provided to audit committees.

4. Timing of Communications

Commenters[216] generally agreed with our proposal that the communications should occur prior to the filing of the issuer's periodic annual report, although a commenter[217] suggested that the communications should occur throughout the period. The Act requires that the communications be timely reported to the audit committee. For purposes of the requirements of this provision, our rule specifies that the communications between the accountant and the audit committee occur prior to the filing of the audit report with the Commission pursuant to applicable securities laws. As a result, these discussions will occur, at a minimum, during the annual audit, but we expect that they could occur as frequently as quarterly or more often on a real-time basis.

The timing of these communications is intended to occur before any audit report is filed with the Commission pursuant to the securities laws. We believe that this rule will ensure that these communications occur prior to filing of annual reports and proxy statements, as well as prior to filing registration statements and other periodic or current reports when audit reports are included.

5. Investment Companies

The proposed rules would have required accountants to communicate with an audit committee of an investment company all critical accounting policies, alternative methodologies and other material information before filing an audit report with the Commission. Although commenters[218] generally agreed that the information required to be communicated was appropriate, the timing of such communications would be problematic for investment companies. Commenters[219] stated that investment companies within an investment company complex frequently have a common board of directors, but have staggered fiscal-year ends. As a result, the proposed rules could require accountants to communicate with audit committees as frequently as monthly. To eliminate this burden, some commenters[220] suggested these discussions occur as infrequently as annually, with two commenters[221] suggesting updates for material changes. Another commenter[222] suggested that we leave communication of these matters up to the discretion of the investment company's audit committee and the accountant.

We believe it is important to discuss critical accounting policies, alternative methodologies, and other material information close to the time when the audit report is filed. It is not our intention, however, to have accountants communicate the same information to the audit committee multiple times during the year. As adopted, the final rules require the accountant to communicate to the audit committee of an investment company annually, and if the annual communication is not within 90 days prior to the filing, provide an update in the 90 day period prior to the filing, of any changes to the previously reported information.[223]

The adopted rules, in effect, would require an accountant of an investment company complex where the individual funds have different fiscal year ends to communicate the required information no more frequently than four times during a calendar year. We believe this should not place an undue burden on investment company audit committees because many of the boards of directors for investment companies meet on a quarterly basis.[224]

H. Expanded Disclosure

To allow the issuer's investors to be better able to evaluate the independence of the accountant, we believe that disclosures should be made by issuers of the scope of services provided by its independent public accountants. Section 202 of the Sarbanes-Oxley Act requires pre-approval of all audit and non-audit services, with exceptions provided for de minimis amounts under certain circumstances, as described in the Act and in rules discussed previously in this release. The Sarbanes-Oxley Act further requires disclosure in periodic reports of non-audit services approved by the audit committee.

Current proxy disclosure rules require that a registrant disclose, in the most recent fiscal year, the professional fees paid for both audit and non-audit services to its principal independent accountant. As a result of the requirements of Sarbanes-Oxley and partly in response to public comment on the current proxy disclosures requirements since their adoption in 2000, we proposed rules to change both the types of fees that must be described and the number of years for which the disclosures must be provided.[225] The proposed rules would have increased the disclosed categories of professional fees paid for audit and non-audit services from three to four. The categories of reportable fees proposed were: (1) Audit Fees, (2) Audit-Related Fees, (3) Tax Fees, and (4) All Other Fees.[226] The proposed disclosure called for information to be provided for each of the two most recent fiscal years, rather than just the most recent fiscal year. In addition, we proposed that registrants be required to describe in subcategories the nature of the services provided that are categorized as audit-related fees and all other fees.

Our proposed changes to the proxy disclosure rules were intended to clarify the categorization of services provided by the audit firm in order to provide increased transparency for investors. Many commenters[227] favored the approach of our proposals, however, some commenters[228] requested clarification relating to the categorization of certain types of services. For example, the discussion accompanying the proposed rules stated that the "tax fees" category would capture all services performed by professional staff in the independent accountant's tax division. Thus, the proposed rules would have required that the fees associated with the review by the tax partner of the tax accrual during the audit be included within the "tax services category." However, as stated elsewhere in the proposing release, the "audit services" category should include services performed to fulfill the accountant's responsibility under GAAS. Likewise, complex accounting issues may require that the firm engage in consultation with national office or other technical reviewers to reach an audit judgment.

Some commenters[229] generally agreed with the proposed categories of services. Some,[230] however, suggested modifications or clarifications to the categories or reductions in the number of categories. Additionally, some commenters suggested that the disclosures should be provided for three years[231] and others suggested that they be provided for only one year.[232]

Our final rules retain the basic provisions of our proposals. In response to the requests by commenters for clarification of the categorization of services, we expect that all services performed to comply with GAAS should be classified as "audit services" in providing the disclosures. Certain services, such as tax services and accounting consultations, may not be billed as audit services. However, to the extent that such services are necessary to comply with GAAS, an appropriate allocation of those fees may be included in the audit fee category. We recognize, however, that some services may be difficult to classify and we encourage issuers and their accountants to contact our staff to discuss the appropriate classifications.

Consistent with our proposal, we are adopting rules requiring issuers to provide disclosures of fees paid to the independent accountant segregated into the four previously-identified categories. Additionally, other than for the audit category, the issuer is required to describe, in qualitative terms, the types of services provided under the remaining three categories. Also, consistent with our proposal, this information is required for the two most recent years. Finally, consistent with our proposal, this information must be provided either in the issuer's proxy statement, or its periodic annual filing.

While the rules we are adopting continue to require issuers to disclose fees paid to the principal accountant for audit services, we are expanding the types of fees that should be included in this category to include fees for services that normally would be provided by the accountant in connection with statutory and regulatory filings or engagements. In addition to including fees for services necessary to perform an audit or review in accordance with GAAS,[233] this category also may include services that generally only the independent accountant reasonably can provide, such as comfort letters, statutory audits, attest services, consents and assistance with and review of documents filed with the Commission.

We believe that the addition of a new category, "Audit-Related Fees," will enable registrants to present the audit fee relationship with the principal accountant in a more transparent fashion. In general, "Audit-Related Fees" are assurance and related services (*e.g* ., due diligence services) that traditionally are performed by the independent accountant. More specifically, these services would include, among others: employee benefit plan audits, due diligence related to mergers and acquisitions, accounting consultations and audits in connection with acquisitions, internal control reviews, attest services that are not required by statue or regulation and consultation concerning financial accounting and reporting standards.

We also believe it is appropriate to add transparency regarding a second category of fees: "Tax Fees." The review of a registrant's tax returns and reserves is a task that often requires extensive knowledge about the audit client. In many public companies, the fee for tax services is substantial in relation to other services. We believe that investors will benefit from being able to consider those fees separately from the "All Other Fees" category. The "Tax Fees" category would capture all services performed by professional staff in the independent accountant's tax division except those services related to the audit as discussed previously. Typically, it would include fees for tax compliance, tax planning, and tax advice. Tax compliance generally involves preparation of original and amended tax returns, claims for refund and tax payment-planning services. Tax planning and tax advice encompass a diverse range of services, including assistance with tax audits and appeals,[234] tax advice related to mergers and acquisitions, employee benefit plans and requests for rulings or technical advice from taxing authorities.

The category of "All Other Fees" would remain unchanged from the existing rule, except that to the extent that financial information systems implementation and design exist they would be disclosed as a component of "All Other Fees."

Consistent with our proposal, we also are requiring that the information be provided for two periods so that investors will have comparative information about the fees paid to the independent accountant by the issuer.

As noted in our previous discussion about audit committee pre-approval requirements, we have clarified the guidance on audit committee pre-approval of services provided by the independent accountant. Accordingly, the issuer must provide disclosure of the audit committee's pre-approval policies and procedures. Additionally, to the extent that the audit committee has applied the de minimis exception discussed previously, the issuer must disclose the percentage of the total fees paid to the independent accountant where the de minimis exception was used. This information should be provided by category.

We expect registrants to provide clear, concise and understandable descriptions of the policies and procedures. Alternatively, registrants could include a copy of those policies and procedures with the information delivered to investors and filed with the Commission. Either method should allow shareholders to obtain a complete and accurate understanding of the audit committee's policies and procedures. We expect the policies and procedures would address auditor independence oversight functions in a prudent and responsible manner. Additionally, these procedures would describe, if applicable, the specific processes in place that monitor activities where the de minimis exception is invoked.

Consistent with our proposal, we are requiring that the disclosures be included in a company's annual report. However, because we believe that this information is relevant to a decision to vote for a particular director or to elect, approve or ratify the choice of an independent public accountant, we are requiring that this disclosure be included in a company's proxy statement on Schedule 14A or information statement on Schedule 14C. Since the information is included in Part III of annual reports on Forms 10-K and 10-KSB, domestic companies are able to incorporate the required disclosures from the proxy or information statement into the annual report.

Our intent is that this information be made available to investors of all registrants. However, not all registrants are required to file proxy statements. Thus, consistent with the provisions in the Act, registrants that do not issue proxy statements are required to include appropriate disclosures in their annual filing included in Form 10-K, Form 10-KSB, 20-F, Form 40-F and Form N-CSR[235] as appropriate. For the reasons noted previously in this release, we are exempting asset-backed issuers and unit investment trusts from these disclosure requirements.

With respect to investment companies, we proposed to require investment companies to make disclosure that is similar to the disclosure proposed for operating companies filing with the Commission. The proposed rule required an investment company to disclose the audit fees paid by the investment company to its accountant and the aggregate fees paid for audit related, tax services, and other services to the investment company's accountant by the investment company and its investment adviser and any entity controlling, controlled by or under common control with the adviser, that provides services to the investment company. The proposed rule also required the disclosure of the percentage, for each category presented, of fees which were subject to: (1) direct pre-approval; (2) pre-approval pursuant to policies and procedures; and (3) pre-approval pursuant to the de minimis exception. Lastly, the proposed rule would require these disclosures in the annual report on proposed Form N-CSR and proxy and information statements.

Commenters[236] generally raised several significant issues related to the disclosure that would be required for investment companies. Many commenters[237] believed the fee disclosures should only be required to be made for the services provided by the accountant to the investment company registrant. One commenter[238] suggested the fees presented should be disclosed separately for those services provided to the investment company directly and those provided to the other entities in the investment company complex. Some commenters[239] believed that only those fees required to be pre-approved by the investment company's audit committee should be disclosed. Lastly, one commenter[240] expressed concern that providing percentage disclosure by type of pre-approval method (*i.e* ., direct, pursuant to policy and procedures, or the de minimis exception) would imply that some of these methodologies were improper.

After considering the comments, we do not believe that the fee disclosures should be limited to only those fees paid directly by the investment company registrant. We believe the fees paid by other entities in the investment company complex can have a bearing on the investment company accountant's independence. However, we are concerned that the disclosures provide meaningful information to investors. Consequently, we have determined to modify the proposed requirements.

Our final rule requires the investment company to disclose separately those audit and non-audit fees from services provided directly to the investment company and those non-audit fees from services provided to all other entities in the investment company complex where the services were subject to pre-approval by the investment company's audit committee. Like an operating company, the investment company would be required to disclose the percentage of fees for each category of fees that were pre-approved pursuant to the deexception. The final rules require disclosure of the total non-audit fees paid to the accountant, regardless of whether those fees were pre-approved by the investment company's audit committee, by the investment company, its adviser, and any entity controlling, controlled by, or under common control with the investment adviser that provides ongoing services to the fund. The final rule also will require the investment company to disclose if the audit committee has considered whether the provision of non-audit services provided to the investment company's adviser and its related parties that were not subject to the investment company audit committee's pre-approval is compatible with maintaining the principal accountant's independence.

These disclosure provisions are effective for periodic annual filings for the first fiscal year ending after December 15, 2003. We encourage issuers who have not previously issued their periodic annual filings to adopt these disclosure provisions earlier.

I. International Impact

The Commission realizes that these rules will have an international impact. It will affect foreign accounting firms that conduct audits of both foreign private issuers and foreign subsidiaries and affiliates of U.S. issuers. Through its participation in the International Organization of Securities Commissions and bilateral meetings, and through a roundtable held in Washington in December, the Commission has made a concerted effort to obtain the views of the international community of regulators, market participants and practitioners. Through this process and public consultation, the Commission has received valuable insight into various foreign regulatory regimes relating to auditor independence, and detailed and specific comments on the proposed rule.

The partner rotation requirements set forth in the proposed rule were of particular concern to the international community. The proposal, as mandated by the Act, called for the rotation of the lead and concurring partners on a five-year basis. In addition, it precluded these partners from returning to an audit of the same registrant for five years. The proposal also applied the same rotation requirement to all partners on the audit engagement team. Commentators noted that the proposed requirements could have a particularly adverse impact in foreign countries, especially in emerging countries, where there may be a more limited pool of accountants and experts conversant in U.S. GAAP and U.S. GAAS. Other commentators indicated that the proposed rotation requirements would cause firms to rotate hundreds of partners in scores of countries. The resulting widespread rotation would affect audit quality adversely, and would be hard, if not impossible, to achieve practically.

We are extending the partner rotation requirements beyond the lead and concurring partners. However, taking into account these and other comments, the rotation will not be applied as broadly as proposed. We believe that partner rotation should be a function of the level of responsibility for decisions on accounting and financial reporting issues, and the level of interaction with senior management of an issuer. Accordingly, under the final rule, the rotation requirement will apply to partners that serve the client at the issuer or parent level. It also will apply to the lead partner serving an issuer's subsidiary whose revenues constitute 20% or more of the consolidated assets or revenues of the parent. Partners serving subsidiaries whose assets and revenues fall below the threshold are not subject to rotation. The same is true for partners, other than lead partners, serving subsidiaries above the threshold.

The international community also requested that the Commission modify its approach to conflicts of interest resulting from employment relationships. The Act requires a "cooling off" period of one year before a member of the audit engagement team can work for a registrant in certain key positions. Under the proposed rule, the restriction applied with regard to employment by the issuer and its affiliates. Some commentators stated that the rule should only apply to partners on the audit engagement team. Commentators also indicated that extending the requirement to apply with regard to key positions at the issuer and its affiliates was overbroad, difficult to monitor, and possibly impossible to control. Moreover, we have become aware that in certain jurisdictions the labor law or jurisprudence would prohibit foreign accounting firms from imposing restrictions on the future employment opportunities of their personnel.

We agree that extending the requirement to the audit client might be difficult to monitor particularly in situations where a member of the audit engagement team begins employment with an affiliate of the issuer. Further, we recognize that in certain foreign jurisdiction it may be extremely difficult to comply with these requirements. In response to the concerns raised, the cooling-off period will apply to the lead, concurring partner or any other member of the audit engagement team, unless exempted, who provides more than ten hours of audit, review or attest services. The restriction on employment will apply only with regard to key positions at the issuer. Members of the audit engagement team, including those employed by a foreign accounting firm, will be able to take positions with the subsidiaries or affiliates of an issuer. They also may take key positions at the issuer in certain circumstances and upon the approval of the audit committee (or a similar body).

The Commission also has given consideration to comments regarding foreign requirements with respect to the provision of appraisal and valuation services. The Commission believes that the extension of these services to audit clients raises concerns with respect to the auditor's independence. The Commission is, therefore, eliminating some exemptions previously provided in this area. However, we understand that laws and regulations in certain foreign countries require auditors to provide contribution-in-kind reports or valuation services. The Commission has historically addressed conflicts between US and foreign requirements regarding non-audit services on an *ad hoc* basis. Commission staff has previously afforded relief from proscriptions against appraisal and valuation services where, among other things, the auditor and issuer were able to demonstrate that the auditor was not providing an opinion on the fairness of a given transaction. The Commission will continue to take this *ad hoc* approach, and will continue to consider requests for exemptive relief from foreign auditors.

Finally, several foreign commentators noted that a prohibition on legal services could amount to a prohibition on the provision of tax services by foreign accounting firms from particular jurisdictions. It would appear that in certain jurisdictions tax services are defined as legal services and can only be rendered by persons licensed to practice law. The Commission is making clear that foreign accounting firms can provide tax services, as appropriate, despite their local definition and local licensing requirements.

The Commission is mindful of the fact that this rule may overlap with foreign requirements designed to achieve auditor independence. The Commission has taken foreign requirements into account, and afforded accommodations to foreign accounting firms in a manner and to the extent consistent with the spirit and intent of the Act. As the rule is implemented, the Commission, as well as the PCAOB, will monitor its international impact and continue to dialogue with its foreign counterparts.

III. Paperwork Reduction Act

Certain provisions of our final amendments contain "collection of information" requirements within the meaning of the Paperwork Reduction

Act of 1995 ("PRA").[241] We published a notice requesting comment on the collection of information requirements in the proposing release for the rule amendments, and we submitted these requirements to the Office of Management and Budget ("OMB") for review in accordance with the PRA.[242] The titles for the collection of information are:

(1) "Proxy Statements - Regulation 14A (Commission Rules 14a-1 through 14a-15 and Schedule 14A)" (OMB Control No. 3235-0059);
(2) "Information Statements - Regulation 14C (Commission Rules 14c-1 through 14c-7 and Schedule 14C)" (OMB Control No. 3235-0057);
(3) "Form 10-K" (OMB Control No. 3235-0063);
(4) "Form 10-KSB" (OMB Control No. 3235-0420);
(5) "Form 20-F" (OMB Control No. 3235-0288);
(6) "Form 40-F" (OMB Control No. 3235-0381);
(7) "Regulation S-X" (OMB Control No. 3235-0009); and
(8) "Form N-CSR" (OMB Control No. 3235-0570).

These regulations and forms were adopted pursuant to the Securities Act, the Exchange Act and the Investment Company Act and set forth the disclosure requirements for periodic reports, registration statements and proxy and information statements filed by companies to ensure that investors are informed. The hours and costs associated with preparing, filing and sending these forms constitute reporting and cost burdens imposed by each collection of information. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number. Compliance with the requirements will be mandatory. There will be no mandatory retention period for the information disclosed, and responses to the requirements will not be kept confidential.

Regulation S-X is the central repository for rules related to the form and content of financial statements with the Commission. Regulation S-X, however, does not direct registrants to file financial statements or to collect financial data. Regulation S-X indicates what should be in the financial statements and how financial statements should be presented when they are required to be filed by other rules and forms under the securities laws. Burden hours and costs associated with the preparation of financial statements in accordance with Regulation S-X are allocated to the rules or forms that require the financial statements to be filed. Because Regulation S-X does not require any information to be filed with the Commission, we previously have assigned one burden hour to Regulation S-X for administrative convenience to reflect the fact that this regulation does not impose any direct burden on companies.

A. Summary of Amendments

1. Communication with Audit Committees

As required by Section 204 of the Sarbanes-Oxley Act, we are amending Regulation S-X to require each public accounting firm registered with the Board that audits an issuer's financial statements to report to the issuer's or investment company's audit committee: (1) all critical accounting policies and practices used by the issuer, (2) all material alternative accounting treatments within GAAP that have been discussed with management, including the ramifications of the use of the alternative treatments and the treatment preferred by the accounting firm, (3) other material written communications between the accounting firm and management of the issuer such as any management letter or schedule of "unadjusted differences," and (4) in the case of registered investment companies, all non-audit services provided to certain entities in the investment company complex that were not pre-approved by the investment company's audit committee. The required reports need not be in writing but the report is required to be presented to the audit committee before the auditor's report on the financial statements is filed with the Commission.[243]

2. Disclosures of Audit and Non-Audit Services

Item 9 of Schedule 14A requires the disclosure of certain information regarding the registrant's relationship with the independent auditor of the company's financial statements when there is a solicitation relating to: (1) a meeting at which directors to the company's board of directors are to be elected (or the solicitation of consents or authorizations in lieu of such a meeting) or (2) the election of the auditor, or the approval or ratification of the company's selection of the auditor. We are amending paragraph (e) of Item 9 to provide more detailed information regarding the categories of fees paid by the registrant to the auditor and to inform investors about the critical role that audit committees play in assuring the auditor's independence. We believe that the disclosure will allow investors to better assess an auditor's independence and certain activities of an audit committee.

Item 9(e) previously required disclosure of fees billed by the auditor in the last fiscal year, with the fees broken down into three categories: audit fees, financial information systems design and implementation fees, and all other fees. The final rules add disclosure of two categories (tax fees and audit-related fees), while eliminating one category (financial information systems design and implementation), and require disclosure of one more past year of each of these fees. Because these fees are already being disclosed, repeating the prior year's disclosures for comparison purposes should not increase significantly a registrant's compliance burden. In addition, breaking tax fees and audit-related fees out of the "all other" category of fees currently being disclosed should not result in any significant incremental burden.

With respect to investment companies, the final rules also will require disclosure of all non-audit fees paid to the investment company's accountant by any entity in the investment company complex and whether the audit committee has considered those non-audit services in evaluating the auditor's independence from the investment company. Since these disclosures exist in some form currently, there should be no significant incremental disclosure burden.

Under the final rules, registrants also will be required to disclose any policies and procedures adopted by an audit committee to be followed for pre-approval of services to be performed by the accounting firm in the event that the audit committee does not expressly pre-approve the particular engagements.[244] In addition, the final rules require registrants to disclose what percentage of fees in each of the categories noted above (audit, audit-related, tax, and other) relate to engagements for which the pre-approval requirement was waived under the de minimis exception.[245]

Some companies that file Forms 10-K or 10-KSB are not subject to the proxy disclosure requirements. These companies, therefore, now will be required to present the required disclosures in the Form 10-K or 10-KSB. Foreign private issuers that file Form 20-F and Canadian companies that file Form 40-F generally are not subject to the proxy disclosure requirements and, therefore, will be required to present the required disclosures on Form 20-F or Form 40-F. Some investment companies do not regularly file proxy or information statements. These investment companies will, therefore, now be required to disclose this information in the investment company's annual report on Form N-CSR.

B. Summary of Comment Letters and Revisions to Proposals

We requested comment on the PRA analysis contained in the proposing release. Two commenters responded generally that they believed the burden estimates seemed unrealistic.[246] However, neither commenter provided supporting data, revised burden hour estimates or other information to support their views. One of these commenters believed that the 25% allocation to outside professionals was unrealistically low.[247] As we have mentioned in many recent releases, we believe that the allocation of 75% of the burden to internal staff and 25% of the burden to outside professionals accurately reflects current practice for proxy and information statements and annual reports for domestic issuers.[248] In particular, the disclosure requirements regarding principal accountant's fees should involve information that already is readily available to internal staff of the registrant. We have not concluded that our burden hour estimates for purposes of the Paperwork Reduction Act should be changed, although we will continue to monitor registrant response to our burden hour estimates.

In addition, we have made several revisions to the proposals. However, we do not believe these changes will significantly change our previous estimates of the burden on registrants from the amendments.

1. Communication with Audit Committees

We have made one change to the proposed rules concerning communication with audit committees. We proposed rules that would have required public accounting firms performing the audit for an issuer or investment company to report to the audit committee of the issuer or investment company, prior to the filing of such audit with the Commission, all alternative treatments of financial information within GAAP that have been discussed with management of the issuer or investment company. In response to commenters, the final rules only require reporting of material alternative treatments of financial information within GAAP that have been discussed with management of the issuer or investment company. This change should aid in focusing the reports to audit committees on important matters and not dilute the usefulness with discussion of less important matters. With respect to investment companies, we have added a requirement to disclose all non-audit services provided to the investment company complex that were not pre-approved by the investment company's audit committee. However, we are changing the requirement to discuss these matters from before each filing, which could have been as frequent as monthly, to annually, with an update, if necessary.

2. Disclosures of Audit and Non-Audit Services

We have made three minor changes in response to commenters' concerns regarding the rules requiring disclosure of audit and non-audit services. The first change clarifies the audit fee category to specifically include services that normally are provided by the accountant in connection with statutory and regulatory filings. The second change relates to tax fees and specifies that registrants will be required to describe each subcategory of services comprising the fees disclosed under the "tax fees" category, similar to the requirement for the "audit-related fees" category. Finally, the third change relates to the requirement to disclose the percentage of audit fees, audit-related fees, tax fees, and all other fees that were approved by the audit committee. The proposed rule would have required this disclosure for all fees derived from engagements that were: (1) approved by the issuer's or investment company's audit committee before the accountant was engaged by the issuer or investment company, (2) entered into pursuant to pre-approval policies and procedures established by the audit committee of the issuer or investment company, provided the audit committee was informed of each service, and (3) for which the pre-approval requirement was waived under the de minimis exception. The final rules will only require disclosure of the percentage of audit fees, audit-related fees, tax fees, and all other fees for which the pre-approval requirement was waived under the de minimis exception.

With respect to investment companies, we have made three changes to the rule. The first change requires the fund to disclose all non-audit fees paid by entities in the investment company complex only to the extent those non-audit services relate to the operations or financial reporting of the investment company. The second change requires investment companies to disclose the aggregate non-audit fees paid to the auditor by any entity in the investment company complex. The third change requires the investment company to disclose if the audit committee has considered whether the provision of non-audit services by the accountant to the investment company complex is compatible with maintaining the accountant's independence.

C. Revisions to Reporting and Burden Estimates

1. Communication with Audit Committees

As discussed in the proposing release, we believe that GAAS currently require discussions between the auditors and the audit committee of significant unusual, controversial, or emerging accounting policies, of the process used by management to select certain estimates, and of disagreements with management over certain accounting matters.[249] We further believe that audit committees generally are aware of management's letter making representations to the auditors, which the auditor uses in completing the audit of the issuer's financial statements.[250] Audit committees also should be aware of "unadjusted differences,"[251] if any, as a result of the enactment of Section 401 of the Sarbanes-Oxley Act, which added Section 13(i) to the Securities Exchange Act of 1934 ("Exchange Act").[252] Under new Section 13(i) of the Exchange Act, therefore, there should be no material "unadjusted differences." In the case of investment companies, we believe auditors already are reporting non-audit services provided to the investment company complex annually and some routinely provide more frequent updates at the request of the audit committee.[253] Because of these GAAS and legal provisions, we believe that the final rules regarding auditor reports to audit committees will not increase significantly the burden hours on accounting firms or registrants.

2. Disclosures of Audit and Non-Audit Services

While we have made some modifications to the proposals relating to disclosure of audit and non-audit services, we do not believe these changes will have a significant effect on the total amount of burden hours for preparing the forms. Accordingly, we believe that our estimates of the burden articulated in the proposing release have not changed as a result of modifications contained in the final rules.

a. Proxy and Information Statements. We estimate that the incremental disclosure changes would impose, on average, two additional burden hours on each of the 7,661 filers of Schedule 14A, or an aggregate 15,322 additional burden hours. We further estimate that approximately 75% of the extra burden hours, or approximately 11,492 hours, would be expended by internal staff and the remaining 25%, or 3,830 hours, would be expended by outside professionals who are retained by the filer. Assuming that outside professional costs would be an average of $300 per hour, the aggregate annual professional costs would be $1,149,000. Similarly, we estimate that these disclosures would impose, on average, two additional burden hours on each of the 464 filers of Schedule 14C, or an aggregate 928 additional burden hours. Using the same allocation of hours and cost estimate of professional fees as for Schedule 14A, we estimate that 696 hours would be expended by internal staff and the remaining 232 hours would be for outside professional assistance, producing an outside professional cost of $69,600.

b. Annual Reports on Form 10-K. We estimate that the incremental disclosure changes will impose, on average, two additional burden hours per year on each of the 8,484 filers of Form 10-K. 6,676 of those filers, however, will provide the information under Schedule 14A and 209 of those filers would provide the information under Schedule 14C.[254] The burden hours for the disclosure by these filers therefore have been assigned to Schedule 14A and Schedule 14C, respectively. The burden imposed on the remaining 1,599 filers is being assigned to Form 10-K. This results in 3,198 (2 hours x 1,599 filers) additional burden hours for Form 10-K. We further estimate that approximately 75% of the extra burden hours, or approximately 2,399 hours, will be expended by internal staff and the remaining 25%, or 799 hours, will be expended by outside professionals. Assuming that outside professional costs average $300 per hour, the estimated aggregate annual professional costs are $239,700.

c. Annual Reports on Form 10-KSB. We estimate that the incremental disclosure changes will impose, on average, two additional burden hours per year on each of the 3,820 filers of Form 10-KSB. 985 of those filers, however, will provide the information under Schedule 14A and 255 of those filers will provide the information under Schedule 14C. The burden hours for the disclosure by these filers have been assigned to Schedule 14A and Schedule 14C, respectively. The burden imposed on the remaining 2,580 filers is being assigned to Form 10-KSB. This results in 5,160 (2 hours x 2,580 filers) additional burden hours. We further estimate that approximately 75% of the extra burden hours, or approximately 3,870 hours, will be expended by internal staff and the remaining 25%, or 1,290 hours, will be expended by outside professionals. Assuming that outside professional costs average $300 per hour, the estimated aggregate annual professional costs are $387,000.

d. Annual Reports by Foreign Private Issuers on Form 20-F. We estimate that the incremental disclosure changes will impose, on average, two additional burden hours per year on each of the 1,194 filers of Form 20-F, or 2,388 additional burden hours. We further estimate that approximately 25% of the extra burden hours, or approximately 597 hours, will be expended by internal staff and the remaining 75%, or 1,791 hours, will be expended by outside professional costs associated with reviewing the disclosures because this form is prepared by foreign private issuers who rely more heavily on outside counsel for assistance. Assuming that outside professional costs average $300 per hour, the estimated aggregate annual professional costs are $537,300.

e. Reports by Certain Canadian Issuers on Form 40-F. We estimate that the incremental disclosure changes will impose, on average, two additional burden hours per year on each of the 134 filers of Form 40-F, or 268 additional burden hours. Consistent with our treatment of foreign private issuers filing Form 20-F, we further estimate that approximately 25% of the extra burden hours, or approximately 67 hours, will be expended by internal staff and the remaining 75%, or 201 hours, will be expended by outside professionals. Assuming that outside professional costs average $300 per hour, the estimated aggregate annual professional costs are $60,300.

f. Form N-CSR. We estimate that the additional disclosure changes will impose, on average, 1.5 additional burden hours per year on each of the anticipated 3,700 filers of Form N-CSR. This results in 5,550 (1.5 hours x 3,700 filers) additional burden hours. We estimate that the cost of these burden hours is $81 per hour, resulting in aggregate internal costs of $449,550.[255] Further, we estimate that this additional disclosure will require 0.5 hours in professional review by outside counsel at an average rate of $300 per hour, resulting in an estimated aggregate annual outside professional costs of $555,000.

IV. Cost - Benefit Analysis

We are sensitive to the costs imposed by and benefits derived from our rules, and we have identified certain costs and benefits of these rules. Additionally, certain of these costs are imposed by Congressional mandate through the enactment of the Sarbanes-Oxley Act.

A. Background

The Sarbanes-Oxley Act was enacted on July 30, 2002. Title II to that Act adds Sections 10A(g) through 10A(l) to the Securities Exchange Act of 1934 ("Exchange Act") and requires that the Commission, within 180 days of enactment, adopt rules to carry out each of those sections.[256]

The final rules:

- Revise the Commission's regulations related to the non-audit services that, if provided to an audit client, would result in the accounting firm being deemed to lack independence with respect to the audit client;[257]

- Require that an issuer's audit committee pre-approve all audit and non-audit services provided to the issuer by the independent accountant;[258]
- Prohibit certain partners on the audit engagement team from providing audit services to the issuer for more than five or seven consecutive years, depending on the partner's involvement in the audit (smaller accounting firms may be exempted from this requirement);[259]
- Prohibit an accounting firm from auditing an issuer's financial statements if a person in a financial reporting oversight role of that issuer had been a member of the accounting firm's audit engagement team within the one-year period preceding the commencement of audit procedures;[260]
- Require that the auditor of an issuer's financial statements report certain matters to the issuer's audit committee, including "critical" accounting policies and practices used by the issuer;[261] and
- Require disclosures to investors of information related to audit and non-audit services provided by, and fees paid by the issuer to, the auditor of the issuer's financial statements.[262]

In addition, under the final rules, an accountant will be deemed to be not independent from an audit client if any "audit partner" receives compensation based directly on selling engagements to that client other than audit, review, or attest services. We have narrowed the final rule by exempting accounting firms with fewer than ten partners and fewer than five audit clients from this provision.[263] While many of the final rules respond directly to the provisions of Title II of the Sarbanes-Oxley Act, certain of the rules go beyond the specific provisions of the Act. These provisions include:

- Applying the partner rotation rules to additional "audit partners";
- Applying the one-year cooling off period to persons in a financial reporting oversight role with the issuer; and
- Prohibiting an accounting firm from compensating an audit partner for directly selling non-audit services to an audit client.

B. Potential Benefits of the Final Rules

Potential benefits resulting from the final amendments include increased investor confidence in the independence of accountants, in the audit process, and in the reliability of reported financial information. As discussed below, clearer auditor independence regulations should provide investors with comfort that auditors are placing the interests of investors over financial or personal incentives. The final rules mandating that accountants communicate certain matters to audit committees should benefit investors by enhancing the opportunities for meaningful audit committee oversight of the financial reporting process. Investors also will benefit from the enhanced disclosure of the non-audit services provided by, and fees paid to, the accounting firm that audits the company's financial statements, and from better disclosure of the audit committee's role in approving the provision of audit and non-audit services by the accounting firm that audits the company's financial statements. We believe that these factors could improve the efficiency of the markets and result in a lower cost of capital.

1. Auditor Independence

The amendments are intended to facilitate the independence of the accountant from management in the following ways:

- Providing clearer definition of the types of non-audit services that would be deemed to impair an auditor's independence;
- Requiring that each engagement of the accountant to perform audit or non-audit services for the company be pre-approved by the audit committee, which serves as the representative of investors;
- Requiring the "rotation" of "audit partners" on the audit engagement team to assure a periodic fresh look at the accounting and auditing issues related to the issuer's financial statements;
- Providing that the accountant's independence would be deemed to be impaired if an "audit partner" is compensated directly for selling non-audit services or products to an audit client. This provision should mitigate the concerns that an accountant might be viewed as compromising accounting judgments in order not to jeopardize the potential for increased income from the act of selling non-audit services to the audit client; and
- Requiring a "cooling off" period between working on the audit engagement team and joining the client in a "financial reporting oversight role" in order to assure that personal relationships and the new member of management's knowledge of the audit plan do not negatively impact the audit process.

Strengthening auditor independence should provide investors with more confidence that the accountants are playing their "gatekeeper" role related to companies' financial reporting and provide further assurance that the financial condition, results of operations, and cash flows of companies are fairly reflected in their financial reports thereby allowing public companies less costly access to the capital markets.

The final rules specify that "audit partners" who are compensated for cross-selling non-audit services are deemed to be not independent with respect to the audit client. This will further enhance the independence of the audit function since the audit partner's focus will be on the conduct of the audit rather than on efforts to sell other engagements to the audit client. The danger inherent in compensating audit partners for cross-selling non-audit services is that it might create a temptation for accountants to compromise the quality of the audit in order to maintain their relationship with management to whom they wish to cross-sell such services.

2. Auditor Reports to Audit Committees

The final rules require that each public accounting firm registered with the Board that audits an issuer's financial statements report specified information to the issuer's audit committee, including: (1) all critical accounting policies and practices used by the issuer, (2) all material alternative accounting treatments within GAAP that have been discussed with management, (3) other material written communications between the accounting firm and management of the issuer, such as any management letter or schedule of "unadjusted differences," and (4) in the case of registered investment companies, all non-audit services provided to entities in the investment company complex that were not pre-approved by the investment company's audit committee.

The report by the Senate Committee on Banking, Housing, and Urban Affairs on the bill that later became the foundation for the Sarbanes-Oxley Act, in addressing the need for such reports from the accountant to the audit committee, stated, in part:

> The Committee believes that it is important for the audit committee to be aware of key assumptions underlying a company's financial statements and of disagreements that the auditor has with management. The audit committee should be informed in a timely manner of such disagreements, so that it can independently review them and intervene if it chooses to do so in order to assure the integrity of the audit.[264]

Almost eight months before passage of the Sarbanes-Oxley Act, in December 2001, we issued cautionary advice regarding the disclosure in the Management's Discussion and Analysis[265] section of its annual report of those accounting policies that management believes are most critical to the preparation of the issuer's financial statements.[266] As part of that cautionary advice, we stated:

> Prior to finalizing and filing annual reports, audit committees should review the selection, application and disclosure of critical accounting policies. Consistent with auditing standards, audit committees should be apprised of the evaluative criteria used by management in their selection of the accounting principles and methods. Proactive discussions between the audit committee and the company's senior management and auditor about critical accounting policies are appropriate.[267]

Communications with the audit committee about such policies facilitate the audit committee's oversight of the financial reporting process. Investors should benefit by the audit committee being better informed and, thus, in a position to better challenge what it may view as non-typical, aggressive, or improper applications of GAAP used by management to enhance or manipulate reports of the company's financial results or financial condition.

3. Enhanced Disclosures About the Services Provided by Auditors to Registrants

Investors will receive more detailed information about:

- Any policies and procedures adopted by an audit committee for pre-approving audit and non-audit services provided by the independent accountant,

- The fees paid by the registrant to the accountant in each of the last two years for audit, audit-related, tax, and all other services,[268] and
- The percentage of fees in each of those categories where the audit committee used the de minimis exception.

These disclosures will provide greater transparency to investors of certain aspects of the auditor-client relationship. Providing better, more complete information in cases where non-audit services occur allows investors to determine for themselves whether there are concerns related to the auditor's independence. It also may allow investors to ask more direct and useful questions of management and directors regarding their decisions to engage the accountants for such services.

C. Potential Costs of the Final Rules

1. Auditor Independence

Changes in our auditor independence rules may impose costs on accounting firms and on any issuers that engage, or would like to consider engaging, the accountant of an issuer's financial statements to perform non-audit services.

a. Non-audit services. According to the information available to the staff in 2000, approximately 12,600 registrants did not purchase any consulting services from the auditor of their financial statements, and 4,100 registrants reported purchasing such services.[269] Based on the scrutiny that these services have received over the past year, the Commission believes that the number of companies purchasing non-audit services from their accountant might have decreased further.

The current auditor independence rules state that the performance of certain non-audit services will be deemed to impair an auditor's independence. The final rules, in some cases, redefine those services and add one more item, "expert services," to the list of prohibited services. These changes may impact the competitive markets for these services. Audit clients are precluded from engaging their independent accountants to perform services in the categories of bookkeeping services, financial systems design and implementation services, appraisal and valuation services, actuarial services, internal audit outsourcing services, management functions, human resources, broker-dealer, investment adviser or investment banking services, legal services and expert services. These companies may incur costs from having to use a separate vendor for such services resulting in the possible loss of any benefits of having a single provider for both audit and non-audit services. Companies also may incur costs in locating a new vendor and developing a business relationship with that vendor. In addition, companies may incur costs from not being able to retain their preferred provider of non-audit services, if that preferred provider is their independent accountant. The difference in value between a preferred provider and a second choice may be substantial, particularly if the preferred provider has relatively rare service offerings or service offerings that are particularly well suited to the needs of the company.

The final rules may cause accountants to lose one or more sources of revenue because they will no longer be able to sell certain non-audit services to their audit clients. Additionally, accounting firms may incur additional costs to market these services with non-audit clients as well as additional learning costs to familiarize themselves with the operations of those non-audit clients. Finally, to the extent that there exist economies of scope in the provision of audit and non-audit services (as, for example, through the use of shared knowledge management systems and other infrastructure) and to the extent that the preclusion of certain non-audit services to audit clients results in the exit of personnel who provide such services from accounting firms, there may be an increase in the cost of both audit and non-audit services.

We believe, however, that in view of the statements by the largest four accounting firms, and others, that they no longer intend to provide internal audit outsourcing services and financial system design and implementation services to audit clients,[270] the cost associated with the adoption of the final rules may be limited. Also, to the extent that the provision of non-audit services is merely redistributed among the firms, there would be no net loss of revenue to public accounting firms as a whole.

b. Audit Committee Pre-approval of Services. Under the final rules, all auditing and non-audit services to be provided by the independent accountant must be pre-approved by the issuer or investment company's audit committee.[271] There may be incremental costs associated with audit committees performing this function. Such costs might include more frequent committee meetings, an increased workload on audit committee members, and having the audit committee's legal counsel review the audit committee's draft policies and procedures for engaging the independent accountants for non-audit services. The increased burden on audit committee members might result in the need to increase their compensation, resulting in additional costs to issuers or investment companies. Some of these costs may be mitigated by the provisions in the Act and the final rules that allow the audit committee to delegate to one or more audit committee members the authority to grant pre-approvals of these services.[272]

Inadvertent violations of the Act and the final rules that would add to the costs of the rules also may be mitigated by the de minimis exception to the pre-approval requirement.[273] This exception applies if: (1) the aggregate amount of the non-audit services is not more than five percent of the total amount of revenues paid by the issuer to the accountant during the fiscal year in which the non-audit services were provided,[274] (2) at the time of the engagement the issuer did not recognize the services to be non-audit services, and (3) the services are approved by the audit committee prior to the completion of the audit.[275]

We also believe that as a result of the Commission's audit committee disclosure requirements adopted in 1999,[276] prior disclosures related to the involvement of the audit committee in recommending or approving changes in independent accountants and the resolution of disagreements between management and the accountants,[277] and professional standards that require communications between the accountant and the audit committee on auditor independence and other issues,[278] many companies currently have audit committees that carefully evaluate the engagement of accountants to perform non-audit services. Accordingly, we believe that the incremental costs associated with these rules will not be substantial.

c. Rotation of Partners on the Audit Engagement. Under the final rules, no "audit partner" will serve on an audit engagement team for more than seven consecutive years, and the "lead" and "concurring" partners will be prohibited from serving for more than five consecutive years. Current professional requirements state that the "lead" partner should be replaced at least once every seven years.[279] The proposed rules would have required any partner on the audit engagement team of an issuer and its significant subsidiaries to rotate after five years. Many commenters believed that the reach of the proposal was too deep, particularly for individuals that have limited participation in the audit. The final rules require fewer partners to rotate than under the proposal. Under the final rules, the lead partner, who has primary responsibility for the audit, along with the concurring partner, must rotate after five years. Other audit partners at the issuer,[280] or a subsidiary of the issuer whose assets or revenues constitute 20% or more of the consolidated assets or revenues of the issuer must rotate after seven years. Accounting firms with fewer than five audit clients and fewer than ten partners may be exempted from the partner rotation requirements if the Board conducts a special review of each of the firm's audit engagements for audit clients at least once every three years. In total, the final rule expands the rotation requirements to cover a greater number of partners than under the current professional requirements.

A number of commenters expressed concern that under the proposed rules many small accounting firms would be unable to meet the partner rotation requirements and may be driven out of business, potentially burdening the ability of smaller companies to retain auditors and access the public markets. We have attempted to mitigate this effect by providing an exemption for smaller accounting firms in the final rules.[281]

Without the exemption, clients of many of the smaller accounting firms would have to change auditors every five years because their incumbent auditor would not be able to meet the partner rotation requirements. This would have imposed marketing and client-specific learning costs on the accounting firms and costs on clients to familiarize the new accountant with their operations.

Costs associated with the periodic replacement of partners might include more frequent company-specific training, conducted by both the accounting firm and the audit client, as new partners join the audit engagement team. For example, the new partners will need to learn the company's accounting and financial reporting procedures, controls and familiarize themselves with key personnel. The final rules also might result in incremental costs related to some partners being required to travel extensively, relocate from one part of the country to another, or from one country to another.[282]

The costs related to these rules will vary based on the proximity of an accounting firm's audit clients, the concentration of the firm's practice within an industry, and the availability of partners to whom the work may be redistributed, and similar factors. We note that these costs may be passed on to issuers in the form of higher audit fees.

Had the proposed rules been adopted, another potential impact would have been the impact on the specialization of accounting firms within each industry. To minimize partners' costs of learning new businesses, accounting firms have an incentive to specialize in certain industries. This, potentially, could have had the effect of creating oligopolies within each industry and could have adversely affected competition among accounting firms.

d. One-Year Cooling Off Period. The final rules indicate that an accounting firm is deemed to be not independent with respect to an audit client if a former member of the audit engagement team is employed by the issuer in a "financial reporting oversight role" unless the individual had not been a member of the audit engagement team during the one year period preceding the initiation of the audit.[283]

Currently, when a former professional employee of an accounting firm joins an audit client within one year of leaving the firm, and the individual has significant interaction with the accounting firm's audit engagement team, professional standards require the accounting firm to perform procedures to assure that the individual's knowledge of, or relationships with, the accounting firm do not adversely influence the quality of the audit.[284] These procedures include modifying the audit plan to adjust for the risk that the individual would be able to circumvent key aspects of the audit, and assuring that the people on the audit engagement team have the stature and objectivity not to be influenced by their former partner or co-employee and to have the appropriate level of skepticism when evaluating the individual's representations and views.

Costs might occur, however, from the company being required to delay the hiring, or not being able to hire, the individual that it believes is the most qualified person to perform a "financial reporting oversight role" at the company. This may add to recruitment costs or result in less efficient operations. Such costs are difficult to estimate and vary from one company to another. However, in response to several commenters' concerns regarding the reach of the propose rules, the final rules limit the prohibitions based on the individual's role on the audit engagement team. These costs might be ameliorated in unusual circumstances due to the exception provided for emergency and unusual circumstances.

e. Compensation. The final rules provide that an accountant is deemed to be not independent with respect to an audit client if any "audit partner" earns or receives compensation in consideration of directly selling engagements to provide any services to that client other than audit, review or attest services. The final rules differ from the proposed rules in three notable respects. First, the proposed rules also would have provided that any accountant is not independent with respect to an audit client if an audit partner earns or receives compensation based on the selling or performance of engagements with an audit client to provide any products or services other than audit, review or attest services. The final rule applies only to compensation based on the direct selling of engagements in the independence determination. Second, several commenters noted that, as proposed, the rules would have precluded a "specialty" partner from receiving compensation when he or she sold services in his or her specialty area. The final rules address this concern because they apply to "audit partners" rather than all partners who are members of the audit engagement team. Third, several commenters indicated the compensation rules might be particularly difficult for smaller accounting firms. To address this concern, the final rules include an exemption for accounting firms with fewer than five audit clients and fewer than ten partners.

Despite these revisions, the provision might affect the compensation plans of those firms that currently reward audit partners of the firm for selling non-audit services to their audit clients. The final rules may result in those revenues being allocated to other persons within the accounting firm. Absent this incentive, auditors may be less inclined to inform issuers of ways to improve their performance or condition through non-audit services. We do not expect, however, that there would be any incremental costs to the firm or to the client.

2. Auditor Reports To Audit Committees

The final rules are identical to those proposed, with two exceptions. The proposed rules would have required accounting firms to report to audit committees all alternative accounting treatments within GAAP that have been discussed with management, including the ramifications of the use of the alternative treatments and the treatment preferred by the accounting firm. The final rules only require accounting firms to report material alternative treatments, which should aid in focusing the reports to audit committees. The final rules add a specific requirement related to investment companies that requires auditors to disclose to the investment company's audit committee all non-audit fees paid to the accountant by any entity in the investment company complex that was not subject to pre-approval by the investment company's audit committee.

Because of existing GAAS and legal provisions,[285] we believe that the final rules regarding accountants' reports to audit committees will not significantly increase costs for accounting firms or registrants. Any such costs may arise from the timing of the communications,[286] which must occur before the auditor's report is filed with the Commission. We also believe limiting the reporting requirement to only material alternative treatments will reduce unnecessary costs. The required reports need not be in writing, but the report is required to be presented to the audit committee before the auditor's report is filed with the Commission.

3. Enhanced Disclosures About the Services Provided by Auditors to Registrants

The existing proxy disclosure rules require disclosure of all professional fees billed by the principal auditor in the last fiscal year, with the fees broken down into three categories: audit fees, financial information systems design and implementation fees, and all other fees. The final rules divide the disclosure into two more categories - tax fees and audit-related fees - and add disclosure of one more year of these fees while eliminating separate disclosure of fees related to financial information systems design and implementation.[287] The final rules also require companies that do not file proxy statements to file this information with the Commission in their annual reports on Forms 10-K and 10-KSB, foreign private issuers to file the information on Form 20-F, certain Canadian issuers to file the information on Form 40-F, and registered management investment companies to file the information on Form N-CSR.[288]

Registrants also are required to disclose the audit committee's policies and procedures for approval of services provided by the accounting firm, and the percentage of fees in each of the four categories noted above (audit, audit-related, tax, and all other) where the audit committee used the de minimis exception to the pre-approval requirements.[289]

Based on the staff's experience, we believe that the additional disclosure contemplated by the final rules will require, on average, approximately one-half of a page in a company's proxy statement or annual report. Accordingly, we believe the additional printing costs from these additional disclosures will be small.

Using estimates derived from our Paperwork Reduction Act analysis, we estimate that the incremental impact of the disclosure changes will result in a total cost of $5,862,400 for all affected filers. The estimate is based on the burden hour estimates calculated under the Paperwork Reduction Act. For purposes of the Paperwork Reduction Act, we estimate that the additional disclosure will result in 26,678 internal burden hours and $2,999,400 in external costs. Assuming a cost of $125/hour for in-house professional staff (and $40 per hour for internal staff review for Form N-CSR), the total cost for the internal burden hours would be $2,863,000.[290] Hence the aggregate cost estimate is $5,862,400 ($2,863,000 + $2,999,400).

4. Transition

In response to the concerns of several commenters, we are providing a transition period for several of the requirements of the final rules. A transition period helps to alleviate the immediate impact of any costs and burdens that may be imposed on certain registrants and their accounting firms. A transition period may even help reduce costs as registrants and accounting firms will have additional time to adjust their processes and procedures to the new requirements.

V. Consideration of Burden on Competition, and Promotion of Efficiency, Competition, and Capital Formation

Section 23(a)(2) of the Exchange Act[291] requires the Commission, when adopting rules under the Exchange Act, to consider the anti-competitive effects of any rule it adopts. In addition, Section 2(b) of the Securities Act of 1933,[292] Section 3(f) of the Exchange Act,[293] and Section 2(c) of the Investment Company Act[294] require the Commission, when engaging in rulemaking that requires it to consider or determine whether an action is necessary or appropriate in the public interest, to consider whether the action will promote efficiency, competition, and capital formation.

The rules prohibit the independent accounting firm from providing certain non-audit services for their audit clients. These rules, therefore, could result in some companies seeking new accounting firms for non-audit services permitted under our previous rules, but not allowed under the Sarbanes-Oxley Act and the final rules. This may have an impact on competition for those services, although to the extent the new vendor is another accounting firm, the result may redistribute services among firms rather than an increase or decrease in services.

The proposed rules may have disadvantaged smaller accounting firms because of the partner rotation requirements, since smaller firms may not have other partners available to continue providing audit services to the client. We have modified the final rules to mitigate this concern. Under the final rules, accounting firms with fewer than five audit clients and fewer than ten partners may be exempted from the audit partner rotation and compensation requirements.

One possible adverse impact on capital formation may come from additional costs related to audit committees. Although the final rules do not require companies to have audit committees, many companies may choose to establish such committees to facilitate the pre-approval requirements of the rules. Additional costs may be associated with forming such committees and, if necessary, recruiting and retaining directors to serve on those committees. One commenter noted that the costs to maintain audit committees may increase due to additional meetings required, increased compensation for members due to the increased time demands, and increased director's and officer's insurance premiums due to increased liability of audit committee members. While the rules may increase the number of meetings required and the time demands of audit committee members, we believe a properly functioning audit committee should enhance the quality and accountability of the financial reporting process and help increase investor confidence, which results in increased efficiency and competitiveness of the U.S. capital markets.

Investors' confidence in the independence of auditors and in the integrity of the financial information fuels our securities markets. These rules are designed to bolster investor confidence in the securities markets by strengthening auditor independence, improving the transparency of the role of corporate audit committees, and enhancing the reliability and credibility of financial statements of public companies. Accordingly, on the whole, we believe the final rules will promote capital formation and market efficiency.

VI. Final Regulatory Flexibility Act Analysis

This Final Regulatory Flexibility Act Analysis has been prepared in accordance with 5 U.S.C. 603. It relates to revisions to Regulation S-X and to Item 9 of Schedule 14A, and to Forms 10-K, 10-KSB, 20-F, 40-F and N-CSR. The rules strengthen the Commission's requirements regarding the independence of auditors, audit committee pre-approval of services provided by the independent accountant and related disclosures, and auditor communications with the audit committee.

A. Reasons for the Rule Amendments

The rules generally implement a congressional mandate. Some of the amendments, although not specifically required by the statute, are designed to implement the intent of the Sarbanes-Oxley Act. The rules are intended to provide greater assurance to investors that independent auditors are performing their public responsibilities.

The rules, in general:

- Revise the Commission's regulations related to the non-audit services that, if provided to an audit client, will impair an accounting firm's independence;

- Require that an issuer's audit committee pre-approve all audit and non-audit services provided to the issuer by the auditor of an issuer's financial statements;
- Prohibit certain partners on the audit engagement team from providing audit services to the issuer for more than five or seven consecutive years, depending on the partner's involvement in the audit, except that certain small accounting firms may be exempted from this requirement;
- Prohibit an accounting firm from auditing an issuer's financial statements if certain members of management of that issuer had been members of the accounting firm's audit engagement team within the one-year period preceding the commencement of audit procedures;
- Require that the auditor of an issuer's financial statements report certain matters to the issuer's audit committee, including "critical" accounting policies used by the issuer; and
- Require disclosures to investors of information related to audit and non-audit services provided by, and fees paid to, the auditor of the issuer's financial statements.
- Provide that an accountant will not be independent from an audit client if an audit partner received compensation based on selling engagements to that client for services other than audit, review and attest services, except that the rules exempt certain small accounting firms from this requirement.

B. Objectives

Our objectives in implementing Title II of the Sarbanes-Oxley Act are to increase investor confidence in the independence of auditors, in the audit process, and in the reliability of reported financial information. The rules accomplish these objectives by having: (1) clearer auditor independence regulations that will assure investors that auditors are placing the interests of investors over financial or personal incentives, (2) rules mandating that auditors communicate certain matters to audit committees which should enhance the opportunities for meaningful audit committee oversight of the financial reporting process, and (3) enhanced disclosure of the non-audit services provided by, and fees paid to, the accounting firm that audits the company's financial statements and disclosure of the audit committee policies for pre-approving the provision of non-audit services by the accounting firm that audits the company's financial statements. We believe that these factors will improve the efficiency of the markets and result in a lower cost of capital.

C. Significant Issues Raised by Public Comment

Several commenters indicated that the partner rotation and compensation rules might be particularly difficult for small accounting firms to implement. They stated that if the rotation requirements were applied to small accounting firms, many of these firms would be unable to provide audit services to their public clients and would be forced to give them up. They further suggested a number of accommodations for small issuers and small firms including: exempting the firms based on criteria such as number of partners, number of SEC clients, firm revenue, or number of professional personnel; and exempting accountants of small issuers as measured by revenue, assets, market capitalization or profitability.

The U.S. Small Business Administration's Office of Advocacy ("Advocacy") was among the commenters recommending that the Commission include a small firm exemption from the audit partner rotation requirements. Advocacy stated that the exemption would ensure that small issuers would not incur marked increases in audit costs. It also expressed the concern that small issuers retaining the services of accounting firms that previously were exempt from audit rotation requirements may no longer be able to retain such firms if the firms lose the exemption and decline to offer audit services as a result. Advocacy asserted that if the small issuers then have to engage the services of larger firms, the costs incurred by these companies would increase due to the need of the new firms to familiarize themselves with the issuers' industries and business practices. Advocacy further stated that an effect of the elimination of small firms from the competitive market for audit services and market consolidation would be an increase in audit prices because of larger firms' gain in power over pricing.

The final amendments provide an alternative application for small accounting firms to address commenters' concerns. Under the final rules, accounting firms with fewer than five audit clients that are issuers and fewer than ten partners may qualify for the exemption from partner rotation, but the Board must conduct a special review of all of the firm's engagements subject to the rule at least once every three years. This special review should focus on the overall quality of the audit, and in particular, the independence and competence of the key personnel on the audit engagement teams. Additionally, accounting firms with fewer than five audit clients that are issuers and fewer than ten partners are exempt from the compensation requirements.

D. Small Entities Subject to the Rules

The rules affect smaller registrants and smaller accounting firms. Exchange Act Rule 0-10(a)[295] and Securities Act Rule 157[296] define a company to be a "small business" or "small organization" if it had total assets of $5 million or less on the last day of its most recent fiscal year. We estimate that approximately 2,500 companies, other than investment companies, are small entities.

For purposes of the Investment Company Act, Rule 0-10[297] defines a "small business" as an investment company complex [298] with net assets of $50 million or less as of the end of its most recent fiscal year. We estimate that approximately 225 investment companies meet this definition.

Our rules do not define "small business" or "small organization" for purposes of accounting firms. The Small Business Administration defines small business, for purposes of accounting firms, as those with under $6 million in annual revenues. We have only limited data indicating revenues for accounting firms, and we cannot estimate the number of firms with less than $6 million in revenues that practice before the Commission. We requested comment on the number of accounting firms with revenue under $6 million. Advocacy provided information indicating that a great majority of the 51,645 accounting firms in the United States have less than $6 million in revenue.[299] Advocacy noted that the U.S. Census does not classify the firms according to revenue, but obtained average per-firm revenue through publicly available IRS tax return information. According to Advocacy, IRS data indicates that in 1998, there were 46,407 tax returns for accounting firms organized as corporations.[300] Advocacy concluded that, of the firms captured by the IRS data, 99.18% (46,025) would likely qualify as small businesses because they had less than $3 million in receipts, and a further 318 corporate filers were reported to have an average of $5.7 million in receipts, indicating that the majority of these firms also had less than $6 million in revenues. Since fewer than 1,000 firms[301] provide audit services to issuers, it is uncertain how many of those firms qualify as small businesses.

E. Reporting, Recordkeeping and Other Compliance Requirements

1. Auditor Independence

The vast majority of registrants are audited by one of the four largest accounting firms, which clearly are not small entities. Nonetheless, changes in the auditor independence regulations may impose compliance requirements, recordkeeping and reporting requirements on smaller accounting firms and on any smaller registrant that engages, or would like to consider engaging, the auditor of an issuer's financial statements to perform non-audit services.

(a) Non-audit services. These auditor independence rules state that the performance of certain non-audit services will impair an auditor's independence. The rules, in some cases, redefine the limits of those non-audit services and add an additional item, "expert services," to the previous list of prohibited services. These changes could impact the competitive markets for these services. In particular, the Commission is withdrawing the specific exemption in the current rules that allows audit clients with less than $200 million in total assets to engage the auditors of their financial statements to perform internal audit outsourcing services.[302] Under these rules, small issuers also are precluded from engaging the independent accountants to perform services in the categories of financial systems design and implementation services, appraisal and valuation services, actuarial services, and others, that could have been performed under the previous rules. Smaller registrants, therefore, may have to use a separate vendor for such services. Smaller accounting firms may lose one or more sources of revenue because they no longer will be able to sell certain non-audit services to their audit clients.

According to the information available to the staff in 2000, however, approximately 12,600 registrants did not purchase any consulting services from the auditor of their financial statements, and 4,100 registrants reported purchasing such services.[303] Based on the attention that non-audit services have received in the past year, the Commission staff believes that the number of smaller registrants purchasing non-audit services from their auditors, and the number of smaller accounting firms providing a significant amount of non-audit services to audit clients that are Commission registrants, might have decreased. Also, to the extent non-audit services are merely redistributed among the firms, there will be no net loss of revenue to public accounting firms as a whole.

(b) Audit Committee Pre-Approval of Services. Under the rules, all audit and non-audit services to be provided by the auditor of an issuer's financial statements must be pre-approved by the issuer's audit committee.[304] The definition of audit committee in the Sarbanes-Oxley Act, which is cited in the rules, however, indicates that if no such committee exists, the entire board of directors of the issuer may perform this function.[305] The rules, therefore, do not require a small company to form an audit committee.

There are reasons to believe that many smaller entities currently have audit committees.[306] Any smaller entity that does not have such a committee and forms one to facilitate operation of the rules, however, will incur costs to establish such a committee and, if necessary, to recruit and retain the required number of independent directors. Smaller entities also may spend time and incur costs to document the audit committee's activities in the areas covered by the rules, including drafting and maintaining the audit committee's policies and procedures related to engaging the auditor to perform non-audit services. Moreover, small entities may incur costs in seeking the help of outside experts, particularly outside legal counsel, in drafting the audit committee's policies and procedures.

(c) Rotation of Partners on the Audit Engagement. Under the rules, certain partners may not serve on an audit engagement team for more than five or seven years, depending on the partner's involvement in the audit. Current professional requirements state that the lead partner should be replaced after serving in that capacity for seven years.[307] The rules, therefore, require more partners to be rotated and the lead partner to be rotated more frequently.

Potential costs associated with the periodic replacement of partners include more frequent company-specific training because new partners joining the audit engagement team will need to learn the company's accounting and financial reporting procedures, controls and familiarize themselves with key personnel. The rules also may result in incremental costs related to some partners being required to relocate.

In response to concerns expressed by commenters, the final rules allow accounting firms with fewer than five audit clients and fewer than ten partners to be exempted from the rotation requirement.

(d) One-Year Cooling Off Period. The rules deem an accounting firm to be not independent with respect to an audit client if a former member of the audit engagement team begins employment in a "financial reporting oversight role" at that issuer if the individual had been a member of the audit engagement team within the one-year period preceding the initiation of the audit.[308] A "financial reporting oversight role" is a role in which a person is in a position to or does influence the contents of financial statements or anyone who prepares them.[309] Such persons include directors, chief executive officers, chief financial officers, chief accounting officers, controllers, and others.

A smaller registrant may incur costs from a delay in hiring, or not being able to hire, the individual that it believes is the most qualified person to perform a "financial reporting oversight role" at the company. This may add to recruitment costs or less efficient operations.

(e) Compensation. Under the rules, an accounting firm's independence will be deemed to be impaired if any audit partner receives compensation based on directly selling to an audit client services other than audit, review and attest services. Thus, accounting firms will have to discontinue compensating these individuals for "cross-selling" services.

Some smaller accounting firms may have a relatively small number of partners, available to serve each client. Such firms may not have personnel, other than the partner in charge of the smaller company's audit with sufficient expertise to market and provide non-audit services to that company. In recognition of the special issues associated with smaller firms, the final rules provide that accounting firms with fewer than five audit clients and fewer than ten partners may be exempted from the compensation rule.

2. Auditor Reports to Audit Committees

Under the rules, each public accounting firm registered with the Board that audits an issuer's financial statements must report to the issuer's audit committee (1) all critical accounting policies and practices used by the issuer, (2) all material alternative accounting treatments within GAAP that have been discussed with management, including the ramifications of the use of the alternative treatments and the treatment preferred by the accounting firm, (3) other material written communications between the accounting firm and management of the issuer such as any management letter or schedule of "unadjusted differences," and (4) in the case of registered investment companies, all non-audit services provided to entities in the investment company complex that were not pre-approved by the investment company's audit committee. The required reports need not be in writing, but must be provided to the audit committee before the auditor's report on the financial statements is filed with the Commission.[310]

GAAS currently require discussions between the auditors and the audit committee of significant unusual, controversial, or emerging accounting policies, of the process used by management to select certain estimates, and of disagreements with management over certain accounting matters. Further, audit committees generally are aware of management's letter making representations to the auditors, which the auditor uses in conducting the audit of the issuer's financial statements, and the auditor's letters to management on reportable conditions in internal controls and other matters. Also, due to enactment of Section 401 of the Sarbanes-Oxley Act, all material adjustments identified by the auditor should be reflected in the issuer's financial statements and, therefore, there should be no material "unadjusted differences." In the case of investment companies, we believe auditors already are reporting non-audit services provided to the investment company complex annually and some routinely provide more frequent updates at the request of the audit committee.

Because of these GAAS and legal provisions, we believe that adoption of the rules regarding auditor reports to audit committees will not significantly increase costs, including costs for smaller accounting firms and smaller registrants. Some costs may be incurred, however, to the extent communications are required before the auditor's report is filed with the Commission.

3. Enhanced Disclosures About the Services Provided by Auditors to Registrants

Currently, disclosure is required in proxy statements of the fees billed in the most recent fiscal year under the categories of audit fees, information systems design and implementation fees, and all other fees.[311] The rules require disclosure of the fees billed in each of the two most recent years. The rules also add the categories of tax fees and audit-related fees but eliminate separate disclosure of information systems design and implementation from the current list of categories of fees. The rules also require disclosure of the percentage of fees in each category where the audit committee used the de minimis exception to the pre-approval requirements. Finally, the rules extend the disclosure requirements to all entities filing Forms 10-K, 10-KSB, 20-F, 40-F and N-CSR.[312]

The rules require all entities filing Forms 10-K, 10-KSB, 20-F, 40-F and N-CSR to include the disclosure either in the proxy or information statement or, if the company is does not issue a proxy or information statement, in Forms 10-K, 10-KSB, 20-F, 40-F or Form N-CSR. The rules, therefore, may require smaller entities to spend additional time and incur additional costs in preparing disclosures. Smaller entities also may incur costs to set up procedures to monitor the activities of the audit committee in order to collect and record the information to be disclosed under the rules.

F. Agency Action to Minimize Effect on Small Entities and Significant Alternatives

The Regulatory Flexibility Act directs us to consider significant alternatives that would accomplish the stated objective, while minimizing any significant adverse impact on small entities. In connection with the amendments, we considered the following alternatives:

- The establishment of differing compliance or reporting requirements or timetables that take into account the resources of smaller entities;
- The clarification, consolidation, or simplification of compliance and reporting requirements under the rule for smaller entities;
- The use of performance rather than design standards; and
- An exemption from coverage of the proposed amendments, or any part thereof, for smaller entities.

We believe investors in both smaller companies and larger companies want and benefit from the revisions to the auditor independence rules, enhanced communications between the auditor and the audit committee, and enhanced disclosures required by the rule.

We, nevertheless, have determined that the two specific exemptions from the final rules for smaller accounting firms that are described above are appropriate and consistent with the Sarbanes-Oxley Act.

VII. Codification Update

The Commission is amending the "Codification of Financial Reporting Policies" announced in Financial Reporting Release No. 1 (April 15, 1982):

By amending Section 602 to add a new discussion at the end of that section under the Financial Reporting Release Number (FR-68) assigned to the adopting release and including the text in the adopting release that discusses the final rules would be as presented in Section II of this release.

The Codification is a separate publication of the Commission. It will not be published in the Code of Federal Regulations.

VIII. Statutory Bases and Text of Amendments

We are adopting amendments to Rules 2-01 and 2-07 of Regulation S-X, Item 9 of Schedule 14A, Forms 10-K, 10-KSB, 20-F and 40-F, Form N-CSR and Exchange Act Rule 10A-2 under the authority set forth in Schedule A and Sections 7, 8, 10, 19 and 28 of the Securities Act, Sections 3, 10A, 12, 13, 14, 17, 23 and 36 of the Exchange Act, Sections 5, 10, 14 and 20 of the Public Utility Holding Company Act of 1935, Sections 8, 30, 31 and 38 of the Investment Company Act of 1940, Sections 203 and 211 of the Investment Advisers Act of 1940, and Sections 3(a) and 208 of the Sarbanes-Oxley Act.

Text of Amendments

List of Subjects

17 CFR Part 210

Accountants, Accounting.

17 CFR Part 240

Broker-dealers, Issuers, Securities.

17 CFR Part 249

Reporting and recordkeeping requirements, Securities.

17 CFR Part 274

Investment companies, Reporting and recordkeeping requirements, Securities.

In accordance with the foregoing, Title 17, Chapter II of the Code of Federal Regulations is amended as follows:

PART 210 - FORM AND CONTENT OF AND REQUIREMENTS FOR FINANCIAL STATEMENTS, SECURITIES ACT OF 1933, SECURITIES EXCHANGE ACT OF 1934, PUBLIC UTILITY HOLDING COMPANY ACT OF 1935, INVESTMENT COMPANY ACT OF 1940, INVESTMENT ADVISERS ACT OF 1940 AND ENERGY POLICY AND CONSERVATION ACT OF 1975

1. The authority citation for Part 210 continues to read as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 77z-2, 77z-3, 77aa(25), 77aa (26), 78c, 78j-1, 78l, 78m, 78n, 78o(d), 78q, 78u-5, 78w(a), 78ll, 78mm, 79e(b), 79j(a), 79n, 79t(a), 80a-8, 80a-20, 80a-29, 80a-30, 80a-37(a), 80b-3, 80b-11 unless otherwise noted.

2. Section 210.2-01 is amended by:

a. Revising paragraph (c)(2)(iii);

b. Revising paragraph (c)(4);

c. Adding paragraph (c)(6);

d. Adding paragraph (c)(7);

e. Adding paragraph (c)(8);

f. Revising paragraph (e)(1);

g. Removing paragraph (e)(2);

h. Redesignating paragraph (e)(3) as (e)(2);

i. Revising paragraph (f)(1);

j. Revising paragraph (f)(3);

k. Revising paragraph (f)(7); and

l. Adding paragraph (f)(17).

The revisions and additions read as follows:

§ 210.2-01 Qualifications of accountants.

* * * * *

(c) * * *

(2) Employment relationships. * * *

(i) * * *

(ii) * * *

(iii) Employment at audit client of former employee of accounting firm.

(A) A former partner, principal, shareholder, or professional employee of an accounting firm is in an accounting role or financial reporting oversight role at an audit client, unless the individual:

(1) Does not influence the accounting firm's operations or financial policies;

(2) Has no capital balances in the accounting firm; and

(3) Has no financial arrangement with the accounting firm other than one providing for regular payment of a fixed dollar amount (which is not dependent on the revenues, profits, or earnings of the accounting firm):

(i) Pursuant to a fully funded retirement plan, rabbi trust, or, in jurisdictions in which a rabbi trust does not exist, a similar vehicle; or

(ii) In the case of a former professional employee who was not a partner, principal, or shareholder of the accounting firm and who has been disassociated from the accounting firm for more than five years, that is immaterial to the former professional employee; and

(B) A former partner, principal, shareholder, or professional employee of an accounting firm is in a financial reporting oversight role at an issuer (as defined in section 10A(f) of the Securities Exchange Act of 1934 (15 U.S.C. 78j-1(f)), except an issuer that is an investment company registered under section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a-8), unless the individual:

(1) Employed by the issuer was not a member of the audit engagement team of the issuer during the one year period preceding the date that audit procedures commenced for the fiscal period that included the date of initial employment of the audit engagement team member by the issuer;

(2) For purposes of paragraph (c)(2)(iii)(B)(1) of this section, the following individuals are not considered to be members of the audit engagement team:

(i) Persons, other than the lead partner and the concurring partner, who provided ten or fewer hours of audit, review, or attest services during the period covered by paragraph (c)(2)(iii)(B)(1) of this section;

(ii) Individuals employed by the issuer as a result of a business combination between an issuer that is an audit client and the employing entity, provided employment was not in contemplation of the business combination and the audit committee of the successor issuer is aware of the prior employment relationship; and

(iii) Individuals that are employed by the issuer due to an emergency or other unusual situation provided that the audit committee determines that the relationship is in the interest of investors;

(3) For purposes of paragraph (c)(2)(iii)(B)(1) of this section, audit procedures are deemed to have commenced for a fiscal period the day following the filing of the issuer's periodic annual report with the Commission covering the previous fiscal period; or

(C) A former partner, principal, shareholder, or professional employee of an accounting firm is in a financial reporting oversight role with respect to an investment company registered under section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a-8), if:

(1) The former partner, principal, shareholder, or professional employee of an accounting firm is employed in a financial reporting oversight role related to the operations and financial reporting of the registered investment company at an entity in the investment company complex, as defined in (f)(14) of this section, that includes the registered investment company; and

(2) The former partner, principal, shareholder, or professional employee of an accounting firm employed by the registered investment company or any entity in the investment company complex was a member of the audit engagement team of the registered investment company or any other registered investment company in the investment company complex during the one year period preceding the date that audit procedures commenced that included the date of initial employment of the audit engagement team member by the registered investment company or any entity in the investment company complex.

(3) For purposes of paragraph (c)(2)(iii)(C)(2) of this section, the following individuals are not considered to be members of the audit engagement team:

(i) Persons, other than the lead partner and concurring partner, who provided ten or fewer hours of audit, review or attest services during the period covered by paragraph (c)(2)(iii)(C)(2) of this section;

(ii) Individuals employed by the registered investment company or any entity in the investment company complex as a result of a business combination between a registered investment company or any entity in the investment company complex that is an audit client and the employing entity, provided employment was not in contemplation of the business combination and the audit committee of the registered investment company is aware of the prior employment relationship; and

(iii) Individuals that are employed by the registered investment company or any entity in the investment company complex due to an emergency or other unusual situation provided that the audit committee determines that the relationship is in the interest of investors.

(4) For purposes of paragraph (c)(2)(iii)(C)(2) of this section, audit procedures are deemed to have commenced the day following the filing of the registered investment company's periodic annual report with the Commission.

* * * * *

(4) Non-audit services. An accountant is not independent if, at any point during the audit and professional engagement period, the accountant provides the following non-audit services to an audit client:

(i) Bookkeeping or other services related to the accounting records or financial statements of the audit client. Any service, unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client's financial statements, including:

(A) Maintaining or preparing the audit client's accounting records;

(B) Preparing the audit client's financial statements that are filed with the Commission or that form the basis of financial statements filed with the Commission; or

(C) Preparing or originating source data underlying the audit client's financial statements.

(ii) Financial information systems design and implementation. Any service, unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client's financial statements, including:

(A) Directly or indirectly operating, or supervising the operation of, the audit client's information system or managing the audit client's local area network; or

(B) Designing or implementing a hardware or software system that aggregates source data underlying the financial statements or generates information that is significant to the audit client's financial statements or other financial information systems taken as a whole.

(iii) Appraisal or valuation services, fairness opinions, or contribution-in-kind reports. Any appraisal service, valuation service, or any service involving a fairness opinion or contribution-in-kind report for an audit client, unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client's financial statements.

(iv) Actuarial services. Any actuarially-oriented advisory service involving the determination of amounts recorded in the financial statements and related accounts for the audit client other than assisting a client in understanding the methods, models, assumptions, and inputs used in computing an amount, unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client's financial statements.

(v) Internal audit outsourcing services. Any internal audit service that has been outsourced by the audit client that relates to the audit client's internal accounting controls, financial systems, or financial statements, for an audit client unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client's financial statements.

(vi) Management functions. Acting, temporarily or permanently, as a director, officer, or employee of an audit client, or performing any decision-making, supervisory, or ongoing monitoring function for the audit client.

(vii) Human resources. (A) Searching for or seeking out prospective candidates for managerial, executive, or director positions;

(B) Engaging in psychological testing, or other formal testing or evaluation programs;

(C) Undertaking reference checks of prospective candidates for an executive or director position;

(D) Acting as a negotiator on the audit client's behalf, such as determining position, status or title, compensation, fringe benefits, or other conditions of employment; or

(E) Recommending, or advising the audit client to hire, a specific candidate for a specific job (except that an accounting firm may, upon request by the audit client, interview candidates and advise the audit client on the candidate's competence for financial accounting, administrative, or control positions).

(viii) Broker-dealer, investment adviser, or investment banking services. Acting as a broker-dealer (registered or unregistered), promoter, or underwriter, on behalf of an audit client, making investment decisions on behalf of the audit client or otherwise having discretionary authority over an audit client's investments, executing a transaction to buy or sell an audit client's investment, or having custody of assets of the audit client, such as taking temporary possession of securities purchased by the audit client.

(ix) Legal services. Providing any service to an audit client that, under circumstances in which the service is provided, could be provided only by someone licensed, admitted, or otherwise qualified to practice law in the jurisdiction in which the service is provided.

(x) Expert services unrelated to the audit. Providing an expert opinion or other expert service for an audit client, or an audit client's legal representative, for the purpose of advocating an audit client's interests in litigation or in a regulatory or administrative proceeding or investigation. In any litigation or regulatory or administrative proceeding or investigation, an accountant's independence shall not be deemed to be impaired if the accountant provides factual accounts, including in testimony, of work performed or explains the positions taken or conclusions reached during the performance of any service provided by the accountant for the audit client.

* * * * *

(6) Partner rotation. (i) Except as provided in paragraph (c)(6)(ii) of this section, an accountant is not independent of an audit client when:

(A) Any audit partner as defined in paragraph (f)(7)(ii) of this section performs:

(1) The services of a lead partner, as defined in paragraph (f)(7)(ii)(A) of this section, or concurring partner, as defined in paragraph (f)(7)(ii)(B) of this section, for more than five consecutive years; or

(2) One or more of the services defined in paragraphs (f)(7)(ii)(C) and (D) of this section for more than seven consecutive years;

(B) Any audit partner:

(1) Within the five consecutive year period following the performance of services for the maximum period permitted under paragraph (c)(6)(i)(A)(1) of this section, performs for that audit client the services of a lead partner, as defined in paragraph (f)(7)(ii)(A) of this section, or concurring partner, as defined in paragraph (f)(7)(ii)(B) of this section, or a combination of those services, or

(2) Within the two consecutive year period following the performance of services for the maximum period permitted under paragraph (c)(6)(i)(A)(2) of this section, performs one or more of the services defined in paragraph (f)(7)(ii) of this section.

(ii) Any accounting firm with less than five audit clients that are issuers (as defined in section 10A(f) of the Securities Exchange Act of 1934 (15 U.S.C. 78j-1(f))) and less than ten partners shall be exempt from paragraph (c)(6)(i) of this section provided the Public Company Accounting Oversight Board conducts a review at least once every three years of each of the audit client engagements that would result in a lack of auditor independence under this paragraph.

(iii) For purposes of paragraph (c)(6)(i) of this section, an audit client that is an investment company registered under section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a-8), does not include an affiliate of the audit client that is an entity in the same investment company complex, as defined in paragraph (f)(14) of this section, except for another registered investment company in the same investment company complex. For purposes of calculating consecutive years of service under paragraph (c)(6)(i) of this section with respect to investment companies in an investment company complex, audits of registered investment companies with different fiscal year-ends that are performed in a continuous 12-month period count as a single consecutive year.

(7) Audit committee administration of the engagement. An accountant is not independent of an issuer (as defined in section 10A(f) of the Securities Exchange Act of 1934 (15 U.S.C. 78j-1(f))), other than an issuer that is an Asset-Backed Issuer as defined in §240.13a-14(g) and §240.15d-14(g) of this chapter, or an investment company registered under section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a-8), other than a unit investment trust as defined by section 4(2) of the Investment Company Act of 1940 (15 U.S.C. 80a-4(2)), unless:

(i) In accordance with Section 10A(i) of the Securities Exchange Act of 1934 (15 U.S.C. 78j-1(i)) either:

(A) Before the accountant is engaged by the issuer or its subsidiaries, or the registered investment company or its subsidiaries, to render audit or non-audit services, the engagement is approved by the issuer's or registered investment company's audit committee; or

(B) The engagement to render the service is entered into pursuant to pre-approval policies and procedures established by the audit committee of the issuer or registered investment company, provided the policies and procedures are detailed as to the particular service and the audit committee is informed of each service and such policies and procedures do not include delegation of the audit committees responsibilities under the Securities Exchange Act of 1934 to management; or

(C) With respect to the provision of services other than audit, review or attest services the pre-approval requirement is waived if:

(1) The aggregate amount of all such services provided constitutes no more than five percent of the total amount of revenues paid by the audit client to its accountant during the fiscal year in which the services are provided;

(2) Such services were not recognized by the issuer or registered investment company at the time of the engagement to be non-audit services; and

(3) Such services are promptly brought to the attention of the audit committee of the issuer or registered investment company and approved prior to the completion of the audit by the audit committee or by one or more members of the audit committee who are members of the board of directors to whom authority to grant such approvals has been delegated by the audit committee.

(ii) A registered investment company's audit committee also must pre-approve its accountant's engagements for non-audit services with the registered investment company's investment adviser (not including a sub-adviser whose role is primarily portfolio management and is sub-contracted or overseen by another investment adviser) and any entity controlling, controlled by, or under common control with the investment adviser that provides ongoing services to the registered investment company in accordance with paragraph (c)(7)(i) of this section, if the engagement relates directly to the operations and financial reporting of the registered investment company, except that with respect to the waiver of the pre-approval requirement under paragraph (c)(7)(i)(C) of this section, the aggregate amount of all services provided constitutes no more than five percent of the total amount of revenues paid to the registered investment company's accountant by the registered investment company, its investment adviser and any entity controlling, controlled by, or under common control with the investment adviser that provides ongoing services to the registered investment company during the fiscal year in which the services are provided that would have to be pre-approved by the registered investment company's audit committee pursuant to this section.

(8) Compensation. An accountant is not independent of an audit client if, at any point during the audit and professional engagement period, any audit partner earns or receives compensation based on the audit partner procuring engagements with that audit client to provide any products or services other than audit, review or attest services. Any accounting firm with fewer than ten partners and fewer than five audit clients that are issuers (as defined in section 10A(f) of the Securities Exchange Act of 1934 (15 U.S.C. 78j-1(f))) shall be exempt from the requirement stated in the previous sentence.

* * * * *

(e)(1) Transition and grandfathering. Provided the following relationships did not impair the accountant's independence under pre-existing requirements of the Commission, the Independence Standards, Board, or the accounting profession in the United States, the existence of the relationship on [insert the effective date of this final rule] will not be deemed to impair an accountant's independence:

(i) Employment relationships that commenced at the issuer prior to [insert the effective date of this final rule] as described in paragraph (c)(2)(iii)(B) of this section.

(ii) Compensation earned or received, as described in paragraph (c)(8) of this section during the fiscal year of the accounting firm that includes the effective date of this section.

(iii) Until [Insert date 12 months after the effective date of this final rule], the provision of services described in paragraph (c)(4) of this section provided those services are pursuant to contracts in existence on [insert the effective date of this final rule].

(iv) The provision of services by the accountant under contracts in existence on [insert the effective date of this final rule] that have not been pre-approved by the audit committee as described in paragraph (c)(7) of this section.

(v) Until the first day of the issuer's fiscal year beginning after [insert the effective date of this final rule] by a "lead" partner and other audit partner (other than the "concurring" partner) providing services in excess of those permitted under paragraph (c)(6) of this section. An accountant's independence will not be deemed to be impaired until the first day of the issuer's fiscal year beginning after [insert date 12 months after the effective date of this final rule] by a "concurring" partner providing services in excess of those permitted under paragraph (c)(6) of this section. For the purposes of calculating periods of service under paragraph (c)(6) of this section:

(A) For the "lead" and "concurring" partner, the period of service includes time served as the "lead" or "concurring" partner prior to [insert the effective date of this final rule]; and

(B) For audit partners other than the "lead" partner or "concurring" partner, and for audit partners in foreign firms, the period of service does not include time served on the audit engagement team prior to the first day of issuer's fiscal year beginning on or after [insert the effective date of this final rule].

* * * * *

(f) * * *

(1) Accountant, as used in paragraphs (b) through (e) of this section, means a registered public accounting firm, certified public accountant or public accountant performing services in connection with an engagement for which independence is required. References to the accountant include any accounting firm with which the certified public accountant or public accountant is affiliated.

* * * * *

(3)(i) Accounting role means a role in which a person is in a position to or does exercise more than minimal influence over the contents of the accounting records or anyone who prepares them.

(ii) Financial reporting oversight role means 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, such as when the person is a member of the board of directors or similar management or governing body, chief executive officer, president, chief financial officer, chief operating officer, general counsel, chief accounting officer, controller, director of internal audit, director of financial reporting, treasurer, or any equivalent position.

* * * * *

(7)(i) Audit engagement team means all partners, principals, shareholders and professional employees participating in an audit, review, or attestation engagement of an audit client, including audit partners and all persons who consult with others on the audit engagement team during the audit, review, or attestation engagement regarding technical or industry-specific issues, transactions, or events.

(ii) Audit partner means a partner or persons in an equivalent position, other than a partner who consults with others on the audit engagement team during the audit, review, or attestation engagement regarding technical or industry-specific issues, transactions, or events, who is a member of the audit engagement team who has responsibility for decision-making on significant auditing, accounting, and reporting matters that affect the financial statements, or who maintains regular contact with management and the audit committee and includes the following:

(A) The lead or coordinating audit partner having primary responsibility for the audit or review (the "lead partner");

(B) The partner performing a second level of review to provide additional assurance that the financial statements subject to the audit or review are in conformity with generally accepted accounting principles and the audit or review and any associated report are in accordance with generally accepted auditing standards and rules promulgated by the Commission or the Public

Company Accounting Oversight Board (the "concurring or reviewing partner");

(C) Other audit engagement team partners who provide more than ten hours of audit, review, or attest services in connection with the annual or interim consolidated financial statements of the issuer or an investment company registered under section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a-8); and

(D) Other audit engagement team partners who serve as the "lead partner" in connection with any audit or review related to the annual or interim financial statements of a subsidiary of the issuer whose assets or revenues constitute 20% or more of the assets or revenues of the issuer's respective consolidated assets or revenues.

* * * * *

(17) Audit committee means a committee (or equivalent body) as defined in section 3(a)(58) of the Securities Exchange Act of 1934 (15 U.S.C. 78c (a)(58)).

3. By adding §210.2-07 preceding General Instructions as to Financial Statements to read as follows:

§ 210.2-07 Communication with audit committees.

(a) Each registered public accounting firm that performs for an audit client that is an issuer (as defined in section 10A(f) of the Securities Exchange Act of 1934 (15 U.S.C. 78j-1(f))), other than an issuer that is an Asset-Backed Issuer as defined in §240.13a-14(g) and §240.15d-14(g) of this chapter, or an investment company registered under section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a-8), other than a unit investment trust as defined by section 4(2) of the Investment Company Act of 1940 (15 U.S.C. 80a-4(2)), any audit required under the securities laws shall report, prior to the filing of such audit report with the Commission (or in the case of a registered investment company, annually, and if the annual communication is not within 90 days prior to the filing, provide an update, in the 90 day period prior to the filing, of any changes to the previously reported information), to the audit committee of the issuer or registered investment company:

(1) All critical accounting policies and practices to be used;

(2) All alternative treatments within Generally Accepted Accounting Principles for policies and practices related to material items that have been discussed with management of the issuer or registered investment company, including:

(i) Ramifications of the use of such alternative disclosures and treatments; and

(ii) The treatment preferred by the registered public accounting firm;

(3) Other material written communications between the registered public accounting firm and the management of the issuer or registered investment company, such as any management letter or schedule of unadjusted differences;

(4) If the audit client is an investment company, all non-audit services provided to any entity in an investment company complex, as defined in §210.2-01(f)(14) of this section, that were not pre-approved by the registered investment company's audit committee pursuant to §210.2-01(c)(7) of this section.

(b) [Reserved]

PART 240 - GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

4. The authority citation for Part 240 continues to read, in part, as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 79q, 79t, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4 and 80b-11, unless otherwise noted.

* * * * *

5. Section 240.10A-2 is added to read as follows:

§240.10A-2 Auditor independence.

It shall be unlawful for an auditor not to be independent under §210.2-01 (c)(2)(iii)(B), (c)(4), (c)(6), (c)(7), and §210.2-07.

6. Section 240.14a-101 is amended by revising paragraph (e) of Item 9 to read as follows:

§ 240.14a-101 Schedule 14A. Information required in proxy statement.

* * * * *

Item 9. Independent public accountants. * * *

* * * * *

(e)(1) Disclose, under the caption Audit Fees, the aggregate fees billed for each of the last two fiscal years for professional services rendered by the principal accountant for the audit of the registrant's annual financial statements and review of financial statements included in the registrant's Form 10-Q (17 CFR 249.308a) or 10-QSB (17 CFR 249.308b) or services that are normally provided by the accountant in connection with statutory and regulatory filings or engagements for those fiscal years.

(2) Disclose, under the caption Audit-Related Fees, the aggregate fees billed in each of the last two fiscal years for assurance and related services by the principal accountant that are reasonably related to the performance of the audit or review of the registrant's financial statements and are not reported under paragraph (e)(1) of this section. Registrants shall describe the nature of the services comprising the fees disclosed under this category.

(3) Disclose, under the caption Tax Fees, the aggregate fees billed in each of the last two fiscal years for professional services rendered by the

principal accountant for tax compliance, tax advice, and tax planning. Registrants shall describe the nature of the services comprising the fees disclosed under this category.

(4) Disclose, under the caption All Other Fees, the aggregate fees billed in each of the last two fiscal years for products and services provided by the principal accountant, other than the services reported in paragraphs (e)(1) through (e)(3) of this section. Registrants shall describe the nature of the services comprising the fees disclosed under this category.

(5)(i) Disclose the audit committee's pre-approval policies and procedures described in 17 CFR 210.2-01(c)(7)(i).

(ii) Disclose the percentage of services described in each of paragraphs (e)(2) through (e)(4) of this section that were approved by the audit committee pursuant to 17 CFR 210.2-01(c)(7)(i)(C).

(6) If greater than 50 percent, disclose the percentage of hours expended on the principal accountant's engagement to audit the registrant's financial statements for the most recent fiscal year that were attributed to work performed by persons other than the principal accountant's full-time, permanent employees.

(7) If the registrant is an investment company, disclose the aggregate non-audit fees billed by the registrant's accountant for services rendered to the registrant, and to the registrant's investment adviser (not including any subadviser whose role is primarily portfolio management and is subcontracted with or overseen by another investment adviser), and any entity controlling, controlled by, or under common control with the adviser that provides ongoing services to the registrant for each of the last two fiscal years of the registrant.

(8) If the registrant is an investment company, disclose whether the audit committee of the board of directors has considered whether the provision of non-audit services that were rendered to the registrant's investment adviser (not including any subadviser whose role is primarily portfolio management and is subcontracted with or overseen by another investment adviser), and any entity controlling, controlled by, or under common control with the investment adviser that provides ongoing services to the registrant that were not pre-approved pursuant to 17 CFR 210.2-01(c)(7)(ii) is compatible with maintaining the principal accountant's independence.

Instruction to Item 9(e).

For purposes of Item 9(e)(2), (3), and (4), registrants that are investment companies must disclose fees billed for services rendered to the registrant and separately, disclose fees required to be approved by the investment company registrant's audit committee pursuant to 17 CFR 210.2-01(c)(7)(ii). Registered investment companies must also disclose the fee percentages as required by item 9(e)(5)(ii) for the registrant and separately, disclose the fee percentages as required by item 9(e)(5)(ii) for the fees required to be approved by the investment company registrant's audit committee pursuant to 17 CFR 210.2-01(c)(7)(ii).

* * * * *

PART 249 - FORMS, SECURITIES EXCHANGE ACT OF 1934

7. The authority citation for Part 249 is amended by revising the sectional authority for §§249.220f, 249.240f, 249.310, 249.310b and 249.331 to read as follows:

Authority: 15 U.S.C. 78a et seq., unless otherwise noted.

Section 249.220f is also issued under secs. 3(a), 202, 208, 302, 306(a), 401(a), 401(b), 406 and 407, Pub. L. No. 107-204, 116 Stat. 745.

Section 249.240f is also issued under secs. 3(a), 202, 208, 302, 306(a), 401(a), 406 and 407, Pub. L. No. 107-204, 116 Stat. 745.

* * * * *

Section 249.310 is also issued under secs. 3(a), 202, 208, 302, 406 and 407, Pub. L. No. 107-204, 116 Stat. 745.

Section 249.310b is also issued under secs. 3(a), 202, 208, 302, 406 and 407, Pub. L. No. 107-204, 116 Stat. 745.

* * * * *

Section 249.331 is also issued under secs. 3(a), 202, 208, 302, 406 and 407, Pub. L. No. 107-204, 116 Stat. 745.

8. Amend Form 20-F (referenced in §249.220f) by adding Item 16C to read as follows:

Note: The text of Form 20-F does not, and this amendment will not, appear in the Code of Federal Regulations.

FORM 20-F

* * * * *

Item 16C. Principal Accountant Fees and Services.

(a) Disclose, under the caption Audit Fees, the aggregate fees billed for each of the last two fiscal years for professional services rendered by the principal accountant for the audit of the registrant's annual financial statements or services that are normally provided by the accountant in connection with statutory and regulatory filings or engagements for those fiscal years.

(b) Disclose, under the caption Audit-Related Fees, the aggregate fees billed in each of the last two fiscal years for assurance and related services by the principal accountant that are reasonably related to the performance of the audit or review of the registrant's financial statements and are not reported under paragraph (a) of this Item. Registrants shall describe the nature of the services comprising the fees disclosed under this category.

(c) Disclose, under the caption Tax Fees, the aggregate fees billed in each of the last two fiscal years for professional services rendered by the principal accountant for tax compliance, tax advice, and tax planning. Registrants shall describe the nature of the services comprising the fees disclosed under this category.

(d) Disclose, under the caption All Other Fees, the aggregate fees billed in each of the last two fiscal years for products and services provided by the principal accountant, other than the services reported in paragraphs (a) through (c) of this Item. Registrants shall describe the nature of the services comprising the fees disclosed under this category.

(e)(1) Disclose the audit committee's pre-approval policies and procedures described in paragraph (c)(7)(i) of Rule 2-01 of Regulation S-X.

(2) Disclose the percentage of services described in each of paragraphs (b) through (d) of this Item that were approved by the audit committee pursuant to paragraph (c)(7)(i)(C) of Rule 2-01 of Regulation S-X.

(f) If greater than 50 percent, disclose the percentage of hours expended on the principal accountant's engagement to audit the registrant's financial statements for the most recent fiscal year that were attributed to work performed by persons other than the principal accountant's full-time, permanent employees.

Instructions to Item 16C.

1. You do not need to provide the information called for by this Item 16C unless you are using this form as an annual report.

2. A registrant that is an Asset-Backed Issuer (as defined in §240.13a-14(g) and §240.15d-14(g) of this chapter) is not required to disclose the information required by this Item.

* * * * *

9. Amend Form 40-F (referenced in §249.240f) by adding paragraph (10) to General Instruction B to read as follows:

Note: The text of Form 40-F does not, and this amendment will not, appear in the Code of Federal Regulations.

FORM 40-F

* * * * *

GENERAL INSTRUCTIONS

* * * * *

B. Information To Be Filed on this Form.

* * * * *

(10) Principal Accountant Fees and Services.

(1) Disclose, under the caption Audit Fees, the aggregate fees billed for each of the last two fiscal years for professional services rendered by the principal accountant for the audit of the registrant's annual financial statements or services that are normally provided by the accountant in connection with statutory and regulatory filings or engagements for those fiscal years.

(2) Disclose, under the caption Audit-Related Fees, the aggregate fees billed in each of the last two fiscal years for assurance and related services by the principal accountant that are reasonably related to the performance of the audit or review of the registrant's financial statements and are not

reported under paragraph B.(10)(1) of this Instruction. Registrants shall describe the nature of the services comprising the fees disclosed under this category.

(3) Disclose, under the caption Tax Fees, the aggregate fees billed in each of the last two fiscal years for professional services rendered by the principal accountant for tax compliance, tax advice, and tax planning. Registrants shall describe the nature of the services comprising the fees disclosed under this category.

(4) Disclose, under the caption All Other Fees, the aggregate fees billed in each of the last two fiscal years for products and services provided by the principal accountant, other than the services reported in paragraphs B.(10)(1) through B.(10)(3) of this Instruction. Registrants shall describe the nature of the services comprising the fees disclosed under this category.

(5)(i) Disclose the audit committee's pre-approval policies and procedures described in paragraph (c)(7)(i) of Rule 2-01 of Regulation S-X.

(ii) Disclose the percentage of services described in each of paragraphs B.(10)(2) through B.(10)(4) of this Instruction that were approved by the audit committee pursuant to paragraph (c)(7)(i)(C) of Rule 2-01 of Regulation S-X.

(6) If greater than 50 percent, disclose the percentage of hours expended on the principal accountant's engagement to audit the registrant's financial statements for the most recent fiscal year that were attributed to work performed by persons other than the principal accountant's full-time, permanent employees.

Notes to Instruction B.(10)

1. You do not need to provide the information called for by this Instruction B.(10) unless you are using this form as an annual report.

2. A registrant that is an Asset-Backed Issuer (as defined in §240.13a-14(g) and §240.15d-14(g) of this chapter) is not required to disclose the information required by this Instruction B.(10).

* * * * *

10. Amend Form 10-K (referenced in § 249.310) by:

a. Redesignating Item 16 of Part IV as Item 17 of Part IV, and

b. Adding new Item 16 to Part III.

The addition reads as follows:

Note: The text of Form 10-K does not, and this amendment will not, appear in the Code of Federal Regulations.

FORM 10-K

* * * * *

GENERAL INSTRUCTIONS

* * * * *

**Annual Report Pursuant to Section 13 or 15(d)
of the Securities Exchange Act of 1934**

* * * * *

PART III

* * * * *

Item 16. Principal Accountant Fees and Services.

Furnish the information required by Item 9(e) of Schedule 14A (§240.14a-101 of this chapter).

(1) Disclose, under the caption Audit Fees, the aggregate fees billed for each of the last two fiscal years for professional services rendered by the principal accountant for the audit of the registrant's annual financial statements and review of financial statements included in the registrant's Form 10-Q (17 CFR 249.308a) or 10-QSB (17 CFR 249.308b) or services that are normally provided by the accountant in connection with statutory and regulatory filings or engagements for those fiscal years.

(2) Disclose, under the caption Audit-Related Fees, the aggregate fees billed in each of the last two fiscal years for assurance and related services by the principal accountant that are reasonably related to the performance of the audit or review of the registrant's financial statements and are not reported under Item 9(e)(1) of Schedule 14A. Registrants shall describe the nature of the services comprising the fees disclosed under this category.

(3) Disclose, under the caption Tax Fees, the aggregate fees billed in each of the last two fiscal years for professional services rendered by the principal accountant for tax compliance, tax advice, and tax planning. Registrants shall describe the nature of the services comprising the fees disclosed under this category.

(4) Disclose, under the caption All Other Fees, the aggregate fees billed in each of the last two fiscal years for products and services provided by the principal accountant, other than the services reported in Items 9(e)(1) through 9(e)(3) of Schedule 14A. Registrants shall describe the nature of the services comprising the fees disclosed under this category.

(5)(i) Disclose the audit committee's pre-approval policies and procedures described in paragraph (c)(7)(i) of Rule 2-01 of Regulation S-X.

(ii) Disclose the percentage of services described in each of Items 9(e)(2) through 9(e)(4) of Schedule 14A that were approved by the audit committee pursuant to paragraph (c)(7)(i)(C) of Rule 2-01 of Regulation S-X.

(6) If greater than 50 percent, disclose the percentage of hours expended on the principal accountant's engagement to audit the registrant's financial statements for the most recent fiscal year that were attributed to work performed by persons other than the principal accountant's full-time, permanent employees.

Instruction to Item 16.

A registrant that is an Asset-Backed Issuer (as defined in §240.13a-14(g) and §240.15d-14(g) of this chapter) is not required to disclose the information required by this Item.

* * * * *

11. Amend Form 10-KSB (referenced in § 249.310b) by adding Item 16 to Part III to read as follows:

Note: The text of Form 10-KSB does not, and this amendment will not, appear in the Code of Federal Regulations.

FORM 10-KSB

* * * * *

PART III

* * * * *

Item 16. Principal Accountant Fees and Services.

Furnish the information required by Item 9(e) of Schedule 14A (§240.14a-101 of this chapter).

(1) Disclose, under the caption Audit Fees, the aggregate fees billed for each of the last two fiscal years for professional services rendered by the principal accountant for the audit of the registrant's annual financial statements and review of financial statements included in the registrant's Form 10-Q (17 CFR 249.308a) or 10-QSB (17 CFR 249.308b) or services that are normally provided by the accountant in connection with statutory and regulatory filings or engagements for those fiscal years.

(2) Disclose, under the caption Audit-Related Fees, the aggregate fees billed in each of the last two fiscal years for assurance and related services by the principal accountant that are reasonably related to the performance of the audit or review of the registrant's financial statements and are not reported under Item 9(e)(1) of Schedule 14A. Registrants shall describe the nature of the services comprising the fees disclosed under this category.

(3) Disclose, under the caption Tax Fees, the aggregate fees billed in each of the last two fiscal years for professional services rendered by the principal accountant for tax compliance, tax advice, and tax planning. Registrants shall describe the nature of the services comprising the fees disclosed under this category.

(4) Disclose, under the caption All Other Fees, the aggregate fees billed in each of the last two fiscal years for products and services provided by the principal accountant, other than the services reported in Items 9(e)(1) through 9(e)(3) of Schedule 14A. Registrants shall describe the nature of the services comprising the fees disclosed under this category.

(5)(i) Disclose the audit committee's pre-approval policies and procedures described in paragraph (c)(7)(i) of Rule 2-01 of Regulation S-X.

(ii) Disclose the percentage of services described in each of Items 9(e)(2) through 9(e)(4) of Schedule 14A that were approved by the audit committee pursuant to paragraph (c)(7)(i)(C) of Rule 2-01 of Regulation S-X.

(6) If greater than 50 percent, disclose the percentage of hours expended on the principal accountant's engagement to audit the registrant's financial statements for the most recent fiscal year that were attributed to work performed by persons other than the principal accountant's full-time, permanent employees.

Instruction to Item 16.

A registrant that is an Asset-Backed Issuer (as defined in §240.13a-14(g) and §240.15d-14(g) of this chapter) is not required to disclose the information required by this Item.

* * * * *

PART 274 - FORMS PRESCRIBED UNDER THE INVESTMENT COMPANY ACT OF 1940

12. The authority citation for Part 274 is amended by adding the following citation in numerical order to read as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 78c(b), 78l, 78m, 78n, 78o (d), 80a-8, 80a-24, 80a-26, and 80a-29, unless otherwise noted.

* * * * *

Section 274.128 is also issued under secs. 3(a), 202, 302, 406, and 407, Pub. L. No. 107-204, 116 Stat. 745.

13. By amending Form N-CSR (referenced in §§ 249.331 and 274.128):

a. By revising General Instruction D; and

b. By adding Item 4.

The revision and addition read as follows:

Note: The text of Form N-CSR does not, and this amendment will not, appear in the Code of Federal Regulations.

FORM N-CSR

* * * * *

GENERAL INSTRUCTIONS

* * * * *

D. Incorporation by Reference.

A registrant may incorporate by reference information required by Items 4 and 10(a). No other Items of the Form shall be answered by incorporating any information by reference. The information required by Item 4 may be incorporated by reference from the registrant's definitive proxy statement (filed or required to be filed pursuant to Regulation 14A (17 CFR 240.14a-1 et seq.)) or definitive information statement (filed or to be filed pursuant to Regulation 14C (17 CFR 240.14c-1 et seq.)) which involves the election of directors, if such definitive proxy statement or information statement is filed with the Commission not later than 120 days after the end of the fiscal year covered by an annual report on this Form. All incorporation by reference must comply with the requirements of this Form and the following rules on incorporation by reference: Rule 10(d) of Regulation S-K under the Securities Act of 1933 (17 CFR 229.10(d)) (general rules on incorporation by reference, which, among other things, prohibit, unless specifically required by this Form, incorporating by reference a document that includes incorporation by reference to another document, and limits incorporation to documents filed within the last 5 years, with certain exceptions); Rule 303 of Regulation S-T (17 CFR 232.303) (specific requirements for electronically filed documents); Rules 12b-23 and 12b-32 under the Exchange Act (additional rules on incorporation by reference for reports filed pursuant to Sections 13 and 15(d) of the Exchange Act); and Rules 0-4, 8b-23, and 8b-32 under the Investment Company Act of 1940 (17 CFR 270.0-4, 270.8b-23, and 270.8b-32) (additional rules on incorporation by reference for investment companies).

* * * * *

Item 4. Principal Accountant Fees and Services.

(a) Disclose, under the caption Audit Fees, the aggregate fees billed for each of the last two fiscal years for professional services rendered by the principal accountant for the audit of the registrant's annual financial statements or services that are normally provided by the accountant in connection with statutory and regulatory filings or engagements for those fiscal years.

(b) Disclose, under the caption Audit-Related Fees, the aggregate fees billed in each of the last two fiscal years for assurance and related services by the principal accountant that are reasonably related to the performance of the audit of the registrant's financial statements and are not reported under paragraph (a) of this Item. Registrants shall describe the nature of the services comprising the fees disclosed under this category.

(c) Disclose, under the caption Tax Fees, the aggregate fees billed in each of the last two fiscal years for professional services rendered by the principal accountant for tax compliance, tax advice, and tax planning. Registrants shall describe the nature of the services comprising the fees disclosed under this category.

(d) Disclose, under the caption All Other Fees, the aggregate fees billed in each of the last two fiscal years for products and services provided by the principal accountant, other than the services reported in paragraphs (a) through (c) of this Item. Registrants shall describe the nature of the services comprising the fees disclosed under this category.

(e)(1) Disclose the audit committee's pre-approval policies and procedures described in paragraph (c)(7) of Rule 2-01 of Regulation S-X.

(2) Disclose the percentage of services described in each of paragraphs (b) through (d) of this Item that were approved by the audit committee pursuant to paragraph (c)(7)(i)(C) of Rule 2-01 of Regulation S-X.

(f) If greater than 50 percent, disclose the percentage of hours expended on the principal accountant's engagement to audit the registrant's financial statements for the most recent fiscal year that were attributed to work performed by persons other than the principal accountant's full-time, permanent employees.

(g) Disclose the aggregate non-audit fees billed by the registrant's accountant for services rendered to the registrant, and rendered to the registrant's investment adviser (not including any sub-adviser whose role is primarily portfolio management and is subcontracted with or overseen by another investment adviser), and any entity controlling, controlled by, or under common control with the adviser that provides ongoing services to the registrant for each of the last two fiscal years of the registrant.

(h) Disclose whether the registrant's audit committee of the board of directors has considered whether the provision of non-audit services that were rendered to the registrant's investment adviser (not including any subadviser whose role is primarily portfolio management and is subcontracted with or overseen by another investment adviser), and any entity controlling, controlled by, or under common control with the investment adviser that provides ongoing services to the registrant that were not pre-approved pursuant to paragraph (c)(7)(ii) of Rule 2-01 of Regulation S-X is compatible with maintaining the principal accountant's independence.

Instructions.

1. The information required by this Item 4 is only required in an annual report on this Form N-CSR.

2. For purposes of paragraphs (b), (c), and (d), registrants that are investment companies must disclose fees billed for services rendered to the registrant and separately, disclose fees required to be approved pursuant to paragraph (c)(7)(ii) of Rule 2-01 of Regulation S-X. Registered investment companies must also disclose the fee percentages as required by Item 4(e)(2) for the registrant and separately, disclose the fee percentages as required by Item 4(e)(2) for the fees required to be approved by the investment company registrant's audit committee pursuant to paragraph (c)(7)(ii) of Rule 2-01 of Regulation S-X.

* * * * *

By the Commission.

Jill M. Peterson
Assistant Secretary

Dated: January 28, 2003

Footnotes

[1] 17 CFR 210.2-07.

[2] 17 CFR 210.2-01.

3 17 CFR 240.14a-101.

4 17 CFR 249.310; 17 CFR 249.310b; 17 CFR 249.220f; 17 CFR 249.240f.

5 17 CFR 249.331; 17 CFR 274.128.

6 17 CRF 240.10A-2.

7 Pub. L. 107-204, 116 Stat. 745 (2002).

8 The amendments were proposed in Securities Act Release No. 8154 (December 2, 2002) 67 FR 76779-76817.

9 In addition to soliciting comments in the Proposing Release, we held one roundtable (December 17, 2002). The public comments we received can be reviewed in our Public Reference Room at 450 Fifth Street, NW, Washington, DC 20549, in File No. S7-49-02. Public comments submitted by electronic mail are on our website, www.sec.gov.

10 The Commission adopted a set of rules governing auditor independence on November 21, 2000. See Release No. 33-7919 (Nov. 21, 2000); 65 FR 76008 (Dec. 5, 2000) (hereinafter "November 2000 release").

11 SAS No. 89, "Audit Adjustments," (Dec. 1999) at AU §380.

12 The Commission's rules respond not only to the provisions of the Sarbanes-Oxley Act but also the rulemaking petitions filed by the AFL-CIO on December 11, 2001 and The Honorable H. Carl McCall on January 21, 2002.

13 Consistent with our existing rules, the terms accounting firm and accountant are used interchangeably in this release. The term "accountant" is defined in §210.2-01(f)(1) below.

14 *See,* Section 206 of the Sarbanes-Oxley Act.

15 *See* , Rule 2-01(f)(7).

16 *See* , Rule 2-01(f)(3)(ii).

17 *See* , Rule 2-01(f)(6).

18 The Independence Standards Board was a private sector body that, from 1997 to 2001, was charged with the responsibility to set auditor independence standards for auditors of the financial statements of SEC registrants. See Financial Reporting Release Nos. 50 (February 18, 1998) and 50A (July 17, 2001).

19 Independence Standards Board, "Employment with Audit Clients," *Discussion Memorandum 99-1* (March 12, 1999).

20 Independence Standards Board, "Employment with Audit Clients," *Standard No. 3* (July 2000).

21 *Id* ., ¶2(b)(iii).

22 *See, e.g.,* letter from Asahi & Co., dated January 10, 2003; letter from CPA Associates, dated January 3, 2003; letter from International Group of Accounting Firms, dated December 24, 2002.

23 *See, e.g* ., letter from Eli Lilly and Company, dated January 9, 2003; letter from KPMG, dated January 9, 2003; letter from

PricewaterhouseCoopers, dated January 8, 2003; letter from Roland G. Ley, dated January 9, 2003.

24 *See, e.g* ., letter from American Institute of Certified Public Accountants, dated January 9, 2003; letter from KPMG, dated January 9, 2003; letter from Instituted of Chartered Accountants of Scotland, dated January 8, 2003.

25 *See, e.g* ., letter from Eli Lilly and Company, dated January 9, 2003; letter from McGladrey & Pullen LLP, dated January 9, 2003; letter from PricewaterhouseCoopers, dated January 8, 2003; letter from Computer Sciences Corporation, dated January 13, 2003.

26 *See, e.g* ., letter from Consumer Federation of America, dated January 13, 2003.

27 *See, e.g* ., letter from Deloitte & Touche, dated January 10, 2003; letter from KPMG, dated January 9, 2003; letter from PricewaterhouseCoopers, dated January 8, 2003.

28 *See* , Rule 2-01(f)(7).

29 *See, e.g* ., letter from KPMG, dated January 9, 2003; letter from PricewaterhouseCoopers, dated January 8, 2003.

30 *See* , Rule 2-01(f)(4).

31 *See* , Section 3(a)(8) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(8)).

32 It should be noted that the ten hour threshold does not apply to the lead or concurring review partner. Such individuals are always subject to these rules, regardless of the number of hours of audit, review or attest services provided.

33 This includes hours of service provided in reviewing the issuer's quarterly filing or in providing attest services for the issuer related to the audit.

34 Use of ten hours as a threshold is consistent with the determination of a "covered person" as specified by §210.2-01(f).

35 *See, e.g* ., letter from Deloitte & Touche, dated January 10, 2003; letter from KPMG, dated January 9, 2003; letter from PricewaterhouseCoopers, dated January 8, 2003.

36 *See, e.g* ., letter from Deloitte & Touche, dated January 10, 2003; letter from European Commission, dated January 13, 2003.

37 These rules do not require the company to have an independent audit committee. *See,* discussion of definitions in this release.

38 *See, e.g* ., letter from Ernst & Young, dated January 6, 2003; letter from KPMG, dated January 9, 2003; letter from Sullivan & Cromwell LLP, dated January 10, 2003; letter from California Public Employees' Retirement System, dated January 10, 2003.

39 As used here, the term annual audit also includes procedures needed to conduct timely review of interim periods as well as procedures needed to attest to the registrant's internal controls.

40 *See,* letter from Deloitte & Touche, dated January 10, 2003; letter from PricewaterhouseCoopers, dated January 8, 2003; letter from Investment Company Institute, dated January 13, 2003.

41 *See* , letter from Investment Company Institute, dated January 13, 2003; letter from Deloitte & Touche, dated January 10, 2003.

42 *See,* letter from PricewaterhouseCoopers dated January 8, 2003.

43 As used in this section of the Act, the term Board refers to the Public Company Accounting Oversight Board.

44 *See,* Preliminary note to Rule 2-01 of Regulation S-X, 17 CFR 210.2-01.

45 *See, e.g* ., letter from California Public Employees' Retirement System, dated January 10, 2003; letter from William E. Fraser, dated November 26, 2002, letter from Ellen Sweet, dated November 26, 2002, letter from Council on Institutional Investors, dated January 10, 2003.

46 *See, e.g* ., letter from Chamber of Commerce of the United States of America, dated January 9, 2003; letter from America's Community Bankers, dated January 13, 2003; letter from Deloitte & Touche LLP, dated January 10, 2003; letter from American Society of Corporate Secretaries, dated January 13, 2003.

47 17 CFR PARTS 210, 240, 249 and 274.

48 Additionally, in the unusual instance where additional time is needed to exit and existing contract, the staff in the Office of the Chief Accountant or the Public Company Accounting Oversight Board may be consulted on a case by case basis.

49 *See, e.g* ., letter from American Institute of Certified Public Accountants, dated January 9, 2003; letter from Radin, Gloss & Co., dated December 31, 2002; letter from Grant Thornton LLP, dated January 13, 2003; letter from International Federation of Accountants, dated January 10, 2003.

50 Letter of Samuel L. Burke, Associate Chief Accountant, SEC, to Florida Institute of Certified Public Accountants re: bookkeeping (March 4, 2002).

51 An example of a situation where it would be reasonable to conclude that the results would not be subject to audit procedures would be where an accounting firm provides a prohibited service to an affiliate of the client, as defined in Rule 2-01(f)(4), but the accounting firm is not the auditor of the entity or entities that controls the accounting firm's audit client or its affiliate.

52 As such, there is a rebuttable presumption that the services are subject to audit procedures.

53 *See, e.g* ., letter from Radin, Glass & Co., dated December 31, 2002; letter from Institute of Chartered Accountants in England & Wales, dated December 24, 2002; letter from Deloitte & Touche LLP, dated January 10, 2003.

54 *See, e.g* ., letter from HarborView Partners LLC, dated December 4, 2002; letter from California Public Employees' Retirement System, dated January 10, 2003; letter from Center for Investor Trust, dated January 13, 2003.

55 *See, e.g* ., letter from Sullivan & Cromwell LLP, dated January 10, 2003.

56 *See,* Section 404(b) of the Sarbanes-Oxley Act.

57 Exemptions proposed to be eliminated included: (1) firm's valuation expert can review the work of a client's specialist; (2) firm's actuaries can value a client's pension or other post-retirement benefit obligation provided that the client assumes responsibility for significant assumptions; (3) valuations performed for planning and implementing tax-planning strategies; and (4) valuations for non-financial purposes which do not affect the financial statements.

58 Laws or regulations in certain foreign countries require the auditor in connection with designated transactions of its audit clients, to provide contribution-in-kind reports that express an opinion on the fairness of the transaction, the value of a security, or the adequacy of consideration to shareholders.

59 *See, e.g* ., letter from Piercy, Bowler, Taylor & Kern, dated January 7, 2003; letter from Robert G. Beard, undated; letter from BDO Seidman LLP, dated January 13, 2003.

60 *See, e.g* ., letter from Stikeman Elliot, dated January 13, 2003; letter from California Public Employees' Retirement System, dated January 10, 2003.

61 *See, e.g* ., letter from American Institute of Certified Public Accountants, dated January 9, 2003; letter from HSBC, dated January 1, 2003; letter from PricewaterhouseCoopers, dated January 8, 2003.

62 *See, e.g* ., letter from Aurora Group, dated January 13, 2003; letter from Cowhey, Girard Consulting, dated December 30, 2002.

63 *See, e.g* ., letter from Japanese Institute of Certified Public Accountants, dated January 13, 2003; letter from The Hundred Group of Finance Directors, dated January 13, 2003; letter from European Commission, dated January 13, 2003.

64 Letter of Lynn Turner, Chief Accountant, SEC, to Commissione Nazionale per le Societa e la Borsa re: auditor independence (August 24, 2000). In that letter, the Chief Accountant did not deem the auditor's independence to be impaired where there were certain agreed-upon procedures for the contribution-in-kind report and the accountant represented in the report that the report did not express an opinion on the fairness of the transaction, the value of the security, or the adequacy of consideration to shareholders. This letter is available on our website.

65 *See, e.g* ., letter from California Public Employees' Retirement System, dated January 10, 2003; letter from Aon Consulting, dated January 13, 2003.

66 *See, e.g* ., letter from PricewaterhouseCoopers, dated January 8, 2003; letter from Deloitte & Touche LLP, dated January 10, 2003; letter from General Electric Company, dated January 9, 2003.

67 *See,* Committee of Sponsoring Organizations of the Treadway Commission (COSO), *Internal Control - Integrated Framework* , at 7 (1992) (the "COSO Report").

68 *See,* SAS No. 65, "The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements," AU §322.

69

SAS No. 55, "Consideration of Internal Control in a Financial Audit," AU §319.

70 *See, e.g* ., letter from Perry Adkins, dated December 24, 2002; letter from The Center for Investor Trust, dated January 13, 2003.

71 *See, e.g* ., letter from James L. Crites, dated December 28, 2002; letter from Cranmore, FitzGerald & Meaney, dated December 27, 2002; letter from America's Community Bankers, dated January 13, 2003; letter from Dixon Odom LLC, dated December 20, 2002.

72 *See, e.g* ., letter from California Public Employees' Retirement System, dated January 10, 2003; letter from Institute of Internal Auditors, dated January 13, 2003.

73 *See, e.g* ., letter from Deloitte & Touche, dated January 10, 2003; letter from Ernst & Young LLP, dated January 6, 2003.

74 *See, e.g* ., letter from Hansen, Barnett & Maxwell, dated January 13, 2003; letter from Deloitte & Touche LLP, dated January 10, 2003; letter from PricewaterhouseCoopers, dated January 8, 2003; letter from American Institute of Certified Public Accountants, dated January 9, 2003.

75 *See* , AT §201, "Agreed-Upon Procedures."

76 *See, e.g* ., letter from American Institute of Certified Public Accountants, dated January 9, 2003; letter from Grant Thornton, LLP dated January 13, 2003; letter from Sullivan & Cromwell LLP, dated January 10, 2003; letter from Computer Sciences Corporation, dated January 13, 2003.

77 AU §319, "Consideration of Internal Control in a Financial Statement Audit." In addition, Section 404(b) of the Act requires a company's audit to attest to the internal control report provided annually by management.

78 AU §325, "Communication of Internal Control Related Matters Noted in an Audit," requires the auditor to communicate reportable conditions and material weaknesses in internal control to the company's audit committee or equivalent.

79 *See* , AT §201, "Agreed-Upon Procedures."

80 *See, e.g* ., letter from California Public Employees' Retirement System, dated January 10, 2003; letter from Aon Consulting, dated January 13, 2003.

81 These rules are not meant to change the Commission's previous position that an audit firm's broker-dealer division can cover an industry (including industry surveys and analyses) which includes an audit client when performing analyst functions. However, analysis of a specific audit client's stock places the auditor in the position of acting as an advocate for the client and would cause the auditor to lack independence.

82 Accountants and the companies that retain them should recognize that the key determination required here is a functional one (*i.e.* , Is the accounting firm or its employee acting as a broker-dealer?). The failure to register as a broker-dealer does not necessarily mean that the accounting firm is not a broker-dealer. In relevant part, the statutory definition of "broker" captures persons "engaged in the

business of effecting transactions in securities for the account of others." Securities Exchange Act of 1934 §3(a)(4). Unregistered persons who provide services related to mergers and acquisitions or other securities-related transactions should limit their activities so they remain outside of that statutory definition. A person may "effect transactions," among other ways, by assisting an issuer to structure prospective securities transactions, by helping an issuer to identify potential purchasers of securities, or by soliciting securities transactions. A person may be "engaged in the business," among other ways, by receiving transaction-related compensation or by holding itself out as a broker-dealer. Involvement of accounting personnel as unregistered broker-dealers not only can impair auditor independence, but also would violate Section 15(a) of the Exchange Act.

83 Floor Statement of Senator Sarbanes, 148 Cong. Rec. S7364 (July 25, 2002) ". . . A public company auditor should not be a promoter of the company's stock or other financial interest (as it would be if it served as broker-dealer, investment adviser, or investment banker for the company)." To do so places the auditor in a position of serving as an advocate for his or her audit client.

84 In the past, some have expressed concern that terms such as "securities professional" and "analyst" are not defined in the securities laws and use of the terms could cause confusion. Because of that concern, we have not used those terms in these rules. We note, however, that broker-dealers provide an array of services that may include certain analyst activities.

85 *See, e.g.,* D.C. Rules of Professional Conduct, Rule 1.3(a).

86 *Id.* at Rule 1.5.

87 In the Matter of Charles Falk, AAER No. 1134 (May 19, 1999) (formally disciplining an attorney/accountant who gave legal advice to an audit client of another partner in his accounting firm).

88 *United States v. Arthur Young* , 465 U.S 805 (1984) at 819-20 n.15.

89 *See, e.g* ., letter of Lynn E. Turner, dated January 13, 2003; letter from California Public Employees' Retirement System, dated January 10, 2003.

90 *See, e.g* ., letter from HSBC, dated January 10, 2003; letter from Institute of Chartered Accountants in England and Wales, dated December 24, 2002; letter from Institut der Wirtschaftsprufer, dated December 27, 2002; letter from Federation des Experts Comptables Europeens, dated January 13, 2003.

91 *See, e.g* ., letter from KPMG, dated January 9, 2003.

92 Letter of Lynn Turner, Chief Accountant, SEC, to Commissione Nazionale per le Sonieta e la Borsa re: statutory procedures (August 24, 2000).

93 *See, e.g* ., letter from Sullivan & Cromwell LLP, letter from Deloitte & Touche LLP, dated January 10, 2003; letter from American Institute of Certified Public Accountants, dated January 9, 2003; letter from Federation des Experts Comptables Europeens, dated January 13, 2003.

94

See, e.g ., letter from Sullivan & Cromwell LLP, dated January 10, 2003; letter from California Public Employees' Retirement System, dated January 10, 2003; letter from Grant Thornton LLP, dated January 13, 2003; letter from American Academy of Actuaries, dated January 6, 2003.

95 *See, e.g* ., letter from Eli Lily and Co., dated January 9, 2003; letter from Federation des Experts Comptables Europeens, dated January 13, 2003; letter from PG&E Corporation, dated January 10, 2003; letter from America's Community Bankers, dated January 13, 2003.

96 The accountant becomes an advocate under such circumstances even if the accountant is working behind the scenes to advance the client's interests.

97 As we discussed in our proposing release, virtually all services provided by an accountant may be perceived to be expert services. This prohibition, however, only applies to those services that involve advocacy in proceedings and investigations (as discussed in this section of the release) and does not apply to other permitted non-audit services, such as tax services.

98 For purposes of this release, an investigation is an inquiry by a regulatory body, including by its staff.

99 *See* , *infra* , discussion stating that if litigation arises or an investigation commences during the auditor's performance of such procedures, completion of the procedures is not prohibited provided the auditor remains in control of his or her work and that work does not become subject to the direction or influence of legal counsel for the issuer.

100 For example, Section 301 of the Act stipulates that each audit committee shall have the authority to engage independent counsel and other advisers, as it determines necessary to carry out its duties.

101 An auditor's independence would, however, be impaired if its assistance to the audit committee included defending, or helping to defend, the audit committee or the company generally in a shareholder class action or derivative lawsuit, other than as a fact witness.

102 *See* , SAS No. 99, "Consideration of Fraud in a Financial Statement Audit," AU §316.

103 The provision of tax services by accountants to their audit clients existed and continued without change when Congress formulated the securities laws in the 1930s. The Sarbanes-Oxley Act also recognized that accountants may engage in certain non-audit services "including tax services . . . only if the activity is approved in advance by the audit committee."

104 Some commenters (*see, e.g* ., letter from Ernst & Young, dated January 6, 2003; letter from Deloitte & Touche, dated January 10, 2003; letter from KPMG, dated January 9, 2003; letter from the Chamber of Commerce of the United States of America, dated January 9, 2003; letter from SafeCo Corporation, dated January 7, 2003; letter from Pfizer, dated January 13, 2003; letter from The Business Roundtable, dated January 14, 2003) believe that asking audit committees to evaluate tax services in light of the three principles in

its pre-approval process creates an unnecessary degree of uncertainty in the marketplace.

105 *See, e.g* ., letter from Norman Marks, dated December 9, 2002; letter from Harbor View Partners, dated December 4, 2002; letter from Douglas Estes, dated November 30, 2002; letter from William Fraser, dated November 26, 3002; letter from M.E. Saunders, dated November 26, 2002.

106 *See, e.g.,* letter from Robert T. Bossart, dated January 2, 2003; letter from FedEx Corporation, dated December 31, 2002; letter from the American Bar Association Section of Taxation, dated January 6, 2003; letter from California Public Employees' Retirement System, dated January 10, 2003.

107 Commenters identified a variety of tax services they believe should be prohibited. However, there was no "consensus" view on what tax services should be prohibited.

108 *See, e.g.,* letter from Philip A. Laskawy, dated January 2, 2003; letter from FedEx Corporation, dated December 31, 2002; letter from The Business Roundtable, dated January 14, 2003.

109 *See* , comment letter of William Kinney, University of Texas, Zoe-Vonna Palmrose, University of Southern California, and Susan Scholz, University of Kansas.

110 Sarbanes-Oxley Act of 2002, Section 201.

111 It would not be appropriate to provide a prohibited service, label it a "tax service," and argue that it is, therefore, permissible. For example, an accountant seeking to provide a broker-dealer service and arguing that, because there are tax implications of certain brokerage activities, the service is permissible would constitute an attempt to improperly circumvent the list of prohibited services. *See* , letter of Ernst & Young dated January 6, 2003 (p. 16).

112 The Commission on Public Trust and Private Enterprise recently concluded as a "best practice" that an accounting firm should not be providing "novel and debatable tax strategies and products that involve income tax shelters and extensive off-shore partnerships or affiliates" to audit clients. *See* The Conference Board Commission on Public Trust and Private Enterprise, *Findings and Recommendations* , January 9, 2003, p. 37.

113 American Institute of Certified Public Accountants (AICPA), *Division for CPA Firms SEC Practice Section Peer Review Manual* , 1978.

114 *See,* Release No. 33-8173 (Jan 8, 2003).

115 In addition to the audit, registrants are required to have their quarterly financial information subjected to a timely review by the accounting firm. Such review is typically conducted according to the provisions required by GAAS--*see* , AU §722. Furthermore, Section 404 of the Sarbanes-Oxley Act, as well as the Commission's proposed rules--*see* , Release No. 33-8138, Oct. 22, 2002, (67 FR 66208)--would require the accounting firm to attest to management's report on the registrant's internal controls. Both a timely review engagement and an attestation engagement require the accounting firm to be independent with respect to the registrant. Accordingly, the Commission's rules for partner rotation extend to partners who serve

on the engagement team that conducts the timely review of the registrant's interim financial information as well as the engagement team that conducts the attest engagement on management's report on the registrant's internal controls.

116 *See* , AU §150.02.

117 *See* , QC §20.13.

118 As defined in Rule 2-01(f).

119 *See, e.g.,* letter from Jason Zahner, dated December 23, 2002; letter from Hugh Higgins, dated November 20, 2002.

120 *See, e.g.* , letter from American Institute of Certified Public Accountants, dated January 9, 2003.

121 *See* , The Commission on Auditors' Responsibilities, "Report, Conclusions, and Recommendations," 1978, p. 109; Report of the National Commission on Fraudulent Financial Reporting, 1987, p. 54; research commissioned by the Committee of Sponsoring Organizations of the Treadway Commission, "Report of the National Commission on Fraudulent Financial Reporting," 1987, p. 113; Committee of Sponsoring Organizations of the Treadway Commission, "Fraudulent Financial Reporting: 1987-1997 An Analysis of U.S. Public Companies," 1999, p. 28; United States General Accounting Office, Report to the Ranking Minority Member, Committee on Commerce, House of Representatives, "The Accounting Profession, Major Issues: Progress and Concerns," 1996, p. 56; Arrunada, Benito, "Mandatory Rotation of Company Auditors: A Critical Examination," *International Review of Law And Economics* , March 1997; St. Pierre, K. and J. Anderson, "An Analysis of Factors Associated with Lawsuits Against Public Accountants," *Accounting Review* (1984), p. 256; and Dallocchio, M. and A. Viganò, "The Impact Of Mandatory Audit Rotation On Audit Quality And On Audit Pricing: The Case Of Italy," SDA Università Bocconi, 2003.

122 Section 207 of the Act directs the Comptroller General of the United States to conduct a study and review of the potential effects of mandatory rotation of firms.

123 AICPA, SEC Practice Section, Requirements of Members, at item e. The membership requirements are available online at www.aicpa.org/members/div/secps/require.htm. Audit firms which are members of the SEC Practice Section must comply with its rules (e.g., partner rotation) and undergo periodic peer review to ensure that the firms' audit practice is consistent with both the rules of the AICPA and those of the Commission.

124 *See, e.g.,* letter from California Public Employees' Retirement System, dated January 10, 2003; letter from Denzil Dias, dated December 11, 2002; letter from HSBC, dated January 11, 2003.

125 While the current lead partner rotation requirements specify a seven-year period prior to rotation, the original rotation requirements developed by the SECPS specified a five-year rotation period. *See* , AICPA, *Division for CPA Firms SEC Practice Section Peer Review Manual* , 1978, p.1-5.

126 *See, e.g.,* letter from The Putnam Funds, not dated; letter from Commercial Federal Bank, dated January 13, 2003; letter from Dixon

Odom, dated December 20, 2002; letter from American Instituted of Certified Public Accountants, dated January 9, 2003.

127 *See, e.g.,* letter from Aetna, Inc., dated January 13, 2003; letter from Royal Philips Electronics, dated January 9, 2003; letter from Lynn Turner, dated January 13, 2003; letter from Medtronic, Inc., dated January 13, 2003.

128 *See, e.g.,* letter from Denzil Dias, dated December 11, 2002.

129 *See, e.g* ., letter from California Public Employees' Retirement System dated January 10, 2003.

130 *See, e.g* ., letter from Lynn E. Turner dated January 13, 2003.

131 *See, e.g* ., letter from Aramark Corporation, dated December 26, 2002; letter from Aetna, Inc., dated January 13, 2003; letter from PricewaterhouseCoopers, dated January 8, 2003; letter from Mellon Financial Corporation, dated January 10, 2003; letter from SAP AG, undated; letter from Chamber of Commerce of the United States of America, dated January 9, 2003; letter from The Business Roundtable, dated January 14, 2003.

132 *See* , letter from PricewaterhouseCoopers dated January 8, 2003.

133 *See* , letter from HSBC dated January 10, 2003.

134 *See, e.g* ., letter from Ernst & Young LLP, dated January 6, 2003; letter from Robert G. Beard, undated; letter from Institute of Chartered Accountants in England and Wales, dated January 10, 2003.

135 *See* , letter from Deloitte & Touche LLP, dated January 10, 2003.

136 *See, e.g* ., letter from The Business Roundtable, dated January 14, 2003; PricewaterhouseCoopers, dated January 8, 2003; letter from KPMG, dated January 9, 2003; letter from Philip A. Laskawy, dated January 9, 2003; letter from Pfizer, dated January 13, 2003; letter from Aetna, Inc., dated January 13, 2003.

137 Specialty partners are, among others, those partners who consult with others on the audit engagement team during the audit, review or attestation engagement regarding technical or industry-specific issues. For example, such partners would include tax specialist and valuation specialist.

138 *See, e.g* ., letter from Ernst & Young LLP, dated January 6, 2003; letter from Deloitte & Touche, dated January 10, 2003.

139 A threshold of 20% often has been used in the accounting literature as a basis for "significance" tests. *See, e.g* ., APB Opinion No. 18, "The Equity Method of Accounting for Investments in Common Stock, and ARB No. 43, Chapter 7, "Capital Accounts."

140 17 CFR 210.2-01(f)(7).

141 *See, e.g* ., letter from Ernst & Young, dated January 6, 2003; letter from Deloitte & Touche, dated January 10, 2003; letter from KPMG, dated January 9, 2003; letter from Dixon Odom, dated December 20, 2002; letter from The Business Roundtable, dated January 14, 2003.

142 An audit partner who starts in a position other than the lead or concurring partner and subsequently moves to the lead or concurring partner cannot serve the client in an audit partner capacity for more than seven consecutive years. For example, a person serving as the

lead partner on a significant subsidiary for a period of four years who then becomes the lead partner on the issuer would be able to serve in that capacity for three additional years before reaching a total of seven years as an audit partner on that client.

143 *See, e.g* ., letter from Piercy, Bowler, Taylor & Kern, dated January 7, 2003; letter from Witt, Mares & Company PLC, dated January 11, 2003; letter from Burton, McCumber & Cortez LLP, dated January 2, 2003; letter from American Institute of Certified Public Accountants, dated January 9, 2003; letter from Spence, Marston, Bunch, Morris & Co., dated January 13, 2003; letter from The Business Roundtable, dated January 14, 2003.

144 *See, e.g* ., letter from Weaver & Martin LLC, dated December 31, 2002; letter from CPA Associates, dated January 3, 2003; letter from Symonds, Evans & Company PC, dated December 19, 2002.

145 *See, e.g* ., letter from U.S. Small Business Administration's Office of Advocacy, January 13, 2003. We note that the GAO also is conducting a study on the consolidation in the accounting industry as directed by Section 701 of the Sarbanes-Oxley Act.

146 *See, e.g* ., letter from Castaing, Hussey & Lolan LLC, dated January 10, 2003; letter from Piercy, Bowler, Taylor & Kern, dated January 7, 2003; letter from Trice, Geary & Myers LLC, dated January 13, 2003; letter from Smith, Carney & Co., dated January 7, 2003; letter from Cranmore, FitzGerald & Meaney, dated December 27, 2002.

147 AICPA, SEC Practice Section, Requirements of Members, at item e.

148 As defined in section 10A(f) of the Securities Exchange Act of 1934 (15 U.S.C. 78j-1(f)).

149 *See, e.g* ., letter from Deloitte & Touche, dated January 10, 2003; letter from Putnam Mutual Funds, not dated; letter from The Vanguard Group, dated January 13, 2003; letter from PricewaterhouseCoopers, dated January 8, 2003.

150 *See,* letter from PricewaterhouseCoopers, dated January 8, 2003; letter from Investment Company Institute, dated January 13, 2003.

151 Commenters also were concerned with the availability of competent audit, tax and other specialized partners to effectively rotate between the investment company audits. One commenter indicated tax partners typically served a far greater number of investment company audit clients per partner than their counterparts in the other industry practices (*see* , letter from Investment Company Institute, dated January 13, 2003). Commenters were concerned that lack of depth in this industry would ultimately reduce audit quality and harm investors (*see, e.g.* , letter from Putnam Mutual Funds, not dated). Commenters also were concerned with the depth of audit resources in certain markets (*see, e.g.* , letter from Oppenheimer Funds, Inc., dated January 13, 2003). One commenter indicated the proposed rule would effectively bar them from performing audits of investment companies (*see* , letter from McCurdy & Associates, CPAs, Inc., dated December 12, 2002). We have addressed these concerns by the changes to the partner rotation requirements that impact all issuers in addition to registered investment companies.

152 *See,* letter from PricewaterhouseCoopers, dated January 8,2003.

153 *See,* letter from PricewaterhouseCoopers, dated January 8, 2003. *See, also* , letter from Investment Company Institute, dated January 6, 2003.

154 Since concurring partners were not previously subject to rotation requirements, it is quite likely that many partners will have served in significantly more than five years in that capacity at the time of transition.

155 *See, e.g* ., letter from The Business Roundtable, dated January 13, 2003; letter from Chamber of Commerce of the United States of America, dated January 9, 2003; letter from Investment Company Institute, dated January 13, 2003; letter from Pfizer, dated January 13, 2003; letter from Sullivan & Cromwell LLP, dated January 10, 2003; letter from Wells Fargo & Company, dated January 13, 2003.

156 *See, e.g* ., letter from America's Community Bankers, dated January 13, 2003; letter from American Society of Corporate Secretaries, dated January 13, 2003; letter from Ernst & Young, dated January 6, 2003.

157 Section 202 of the Sarbanes-Oxley Act.

158 Section 202 of the Sarbanes-Oxley Act; 15U.S.C 78j-1(i)(1)(A).

159 The Act permits the audit committee to pre-approve a service at any time in advance of the activity. We expect that audit committees will establish policies for the maximum period in advance of the activity the approval may be granted. *See* "Report of the Senate Committee on Banking, Housing and Urban Affairs, Public Company Accounting Reform and Investor Protection Act of 2002," 107th Cong., 2nd Sess., at 20 (Report 107-205. July 3, 2002).

160 *See, e.g.* , letter from Deloitte & Touche, dated January 10, 2003; letter from Ernst & Young, dated January 6, 2003; letter from Investment Company Institute, dated January 13, 2003.

161 *See, e.g.* , letter from Ernst & Young, dated January 6, 2003; letter from Deloitte & Touche, dated January 10, 2003; letter from PricewaterhouseCoopers, dated January 8, 2003.

162 *See,* letter from PricewaterhouseCoopers, dated January 8, 2003; letter from Investment Company Institute, dated January 13, 2003.

163 *See,* letter from Investment Company Institute, dated January 13, 2003.

164 *See,* letter from PricewaterhouseCoopers, dated January 8, 2003; letter from Deloitte & Touche, LLP, dated January 10, 2003.

165 *See* , letter from Ernst & Young, LLP, dated January 6, 2003; letter from Investment Company Institute, dated January 13, 2003.

166 *See,* letter from PricewaterhouseCoopers, dated January 8, 2003.

167 *See,* letter from PricewaterhouseCoopers, dated January 8, 2003.

168 *See,* letter from KPMG, LLP, dated January 9, 2003.

169 *See,* letter from PricewaterhouseCoopers, dated January 8, 2003.

170 *See,* letter from Investment Company Institute, dated January 13, 2003.

171

See, e.g ., AICPA, *Practice Alert 99-1* , Guidance for Independence Discussions with Audit Committees, (May 1999).

172 *See, e.g* ., letter from American Institute of Certified Public Accountants, dated January 9, 2003; letter from Deloitte & Touche, LLP, dated January 10, 2003; letter from Ernst & Young, LLP, dated January 6, 2003; letter from Federation des Experts Comptables Europeens, dated January 13, 2003; letter from Institute of Chartered Accountants in England and Wales, dated December 24, 2002; letter from KPMG, LLP, dated January 9, 2003; letter from PricewaterhouseCoopers, dated January 8, 2003.

173 *See, e.g* ., letter from Ernst & Young, LLP, dated January 6, 2003; letter from Deloitte & Touche, LLP, dated January 10, 2003; letter from KPMG, LLP, dated January 9, 2003; letter from McGladrey & Pullen, LLP, dated January 9, 2003.

174 As discussed previously, partners who provided ten or fewer hours of service are excluded from the definition of audit partner.

175 For purposes of this rule, the term "sale" is meant to encompass any revenue, fees, or compensation related to non-audit services provided over the period of the evaluation, regardless when contracted.

176 *Id* .

177 Consistent with the idea that an audit partner cannot be directly compensated for selling non-audit services, no part of that partner's distribution or other form of compensation should be directly received from selling of non-audit services (for example, from a "pool" of profits generated by a valuation services business unit). In contrast, that partner may receive distributions or other compensation from the "pool" attributable to the audit practice, a geographic unit comprised of several services or offices, or the entire firm.

178 For example, an audit partner could be evaluated on the complexity of his or her engagements, the overall management of the relationship with an audit client including the provision of non-audit services, and/or the attainment of explicit sales goals.

179 An audit partner could be compensated for selling audit or audit-related services to an audit client. Additionally, an audit partner could be compensated for selling either audit or non-audit services to a non-audit client.

180 "Audit and professional engagement period" includes both the period covered by the financial statements being audited or reviewed and the period of engagement to audit or review the client's financial statements or to prepare a report filed with the Commission. The period of engagement begins when the auditor signs an initial engagement letter or begins audit, review or attest procedures, and ends when the client or the auditor notifies the Commission that the client is no longer the auditor's audit client. *See* Rule 2-01(f)(5) of Regulation S-X, 17 CFR 210.2-01(f)(5).

181 17 CFR 210.2-01(f)(7)(ii).

182 Specialty partners are, among others, those partners who consults with others on the audit engagement team during the audit, review or attestation engagement regarding technical or industry-specific issues.

For example, such partners would include tax specialist and valuation specialist.

183 Nothing in these rules is meant to limit the ability of an accounting firm from distributing profits in a manner that is consistent with the operation of a partnership or service organization.

184 For purposes of this discussion, services include tangible products as well as professional services.

185 *See e.g* ., *In the Matter of Arthur Andersen LLP* , Accounting and Auditing Enforcement Release No. 1405 (June 19, 2001), at notes 15 -17.

186 *See,* letter from Investment Company Institute, dated January 13, 2003.

187 As defined in section 10A(f) of the Securities Exchange Act of 1934 (15 U.S.C. 78j-1(f)).

188 17 CFR 2-01(f)(1).

189 *See,* Section 102(a) of the Sarbanes-Oxley Act.

190 *See* , Release No. 33-8173 (Jan. 8, 2003).

191 As defined in 17 CFR 240.13a-14(g) and 240.15d-14(g).

192 As defined by Section 4(2) of the Investment Company Act [15 U.S.C. 80a-4(2)].

193 The term "audit partner" also would include any audit partner on a registered investment company whether or not the investment company issues consolidated financial statements.

194 *See,* AU § 380, "Communication with Audit Committees." There are additional GAAS requirements related to auditor communications that are not included in this rule, such as the auditor's responsibilities under GAAS, the auditor's responsibilities related to documents containing audited financial statements, and disagreements with management, consultations with other accountants, major issues discussed with management prior to retention, and difficulties encountered in performing the audit, to the extent that those matters do not relate to accounting policies and practices.

195 *Id.*

196 *See, e.g* ., letter from The Institute of Chartered Accountants of Scotland, dated January 8, 2003; letter from Battelle & Battelle, LLP, dated December 20, 2002; letter from Grant Thornton LLP, dated January 13, 2003.

197 *See, e.g* ., letter from Gelford Hochstadt Pangburn, PC, dated January 3, 2003; letter from Ernst & Young LLP, dated January 6, 2003.

198 *See, e.g* ., letter from Piercy Bowler Taylor & Kern, dated January 7, 2003; letter from Robert G. Beard, undated; letter from Eide Bailly LLP, dated January 8, 2003; letter from California Public Employees' Retirement System, dated January 10, 2003; letter from Lynn E. Turner, dated January 13, 2003.

199 *See, e.g* ., letter from Computer Sciences Corporation, dated January 13, 2003; letter from Sullivan & Cromwell LLP, dated January 10,

2003; letter from America's Community Bankers, dated January 13, 2003; letter from Deloitte & Touche LLP, dated January 10, 2003.

200 *See* , "Audit Committee Disclosures," Release No. 34-42266, Dec. 22, 1999.

201 Warren Buffett, Comments during SEC "Roundtable Discussion on Financial Disclosure and Auditor Oversight," March 4, 2002.

202 In this release, the terms "critical accounting policies and practices" and "critical accounting policies" are used interchangeably.

203 Item 303 of Regulation S-K, (17 CFR 229.303), which requires disclosure about, among other things, trends, events or uncertainties known to management that would have a material impact on reported financial information.

204 Release No. 33-8040, Dec. 12, 2001, (66 FR 65013).

205 *Id.*

206 *Id.* (footnotes omitted).

207 Release No. 33-8090, May 10, 2002, (67 FR 35620).

208 *See, e.g* ., letter from Chamber of Commerce of the United States of America, dated January 9,2003; letter from Battelle & Battelle LLP, dated December 20, 2002; letter from Eli Lilly and Company, dated January 9, 2003; letter from Computer Sciences Corporation, dated January 13, 2003; letter from PricewaterhouseCoopers, dated January 8, 2003.

209 *See, e.g* ., letter from Deloitte & Touche LLP, dated January 10, 2003.

210 *See* , AU §380.

211 *See,* SAS No. 85, "Management Representations," AU §333.

212 *See,* SAS 60, "Communication of Internal Control Related Matters Noted in an Audit," AU §325.

213 *See,* SAS No. 89, "Audit Adjustments," AU §333.

214 *See,* SAS No. 83, "Establishing an Understanding With the Client," AU §310.

215 *See,* SQCS No. 2, "System of Quality Control for a CPA Firm's Accounting and Auditing Practice," QC §20.

216 *See, e.g* ., letter from California Public Employees' Retirement System, dated January 10, 2003; letter from Computer Sciences Corporation, dated January 13, 2003; letter from American Institute of Certified Public Accountants, dated January 9, 2003; letter from PricewaterhouseCoopers, dated January 8, 2003.

217 *See, e.g* ., letter from Lynn E. Turner, dated January 13, 2003.

218 *See,* letter from The Vanguard Group, dated January 13, 2003; letter from Investment Company Institute, dated January 13, 2003; letter from PricewaterhouseCoopers, dated January 8, 2003.

219 *See, e.g.,* letter from The Vanguard Group, dated January 13, 2003; letter from Investment Company Institute, dated January 13, 2003; letter from Ernst & Young, dated January 6, 2003.

220

See, letter from The Vanguard Group, dated January 13, 2003; letter from Investment Company Institute, dated January 13, 2003; letter from PricewaterhouseCoopers, dated January 8, 2003.

221 *See,* letter from Investment Company Institute, dated January 13, 2003; letter from The Vanguard Group, dated January 13, 2003.

222 *See,* letter from Ernst & Young, dated January 6, 2003.

223 The rule also would require communication of a description of all non-audit services provided, including fees associated with the services, to the investment company complex that were not subject to the pre-approval requirements for investment companies as discussed in Section II.D of this release.

224 Similarly, the accountant only would need to disclose those non-audit services provided to the investment company complex that they were engaged to perform during the intervening period since their last communication, but for which pre-approval by the investment company's audit committee was not required.

225 *See,* proposed Item 9(e), Schedule 14A.

226 Previously, registrants were required to disclose only "Audit Fees," "Financial Systems Design and Implementation Fees" and "All Other Fees."

227 *See, e.g* ., letter from California Public Employees' Retirement System, dated January 10, 2003; letter from The Business Roundtable, dated January 13, 2003; letter from America' Community Bankers, dated January 13, 2003; letter from American Institute of Certified Public Accountants, dated January 9, 2003; letter from Financial Executives International's Committee on Corporate Reporting, dated January 14,2003.

228 *See, e.g* ., letter from Eli Lilly and Company, dated January 9, 2003; letter from KPMG, dated January 9, 2003; letter from Deloitte & Touche, LLP, dated January 10, 2003.

229 *See, e.g* ., letter from Ralph S. Saul, dated December 23,2002; letter from Ernst & Young, dated January 6, 2003; letter from Commercial Federal Corporation, dated January 13, 2003.

230 *See, e.g* ., letter from Lynn E. Turner, dated January 13, 2003; letter from California Public Employees' Retirement System, dated January 10, 2003; letter from Eli Lily and Company, dated January 9, 2003; letter from American Bar Association, Sector of Business Law, dated January 14, 2003.

231 *See, e.g* ., letter from California Public Employees' Retirement System, dated January 10, 2003; letter from California Board of Accountancy, dated January 13, 2003; letter from Lynn E. Turner, dated January 13, 2003.

232 *See, e.g* ., letter from American Institute of Certified Public Accountants, dated January 9, 2003; letter from Wells Fargo & Company, dated January 13, 2003.

233 *See also,* Section 2(a)(2) the Sarbanes-Oxley Act which defines the term "audit."

234

As discussed previously in this release an accountant's independence is deemed to be impaired when representing the audit client before a tax court, district court and U.S. federal court of claims.

235 We recently adopted Form N-CSR to be used by registered management investment companies to file certified shareholder reports with the Commission under the Sarbanes-Oxley Act of 2002.

236 *See, e.g.* , letter from Investment Company Institute, dated January 13, 2003; letter from PricewaterhouseCoopers, dated January 8, 2003.

237 *See, e.g.,* letter from KPMG, dated January 9, 2003; letter from PricewaterhouseCoopers, dated January 8, 2003; letter from Ernst & Young, dated January 6, 2003.

238 *See,* letter from Ernst & Young, dated January 6, 2003.

239 *See,* letter from PricewaterhouseCoopers, dated January 8, 2003; letter from Deloitte & Touche, dated January 10, 2003.

240 *See,* letter from Investment Company Institute, dated January 13, 2003.

241 44 U.S.C. 3501 *et seq.*

242 44 U.S.C. 3507(d) and 5 CFR 1320.11.

243 *See,* Release No. 33-8040, Dec. 12, 2001 (66 FR 65013). In this release the Commission provided cautionary advice regarding disclosure about critical accounting policies. *See also,* Release No. 33-8098, May 10, 2002, (67 FR 35620). In this release the Commission proposed rules to require disclosures that would enhance investors' understanding of the application of companies' critical accounting policies. The proposed disclosures would focus on accounting estimates a company makes in applying its accounting policies and the initial adoption by a company of an accounting policy that has a material impact on its financial presentation.

244 17 CFR 210.2-01(c)(7)(A) and (B).

245 17 CFR 210.2-01(c)(7)(C).

246 *See, e.g* ., letter from Deloitte & Touche LLP, dated January 10, 2003; letter from Lynn E. Turner, dated January 13, 2003.

247 *See, e.g* ., letter from Deloitte & Touche LLP, dated January 10, 2003.

248 *See, e.g* ., Release No. 33-8098, May 10, 2002, (67 FR 35620); Release No. 33-8106, Jun. 17, 2002, (67 FR 42914); Release No. 33-8124, Aug. 28, 2002, (67 FR 57276); Release No. 33-8128, Sept. 5, 2002, (67 FR 58480); Release No. 33-8138, Oct. 22, 2002, (67 FR 66208); Release No. 33-8144, Nov. 4, 2002, (67 FR 68054); Release No. 34-46778, Nov. 6, 2002, (67 FR 69430); Release No. 33-8154, Dec. 2, 2002, (67 FR 76780); Release No. 33-8160, Dec. 10, 2002, (67 FR 77594); and Release No. 33-8173, Jan. 8, 2003.

249 *See,* SAS 61, "Communication with Audit Committees or Others with Equivalent Authority and Responsibility," AU §380.

250 SAS No. 85, "Management Representations," AU §333.

251 *See* , SAS No. 89, "Audit Adjustments," AU §333.

252

Each financial report that contains financial statements, and that is required to be prepared in accordance with (or reconciled to) generally accepted accounting principles under this title and filed with the Commission shall reflect all material correcting adjustments that have been identified by a registered public accounting firm in accordance with generally accepted accounting principles and the rules and regulations of the Commission.

253 *See* , Independence Standards Board, "Independence Discussions with Audit Committees," *Independence Standard No. 1* (Jan. 1999).

254 These numbers are obtained by reviewing the number of filers that filed a Form 10-K and Schedule 14A or Schedule 14C, respectively, between October 1, 2001 and September 30, 2002.

255 *See,* Securities Industry Association, *Report on Management & Professional Earnings in the Securities Industry 2002* (2002).

256 Section 208(a) of the Sarbanes-Oxley Act of 2002.

257 *See,* Section 201 of the Sarbanes-Oxley Act.

258 *See,* Section 202 of the Sarbanes-Oxley Act.

259 *See,* Section 203 of the Sarbanes-Oxley Act.

260 *See,* Section 206 of the Sarbanes-Oxley Act.

261 *See,* Section 204 of the Sarbanes-Oxley Act.

262 *See, generally* , Section 202 of the Sarbanes-Oxley Act; Section 10A(i)(2) of the Exchange Act, 15 U.S.C. 78j-1(i)(2).

263 *See, e.g* ., letter from U.S. Small Business Administration's Office of Advocacy, January 13, 2002.

264 Report of the Senate Committee on Banking, Housing, and Urban Affairs, "Public Company Accounting Reform and Investor Protection Act of 2002," Senate Report 107-205, 107th Cong., 2d Sess., at 21 (July 3, 2002).

265 Item 303 of Regulation S-K (17 CFR 229.303), which requires disclosure about, among other things, trends, events or uncertainties known to management that would have a material impact on reported financial information.

266 Release No. 33-8040, Dec. 12, 2001, (66 FR 65013).

267 *Id.* (footnotes omitted).

268 In the case of an investment company, the investors will receive this information for the investment company registrant and separately, for all other entities in the investment company complex where the services were subject to pre-approval by the investment company's audit committee.

269 *Id.* ; 65 FR at 43185.

270 Report of the Senate Committee on Banking, Housing, and Urban Affairs, "Public Company Accounting Reform and Investor Protection Act of 2002," Senate Report 107-205, 107th Cong., 2d Sess., at 18 (July 3, 2002). *See* also letter from HarborView Partners LLC, dated December 4, 2002.

271 Section 301 of the Sarbanes-Oxley Act of 2002 requires the Commission to direct the national securities exchanges and national securities associations to prohibit the listing of any security of an

issuer that does not meet certain criteria, including having an audit committee that performs certain functions. *See* Section 10A(m) of the Exchange Act, 15 U.S.C. 78j-1(m), and Release No. 33-8173 (Jan. 8, 2003). The Sarbanes-Oxley Act defines "audit committee" to be "(A) a committee (or equivalent body) established by and amongst the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer; and (B) if no such committee exists with respect to an issuer, the entire board of directors of the issuer." Section 205(a) of the Sarbanes-Oxley Act, which, among other things, adds Section 3(a)(58) to the Exchange Act.

272 Section 202 of the Sarbanes-Oxley Act; Section 10A(i)(3) of the Exchange Act, 15 U.S.C. 78j-1(i)(3).

273 Section 202 of the Sarbanes-Oxley Act; Section 10A(i)(1)(B) of the Exchange Act, 15 U.S.C. 78j-1(i)(1)(B).

274 In the case of an investment company, the five percent threshold is calculated based on the services provided to the investment company complex that were subject to the pre-approval requirements for the investment company's audit committee.

275 *Id.*

276 Item 306 of Regulation S-K (17 CFR 229.306), and Item 306 of Regulation S-B (17 CFR 228.306); see generally*,* Release No. 34-42266, Dec. 22, 1999, (64 FR 73389). These disclosure requirements are discussed *supra* , in Section II.C. of this release.

277 Item 4 of Form 8-K, 17 CFR 249.308 and Item 304 of Regulation S-K, 17 CFR 229.304, which require disclosure of "whether the decision to change accountants was recommended or approved by: (A) any audit or similar committee of the board of directors, if the issuer has such a committee; or (B) the board of directors, if the issuer has no such committee" and "whether any audit or similar committee of the board of directors, or the board of directors, discussed the subject matter of each of such disagreements with the former accountant ." Item 304(a)(1)(iii)(A), (iii)(B), and (iv)(B). 17 CFR 229.304(a)(1)(iii)(A), (iii)(B) and (iv)(B). For small business issuers, Item 304(a)(1)(iii) of Regulation S-B, 17 CFR 228.304(a)(1)(iii) requires disclosure of "whether the decision to change accountants was recommended or approved by the board of directors or an audit or similar committee of the board of directors."

278 *See, e.g* ., SAS No. 61, as amended by SAS No. 89 and No. 90, "Communications With Audit Committees," AU § 380; Independence Standards Board, "Independence Discussions with Audit Committees," *Independence Standard No. 1* (Jan. 1999).

279 *See,* AICPA, SEC Practice Section, *Requirements of Members* , at item e. The membership requirements are available online at http://www.aicpa.org/members/div/secps/require.htm.

280 In the case of investment companies, other audit partners would include all audit partners working on an investment company registrant.

281 According to data provided by the SECPS, out of 767 accounting firms with audit clients, 462 firms are eligible for the exemption from partner rotation.

282 For example, one commenter estimated that on certain large engagements, the proposed rotation requirements would result in an average annual incremental cost of $1,250,000; *see* , letter from Deloitte & Touche LLP dated January 10, 2003. Another commenter estimated the cost to be as much as $2,000,000 per year for large registrants; *see* , letter from KPMG dated January 9, 2003.

283 In the case of investment companies, the cooling off period would extend not only to positions at the investment company, but also to positions at any entity in the investment company complex that is directly responsible for the operations or financial reporting of the investment company.

284 Independence Standards Board, "Employment with Audit Clients" *Independence Standard No. 3* (July 2000).

285 *See,* Item 303 of Regulation S-K, 17 CFR 229.303; Release No. 33-8040 (Dec. 12, 2001); and SAS 61, "Communication with Audit Committees or Others with Equivalent Authority and Responsibility," AU §380.

286 An investment company's auditor will only be required to communicate this information to the audit committee annually, unless there have been changes from the previously-reported information and the annual communication was completed more than 90 days prior to the filing. This should reduce the cost for investment companies to comply with this requirement.

287 In the case of investment companies, the investors will receive this information for the investment company registrant and separately, for all other entities in the investment company complex where the services were subject to pre-approval by the investment company's audit committee.

288 Form 10-K is the annual report that registrants file with the Commission pursuant to Section 13 or 15(d) of the Exchange Act, if no other annual reporting form has been prescribed. Small business issuers may use abbreviated Form 10-KSB. A "small business issuer" is an entity that (1) has revenues of less than $25,000,000, (2) is a U.S. or Canadian issuer, (3) is not an investment company, and (4) if a majority owned subsidiary, the parent corporation is also a small business issuer. An entity is not a "small business issuer," however, if the aggregate market value of its outstanding voting and non-voting common stock held by non-affiliates is $25,000,000 or more. *See,* 17 CFR 240.12b-2. Registered management investment companies would use Form N-CSR to file certified shareholder reports with the Commission under the Sarbanes-Oxley Act of 2002.

289 With respect to investment companies, the final rules also will require disclosure of all non-audit fees paid to the investment company's accountant by all entities in the investment company complex, and whether the audit committee considered those non-audit services in evaluating the auditor's independence with respect to the investment company.

290 The $125/hour cost estimate is based on data obtained from *The SIA Report on Management and Professional Earnings in the Securities Industry* (Oct. 2001).

291 15 U.S.C. 78w(a)(2).

[292] 15 U.S.C. 77b(b).

[293] 15 U.S.C. 78c(f).

[294] 15 U.S.C. 80a-2(c).

[295] 17 CFR 240.0-10(a).

[296] 17 CFR 230.157.

[297] 17 CFR 270.0-10.

[298] The definition of a "small business" also includes a "unit investment trust" and a "business development company."

[299] Advocacy cited recent U.S. Census Statistics. *See,* Bureau Of The Census, U.S. Department Of Commerce, "Statistics Of U.S. Business," 1998 (NAICS Code #541211).

[300] *See,* IRS, "1998 Corporation Source Book Of Statistics Of Income, Income Tax Returns of Active Corporations with Accounting periods ended July 1998 Through June 1999," Minor Industry 541215 (1998).

[301] Data provided by the SEC Practice Section of the AICPA.

[302] 17 CFR 210.2-01(c)(4)(v)(A).

[303] *Id* .; 65 FR at 43185.

[304] In the case of investment companies, all non-audit services provided by the auditor to an entity in the investment company complex that relate to the operations or financial reporting of the investment company must be pre-approved by the audit committee of the investment company.

[305] Section 301 of the Sarbanes-Oxley Act of 2002 requires the Commission to direct the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that does not meet certain criteria, including having an audit committee that performs certain functions. *See,* Section 10A(m) of the Exchange Act, 15 U.S.C. 78j-1(m). The Sarbanes-Oxley Act defines "audit committee" to be "(A) a committee (or equivalent body) established by and amongst the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer; and (B) if no such committee exists with respect to an issuer, the entire board of directors of the issuer." Section 205(a) of the Sarbanes-Oxley Act, among other things, adds Section 3(a)(58) to the Exchange Act.

[306] *See, e.g* ., NACD, 2001-2002 Public Company Governance Survey (Nov. 2001).

[307] *See* , AICPA, SEC Practice Section, Requirements of Members, at item e. The membership requirements are available online at http://www.aicpa.org/members/div/secps/require.htm. In its comment letter, Advocacy stated its belief that there are approximately 460 audit firms in the United States providing audit services to 765 smaller reporting companies who are currently exempt from the AICPA audit partner rotation requirements.

[308] In the case of investment companies, the cooling off period extends not only to positions at the investment company, but also to positions at any entity in the investment company complex that is directly

responsible for the operations or financial reporting of the investment company.

309 *See* , Rule 2-01(f)(3)(ii) of Regulation S-X.

310 In the case of investment companies, the auditors are required to discuss these matters with the audit committee annually, with an update, if necessary.

311 In the case of investment companies, the investors will receive this information for the investment company registrant and separately, for all other entities in the investment company complex where the services were subject to pre-approval by the investment company's audit committee.

312 Form 10-K is the annual report that registrants file with the Commission pursuant to Section 13 or 15(d) of the Exchange Act, if no other annual reporting form has been prescribed. Small business issuers may use abbreviated Form 10-KSB. A "small business issuer" is an entity that (1) has revenues of less than $25,000,000, (2) is a U.S. or Canadian issuer, (3) is not an investment company, and (4) if a majority owned subsidiary, the parent corporation also is a small business issuer. An entity is not a "small business issuer," however, if the aggregate market value of its outstanding voting and non-voting common stock held by non-affiliates is $25,000,000 or more. See 17 CFR 240.12b-2. Registered management investment companies use Form N-CSR to file certified shareholder reports with the Commission.

http://www.sec.gov/rules/final/33-8183.htm

SECURITIES AND EXCHANGE COMMISSION

17 CFR PART 249

[RELEASE NO. 33-8183A; 34-47265A; 35-27642A; IC-25915A; IA-2103A, FR-68, File No. S7-49-02]

RIN 3235-AI73

STRENGTHENING THE COMMISSION'S REQUIREMENTS REGARDING AUDITOR INDEPENDENCE

AGENCY: Securities and Exchange Commission.

ACTION: Corrections to final regulations.

SUMMARY: We are making technical corrections to rules adopted in Release No. 33-8183 (January 28, 2003), which were published in the Federal Register on February 5, 2003 (68 FR 6005). The rules relate to requirements regarding auditor independence and enhanced disclosure of fees paid to auditors. This document corrects the numbering scheme for items within Forms 10-K and 10-KSB.

EFFECTIVE DATE: March 31, 2003

FOR FURTHER INFORMATION CONTACT: Ray Be, Special Counsel, Office of Rulemaking, Division of Corporation Finance, at (202) 942-2910, U.S. Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0312.

SUPPLEMENTARY INFORMATION:

I. Background

On January 28, 2003, the Commission adopted amendments to strengthen requirements regarding auditor independence and enhance disclosure regarding fees paid to auditors.[1] These rules were designed to implement provisions of the Sarbanes-Oxley Act of 2002.[2] The adopting release made erroneous references to items within Forms 10-K and 10-KSB. Accordingly, the amendments correct the numbering of items in these forms, but do not alter the disclosure requirements described in the original adopting release.

II. Need for Correction

As published, the final regulations contain errors which are in need of clarification.

III. Correction of Publication

In FR Doc. 03-2364 published on February 5, 2003 (68 FR 6005) make the following corrections.

1. On page 6050, in the first column, instruction 10 is corrected to read as follows:

10. Amend Form 10-K (referenced in § 249.310) by:

a. Redesignating Item 15 of Part IV as Item 16 of Part IV, and

b. Adding new Item 15 to Part III.

The addition reads as follows:

* * * * *

2. On page 6050, in the first, second and third columns, "Item 16." is corrected to read "Item 15." in each place it appears.

Jill M. Peterson
Assistant Secretary

Dated: March 26, 2003

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1 See Release No. 33-8183 (Jan. 28, 2003) [68 FR 6006].

2 Pub. L. 107-204, 116 Stat. 745 (2002).

http://www.sec.gov/rules/final/33-8183a.htm

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 210

RELEASE NO. 33-10648; 34-86127; FR-85; IA-5255; IC-33511; FILE NO. S7-10-18

RIN 3235-AM01

Auditor Independence With Respect to Certain Loans or Debtor-Creditor Relationships

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission ("Commission") is adopting amendments to its auditor independence rules to refocus the analysis that must be conducted to determine whether an auditor is independent when the auditor has a lending relationship with certain shareholders of an audit client at any time during an audit or professional engagement period. The amendments focus the analysis on beneficial ownership rather than on both record and beneficial ownership; replace the existing 10 percent bright-line shareholder ownership test with a "significant influence" test; add a "known through reasonable inquiry" standard with respect to identifying beneficial owners of the audit client's equity securities; and exclude from the definition of "audit client," for a fund under audit, any other funds, that otherwise would be considered affiliates of the audit client under the rules for certain lending relationships. The amendments will more effectively identify debtor-creditor relationships that could impair an auditor's objectivity and impartiality, as opposed to certain more attenuated relationships that are unlikely to pose such threats, and thus will focus the analysis on those borrowing relationships that are important to investors.

DATES: The final rules are effective on [INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER].

FOR FURTHER INFORMATION CONTACT: Peggy Kim, Senior Special Counsel, Office of the Chief Accountant, or Giles T. Cohen, Acting Chief Counsel, at (202) 551-5300; Daniel Rooney, Assistant Chief Accountant, Chief Accountant's Office, Division of Investment Management, at (202) 551-6918; or Joel Cavanaugh, Senior Counsel, Investment Company Regulation Office, Division of Investment Management, at (202) 551-6792, U.S. Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549.

SUPPLEMENTARY INFORMATION: We are adopting amendments to 17 CFR 210.2-01 ("Rule 2-01 of Regulation S-X").

Table of Contents

I. Introduction

The Commission's auditor independence standard set forth in Rule 2-01 of Regulation S-X requires auditors[1] to be independent of their audit clients both "in fact and in appearance."[2] Rule 2-01(b) provides that the Commission will not recognize an accountant as independent with respect to an audit client if the accountant is not (or if a reasonable investor 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.[3] Furthermore, in determining whether an accountant is independent, the Commission will consider all relevant circumstances, including all relationships between an accountant and the audit client.[4]

Rule 2-01(c) sets forth a nonexclusive list of circumstances that the Commission considers to be inconsistent with the independence standard in Rule 2-01(b), including certain direct financial relationships between an accountant and audit client and other circumstances where the accountant has a financial interest in the audit client.[5] In particular, the existing

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1 Rule 2-01 refers to "accountants" rather than "auditors." We use these terms interchangeably in this Release.

2 *See* Preliminary Note 1 to Rule 2-01 and Rule 2-01(b) of Regulation S-X. *See also* United States v. Arthur Young & Co., 465 U.S. 805, 819 n.15 (1984) ("It is therefore not enough that financial statements be accurate; the public must also perceive them as being accurate. Public faith in the reliability of a corporation's financial statements depends upon the public perception of the outside auditor as an independent professional.").

3 *See* Rule 2-01(b) of Regulation S-X.

4 *See id.*

5 *See* Rule 2-01(c) of Regulation S-X; *see also* Revision of the Commission's Auditor Independence Requirements, Release No. 33-7919 (Nov. 21, 2000) [65 FR 76008 (Dec. 5, 2000)] ("2000 Adopting Release") available at https://www.sec.gov/rules/final/33-7919.htm, at 65 FR 76009 ("The amendments [to Rule 2-01 adopted in 2000] identify certain relationships that render an accountant not independent of an audit client under the standard in Rule 2-01(b). The relationships addressed include, among others, financial, employment, and business relationships between auditors and audit clients . . . .").

restriction on debtor-creditor relationships in Rule 2-01(c)(1)(ii)(A) (the "Loan Provision") generally provides that an accountant is not independent when (a) the accounting firm, (b) any covered person[6] in the accounting firm (*e.g.*, the audit engagement team and those in the chain of command), or (c) any of the covered person's immediate family members has any loan (including any margin loan) to or from (x) an audit client, or (y) an audit client's officers, directors, or (z) record or beneficial owners of more than 10 percent of the audit client's equity securities.[7] Simply because a lender to an auditor holds 10 percent or less of an audit client's equity securities does not, in itself, establish that the auditor is independent under Rule 2-01 of Regulation S-X. The general standard under Rule 2-01(b) and the remainder of Rule 2-01(c) still apply to auditors and their audit clients regardless of the applicability of the Loan Provision.

In the below illustration, pursuant to the Loan Provision, a lending relationship between any entity in the left hand column and any entity in the right-hand column impairs independence, unless an exception applies.

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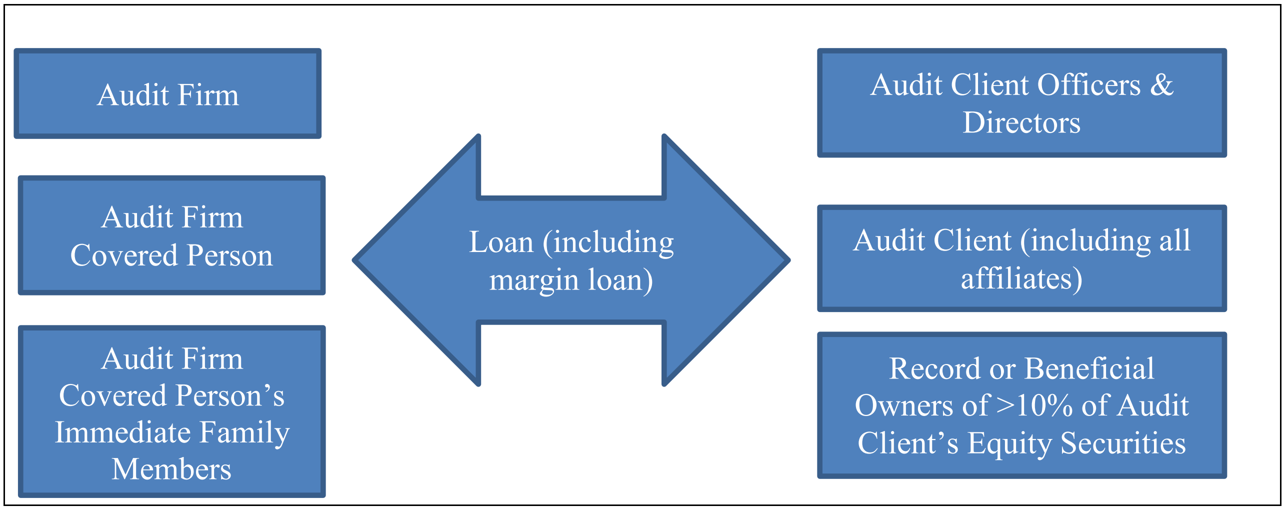
[6] *See* Rule 2-01(f)(11) of Regulation S-X (defining the term "covered person").

[7] *See* 2000 Adopting Release, *supra* footnote 5 at 65 FR 76035.

Figure 1. Loan Provision Relationships



When the Commission proposed the Loan Provision in 2000, it noted that a debtor-creditor relationship between an auditor and its audit client reasonably could be viewed as "creating a self-interest that competes with the auditor's obligation to serve only investors' interests."[8] The Commission's concern about a competing self-interest extended beyond loans directly between the auditor and its audit client to loans between the auditor and those shareholders of the audit client who have a "special and influential role" with the audit client.[9] As a proxy for identifying a "special and influential role," the Commission adopted a bright-line test for loans to or from a record or beneficial owner of more than 10 percent of an audit client's equity securities.[10]

8 *See* Proposed Rule: Revision of the Commission's Auditor Independence Requirements, Release No. 33-7870 (June 30, 2000) [65 FR 43148 (July 12, 2000)] ("2000 Proposing Release"), *available at* https://www.sec.gov/rules/proposed/34-42994.htm, at 65 FR 43161.

9 *See* 2000 Adopting Release, *supra* footnote 5, at 65 FR 76035.

10 The Commission proposed that the Loan Provision include a five-percent equity ownership threshold, but raised the threshold to 10 percent when it adopted the Loan Provision. *See* 2000 Adopting Release, *supra* footnote 5, at 65 FR 76035. As the basis for its use of a 10 percent threshold, the Commission pointed to similar 10 percent ownership thresholds elsewhere in the federal securities laws, including Rule 1-02(r) of Regulation S-X (defining "principal holder of equity securities"), Rule 1-02(s) of Regulation S-X (defining

Under Rule 2-01(f)(6) of Regulation S-X, the term "audit client" is defined to include any affiliate of the entity whose financial statements are being audited.[11] Rule 2-01(f)(4) provides that "affiliates of the audit client" include entities that control, are controlled by, or are under common control with the audit client.[12] As a result, generally, an accounting firm is not independent under the Loan Provision if it has a lending relationship with an entity having record or beneficial ownership of more than 10 percent of the equity securities of either (a) the firm's audit client; or (b) any entity that is a controlling parent company of the audit client, a controlled subsidiary of the audit client, or an entity under common control with the audit client.

In addition, the term "affiliate of the audit client" includes each entity in an investment company complex ("ICC") of which the audit client is a part.[13] Accordingly, in the ICC context,

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"promoter"), and Section 16 of the Securities Exchange Act of 1934 [15 U.S.C. 78a *et seq*] (the "Exchange Act") (requiring reporting to the Commission of beneficial ownership information by directors, officers, and beneficial owners of more than 10 percent of any class of equity securities of an issuer). *Id.*

[11] *See* Rule 2-01(f)(6) of Regulation S-X.

[12] *See* Rule 2-01(f)(4) of Regulation S-X, in which an "affiliate of the audit client" is defined to include the following:

> (i) An entity that has control over the audit client, or over which the audit client has control, or which is under common control with the audit client, including the audit client's parents and subsidiaries;
>
> (ii) An entity over which the audit client has significant influence, unless the entity is not material to the audit client;
>
> (iii) An entity that has significant influence over the audit client, unless the audit client is not material to the entity; and
>
> (iv) Each entity in the investment company complex when the audit client is an entity that is part of an investment company complex.

[13] *See id.* "Investment company complex" is defined in Rule 2-01(f)(14) of Regulation S-X to include: "(A) An investment company and its investment adviser or sponsor; (B) Any entity controlled by or controlling an investment adviser or sponsor in paragraph (f)(14)(i)(A) of this section, or any entity under common control with an investment adviser or sponsor in paragraph (f)(14)(i)(A) of this section if the entity: (*1*) Is an investment adviser or sponsor; or (*2*) Is engaged in the business of providing administrative, custodian, underwriting, or transfer agent services to any investment company, investment adviser, or sponsor; and

an accounting firm is considered not independent under the Loan Provision if it has a lending relationship with an entity having record or beneficial ownership of more than 10 percent of any entity within the ICC, regardless of which entities in the ICC are audited by the accounting firm.

The Commission has become aware that, in certain circumstances, the existing Loan Provision may not be functioning as it was intended. Registered investment companies, other pooled investment vehicles, and registered investment advisers have expressed concerns about the Loan Provision in both public disclosures and, together with their auditors, in extensive consultations with Commission staff.[14] It has become clear that there are certain fact patterns in which an auditor's objectivity and impartiality are not impaired despite a failure to comply with the requirements of the Loan Provision. These fact patterns have arisen most frequently with respect to funds, although as noted in the Proposing Release, non-fund issuers also have faced challenges associated with the Loan Provision.[15]

The Commission understands that accounting firms use loans to help finance their core business operations. Accounting firms frequently obtain financing to pay for their labor and out-of-pocket expenses before they receive payments from audit clients for those services. Accounting firms also use financing to fund current operations and provide capital to fund

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(C) Any investment company or entity that would be an investment company but for the exclusions provided by section 3(c) of the Investment Company Act of 1940 (15 U.S.S. 80a-3(c) that has an investment adviser or sponsor included in this definition by either paragraph (f)(14)(i)(A) or (f)(14)(i)(B) of this section."

14 *See* Section I.B. of Auditor Independence With Respect to Certain Loans or Debtor-Creditor Relationships, Release No. 33-10491 (May 2, 2018) [83 FR 20753 (May 8, 2018)] ("Proposing Release"), at 83 FR 20756.

15 *See* footnote 20 of the Proposing Release. As discussed below, our amendments to Rule 2-01 will define "fund" as it relates to the Loan Provision as: (i) an investment company or an entity that would be an investment company but for the exclusions provided by Section 3(c) (15 U.S.C. 80a-3(c)) of the Investment Company Act of 1940 (the "Investment Company Act"); or (ii) a commodity pool as defined in Section 1a(10) of the U.S. Commodity Exchange Act, as amended ("CEA") that is not an investment company or does not rely on Section 3 of the Investment Company Act. *See* Rule 2-01(c)(1)(ii)(A)(2)(ii).

ongoing investments in their audit methodologies and technology. Accounting firms borrow from commercial banks or through private placement debt issuances, typically purchased by large financial institutions, both of which give rise to debtor-creditor relationships.[16] For creditor diversification purposes, credit facilities provided or arranged by commercial banks are often syndicated among multiple financial institutions, thereby expanding the number of lenders to an accounting firm. As a result, accounting firms typically have a wide array of borrowing arrangements. These arrangements facilitate firms' provision of audit services to investors and other market participants, but also multiply the number of lenders that may be record or beneficial owners of securities in audit clients and that must be analyzed under the Loan Provision.

These accounting firms' financing methods appear to have resulted in various scenarios in which the Loan Provision deems an accounting firm's independence to be impaired, notwithstanding that the relevant facts and circumstances regarding the relationships between the auditor and the audit client suggest that in most cases the auditor's objectivity and impartiality do not appear to be affected as a practical matter. Nevertheless, auditors and audit committees[17] may feel obligated to devote substantial resources to evaluating potential instances of non-compliance with the existing Loan Provision, which could distract auditors' and audit

16 The Commission further understands that insurance companies may purchase accounting firms' private placement notes. Insurance companies may also act as sponsors of insurance products and may be record owners, on behalf of contract holders, of certain investment companies' equity securities.

17 The audit committees of issuers, including registered investment companies, may also be focused on this issue because, under the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley Act"), audit committees are responsible for the selection, compensation, and oversight of such issuers' independent auditors. *See* Rule 10A-3 under the Exchange Act [17 CFR 240.10A-3]. In this Release, we use the term "audit committee," when referring to funds, generally to refer to audit committees established by a fund's board of directors or trustees or, where no formal audit committee exists (*e.g.,* for certain private funds), those responsible for the governance of the fund. In the absence of an audit committee, the entire board of directors will be considered to be the audit committee. *See, e.g.*, Standards Relating to Listed Company Audit Committees, Release No. 33-8220 (Apr. 3, 2003) [68 FR 18788 (Apr. 16, 2003)].

committees' attention from matters that may be more likely to bear on the auditor's objectivity and impartiality.[18] Audit committees' receipt of a high volume of communications of such relationships could dilute the impact of communications that identify issues that may actually raise concerns about an auditor's independence.

Similarly, numerous violations of the independence rules that no reasonable investor would view as implicating an auditor's objectivity and impartiality could desensitize market participants to other, more significant violations of the independence rules. Respect for the seriousness of these obligations, and attention to any breach or potential breach of these obligations, is better fostered through limiting violations to those instances in which the auditor's independence would be impaired in fact or in appearance.

Moreover, searching for, identifying, and assessing non-compliance or potential non-compliance with the Loan Provision and reporting these instances to audit committees also may generate significant costs for entities and their advisers and auditors, which are ultimately borne by shareholders. These costs are unlikely to have corresponding benefits to the extent that the Loan Provision's breadth identifies and requires analysis of circumstances that are unlikely to bear on the auditor's independence.

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[18] For audits conducted pursuant to the standards of the Public Company Accounting Oversight Board ("PCAOB"), auditors are required to communicate any relationships, including lending relationships, with the audit client that may reasonably be thought to bear on independence to the audit committee at least annually. *See, e.g.*, PCAOB Rule 3526 (requiring a registered public accounting firm, at least annually with respect to each of its audit clients, to: (1) describe, in writing, to the audit committee of the audit client, all relationships between the registered public accounting firm or any affiliates of the firm and the audit client or persons in financial reporting oversight roles at the audit client that, as of the date of the communication, may reasonably be thought to bear on independence; (2) discuss with the audit committee of the audit client the potential effects of the relationships described in subsection (b)(1) on the independence of the registered public accounting firm; (3) affirm to the audit committee of the audit client, in writing, that, as of the date of the communication, the registered public accounting firm is independent in compliance with Rule 3520; and (4) document the substance of its discussion with the audit committee of the audit client).

In addition, the compliance challenges associated with the Loan Provision can have broader disruptive effects, particularly for funds.[19] For example, in order for a registered open-end fund to make a continuous offering of its securities, it must maintain a current prospectus by periodically filing post-effective amendments to its registration statement that contain updated financial information audited by an independent public accountant in accordance with Regulation S-X.[20] In addition, the federal securities laws require that investment companies registered under the Investment Company Act transmit annually to shareholders and file with the Commission financial statements audited by an independent registered public accounting firm.[21] Accordingly, non-compliance with the auditor independence rules in some cases could result in affected funds not being able to offer or sell shares, investors not being able to rely on affected financial statements, or funds (and, indirectly, but importantly, their investors) having to incur the costs of re-audits.

In order to provide time for the Commission to address these challenges, and recognizing that funds and their advisers were most acutely affected by the Loan Provision, the Commission staff issued a no-action letter to Fidelity Management & Research Company in 2016 regarding

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19 Registered investment advisers that have custody of client funds or securities also face compliance challenges from the Loan Provision. These advisers generally are required by Rule 206(4)-2 (the "Custody Rule") under the Investment Advisers Act of 1940 (the "Investment Advisers Act") to obtain a surprise examination conducted by an independent public accountant or, for pooled investment vehicles, may be deemed to comply with the requirement by distributing financial statements audited by an independent public accountant to the pooled investment vehicle's investors. An auditor's inability, or potential inability, to comply with the Loan Provision raises questions concerning an adviser's ability to satisfy the requirements of the Custody Rule.

20 *See generally* Section 10(a)(3) of the Securities Act of 1933 (the "Securities Act") [15 U.S.C. 77a *et seq.*] and Item 27 of Form N-1A.

21 15 U.S.C. 80a-1 *et seq*. *See* Rules 30e-1 and 30b2-1 under the Investment Company Act [17 CFR 270.30e-1 and 17 CFR 270.30b2-1].

the application of the Loan Provision ("Fidelity No-Action Letter").[22] In the Fidelity No-Action Letter, the staff stated that it would not recommend enforcement action to the Commission, even though certain Fidelity entities identified in the letter used audit firms that were not in compliance with the Loan Provision, subject to certain conditions specified in the letter (*e.g.*, that notwithstanding such non-compliance, the audit firm had concluded that it is objective and impartial with respect to the issues encompassed within the engagement).[23] Staff has continued to receive inquiries from registrants and accounting firms regarding the application of the Loan Provision, clarification of the Fidelity No-Action Letter, and requests for consultation regarding issues not covered in the Fidelity No-Action Letter.

In order to address the compliance challenges discussed above, on May 2, 2018, the Commission proposed amendments to its auditor independence rules to refocus the analysis that must be conducted to determine whether an auditor is independent when the auditor has a lending relationship with certain shareholders of an audit client at any time during an audit or

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[22] *See* No-Action Letter from the Division of Investment Management to Fidelity Management & Research Company (June 20, 2016) ("June 20, 2016 Letter"), *available at* https://www.sec.gov/divisions/investment/noaction/2016/fidelity-management-research-company-062016.htm. The June 20, 2016 Letter provided temporary no-action relief and was to expire 18 months from the issuance date. On September 22, 2017, the staff extended the June 20, 2016 Letter until the effective date of any amendments to the Loan Provision adopted by the Commission that are designed to address the concerns expressed in the June 20, 2016 Letter. *See* No-Action Letter from the Division of Investment Management to Fidelity Management & Research Company (Sept. 22, 2017) ("September 22, 2017 Letter"), *available at* https://www.sec.gov/divisions/investment/noaction/2017/fidelity-management-research-092217-regsx-rule-2-01.htm. The Fidelity No-Action Letter therefore will be withdrawn on the effective date of the amendments we are adopting in this release.

[23] The June 20, 2016 Letter described the following circumstances, each of which could have potential implications under the Loan Provision: (i) "An institution that has a lending relationship with an Audit Firm holds of record, for the benefit of its clients or customers (for example, as an omnibus account holder or custodian), more than 10 percent of the shares of a Fidelity Entity;" (ii) "An insurance company that has a lending relationship with an Audit Firm holds more than 10 percent of the shares of a Fidelity Fund in separate accounts that it maintains on behalf of its insurance contract holders;" and (iii) "An institution that has a lending relationship with an Audit Firm and acts as an authorized participant or market maker to a Fidelity ETF and holds of record or beneficially more than 10 percent of the shares of a Fidelity ETF."

professional engagement period.[24] The proposed amendments to the Loan Provision were intended to more effectively identify debtor-creditor relationships that could impair an auditor's objectivity and impartiality, as opposed to certain more attenuated relationships that are unlikely to present threats to objectivity or impartiality. To achieve this objective, the proposed amendments to the Loan Provision would have: (1) focused the analysis solely on beneficial ownership rather than on both record and beneficial ownership; (2) replaced the existing 10 percent bright-line shareholder ownership test with a "significant influence" test; (3) added a "known through reasonable inquiry" standard with respect to identifying beneficial owners of the audit client's equity securities; and (4) amended the definition of "audit client" for a fund under audit to exclude funds that otherwise would be considered affiliates of the audit client. The Commission also requested comment on certain other potential amendments to its auditor independence rules.

In developing the final amendments, we considered the thirty-one comment letters received in response to the Proposing Release.[25] Most commenters expressed general support for the proposed amendments, and only a few commenters did not.

II. Final Amendments

A. Overview of the Final Amendments

We are adopting amendments to Rule 2-01 of Regulation S-X that we believe would more effectively identify those debtor-creditor relationships that could impair an auditor's objectivity and impartiality, yet would not include certain attenuated relationships that are

[24] *See generally* Proposing Release.

[25] The comment letters received in response to the Proposing Release are available at https://www.sec.gov/comments/s7-10-18/s71018.htm.

unlikely to present threats to objectivity or impartiality.[26] Because compliance challenges associated with applying the Loan Provision have arisen with entities other than funds, and given that we did not receive comments objecting to our proposal to apply these amendments broadly, the final amendments will apply to entities beyond the investment management industry, including operating companies and registered broker-dealers.

We are adopting the amendments generally as proposed with a few additional changes. As was proposed, we are focusing the analysis on beneficial ownership rather than on both record and beneficial ownership. Also, as proposed, we are replacing the existing 10 percent bright-line shareholder ownership test with a "significant influence" test and adding a "known through reasonable inquiry" standard with respect to identifying beneficial owners of the audit client's equity securities. In addition, we are excluding from the definition of "audit client," for a fund under audit, any other funds that otherwise would be considered affiliates of the audit client under the Loan Provision. In a change from the proposal and in response to comments, the final amendments define "fund" for these purposes to also exclude commodity pools and we clarify that foreign funds (as described below) are excluded for purposes of the definition of audit client. Finally, the Chairman has directed the staff to formulate recommendations to the Commission for possible additional changes to the auditor independence rules, as discussed further below.

B. Focus the Analysis on Beneficial Ownership

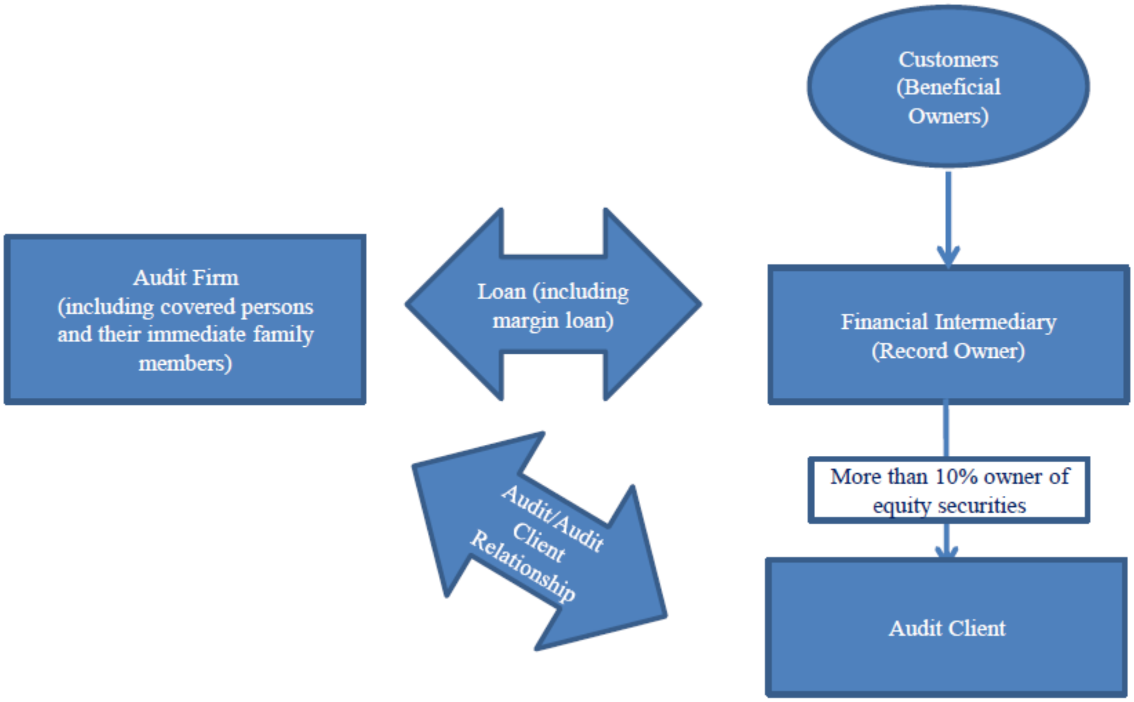
Where a lender to an auditor holds more than 10 percent of the equity securities of that auditor's audit client either as a beneficial owner or as a record owner, current rules dictate that

26 *See* Rule 2-01(b) of Regulation S-X.

the auditor is not independent of the audit client. As noted in the Proposing Release, one challenge associated with the Loan Provision is that it applies to both "record" and "beneficial" owners of the audit client's equity securities. However, publicly traded shares, as well as certain fund shares, often are registered in the name of a relatively small number of financial intermediaries[27] as "record" owners for the benefit of their clients or customers. Certain of these financial intermediaries may also be lenders to public accounting firms or be affiliated with financial institutions that may be lenders to public accounting firms. As a result, audit clients may have financial intermediaries that own, on a "record" basis, more than 10 percent of the issuer's shares and are also lenders to public accounting firms, covered persons of accounting firms, and their immediate family members, or are affiliated with companies that are lenders to public accounting firms (see Figure 2 below for illustration). However, these financial intermediaries are not "beneficial" owners and may not have control over whether they are "record" owners of more than 10 percent of the issuer's shares.

[27] *See infra* footnote 28.

Figure 2. Audit Firm is not independent under the Loan Provision when a Financial Intermediary that is a lender to the Audit Firm is also a record owner of more than 10 percent of the equity securities of the Audit Client.



For example, open-end funds, such as mutual funds, may face significant challenges, because the record ownership percentages of open-end funds may fluctuate greatly within a given period for reasons completely out of the control or knowledge of a lender who is also a fund shareholder of record, regardless of their diligence in monitoring compliance. Specifically, as a result of underlying customer activity in an omnibus account (such as when beneficial owners purchase or redeem their shares in an open-end fund) or as a result of the activity of other record or beneficial owners, the record ownership of a lender that is a financial intermediary holding fund shares for customers may exceed, or conversely fall below, the 10 percent threshold within a given period without any affirmative action on the part of the financial intermediary.[28]

28 Financial intermediaries such as broker-dealers, banks, trusts, insurance companies, and retirement plan third-party administrators perform the recordkeeping of open-end fund positions and provide services to customers, including beneficial owners and other intermediaries and, in most cases, aggregate their

In this scenario, the financial intermediary's holdings might constitute less than 10 percent of a mutual fund and, as a result of subsequent redemptions by beneficial owners through other non-affiliated financial intermediaries, the same investment could then constitute more than 10 percent of the mutual fund. However, regardless of their diligence in monitoring compliance, the financial intermediary, the fund, and the auditor may not know that the 10 percent threshold had been exceeded until after the fact.

1. Proposed Amendments

Under the proposed amendments, the Loan Provision would apply only to beneficial owners of the audit client's equity securities and not to those who merely hold the audit client's equity securities as a holder of record on behalf of their beneficial owners.[29] The Proposing Release noted that tailoring the Loan Provision to focus on the beneficial ownership of the audit client's equity securities would more effectively identify shareholders "having a special and

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customer records into a single or a few "omnibus" accounts registered in the intermediary's name on the fund transfer agent's recordkeeping system. Shares of other types of registered investment companies, such as closed-end funds, also are frequently held by broker-dealers and other financial intermediaries as record owners on behalf of their customers, who are not required and may be unwilling to provide, information about the underlying beneficial owners to accounting firms, and particularly accounting firms that do not audit the fund. In addition, a financial intermediary may act as an authorized participant or market maker to an exchange-traded fund ("ETF") and be the holder of record or beneficial owner of more than 10 percent of an ETF.

An open-end fund, or open-end company, is a management company that is offering for sale or has outstanding any redeemable securities of which it is the issuer. A closed-end fund, or closed-end company, is any management company other than an open-end company. *See* Section 5 of the Investment Company Act [15 U.S.C. 80a-5]. ETFs registered with the Commission are organized either as open-end management companies or unit investment trusts. *See* Section 4 of the Investment Company Act [15 U.S.C. 80a-4] (defining the terms "management company" and "unit investment trust"). References to "funds" in this Release include ETFs, unless specifically noted.

29 An equity holder who acquired such ownership by buying a certificated share would be both a record owner and a beneficial owner and thus would continue to be analyzed under the Loan Provision.

influential role with the issuer" and therefore better capture those debtor-creditor relationships that may impair an auditor's independence.[30]

2. Comments

Commenters generally supported the proposed amendment to focus the analysis on beneficial owners,[31] and several of these commenters agreed that tailoring the Loan Provision to focus only on the beneficial ownership of the audit client's equity securities would more effectively identify shareholders "having a special and influential role with the issuer" and therefore better capture those debtor-creditor relationships that may impair an auditor's independence.[32] One commenter expressed the view that auditors should not have any lending relationship with any shareholders of an audit client.[33] Several commenters requested clarification of the definition of "beneficial owner" and expressed support for defining

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30 *See* Proposing Release at 20760.

31 *See, e.g.,* CII; Letter from Deloitte LLP, dated June 29, 2018 ("Deloitte"); Letter from PricewaterhouseCoopers LLP, dated June 29, 2018 ("PwC"); Letter from KPMG LLP, dated July 3, 2018 ("KPMG"); Letter from Crowe LLP, dated July 3, 2018 ("Crowe"); Letter from Center for Audit Quality, dated July 3, 2018 ("CAQ"); Letter from National Association of State Boards of Accountancy, dated July 5, 2018 ("NASBA"); Letter from New York State Society of Certified Public Accountants, dated July 6, 2018 (NYSCPA"); Letter from Piercy, Bowler, Taylor & Kern, dated July 6, 2018 ("PBTK"); Letter from MFS Funds Board Audit Committee, dated July 6, 2018 ("MFS Funds"); Letter from Prof. Joseph A. Grundfest, dated July 9, 2018 ("Grundfest"); Letter from Grant Thornton LLP, dated July 9, 2018 ("Grant Thornton"); Letter from Mutual Fund Directors Forum, dated July 9, 2018 ("MFDF"); Letter from BDO USA, LLP, dated July 9, 2018 ("BDO"); Letter from Ernst & Young LLP, dated July 9, 2018 ("EY"); Letter from Fidelity Management Research Company, dated July 9, 2018 ("Fidelity"); Letter from Association of the Bar of the City of New York, dated July 9, 2018 ("NYC Bar"); Letter from Investment Company Institute and Independent Directors Council, dated July 9, 2018 ("ICI/IDC"); Letter from U.S. Chamber of Commerce Center for Capital Markets Competitiveness, dated July 9, 2018 ("CCMC"); Letter from RSM US LLP, dated July 9, 2018 ("RSM"); Letter from T. Rowe Price Funds, dated July 9, 2018 ("T. Rowe Price"); Letter from Financial Executives International, dated July 9, 2018 ("FEI"); Letter from American Institute of Certified Public Accountants, dated July 9, 2018 ("AICPA"); Letter from American Investment Council, dated Jul 9, 2018 ("AIC"); Letter from Securities Industry and Financial Markets Association, dated July 9, 2018 ("SIFMA"); Letter from Invesco Funds, dated July 9, 2018 ("Invesco"); and Letter from Federated Investors, Inc., dated July 10, 2018 ("Federated").

32 *See, e.g.,* CII, Deloitte, PwC, CAQ, BDO, EY, RSM, and ICI/IDC.

33 *See* Letter from Tinee Carraker, dated May 20, 2018 ("Carraker").

"beneficial owner" to refer to those owners with an economic interest in the relevant securities.[34] A number of commenters requested that the Commission reiterate the guidance set forth in footnote 22 of the Proposing Release,[35] describing the entities that are excluded from the scope of the Loan Provision (*e.g.*, entities that are under common control with or controlled by the beneficial owner are excluded from the scope).[36]

A few commenters agreed that the proposed amendment would ease compliance burdens,[37] and two commenters stated that the proposed amendment did not raise other auditor independence concerns.[38] Two commenters expressed the view that, even if the Commission amended the Loan Provision to provide for evaluation of beneficial ownership alone, the other proposed amendments would still be necessary and appropriate.[39]

3. Final Amendments

After considering the comments received, and consistent with the proposal, we are adopting amendments that focus the analysis on beneficial ownership rather than on both record and beneficial ownership. We continue to believe that tailoring the Loan Provision to focus on the beneficial ownership of the audit client's equity securities would more effectively identify

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34 *See, e.g.,* Deloitte, PwC, KPMG, CAQ, Grant Thornton, ICI/IDC, and Invesco.

35 *See* footnote 22 of the Proposing Release: "We note that the Loan Provision can be implicated by lending relationships between an auditing firm and those that control the record or beneficial owner of more than 10 percent of the shares of an audit client (*i.e.*, ***entities that are under common control with or controlled by the record or beneficial owner are not as such implicated by the Loan Provision***)" (emphasis added). *See also* footnote 5 of the Fidelity No-Action Letter.

36 *See, e.g.,* Deloitte, PwC, KPMG, Grant Thornton, ICI/IDC, Invesco, MFS Funds, T. Rowe Price, SIFMA, and Federated.

37 *See, e.g.,* KPMG, Crowe, CAQ, and EY.

38 *See* KPMG and EY.

39 *See* KPMG and EY.

shareholders "having a special and influential role with the issuer" and therefore better capture those debtor-creditor relationships that may impair an auditor's independence.

In response to commenters who requested clarification of the term "beneficial owner," we are providing additional guidance that financial intermediaries, who hold shares as record owners, and who have limited authority to make or direct voting or investment decisions on behalf of the underlying shareholders of the audit clients, are not considered "beneficial owners" for purposes of the Loan Provision.[40] Furthermore, if the financial intermediary undertakes steps to remove its discretion over the voting or disposition of shares, the financial intermediary generally will not be considered to be a beneficial owner for purposes of the Loan Provision. Such steps could include, for example: (1) mirror voting (*i.e.*, the intermediary is obligated to vote the shares held by it in the same proportion as the vote of all other shareholders); (2) the financial intermediary holds the shares in an irrevocable voting trust without discretion for the institution to vote the shares; (3) an agreement to pass through the voting rights to an unaffiliated third-party entity; or (4) the intermediary has otherwise relinquished its right to vote such shares.[41] As requested by commenters, we also are reiterating the guidance set forth in the Proposing Release,[42] but with certain conforming changes because the final amendments remove the reference to "record owners" from the Loan Provision and replace the 10 percent bright-line test with a significant influence test.[43] Accordingly, entities that are under common control with or controlled by the beneficial owner of the audit client's equity securities when such beneficial

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40 By providing this guidance, we are not interpreting Exchange Act Rule 13d-3, applying the existing standards for determining who is a beneficial owner under Rule 13d-3, or altering these standards.

41 *See* 2000 Adopting Release, *supra* footnote 5.

42 *See supra* footnote 35.

43 *See supra* Section II.C.

owner has significant influence over the audit client, are excluded from the scope of the Loan Provision.

C. Significant Influence Test

As discussed in the Proposing Release, the current bright-line 10 percent test may be both over- and under-inclusive as a means of identifying those debtor-creditor relationships that actually impair the auditor's objectivity and impartiality. For example, the existing Loan Provision may apply even in situations where the lender may be unable to influence the audit client through its holdings (such as with omnibus accounts that hold as record owner more than 10 percent of the equity shares of an audit client). In such circumstances, the lender's ownership of an audit client's equity securities alone would not threaten an audit firm's objectivity and impartiality. Conversely, the existing Loan Provision does not apply if the auditor's lender owns 10 percent or less of the audit client's equity securities, despite the fact that such an owner may be able to exert significant influence over the audit client through contractual or other means. A holder of 10 percent or less of an audit client's equity securities could, for example, have the contractual right to remove or replace a pooled investment vehicle's investment adviser.

1. Proposed Amendments

The Commission proposed to replace the existing 10 percent bright-line test in the Loan Provision with a "significant influence" test similar to that referenced in other parts of the Commission's auditor independence rules.[44] Specifically, the proposed amendment would provide, in part, that an accountant would not be independent when the accounting firm, any covered person in the firm, or any of his or her immediate family members has any loan

44 *See* Rule 2-01(c)(1)(i)(E)(*1*)(*i*), (E)(*1*)(*ii*), (E)(*2*), (E)(*3*), (f)(4)(ii) and (f)(4)(iii) of Regulation S-X.

(including any margin loan) to or from an audit client, or an audit client's officers, directors, or beneficial owners (known through reasonable inquiry) of the audit client's equity securities where such beneficial owner has significant influence over the audit client.[45] Although not specifically defined, the term "significant influence" appears in other parts of Rule 2-01 of Regulation S-X,[46] and the Proposing Release noted that use of the term "significant influence" in the proposed amendment was intended to refer to the principles in the Financial Accounting Standards Board's ("FASB's") ASC Topic 323, Investments – Equity Method and Joint Ventures.[47]

2. Comments

a) Significant Influence Test

Most commenters supported the proposed amendment to replace the 10 percent bright-line shareholder ownership test with a significant influence test.[48] Generally, these commenters agreed that significant influence is a more appropriate framework to identify those lending

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45 *See* proposed Rule 2-01(c)(1)(ii)(A) (replacing the phrase "record or beneficial owners of more than ten percent of the audit client's equity securities" with "beneficial owners (known through reasonable inquiry) of the audit client's equity securities, where such beneficial owner has significant influence over the audit client"). Under the proposed amendments, the rule would continue to have exceptions for four types of loans: (1) automobile loans and leases collateralized by the automobile; (2) loans fully collateralized by the cash surrender value of an insurance policy; (3) loans fully collateralized by cash deposits at the same financial institution; and (4) a mortgage loan collateralized by the borrower's primary residence provided the loan was not obtained while the covered person in the firm was a covered person. We discuss the proposed "known through reasonable inquiry" standard below. *See infra* Section II.D.

46 *See* Rule 2-01(c)(1)(i)(E) ("investments in audit clients") and Rule 2-01(f)(4) of Regulation S-X ("affiliate of the audit client" definition).

47 *See* Proposing Release at section II.C; ASC 323 Investments—Equity Method and Joint Ventures ("ASC 323"). *See also* 2000 Adopting Release, *supra* footnote 5, at 65 FR 76034, note 284 (referring to Accounting Principles Board Opinion No. 18, "The Equity Method of Accounting for Investments in Common Stock" (Mar. 1971), which was codified at ASC 323).

48 *See, e.g.,* Deloitte, PwC, KPMG, Crowe, CAQ, NASBA, NYSCPA, PBTK, MFS Funds, Grundfest, Grant Thornton, MFDF, BDO, EY, Fidelity, NYC Bar, ICI/IDC, CCMC, RSM, T. Rowe Price, First Data, FEI, AICPA, AIC, SIFMA, Invesco, and Federated.

relationships that impair an accountant's objectivity and impartiality.[49] A few commenters supported codifying the significant influence test found in ASC 323 (or specific elements of that test) in our rules to promote consistent application,[50] but one commenter did not support codification in our rules so as to avoid confusion in the future if changes are made to ASC 323.[51] A few commenters requested that we affirm that the Commission's auditor independence standards involve a shared responsibility of the audit client and the auditor.[52] One commenter did not support replacing the 10 percent bright-line test with a significant influence test in part because the commenter questioned the quality of the equity method of accounting in general.[53]

b) ASC 323

Many commenters agreed that the framework in ASC 323 is generally appropriate for assessing significant influence.[54] Several commenters, however, asserted that the concepts in ASC 323 may not be useful to apply to funds or may not be routinely applied in the fund context.[55] Two commenters asserted that ASC 323 is not an appropriate framework for the "significant influence" test, and instead proposed a decision framework with a "singular focus on the beneficial owner's ability to exert significant influence over the audit client's operating and

49 *See, e.g.,* Deloitte, PwC, KPMG, CAQ, NYSCPA, Grant Thornton, BDO, EY, ICI/IDC, Fidelity, RSM, FEI, AICPA, and Invesco.

50 *See, e.g.,* KPMG, NYSCPA, and Grant Thornton.

51 *See* EY.

52 *See e.g.,* Deloitte, CAQ, and Crowe.

53 *See* CII.

54 *See, e.g.,* Deloitte, PwC, KPMG, Crowe, CAQ, NYSCPA, Grant Thornton, BDO, EY, ICI/IDC, MFS Funds, T. Rowe Price, SIFMA, Federated, RSM, and FEI.

55 *See, e.g.,* PwC, KPMG, Crowe, CAQ, EY, and Grant Thornton.

financial policies," based on the totality of the facts and circumstances.[56] A number of commenters requested that the Commission reiterate the fund guidance from the Proposing Release,[57] which clarified that in the fund context, the operating and financial policies relevant to the significant influence test would include the fund's portfolio management processes. A few commenters recommended that the Commission provide additional guidance regarding the application of the significant influence test in the fund context (*e.g.*, mutual funds, preferred stockholders in closed-end funds, and exchange-traded funds).[58]

Several commenters agreed that it would be appropriate to consider the nature of the services provided by the investment adviser as a factor in determining whether a beneficial owner has significant influence.[59] Several commenters also supported analyzing the concept of "portfolio management processes" as the first step to the significant influence test for investment companies. These commenters agreed that, in circumstances in which the advisory contract grants the investment adviser significant discretion with respect to the fund's portfolio management processes, it is unlikely that a shareholder will have significant influence and the factors in ASC 323 would not have to be further analyzed.[60] Some commenters recommended that the Commission confirm that an audit firm need not monitor beneficial ownership if it initially determines that, based on portfolio management processes, the audit client cannot be

56 *See* KPMG and Invesco.

57 *See, e.g.,* Deloitte, Crowe, CAQ, ICI/IDC, MFS Funds, T. Rowe Price, SIFMA, Federated, Fidelity, and Invesco. *See also* the discussion of fund guidance in the Proposing Release at 20761.

58 *See, e.g.,* PwC, KPMG, Grant Thornton, ICI/IDC, and EY.

59 *See, e.g.,* Deloitte, Grant Thornton, KPMG, EY, and CAQ.

60 *See, e.g.,* Deloitte, ICI/IDC, MFS Funds, T. Rowe Price, SIFMA, Federated, and Invesco. Deloitte added this as a first step for limited partnerships and general partners.

subject to significant influence and periodically determines that there are no changes to the fund's governance structure and governing documents.[61] Two commenters proposed a framework that focused on the beneficial owner's ability to exert significant influence over the audit client's operating and financial policies, based on the totality of the circumstances, and to avoid the exclusive reliance on the ASC 323 framework in the investment fund context.[62]

c) Rebuttable Presumption

ASC 323 incorporates a rebuttable presumption of significant influence once beneficial ownership meets or exceeds 20 percent of an investee's voting securities.[63] Two commenters recommended codifying the rebuttable presumption assessment under the proposed significant influence test consistent with the accounting standard,[64] and one commenter stated that although ASC 323 includes a rebuttable presumption with respect to 20 percent ownership, it is merely a guide and may be raised or lowered depending on the facts and circumstances.[65] A few commenters did not support applying the 20 percent rebuttable presumption to funds, but rather supported an analysis of the rights of fund owners under the fund's governance provisions.[66] Two commenters viewed the 20 percent rebuttable presumption as substituting a new 20 percent bright-line test for the existing 10 percent bright-line test, in the absence of the fund guidance set

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61 *See, e.g.,* ICI/IDC and T. Rowe Price.

62 *See* KPMG and Invesco.

63 Conversely, ASC 323 also incorporates a rebuttable presumption of no significant influence if beneficial ownership is less than twenty percent of investee's voting securities.

64 *See* FEI and Grant Thornton.

65 *See* NYSCPA.

66 *See, e.g.,* ICI/IDC, T. Rowe Price, Invesco, KPMG, EY, and Fidelity.

forth in the Proposing Release.[67] One commenter was concerned that the 20 percent rebuttable presumption could potentially conflict with the analysis of "control" under the federal securities laws by introducing a new standard that could increase compliance costs.[68]

d) Participation on an Advisory Committee

The Proposing Release noted that if a shareholder in a private fund, for example, has a side letter agreement outside of the standard partnership agreement that allows for participation in portfolio management processes (including participation on a fund advisory committee), then the shareholder would likely have significant influence.[69] A few commenters asserted that although participation on an advisory committee should be one factor in assessing significant influence, this factor alone is not likely to indicate significant influence.[70] Two commenters noted that the responsibilities of an advisory committee can vary.[71] One of these commenters noted that, when the board or advisory committee has substantive oversight responsibility or decision-making capacity over operating and financial policies significant to the fund, the commenter would likely view a shareholder on the board or advisory committee as having significant influence. In the absence of those characteristics, the commenter indicated that it would likely not consider a member of the board or advisory committee to have significant influence.[72] The other commenter stated that the purpose of an advisory committee generally is

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67 *See* Fidelity and Invesco.

68 *See* NYC Bar.

69 *See* Proposing Release, at 83 FR 20761.

70 *See, e.g.,* Deloitte, KPMG, and CAQ.

71 *See* Deloitte and PwC.

72 *See* PwC.

to provide suggestions to the investment adviser or general partner, and that advisory committees typically do not oversee the investment adviser or general partner and do not participate in the portfolio management process.[73]

Two commenters asserted that the right to remove a general partner or adviser was unlikely to indicate significant influence.[74] Another commenter supported drawing a distinction between rights that provide a shareholder with an ability to actively participate in fund investment decisions (*e.g.*, approval or veto rights over a new fund investment), which would indicate significant influence, and rights that allow a shareholder to address inappropriate behavior on the part of the investment adviser (*e.g.*, a right to remove an adviser for cause or the right to approve material changes to the fund governance documents), which would not indicate significant influence.[75]

e) Authorized Participants

Authorized participants ("APs") for ETFs deposit or receive basket assets in exchange for creation units of the fund. The Proposing Release noted that the deposit or receipt of basket assets by an AP that is also a lender to the auditor alone would not constitute significant influence over an ETF audit client. Several commenters agreed that the deposit or receipt of basket assets by an authorized participant that is also a lender to the auditor would not alone constitute significant influence over an ETF audit client.[76] A few commenters stated that market

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[73] *See* Deloitte.

[74] *See* Deloitte and PwC.

[75] *See* EY.

[76] *See, e.g.,* Deloitte, KPMG, EY, PwC, ICI/IDC, MFS Funds, T. Rowe Price, SIFMA, and Federated.

makers also should not be considered to have significant influence over an ETF audit client since their objective is not to influence the fund or the portfolio management process, but to provide liquidity to ETFs.[77] One commenter recommended that the Commission clarify that market makers typically would not be considered to have significant influence for purposes of the Loan Provision.[78]

f) Evaluation of Compliance with the Loan Provision

The Proposing Release indicated that, if the auditor determines that significant influence does not exist based on the facts and circumstances at the time of the auditor's initial evaluation,[79] the auditor should monitor the Loan Provision on an ongoing basis, which could be done, for example, by reevaluating its determination when there is a material change in the fund's governance structure and governing documents, publicly available information about beneficial owners, or other information that may implicate the ability of a beneficial owner to exert significant influence of which the audit client or auditor becomes aware. Several commenters agreed with this proposal.[80] A few commenters indicated that communications with shareholders or documentation regarding investor rights could be examples of other information implicating significant influence of which the audit client or auditor becomes aware.[81]

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[77] *See, e.g.*, Deloitte, EY, and PwC.

[78] *See* Deloitte.

[79] For funds, the auditor's initial determination would be based on an evaluation of a fund's governance structure and governing documents, the manner in which its shares are held or distributed, and any contractual arrangements, among any other relevant factors.

[80] *See, e.g.,* Deloitte, PwC, Crowe, CAQ, Grant Thornton, and EY.

[81] *See e.g.*, PwC, Crowe, and CAQ.

The Proposing Release also requested comment on whether the Commission should permit the Loan Provision or other financial relationships to be addressed at specific dates during the audit and professional engagement period, or the beginnings or ends of specific periods, or under specified circumstances. Rule 2-01(c)(1) of Regulation S-X provides that an accountant is not independent if the accountant has an independence-impairing relationship specified in the rule at any point during the audit and professional engagement period. Certain existing disclosure requirements require information about beneficial owners as of a specified date.[82] Several commenters expressed the view that specific dates were not needed to assess compliance with the Loan Provision, and that the frequency and timing of the evaluation should be developed based on the particular facts and circumstances relevant to the audited entity.[83]

A few commenters supported including specific dates or periods, such as:

- The onset of the engagement period and the balance sheet date for each audit;[84]
- At the planning and reporting stages of the audit and potentially significant or material events;[85] or
- The beginning of the engagement, prior to accepting a new engagement, and when the governance structure (including any contractual relationships) of the audit client changes.[86]

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82 *See, e.g.,* Item 18 of Form N-1A and Item 19 of Form N-2.

83 *See, e.g.,* Deloitte, PwC, Crowe, CAQ, Grant Thornton, BDO, EY, and RSM.

84 *See* KPMG.

85 *See* FEI.

86 *See* Invesco.

g) Alternatives to the Significant Influence Test

Two commenters proposed alternatives to the significant influence test: (1) focusing on material direct financial interests,[87] and (2) focusing the analysis on beneficial ownership, but maintaining the existing 10 percent bright-line shareholder ownership test.[88] The commenter that recommended maintaining the existing 10 percent bright-line ownership test but applying it to beneficial owners argued that this alternative approach would be simpler and easier to understand than the proposed significant influence test.[89] This commenter also asserted that the alternative approach would address most of the issues raised in the Fidelity No-Action Letter and avoid replacing the 10 percent bright-line test with a significant influence test that incorporates a 20% rebuttable presumption.[90]

One commenter stated that alternatives to the significant influence test are not needed.[91] The Proposing Release also requested comment on whether the modifier "significant" should be removed, such that the test would hinge on whether a lender shareholder has influence over an audit client. Two commenters opposed the removal of the modifier "significant" from the significant influence test, arguing that it would not achieve the objective of more effectively identifying those lending relationships that impair objectivity and impartiality.[92] Another commenter did not support an alternative test based on mere "influence," describing significant

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[87] *See* Invesco.

[88] *See* CII. A separate commenter suggested that auditors should resign or the engagement partner be replaced in circumstances involving both significant influence and related party transactions, but did not provide further explanation. *See* Letter from Elisabeth Rossen, dated June 3, 2018 ("Rossen").

[89] *See* CII.

[90] *See id.*

[91] *See* Grant Thornton.

[92] *See* KPMG and EY.

influence as being able to alter management's decision-making process, whereas mere "influence" could be disregarded by management.[93]

3. Final Amendments

After carefully considering the comments received, and consistent with the proposal, we are adopting amendments to replace the existing 10 percent bright-line test in the Loan Provision with a "significant influence" test similar to that referenced in other parts of the Commission's auditor independence rules and based on the concepts applied in ASC 323. We are not adopting an alternative framework, as suggested by two commenters,[94] that focuses on the beneficial owner's ability to exert significant influence over the audit client's operating and financial policies, based on the totality of the facts and circumstances, rather than the concepts applied in ASC 323. We continue to believe that given its use in other parts of the Commission's independence rules,[95] the concept of "significant influence" is one with which audit firms and their clients are already required to be familiar and would effectively identify those debtor-creditor relationships that could impair an auditor's objectivity and impartiality. In this regard, introducing a separate significant influence determination for these purposes would introduce additional complexity to the auditor independence rules without, in our view, necessarily resulting in more accurate assessments of auditor independence.

While the term "significant influence" in the final amendment refers to the principles in ASC 323, we agree with the commenter who stated that the specific considerations described in the significant influence test in ASC 323 should not be codified in our rules so as to avoid

93 *See* NYSCPA.

94 *See* Invesco and KPMG.

95 *See supra* footnote 44.

confusion in the future if changes are made to ASC 323.[96] For similar reasons, we are not codifying ASC 323's 20 percent rebuttable presumption in our rules.

While audit firms and audit committees of operating companies already should be familiar with application of the "significant influence" concept, we appreciate that this concept is not as routinely applied by funds for financial reporting purposes. Therefore, in response to comments requesting that the Commission reiterate the fund guidance from the Proposing Release[97] and comments recommending additional guidance regarding the application of the significant influence test in the fund context,[98] we are reiterating the fund guidance in the Proposing Release, with further clarification about the application in this context of the rebuttable presumption and other fund specific issues. In the fund context, we believe that the operating and financial policies relevant to the significant influence test would include the fund's investment policies and day-to-day portfolio management processes, including those governing the selection, purchase and sale, and valuation of investments, and the distribution of income and capital gains (collectively "portfolio management processes"). An audit firm could analyze, in its initial assessment under the rule, whether significant influence over the fund's portfolio management processes exists based on an evaluation of the fund's governance structure and governing documents, the manner in which its shares are held or distributed, and any contractual arrangements, among any other relevant factors.

We believe that it would be appropriate to consider the nature of the services provided by the fund's investment adviser(s) pursuant to the terms of an advisory contract with the fund as

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96 *See* EY.

97 *See supra* footnote 57.

98 *See supra* footnote 58.

part of this analysis. In circumstances where the terms of the advisory agreement grant the adviser significant discretion with respect to the fund's portfolio management processes and the shareholder does not have the ability to influence those portfolio management processes, significant influence generally would not exist and the evaluation of significant influence would be complete unless there is a material change in the fund's governance structure and governing documents (as discussed below). This should be the case even if the shareholder holds 20 percent or more of a fund's equity securities, which would otherwise trigger the rebuttable presumption under application of the concepts described in ASC 323.

The ability to vote on the approval of a fund's advisory contract or a fund's fundamental policies on a *pro rata* basis with all holders of the fund alone generally should not lead to the determination that a shareholder has significant influence. Similarly, the ability to remove or terminate a fund's advisory contract alone generally should not lead to a determination that a shareholder has significant influence.

As the Commission observed in the Proposing Release, if a shareholder in a private fund, for example, has a side letter agreement outside of the standard partnership agreement that allows for participation in portfolio management processes (including participation on a fund advisory committee), then the shareholder would likely have significant influence. In response to commenters noting that the responsibilities of an advisory committee can vary,[99] we are further clarifying that a shareholder in a private fund that participates on a fund advisory committee would likely have significant influence if that committee involves substantive oversight responsibility or decision-making capacity over operating and financial policies significant to the fund.

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[99] *See* Deloitte and PwC.

In addition, we believe that the deposit or receipt of basket assets by an AP that is also a lender to the auditor would not alone constitute significant influence over an ETF audit client. Similarly, in circumstances where a market maker is a lender to the auditor, the deposit or receipt of basket assets by a market maker (acting through an AP) would not alone constitute significant influence over such an ETF audit client.

Holders of a closed-end fund's preferred stock have certain rights that may be relevant to a significant influence analysis.[100] The determination of whether preferred stockholders have significant influence over the fund would be based on an evaluation of the relevant facts and circumstances.

Further to the guidance set forth above, we wish to emphasize that auditor independence is a shared responsibility between the audit firm and audit client.[101] The reliability of the process for identifying beneficial owners will be enhanced when both auditors and audit clients take responsibility for promoting the accuracy of information required to assess the auditor's independence.

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100 *See* section 18(a)(2)(C) of the Investment Company Act. *See also* ICI/IDC.

101 *See* Commission Final Rule, *Revision of the Commission's Auditor Independence Requirements*, Release No. 33-7919 (Nov. 21, 2000) ("[Issuers and other registrants] have the legal responsibility to file the financial information with the Commission, as a condition to accessing the public securities markets, and it is their filings that are legally deficient if auditors who are not independent certify their financial statements"). Moreover, many Commission regulations require entities to file or furnish financial statements that have been audited by an independent auditor. For example, Items 25 and 26 of Schedule A to the Securities Act [15 U.S.C. 77aa(25) and (26)] and Section 17(e) of the Exchange Act [15 U.S.C. 78q] expressly require that financial statements be certified by independent public or certified accountants. In addition, Sections 12(b)(1)(J) and (K) and 13(a)(2) of the Exchange Act [15 U.S.C. 78l and 78m], Sections 8(b)(5) and 30(e) and (g) of the Investment Company Act [15 U.S.C. 80a-8 and 80a-29], and Section 203(c)(1)(D) of the Investment Advisers Act [15 U.S.C. 80b-3(c)(1)] authorize the Commission to require the filing of financial statements that have been audited by independent accountants. Paragraph (f)(1) of Rule 17a-5 under the Exchange Act [17 CFR 240.17a-5(f)(1)] requires that for audits under paragraph (d) of Rule 17a-5 of broker-dealers registered with the Commission, an independent public accountant must be independent in accordance with Rule 2-01 of Regulation S-X. *See also id*. (discussing Rule 206(4)-2 under the Investment Advisers Act).

If the auditor determines that significant influence over the fund's management processes does not exist at the time of the initial application of the rule, the auditor should monitor the Loan Provision on an ongoing basis.[102] We continue to believe, as expressly supported by several commenters,[103] that the auditor could satisfy this obligation to monitor its independence on an ongoing basis by reevaluating its determination in response to a material change in the fund's governance structure and governing documents, Commission filings about beneficial owners,[104] or other information which may implicate the ability of a beneficial owner to exert significant influence of which the audit client or auditor becomes aware. Outside of the fund context, audit firms and their audit clients should continue to monitor the auditor's independence on an ongoing basis by using their existing processes for determining whether significant influence exists consistent with the principles of ASC 323. In this regard, we agree with those commenters[105] who indicated that the frequency and timing of the significant influence evaluation should be based on the particular facts and circumstances relevant to the audited entity, consistent with the requirement that the auditor be independent throughout the audit and professional engagement period. Accordingly, we have not included specific dates, periods or circumstances upon which the significant influence evaluation should occur.

Finally, although we carefully considered the comments regarding alternatives to the significant influence test, we have not been persuaded to retain the existing 10 percent bright-line

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102 *See* Proposing Release at 20761.

103 *See, e.g.,* Deloitte, PwC, Crowe, CAQ, Grant Thornton, and EY.

104 This language is a slight change from the guidance provided in the Proposing Release, which referenced "publicly available information about beneficial owners." *See* Proposing Release at 20765. We believe reference to Commission filings is more precise and will clarify the scope of monitoring that is discussed above.

105 *See* KPMG, FEI, and Invesco.

shareholder ownership test. We believe that in situations where the lender is unable to influence the audit client through its holdings, the lender's ownership of an audit client's equity securities alone would not threaten an audit firm's objectivity and impartiality. In these situations, we continue to believe that the significant influence test would more effectively determine which shareholders have "a special and influential role with the issuer" by focusing on a shareholder's ability to influence the policies and management of an audit client.

We disagree with the commenter who expressed support for retaining a 10 percent bright-line test based on beneficial ownership.[106] We continue to believe that a test based on significant influence, rather than one based on numerical bright lines, will better address the compliance challenges associated with the Loan Provision while also more effectively identifying debtor-creditor relationships that could impair an auditor's objectivity and impartiality. One potential benefit of the final amendments is that the significant influence test could potentially identify risks to auditor independence that might not have been identified under the existing 10 percent bright-line test. For example, a beneficial owner that holds slightly less than 10 percent of an audit client's equity securities is likely to have similar incentives and ability to influence the auditor's report than a beneficial owner that holds slightly more than 10 percent of the same audit client's equity securities. The existing 10 percent threshold in the Loan Provision would differentially classify these two hypothetical situations, despite their similarity. Under the final amendments, an audit firm, where it is evaluating beneficial owners for significant influence, would evaluate both beneficial owners to determine if they have significant influence, thus providing a consistent analysis under the Loan Provision for these economically similar fact

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106 *See* CII.

patterns. Regarding the alternative of focusing on material direct financial interests, we discuss our reasons for not adopting a materiality qualifier below.[107]

One commenter raised concerns that the 20 percent rebuttable presumption included in the significant influence analysis would introduce a new standard and require performing multiple layers of overlapping and potentially conflicting analysis.[108] The commenter cited to the definition of "affiliate of the audit client" set forth in Rule 2-01(f)(4) of Regulation S-X to suggest that the reference to "control" under that definition could overlap with the application of the significant influence test.[109] However, the concept of "significance influence" in ASC 323 is distinct from any reference to "control" in Rule 2-01(f)(4) or elsewhere under the federal securities laws. Specifically, the determination of whether an entity has control of another entity is distinct from whether an entity has significant influence over the audit client. For this reason, we do not believe the concept of "significant influence" in ASC 323 overlaps with other definitions. Moreover, the concept of "significant influence," which includes the 20 percent rebuttable presumption, is not a new standard but has been part of the Commission's auditor independence rules since 2000 and part of the accounting standards since 1971.[110]

D. Reasonable Inquiry Compliance Threshold

1. Proposed Amendments

As noted in the Proposing Release, another challenge in the application of the current Loan Provision involves the difficulty in accessing information about the ownership percentage

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107 *See infra* Section II.F.1.

108 *See* NYC Bar.

109 *See id.*

110 *See* Accounting Principles Board (APB) Opinion No. 18 (March 1971).

of an audit client for purposes of the current 10 percent bright-line test. The proposed amendments to the Loan Provision would have addressed concerns about accessibility to records or other information about beneficial ownership by adding a "known through reasonable inquiry" standard with respect to the identification of such owners. Under this proposed amendment, an audit firm, in coordination with its audit client, would be required to assess beneficial owners of the audit client's equity securities who are known through reasonable inquiry. The Proposing Release noted that if an auditor does not know after reasonable inquiry that one of its lenders is also a beneficial owner of the audit client's equity securities, including because that lender invests in the audit client indirectly through one or more financial intermediaries, the auditor's objectivity and impartiality is unlikely to be impacted by its debtor-creditor relationship with the lender. The Proposing Release also noted that this "known through reasonable inquiry" standard is generally consistent with regulations implementing the Investment Company Act, the Securities Act, and the Exchange Act,[111] and therefore is a concept that already should be

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[111] *See, e.g.,* Rule 3b-4 under the Exchange Act [15 U.S.C. 78a *et seq*.] (stating, with respect to the definition of foreign private issuer, that "[i]f, after reasonable inquiry, you are unable to obtain information about the amount of shares represented by accounts of customers resident in the United States, you may assume, for purposes of this definition, that the customers are residents of the jurisdiction in which the nominee has its principal place of business.); Rule 144(g) under the Securities Act (noting that "[t]he term brokers' transactions in section 4(4) of the [Securities] Act shall… be deemed to include transactions by a broker in which such broker:… (4) After reasonable inquiry is not aware of circumstances indicating that the person for whose account the securities are sold is an underwriter with respect to the securities or that the transaction is a part of a distribution of securities of the issuer"); Rule 502(d) under the Securities Act (stating, with respect to limits on resales under Regulation D, that "[t]he issuer shall exercise reasonable care to assure that the purchasers of the securities are not underwriters within the meaning of section 2(a)(11) of the [Securities] Act, which reasonable care may be demonstrated by the following: (1) Reasonable inquiry to determine if the purchaser is acquiring the securities for himself or for other persons"). Registered investment companies also are subject to a similar requirement to disclose certain known beneficial owners. *See* Item 18 of Form N-1A ("State the name, address, and percentage of ownership of each person who owns of record or is known by the Fund to own beneficially 5% or more of any Class of the Fund's outstanding equity securities."); and Item 19 of Form N-2 ("State the name, address, and percentage of ownership of each person who owns of record or is known by the Registrant to own of record or beneficially five percent or more of any class of the Registrant's outstanding equity securities.").

familiar to those charged with compliance with the Loan Provision.

2. Comments

Commenters generally expressed support for the proposed amendment to add a "known through reasonable inquiry" standard with respect to identifying beneficial owners of the audit client's equity securities.[112] A number of these commenters agreed that the proposed amendment would address compliance challenges and further agreed that if an auditor does not know after reasonable inquiry that one of its lenders is also a beneficial owner of the audit client's equity securities, the auditor's objectivity and impartiality is unlikely to be impacted by its debtor-creditor relationship with the lender.[113]

Other commenters requested guidance on what constituted "reasonable inquiry,"[114] such as whether reviewing publicly available information or information readily available to the issuer would be sufficient for this purpose. Several commenters requested substituting the proposed "known through reasonable inquiry" standard with a "known" standard,[115] while two commenters viewed both the "known" and "known through reasonable inquiry" standards to be similar.[116]

112 *See, e.g.,* Deloitte, PwC, KPMG, Crowe, CAQ, NASBA, NYSCPA, PBTK, MFS Funds, Grundfest, Grant Thornton, MFDF, BDO, EY, Fidelity, NYC Bar, ICI/IDC, CCMC, RSM, T. Rowe Price, FEI, AICPA, AIC, SIFMA, Invesco, and Federated.

113 *See, e.g.,* Deloitte, PwC, KPMG, CAQ, Grant Thornton, MFDF, BDO, RSM, FEI, and AICPA.

114 *See, e.g.,* KPMG, CAQ, Grant Thornton, BDO, EY, ICI/IDC, MFS Funds, RSM, T. Rowe Price, FEI, SIFMA, and Federated.

115 *See, e.g.,* ICI/IDC, MFS Funds, T. Rowe Price, SIFMA, Invesco, and Federated.

116 *See* EY and FEI.

3. Final Amendments

After considering the comments received, we are adopting the amendment to add a "known through reasonable inquiry" standard with respect to identifying beneficial owners of the audit client's equity securities as proposed. In response to commenters, we believe auditors and their audit clients could conduct the reasonable inquiry analysis by looking to the audit client's governance structure and governing documents, Commission filings about beneficial owners, or other information prepared by the audit client which may relate to the identification of a beneficial owner.[117]

In addition, we have determined not to substitute a "known through reasonable inquiry" standard with a "known" standard because we believe an inquiry by the auditor and the audit client in conjunction with the consideration of the audit client's governance structure, governing documents, Commission filings, or other information prepared by the audit client, would be a practical approach that would not impose an undue burden in identifying and evaluating beneficial owners of the audit client's equity securities.

E. Excluding Other Funds That Would Be Considered Affiliates of the Audit Client

As discussed in the Proposing Release, the current definition of "audit client" in Rule 2-01 of Regulation S-X includes all "affiliates of the audit client," which broadly encompasses, among others, each entity in an ICC of which the audit client is a part. In the fund context, this expansive definition of "audit client" could result in an audit firm being deemed not to be independent as to a broad range of entities, even where an auditor does not audit that entity.[118]

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117 *See also supra* Section II.C.

118 For example, under the current Loan Provision, an audit firm ("Audit Firm B") could be deemed not to be independent as to an audit client under the following facts: Audit Firm A audits an investment company

Yet, in the investment management context, investors in a fund typically do not possess the ability to influence the policies or management of another fund in the same fund complex. Although an investor in one fund in a series company can vote on matters put to shareholders of the company as a whole, rather than only to shareholders of one particular series, even an investor with a substantial investment in one series would be unlikely to have a controlling percentage of voting power of the company as a whole.

Moreover, as noted in the Proposing Release, for the purposes of the Loan Provision, the inclusion of certain entities in the ICC as a result of the definition of "audit client" is in tension with the Commission's original goal to facilitate compliance with the Loan Provision without decreasing its effectiveness.[119] Indeed, auditors often have little transparency into the investors of other funds in an ICC (unless they also audit those funds), and therefore, are likely to have little ability to collect such beneficial ownership information.

("Fund A") for purposes of the Custody Rule. A global bank ("Bank") has a greater than 10 percent interest in Fund A. Bank is a lender to a separate Audit Firm B, but has no lending relationship with Audit Firm A. Audit Firm B audits another investment company ("Fund B") that is part of the same ICC as Fund A because it is advised by the same registered investment adviser as Fund A. Under these facts, Audit Firm B would not be independent under the existing Loan Provision because the entire ICC would be tainted as a result of Bank's investment relationship with Fund A.

119 *See* Proposing Release at 20762. *See also* 2000 Adopting Release, *supra* footnote 5, at 76035 (The Commission, in adopting an ownership threshold of 10 percent, rather than the five percent proposed, stated that "[w]e have made this change because we believe that doing so will not make the rule significantly less effective, and may significantly increase the ease with which one can obtain the information necessary to assure compliance with this rule.").

1. Proposed Amendments

In order to address these compliance challenges, the proposed rules, for purposes of the Loan Provision, would have excluded from the definition of audit client, for a fund under audit, any other fund that otherwise would be considered an affiliate of the audit client.[120] Thus, for example, if an auditor were auditing Fund ABC, a series in Trust XYZ, the audit client for purposes of the Loan Provision would exclude all other series in Trust XYZ and any other fund that otherwise would be considered an affiliate of the audit client. The proposed amendment would have, without implicating an auditor's objectivity and impartiality, addressed the compliance challenges associated with the application of the Loan Provision where the audit client is part of an ICC, such as when an accountant is an auditor of only one fund within an ICC, and the auditor must be independent of every other fund (and other entity) within the ICC, regardless of whether the auditor audits that fund.

2. Comments

Many commenters supported the proposal to amend the definition of "audit client" for a fund under audit to exclude funds that otherwise would be considered affiliates of the audit client.[121] Several of these commenters also agreed that the proposed amendment would address some of the compliance challenges associated with the Loan Provision while still effectively

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120 *See* proposed Rule 2-01(c)(1)(ii)(A)(2) of Regulation S-X: "For purposes of paragraph (c)(1)(ii)(A) of this section, the term *audit client* for a fund under audit excludes any other fund that otherwise would be considered an *affiliate of the audit client*. The term *fund* means an investment company or an entity that would be an investment company but for the exclusions provided by section 3(c) of the Investment Company Act of 1940 (15 U.S.C. 80a-3(c))."

121 *See, e.g.,* Deloitte, PwC, KPMG, Crowe, CAQ, NASBA, PBTK, MFS Funds, Grundfest, Grant Thornton, MFDF, BDO, EY, Fidelity, NYC Bar, ICI/IDC, CCMC, RSM, T. Rowe Price, First Data, FEI, AICPA, AIC, SIFMA, Invesco, and Federated.

identifying lending relationships that may impair independence.[122] Two commenters, however, asserted that affiliates of an audit client should not be categorically excluded from the definition of "audit client" when evaluating significant influence.[123] Many commenters supported expanding the proposed amendment to exclude other non-fund affiliates in an investment company complex or private fund complex (*e.g.,* investment advisers, broker-dealers, and service providers, such as custodians, administrators, and transfer agents),[124] while other commenters supported broadening the proposed exclusion to all audit clients, not just fund affiliates.[125] Several commenters recommended we address downstream affiliates of excluded funds, such as portfolio companies of the excluded funds.[126] These commenters generally argued that downstream affiliates of excluded funds that are not audit clients do not pose a threat to auditor independence since these affiliates, and investors in these affiliates, do not have the ability to exert significant influence over the entity under audit.[127]

Several other commenters also suggested excluding from the definition of "audit client" other pooled investment vehicles in an investment company complex that may be deemed to be

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122 *See, e.g.,* KPMG, BDO, EY, and FEI.

123 *See* KPMG and NYSCPA. One of these commenters stated that affiliates of the audit client should be excluded from the definition of "audit client" for the purposes of the Loan Provision, and also described scenarios where it believes it is possible that an investor's significant influence over an entity can affect other affiliates of that entity. For example, the commenter described a scenario where the policies for the portfolio management of the fund under audit span a wider group of funds. Under this scenario, an investor may have significant influence in a large fund in the complex that could result in effective influence over a sister fund, where both funds are managed by the same team under the same policies. *See* KPMG.

124 *See, e.g.,* Deloitte, PwC, KPMG, Crowe, CAQ, MFS Funds, BDO, EY, Fidelity, ICI/IDC, RSM, T. Rowe Price, AICPA, AIC, SIFMA, Invesco, and Federated.

125 *See, e.g.,* Deloitte, PwC, KPMG, CAQ, Grant Thornton, BDO, EY, NYC Bar, RSM, First Data, FEI, and AICPA.

126 *See, e.g.,* Crowe, CAQ, Grant Thornton, RSM, EY, and AICPA. Crowe supported excluding downstream entities unless they had significant influence over an entity being audited.

127 *See, e.g.,* Crowe, CAQ, and RSM.

an affiliate of the audit client, including pooled products that are not investment companies and do not rely on Section 3(c) of the Investment Company Act (*e.g.*, commodity pools), as well as certain foreign funds.[128] These commenters were concerned that these types of pooled investment vehicles could be deemed to be "affiliates of the audit client," even though a lender likely would not have the ability to influence these other funds in the fund complex.[129] Another commenter stated that investment advisers that are part of an ICC of which an audit client is a part may conduct business that is unrelated to serving as the investment adviser to registered investment companies.[130] A number of commenters also specifically discussed excluding certain entities in the typical private equity fund structure from the definition of audit client, including other funds advised by the private equity sponsor when the private equity sponsor is the audit client.[131] We also received other comments on the "affiliate of the audit client" definition, which would impact other provisions of the auditor independence rules and are discussed below.[132]

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128 *See, e.g.,* ICI/IDC, MFS Funds, T. Rowe Price, SIFMA, Federated, and Invesco. As discussed below, for purposes of Rule 2-01, a "commodity pool" would be a commodity pool as defined in Section 1a(10) of the CEA that is not an investment company and does not rely on Section 3(c) of the Investment Company Act. *See, e.g.,* Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operations and Commodity Trading Advisors on Form PF, Investment Company Act Release No. 3308 (Oct. 31, 2011) [76 FR 71128 (Nov. 16, 2011)]. We use the term "foreign fund" in this release to refer to an "investment company" as defined in Section 3(a)(1)(A) of the Investment Company Act that is organized outside the U.S. and that does not offer or sell its securities in the U.S. in connection with a public offering. *See* Section 7(d) of the Investment Company Act (prohibiting a foreign fund from using the U.S. mails or any means or instrumentality of interstate commerce to offer or sell its securities in connection with a public offering unless the Commission issues an order permitting the foreign fund to register under the Act). A foreign fund may conduct a private U.S. offering in the United States without violating Section 7(d) of the Act only if the foreign fund conducts its activities with respect to U.S. investors in compliance with either section 3(c)(1) or 3(c)(7) of the Act (or some other available exemption or exclusion). *See* Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers, Investment Advisers Act Release No. 3222 (June 22, 2011) [76 FR 39646 (July 6, 2011)].

129 *See* ICI/IDC.

130 *See* Invesco.

131 *See, e.g.,* AIC, EY, RSM, CCMC, Deloitte, CAQ, and Grundfest.

132 *See infra* Section II.F.2.

3. Final Amendments

We are adopting, as proposed, the amendment to the Loan Provision to exclude from the definition of audit client, for a fund under audit, any other fund (*e.g.*, "sister fund") that otherwise would be considered an affiliate of the audit client. Commenters generally supported this exclusion. However, in response to commenters that urged us to exclude commodity pools that are part of an ICC, we have expanded the definition of "fund" in the final amendments to provide that a commodity pool that is not an investment company or does not rely on Section 3 of the Investment Company Act also is not considered a fund for purposes of the Loan Provision.[133] A foreign fund that is part of an ICC would be covered by the exclusion for funds other than the fund under audit.

We agree that investors in a fund typically do not possess the ability to influence the policies or management of other "sister" funds and that this does not depend on whether the funds are investment companies or other types of pooled investment vehicles. We also believe that expanding the definition of "fund" to encompass commodity pools is consistent with our intent to exclude for a fund under audit any other funds that otherwise would be considered an affiliate of the audit client.

Commenters also urged that we exclude any downstream affiliates of excluded funds. We do not believe it is necessary to expressly carve these entities out of the audit client definition. However, to avoid any confusion, we are clarifying that, for purposes of the Loan Provision, the exclusion of sister funds from the audit client definition also excludes entities that would otherwise be included in the audit client definition solely by virtue of their association

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133 A commodity pool that is an investment company or that relies on Section 3 of the Investment Company Act would already be covered by the fund exclusion.

with an excluded sister fund. This clarification should remove any questions about whether entities in which a sister fund invests (and that have an even more attenuated relationship to a fund audit client) could themselves be treated as an audit client for purposes of the Loan Provision. We agree with commenters that these types of affiliates do not have the ability to exert significant influence over the entity under audit in these circumstances and, therefore, should not be treated as an audit client.

F. Other Comments

In the Proposing Release, the Commission also requested comment on other matters that might have an effect on the proposed amendments or the Loan Provision and any suggestions for additional changes to other parts of Rule 2-01 of Regulation S-X.

1. Materiality Qualifier

The Proposing Release did not include a materiality qualifier for the Loan Provision but requested comment on whether one should be included. Although a number of commenters expressed support for a materiality qualifier,[134] there were diverse recommendations about how it should be applied. A number of commenters expressed support for assessing the materiality of the loan to the auditor or covered person,[135] while other commenters supported assessing the materiality of the lender's investment in the audit client.[136] Several commenters held the view

134 *See, e.g.,* Deloitte, PwC, KPMG, Crowe, CAQ, PTBK, Grant Thornton, BDO, EY, ICI/IDC, MFS Funds, T. Rowe Price, SIFMA, Federated, CCMC, RSM, First Data, FEI, AICPA, and Invesco.

135 *See, e.g.,* Deloitte, PwC, KPMG, CAQ, BDO, EY, ICI/IDC, MFS Funds, T. Rowe Price, SIFMA, Federated, RSM, First Data, and Invesco.

136 *See, e.g.,* PwC, Crowe, CAQ, PTBK, Grant Thornton, BDO, EY, CCMC, RSM, First Data, and FEI.

that if their recommendation to exclude all affiliates of the entity under audit was adopted, then a materiality qualifier would not be necessary.[137]

After carefully considering the comments, we believe that the final amendments appropriately address the compliance challenges raised by the existing Loan Provision while refocusing the rule on the qualitative nature of those lending relationships auditors may have with lenders that "hav[e] a special and influential role with the audit client." Accordingly, we have retained the significant influence test, as proposed, rather than having the analysis turn on whether a specific loan may be material to the lender or audit firm. We also believe that given the size of the financial institutions, in terms of revenue or other quantitative measures, and the audit firms that have lending relationships with them, a materiality qualifier would result in scoping out from the Loan Provision a broad range of lending relationships and would not sufficiently address the threat to auditor independence, in fact or appearance, posed by at least some of these lending relationships. Furthermore, when determining whether an accountant is capable of exercising objective and impartial judgment, the auditor and audit client should consider all relevant circumstances between an accountant and the audit client,[138] which would include any qualitative and quantitative factors. Moreover, adding a materiality qualifier could cause the auditor independence inquiry to be affected by fluctuating market conditions, rather than an assessment that is market neutral.[139]

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137 *See, e.g.,* KPMG, Crowe, CAQ, EY, Grant Thornton, RSM, and AICPA.

138 *See* Rule 2-01(b) of Regulation S-X.

139 For example, fluctuating market conditions could cause changes in the value of the assets securing a loan, thereby leading to different determinations at different times of the materiality of a lending relationship.

2. Other Potential Changes to the Auditor Independence Rules

The final amendments are intended to address the significant practical challenges associated with the existing Loan Provision. The Proposing Release also solicited comment on other changes to the Loan Provision and to the other auditor independence rules. Generally, these comments can be categorized as follows: (1) relating to the Loan Provision, but not the significant compliance challenges that need to be immediately addressed (*e.g.*, other types of loans that commenters suggested should be excluded from the Loan Provision, such as student loans); (2) broadly impacting provisions of the auditor independence rules, including the Loan Provision (*e.g.*, comments relating to the "covered person" and "affiliate of the audit client" definitions); or (3) broadly impacting provisions of the auditor independence rules other than the Loan Provision (*e.g.*, suggestions to narrow the look-back period for domestic initial public offerings so that the period is similar to that for foreign private issuers). In response to these comments and the need for more information gathering as to how best to address these categories of comments, the Chairman has directed the staff to formulate recommendations to the Commission for possible additional changes to the auditor independence rules in a future rulemaking.

III. Other Matters

If any of the provisions of these amendments, or the application of these provisions to any person or circumstance, is held to be invalid, such invalidity shall not affect other provisions or application of such provisions to other persons or circumstances that can be given effect without the invalid provision or application.

Pursuant to the Congressional Review Act,[140] the Office of Information and Regulatory Affairs has designated these amendments as not a "major rule," as defined by 5 U.S.C. § 804(2).

IV. Paperwork Reduction Act

The final amendments do not impose any new "collections of information" within the meaning of the Paperwork Reduction Act of 1995 ("PRA"),[141] nor do they create any new filing, reporting, recordkeeping, or disclosure requirements. Accordingly, we are not submitting the final amendments to the Office of Management and Budget for review in accordance with the PRA.[142] We did not receive any comments about our conclusion that there are no collections of information.

V. Economic Analysis

As discussed above, the Commission is adopting amendments to the Loan Provision in Rule 2-01 of Regulation S-X to focus the analysis on beneficial ownership rather than both record and beneficial ownership; replace the existing 10 percent bright-line shareholder ownership test with a "significant influence" test;[143] add a "known through reasonable inquiry" standard with respect to identifying beneficial owners of the audit client's equity securities; and exclude from the definition of "audit client," for a fund under audit, any other funds that otherwise would be considered affiliates of the audit client under the Loan Provision.

Under the existing rules, the 10 percent bright-line shareholder ownership test does not

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[140] 5 U.S.C. § 801 *et seq*.

[141] 44 U.S.C. 3501 *et seq.*

[142] 44 U.S.C. 3507(d) and 5 CFR 1320.11.

[143] *See* Section II.C for a discussion of the concept of "significant influence."

recognize an accountant as independent if the accounting firm, any covered person in the firm, or any of his or her immediate family members has certain loans to or from an audit client or an audit client's officers, directors, or record or beneficial owners of more than 10 percent of the audit client's equity securities. In addition, under the existing rules, "audit client" is defined broadly to include any affiliate of the entity whose financial statements are being audited, which, for funds, would include each entity in an ICC of which the audit client is a part. As discussed above, Commission staff has engaged in extensive consultations with audit firms, funds, and operating companies regarding the application of the Loan Provision. These consultations revealed that a number of entities face significant practical challenges to comply with the Loan Provision. These discussions also revealed that in certain scenarios, in which the Loan Provision was implicated, the auditor's objectivity and impartiality in performing the required audit and interim reviews were not impaired.

We are mindful of the benefits obtained from and the costs imposed by our rules and amendments.[144] The following economic analysis seeks to identify and consider the likely benefits and costs that will result from the final amendments, including their effects on efficiency, competition, and capital formation. The discussion below elaborates on the likely economic effects of the final amendments.

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[144] Section 2(b) of the Securities Act [15 U.S.C. 77b(b)], Section 3(f) of the Exchange Act [17 U.S.C. 78c(f)], Section 2(c) of the Investment Company Act [15 U.S.C. 80a-2(c)], and Section 202(c) of the Investment Advisers Act [15 U.S.C. 80b-2(c)] require the Commission, when engaging in rulemaking where it is required to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition and capital formation. Additionally, Section 23(a)(2) of the Exchange Act [15 U.S.C. 78w(a)(2)] requires the Commission, when adopting rules under the Exchange Act, to consider, among other things, the impact that any new rule would have on competition and not to adopt any rule that would impose a burden on competition that is not necessary or appropriate in furtherance of the Exchange Act.

A. General Economic Considerations

In order for the reported information to be useful to investors, it needs to be relevant and reliable. The independent audit of such information by impartial skilled professionals (*i.e.*, auditors) is intended to enhance the reliability of financial reports.[145] Conflicts of interest between companies or funds and their auditors may impair the objectivity and impartiality of the auditors in certifying the audit client's reported performance, thus lowering the credibility and usefulness of these disclosures to investors. Academic literature discusses and documents the importance of the role of auditors as an external governance mechanism for the firm.[146] These studies generally find that better audit quality improves financial reporting by increasing the credibility of the financial reports.

An accounting firm is not independent under the Loan Provision's existing bright-line shareholder ownership test if the firm has a lending relationship with an entity having record or beneficial ownership of more than 10 percent of the equity securities of either: (1) the firm's audit client; or (2) any "affiliate of the audit client," including, but not limited to, any entity that is a controlling parent company of the audit client, a controlled subsidiary of the audit client, or an entity under common control with the audit client. The magnitude of a party's investment in a company or fund is likely to be positively related with any incentive of that party to use leverage over the auditor with whom the party has a lending relationship in order to obtain personal gain.

The 10 percent bright-line test in the Loan Provision does not, however, distinguish

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145 *See* M. Defond & J. Zhang, *A Review of Archival Auditing Research*, 58 J. Acct. & Econ. 275-326 (2014).

146 *See e.g.,* N. Tepalagul & L. Lin, *Auditor Independence and Audit Quality: A Literature Review*, 30 J. Acct. Audit. & Fin. 101-121 (2015); M. Defond & J. Zhang, *A Review of Archival Auditing Research*, 58 J. Acct. & Econ. 275-326 (2014); Y. Chen, S. Sadique, B. Srinidhi, & M. Veeraraghavan, *Does High-Quality Auditing Mitigate or Encourage Private Information Collection?*; and R. Ball, S. Jayaraman & L. Shivakumar, *Audited Financial Reporting and Voluntary Disclosure as Complements: A Test of the Confirmation Hypothesis*, J. Acct. & Econ. 53(1): 136-166 (2012).

between holders of record and beneficial owners even though beneficial owners are more likely to pose a risk to auditor independence than record owners given that the financial gain of beneficial owners is tied to the performance of their investment, and as such, beneficial owners may have strong incentives to influence the auditor's report. Record owners, on the other hand, may not benefit from the performance of securities of which they are record owners, and as such, they may have low incentives to influence the report of the auditor. Both the magnitude and the type of ownership in the audit client, are likely to be relevant factors in determining whether incentives exist for actions that could impair auditor independence. Beneficial ownership of a company's or fund's equity securities by a lender to the company's or fund's auditor is likely to pose a more significant risk to auditor independence than record ownership of the company's or fund's securities by the same lender.

The current Loan Provision may in some cases over-identify and in other cases under-identify threats to auditor independence. The likelihood that the provision over-identifies threats to auditor independence will tend to be higher when the lender is not a beneficial owner of an audit client and does not have incentives to influence the auditor's report, but has record holdings that exceed the 10 percent ownership threshold. On the other hand, under-identification of the threat to auditor independence may occur when the lender is a beneficial owner—implying the existence of potential incentives to influence the auditor's report—and the investment is close to, but does not exceed, the 10 percent ownership threshold.[147]

We are not aware of academic studies that specifically examine the economic effects of the Loan Provision. The remainder of the economic analysis in this section presents the baseline

[147] We are unable to estimate the extent to which the 10 percent ownership threshold may over- or under-identify threats to independence because, among other reasons, fund ownership data is not readily available.

against which we perform our analysis, the anticipated benefits and costs of the final amendments, potential effects on efficiency, competition and capital formation, and an analysis of alternatives to the final amendments.

B. Baseline

The final amendments will change the Loan Provision compliance requirements for the universe of affected registrants. We believe the main affected parties will be audit clients, audit firms, and institutions engaging in financing transactions with audit firms and their partners and employees. Other parties that may be affected are covered persons and their immediate family members. Indirectly, the final amendments will affect audit clients' investors.

We are not able to precisely estimate the number of current auditor engagements that will be immediately affected by the final amendments. Specifically, precise data on how audit firms finance their operations and how covered persons arrange their personal financing are not available to us, and no commenters provided data to enable such an estimate. As such we are not able to identify pairs of auditors-institutions (lenders). Moreover, sufficiently detailed and complete data on fund ownership are not available to us, and no commenters provided such data, thus limiting our ability to estimate the prevalence/frequency of instances of significant fund ownership by institutions that are also lenders to fund auditors.

Although data on fund ownership are not readily available, academic studies of operating companies have shown that, for a selected sample of firms, the average blockholder (defined as beneficial owners of five percent or more of a company's stock) holds about 8.5 percent of a company's voting stock.[148] These studies also show that numerous banks and insurance

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148 *See* Y. Dou, O. Hope, W. Thomas & Y. Zou, *Blockholder Heterogeneity and Financial Reporting Quality,* working paper (2013).

companies are included in the list of blockholders. These findings suggest that the prevalence of instances of significant ownership by institutions that are also lenders to auditors could be high.

As mentioned above, the final amendments will impact audits for the universe of affected entities. The baseline analysis below focuses mainly on the investment management industry because that is where the most widespread issues with Loan Provision compliance have been identified to date; however, the final rule will affect entities outside of this space, which are also subject to the auditor independence rules.[149]

As shown in Table 1 below, as of December 2018, there were approximately 12,577 fund series, with total net assets of $23 trillion, that are covered by Morningstar Direct with identified accounting firms.[150] In addition, there were 23 accounting firms performing audits for these investment companies, though these auditing services were concentrated among the four largest accounting firms. Indeed, about 86 percent of the funds were audited by the four largest accounting firms, corresponding to 98 percent of the aggregate fund asset value.[151]

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149 Based on data in the SEC's EDGAR database, during the period from January 1, 2018 to December 31, 2018, there were a total of 6,919 entities that filed at least one Form 10-K, 20-F, or 40-F, or an amendment to one of these forms. This total does not include investment companies and business development companies**.**

150 These fund statistics are based on information available from Morningstar Direct, and may not represent the universe of fund families. The statistics include open-end funds, closed-end funds, and exchange traded funds.

151 According to aggregated information from Forms 2, as of December 31, 2018, there were 1,862 audit firms registered with the PCAOB (of which 984 are domestic audit firms, with the remaining 878 audit firms located outside the United States). The concentration in the provision of audit services for investment companies is indicative of the overall market as well. According to a report by Audit Analytics, the four largest accounting firms audit 75% of accelerated and large accelerated filers. *See Who Audits Larger Public Companies-2018 Edition*, *available at* http://www.auditanalytics.com/blog/who-audits-larger-public-companies-2018-edition.

Table 1: Audited Fund Series and Their Investment Company Auditors

As of December 31, 2018

Total Number of Fund Series	12,577
Average Number of Fund Series Per Auditor	547
Average Net Assets (in millions) Per Auditor	1,023,086
Four Largest Audit Firms	
Total Number of Fund Series	10,876
Average Number of Fund Series Per Auditor	2,719
Average Net Assets (in millions) Per Auditor	5,757,533
% of Four Audit Firms by Series	86%
% of Four Audit Firms by Net Assets	98%

The scope of the auditor independence rules, including the Loan Provision, extends beyond the audit client to encompass affiliates of the audit client. According to Morningstar Direct, as of December 31, 2018, 543 out of 901 fund families[152] have more than one fund, 162 have at least 10 funds, 57 have more than 50 funds, and 38 have more than 100 funds. According to the Investment Company Institute, also as of December 31, 2018, there were approximately 11,587 open-end funds and around 5,500 closed-end funds, with many funds belonging to the same fund family. Given that many fund complexes have several funds, with some complexes having several hundred funds, if any auditor is deemed not in compliance with the Loan Provision with respect to one fund, under the current rule it cannot audit any of the other funds within the same ICC.

In response to compliance challenges, and as discussed above, Commission staff issued the Fidelity No-Action Letter. The Fidelity No-Action Letter, however, did not resolve all

152 These fund statistics are based on information available from Morningstar Direct and may not represent the universe of fund families. The statistics include open-end funds, closed-end funds and ETFs.

compliance uncertainty, was limited in scope, and provided staff-level no-action relief to the requestor based on the specific facts and circumstances in the request. Importantly, the Fidelity No-Action Letter did not amend the underlying rule. Staff has continued to receive inquiries from registrants and accounting firms regarding the application of the Loan Provision, or clarification of the Fidelity No-Action Letter, and requests for consultation regarding issues not covered in the Fidelity No-Action Letter. As a result of the remaining compliance uncertainty, auditors and audit committees may spend a significant amount of time and effort to comply with the Loan Provision.

C. Anticipated Benefits and Costs

1. Anticipated Benefits

Overall, we anticipate monitoring for non-compliance throughout the reporting period will be less burdensome for registrants under the final amendments. For example, based on the 10 percent bright-line test, an auditor may be in compliance at the beginning of the reporting period. However, the percentage of ownership may change during the reporting period, which may result in an auditor becoming non-compliant, even though there may be no threat to the auditor's objectivity or impartiality. A significant influence framework is likely to better identify a lack of independence and help avoid such anomalous outcomes.

There are also potential benefits associated with excluding record holders from the Loan Provision. Currently, the Loan Provision uses the magnitude of ownership by an auditor's lender as an indication of the likelihood of a threat to auditor independence regardless of the nature of ownership. From an economic standpoint, the nature of ownership also could determine whether the lender has incentives as well as the ability to use any leverage (due to the lending relationship) over the auditor that could affect the objectivity of the auditor. For example, a lender that is a record owner of the audit client's equity securities may be less likely to attempt to influence the auditor's report than a lender that is a beneficial owner of the audit client's equity securities because, unlike a record holder, a beneficial owner has an economic interest in the equity securities. By taking into account the nature as well as the magnitude of ownership, the final amendments will focus on additional qualitative information to assess the relationship between the lender and the investee (*e.g.,* a company or fund). Thus, we believe that, where there may be weak incentives by the lender to influence the audit, such as when the lender is only a holder of record, the final amendments will exclude relationships that are not likely to be a risk to auditor independence. The final amendments will thus provide benefits to the extent that they alleviate compliance and related burdens that auditors and audit clients would otherwise incur to analyze debtor-creditor relationships that are not likely to threaten an auditor's objectivity and impartiality. Affected registrants also will be less likely to disqualify auditors in situations that do not pose a risk to auditor independence, thereby reducing auditor search costs for these entities.

The potential expansion of the pool of eligible auditors also could result in better matching between the auditor and the client. For example, auditors tend to exhibit a degree of specialization in certain industries.[153] If fewer auditors are considered to be independent due to the Loan Provision, then companies may have to select an auditor without the relevant specialization to perform the audit. Such an outcome could impact the quality of the audit and, as a consequence, negatively impact the quality of financial reporting to the detriment of the

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153 *See e.g.,* N. Dopuch & D. Simunic, *Symposium, Competition in Auditing: An Assessment*, Fourth Symposium on Auditing Research, p 401-450 (1982); and R.W. Knechel, V. Naiker & G. Pachecho, *Does Audit Industry Specialization Matter? Evidence from Market Reaction to Auditor Switches*, 26 Audit. J. Prac. & Theory 19-45 (2007).

users of information contained in audited financial reports. Because they lack experience in the relevant industry, this outcome also may lead to less specialized auditors expending more time to perform the audit service, thereby increasing audit fees for registrants. We anticipate that the final amendments likely will positively impact audit quality for scenarios such as the one described above. Relatedly, if the final amendments expand the pool of eligible auditors, we expect increased competition among auditors, which could reduce the cost of audit services to affected companies and, if such cost savings are passed through to investors, could result in a lower cost to investors. However, as discussed in Section V.B above, the audit industry is highly concentrated, and as a consequence, such a benefit may not be significant.[154]

Another potential benefit of the final amendments is that the replacement of the bright-line test with the significant influence test could potentially identify risks to auditor independence that might not have been identified under the existing 10 percent bright-line test.[155] For example, a beneficial owner that holds slightly less than 10 percent of an audit client's equity securities is likely to have similar incentives and ability to influence the auditor's report than a beneficial owner that holds the same audit client's equity securities at slightly above the 10 percent threshold. The existing Loan Provision differentially classifies these two hypothetical situations, despite their similarity. To the extent that the final amendments are able to improve identification of potential risks to auditor independence through the use of qualitative criteria, investors are likely to benefit from the final amendments. In the example above, under the final

[154] The final amendments could result in some crowding-out effect, as the four largest audit firms may be deemed to be independent with more clients, potentially crowding out smaller audit firms. We discuss this effect in more detail in Section V.D below. However, we believe that better matching between auditors' specialization and their clients and reduced unnecessary auditor turnovers could potentially prevent audit quality decline and in the long run may improve audit quality.

[155] This benefit will be limited to the extent that an auditor whose lending relationships are not implicated by the Loan Provision's existing 10 percent bright-line ownership test would be otherwise identified as not meeting the general independence requirement in Rule 2-01(b) of Regulation S-X.

amendments, an audit firm will evaluate both beneficial owners to determine if they have significant influence, thus providing a consistent analysis under the Loan Provision for these economically similar fact patterns.

Another potential benefit of replacing the bright-line ownership test with a significant influence test is that fluctuations in the ownership percentage that do not change the economics of the relationship between the auditor and the audit client likely will not result in the auditor being deemed not to be independent. For instance, there may be instances in which non-compliance with the Loan Provision may occur during the reporting year, after an auditor is selected by the registrant or fund. Particularly for companies in the investment management industry, an auditor may be deemed to comply with the Loan Provision using the bright-line test when the auditor is hired by the fund but, due to external factors, such as redemption of investments by other owners of the fund during the period, the lender's ownership level may increase and exceed 10 percent. Such outcomes will be less likely under the final amendments, which take into account multiple qualitative factors in determining whether the Loan Provision is implicated during the period. We anticipate that the final amendments likely will avoid changes in auditors' independence status solely as a result of small changes in the magnitude of ownership of audit client securities and thereby mitigate any negative consequences that can arise from uncertainty about compliance and the associated costs to the funds or companies and their investors.

Adding a "known through reasonable inquiry" standard could potentially improve the practical application of the Loan Provision, particularly in the context of funds. As described above, some of the challenges to compliance with the existing Loan Provision involve the lack of access to information about the ownership percentage of a fund that was also an audit client. If an auditor does not know that one of its lenders is also an investor in an audit client, including because that lender invests in the audit client indirectly through one or more financial intermediaries, the auditor's objectivity and impartiality may be less likely to be impacted by its debtor-creditor relationship with the lender. The "known through reasonable inquiry" standard we are adopting is generally consistent with regulations implementing the Investment Company Act, the Securities Act and the Exchange Act,[156] and therefore is a concept that already should be familiar to those charged with compliance with the provision. This standard is expected to reduce the compliance costs for audit firms as they could significantly reduce their search costs for information and data to determine beneficial ownership. Given that this will not be a new standard in the Commission's regulatory regime, we do not expect a significant adjustment to apply the "known through reasonable inquiry" standard for auditors and their audit clients.

Amending the definition of "audit client" to exclude any fund not under audit that otherwise would be considered an "affiliate of the audit client" might potentially lead to a larger pool of eligible auditors, potentially reducing the costs of switching auditors and creating better matches between auditors and clients. In addition, the larger set of potentially eligible auditors could improve matching between auditor specialization and client needs and may lead to an increase in competition among auditors. Though the concentrated nature of the audit industry may not give rise to a significant increase in competition,[157] the improved matching between specialized auditors and their clients should have a positive effect on audit quality. In contrast to the proposal, the final amendments also exclude commodity pools from the definition of "audit

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156 *See supra* footnote 111.

157 *See infra* Section V.D.

client," extending these benefits to a broader set of auditor-client relationships.

The final amendments also could have a positive impact on the cost of audit firms' financing. The final amendments may result in an expanded set of choices among existing sources of financing. This could lead to more efficient financing activities for audit firms, thus potentially lowering the cost of capital for these firms. If financing costs for audit firms decrease as a result of the final amendments, then such savings may be passed on to the audit client in the form of lower audit fees. Investors also may benefit from reduced audit fees if the savings are passed on to investors. The Commission understands, however, that audit firms likely already receive market financing terms. Therefore, this effect may not be significant in practice.

Replacing the 10 percent bright-line test with the significant influence test also potentially allows more financing channels for the covered persons in accounting firms and their immediate family members.[158] For example, the covered persons may not be able to borrow money from certain lenders due to potential non-compliance with the existing Loan Provision. A larger set of financing channels may potentially lead to lower borrowing costs for covered persons. Lower borrowing costs may encourage covered persons to make additional investments.

2. Anticipated Costs and Potential Unintended Consequences

Using a significant influence test for the Loan Provision may increase the demands on the time of auditors and audit clients as they seek to familiarize themselves with the test and gather and assess the relevant information to apply the test. However, given that the significant influence test has been part of the Commission's auditor independence rules since 2000 and has

158 *See* Rule 2-01(f)(11) of Regulation S-X.

existed in U.S. GAAP since 1971, we do not expect a significant learning curve in applying the test. We also do not expect significant compliance costs for auditors to implement the significant influence test in the context of the Loan Provision given that they already are required to apply the concept in other parts of the auditor independence rules. We recognize that funds do not generally apply a significant influence test for financial reporting purposes. As such, despite the fact that they are required to apply the significant influence test to comply with the existing Commission independence rules, their overall familiarity in other contexts may be less and thus the demands on their time to apply the test may be relatively greater than for operating companies. However, the Commission is reiterating and providing expanded guidance about the application of the significant influence test in the fund context,[159] which may reduce the attendant costs for funds.

The replacement of the bright-line test with the significant influence test and the adoption of the "known through reasonable inquiry" standard will introduce more judgment in the determination of compliance with the Loan Provision. As discussed earlier, the significant influence test contains multiple qualitative elements to be considered in determining whether an investor has significant influence over the operating and financial policies of the investee. As a result, there may be additional transition costs to the extent an auditor and audit client need to adjust their compliance activities to now focus on these new elements. The judgment involved in the application of the significant influence test also could lead to potential risks regarding auditor independence. In particular, because the significant influence test relies on qualitative factors that necessarily involve judgment, there is a risk that the significant influence test could result in mistakenly classifying a non-independent auditor as independent under the Loan Provision.

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159 *See supra* section II.C.3.

However, auditor reputational concerns may impose some discipline on the application of the significant influence test in determining compliance with the Loan Provision, thus mitigating this risk.

D. Effects on Efficiency, Competition, and Capital Formation

The Commission believes that the final amendments are likely to improve the application of the Loan Provision, enhance efficiency of implementation, and reduce compliance burdens. The final amendments also may facilitate capital formation.

The final amendments may expand an audit client's choices by expanding the number of auditors that meet the auditor independence rules under the Loan Provision. As discussed earlier, the current bright-line test may be over-inclusive under certain circumstances. If more audit firms are eligible to undertake audit engagements without implicating the Loan Provision, then audit clients will have more options and, as a result, audit costs may decrease, although given the highly concentrated nature of the audit industry, this effect may not be significant. Moreover, the potential expansion of choice among eligible audit firms and the reduced risk of being required to switch auditors may lead to better matching between the audit client and the auditor. Improved matching between auditor specialties and audit clients could enable auditors to perform auditing services more efficiently, thus potentially reducing audit fees and increasing audit quality over the long term. Higher audit quality is linked to better financial reporting, which could result in a lower cost of capital. Reduced expenses and higher audit quality may decrease the overall cost of investing as well as the cost of capital with potential positive effects on capital formation. However, due to the concentrated nature of the audit industry, we acknowledge that any such effects may not be significant.

The replacement of the existing bright-line test with the significant influence test could more effectively capture those relationships that may pose a threat to an auditor's objectivity and impartiality. To the extent that the final amendments do so, the quality of financial reporting is likely to improve, and the amount of board attention to independence questions when impartiality is not at issue is likely to be reduced, thus allowing the board to focus on its other responsibilities. For example, an operating company's board might focus on hiring the best management, choosing the most value-enhancing investment projects, and monitoring management to maximize shareholder value, and this sharpened focus could potentially benefit shareholders. Furthermore, we expect that improved identification of threats to auditor independence would increase investor confidence about the quality and accuracy of the information reported. Reduced uncertainty about the quality and accuracy of financial reporting should attract capital, and thus facilitate capital formation.

Under the final amendments, audit firms would potentially be able to draw upon a larger set of lenders, which could lead to greater competition among lending institutions and thus lower borrowing costs for audit firms. Again, this could result in lower audit fees, lower fund fees, lower compliance expenses, and help facilitate capital formation, to the extent that lower borrowing costs for audit firms get passed on to their audit clients. However, as noted above, this effect may not be significant given that audit firms likely already receive market financing terms.

The final amendments also may lead to changes in the competitive structure of the audit industry. We expect more accounting firms to be eligible to provide auditing services and be in compliance with auditor independence under the final amendments. If larger audit firms are more likely to engage in significant financing transactions and are more likely not to be in compliance with the existing Loan Provision, then these firms are more likely to be positively affected by the final amendments. In particular, these firms may be able to compete for or retain a larger pool of audit clients. At the same time, the larger firms' potentially increased ability to compete for audit clients could potentially crowd out smaller audit firms. However, we estimate that four audit firms already perform 86 percent of audits in the investment management industry.[160] As a result, we do not expect any potential change in the competitive dynamics among auditors for registered investment companies to be significant.

E. Alternatives

The existing Loan Provision applies to loans to and from the auditor by "record or beneficial owners of more than 10 percent of the audit client's equity securities." As discussed earlier, record owners are relatively less likely to have incentives to take actions that would threaten auditor independence than are beneficial owners. An alternative approach to the final amendments would be to maintain the 10 percent bright-line test, but to distinguish between types of ownership under the 10 percent bright-line test and tailor the rule accordingly. For example, record owners could be excluded from the 10 percent bright-line test, to which beneficial owners would remain subject. The potential benefit of distinguishing between types of ownership while retaining the 10 percent bright-line test is that applying a bright-line test would involve less judgment than a significant influence test. One commenter supported such an approach.[161] Although excluding record holders could partially overcome the over-inclusiveness of the existing rule, we believe the significant influence test we are adopting will more effectively detect possible threats to auditor independence by focusing on the shareholder's

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[160] The market share of the four largest accounting firms in other industries is significantly high as well. According to the sample of 6,754 registrants covered by Audit Analytics in 2018, the four largest accounting firms' mean (median) market share across industries (based on two digit standard industry code) is 58% (56%). The upper quartile is as high as 62% with low quartile of the distribution being 49%.

[161] *See* CII.

ability to influence the financial and operating policies of an audit client. For example, merely owning more than 10 percent of an audit client's equity securities might not necessarily mean a lender to the auditor has the ability to influence the auditor's report (*i.e.,* the lender's ownership of the audit client's equity securities may not, in itself, threaten an audit firm's objectivity and impartiality). The adopted significant influence test also could identify risks to auditor independence in situations where a beneficial owner holds slightly under 10 percent of an audit client's equity and is likely to have incentives and ability to influence the auditor's report, but the lending relationship would not have been identified as independence-impairing under the existing 10 percent bright-line test.

A second alternative would be to use the materiality of a stock holding to the lender in conjunction with the significant influence test as a proxy for incentives that could threaten auditor independence. Specifically, the significance of the holding to the lender could be assessed based on the magnitude of the stock holding to the lender (*i.e.*, what percentage of the lender's assets are invested in the audit client's equity securities), after determining whether the lender has significant influence over the audit client. For example, two institutions that hold 15 percent of a fund may be committing materially different amounts of their capital to the specific investment. The incentives to influence the auditor's report are likely to be stronger for the lender that commits the relatively larger amount of capital to a specific investment. As such, the materiality of the investment to a lender with significant influence could be used as an indicator of incentives by the lender to attempt to influence the auditor's report and may better capture those incentives that could pose a threat to auditor independence. However, given the typical size of lending institutions, a materiality component might effectively exclude most, if not all, lending relationships, including those that pose a threat to an auditor's objectivity and impartiality. In addition, this alternative could impose additional costs on auditors and audit clients, as they would need to gather and analyze additional information to assess their compliance with the Loan Provision.

Another alternative would be to assess the materiality of the lending relationship between the auditor and the lending institution in conjunction with the significant influence test. A number of commenters supported such an approach.[162] The materiality of the lending relationship between the lender and the auditor, from both the lender's and the auditor's points of view, could act as an indicator of the leverage that the lender may have if it attempts to influence the auditor's report. However, given the typical size of most impacted audit firms and lending institutions, a materiality component might effectively exclude most, if not all, lending relationships, including those that pose a threat to an auditor's objectivity and impartiality. In addition, lending relationships could be affected by market conditions, which might affect the market neutrality of the auditor independence inquiry. For example, fluctuating market conditions could cause changes in the value of the assets securing a loan thereby causing different determinations at different times of the materiality of a lending relationship.

VI. Final Regulatory Flexibility Analysis

The Regulatory Flexibility Act ("RFA")[163] requires the Commission, in promulgating rules under section 553 of the Administrative Procedure Act,[164] to consider the impact of those rules on small entities. We have prepared this Final Regulatory Flexibility Analysis ("FRFA") in accordance with Section 604 of the RFA.[165] This FRFA relates to final amendments to Rule 2-01 of Regulation S-X. An Initial Regulatory Flexibility Analysis ("IRFA") was prepared in

[162] *See supra* footnote 136.

accordance with the RFA and was included in the Proposing Release. The Proposing Release included, and solicited comment on, the IRFA.

A. Need for the Amendments

As discussed above, the primary reason for, and objective of, the final amendments is to address certain significant compliance challenges for audit firms and their audit clients resulting from application of the Loan Provision that do not otherwise appear to affect the impartiality or objectivity of the auditor. Specifically, the final amendments will:

- focus the analysis on beneficial ownership;
- replace the existing 10 percent bright-line shareholder ownership test with a "significant influence" test;
- add a "known through reasonable inquiry" standard with respect to identifying beneficial owners of the audit client's equity securities; and
- exclude from the definition of "audit client," for a fund under audit, any other funds that otherwise would be considered affiliates of the audit client under the Loan Provision.

The need for, and objectives of, the final amendments are discussed in more detail in Sections I and II above.

B. Significant Issues Raised by Public Comment

In the Proposing Release, we requested comment on the IRFA, requesting in particular comment on the number of small entities that would be subject to the proposed amendments to

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[163] 5 U.S.C. 601 *et seq*.

[164] 5 U.S.C. 553.

[165] 5 U.S.C. 604.

Rule 2-01 of Regulation S-X, and the existence or nature of the potential impact of the proposed amendments on small entities discussed in the analysis. In addition, we requested comments regarding how to quantify the impact of the proposed amendments and alternatives that would accomplish our stated objectives while minimizing any significant adverse impact on small entities. We also requested that commenters describe the nature of any effects on small entities subject to the proposed amendments to Rule 2-01 of Regulation S-X and provide empirical data to support the nature and extent of such effects. Furthermore, we requested comment on the number of accounting firms with revenue under $20.5 million. We did not receive comments regarding the impact of our proposal on small entities.

C. Small Entities Subject to the Final Rules

The final amendments will affect small entities that file registration statements under the Securities Act, the Exchange Act, and the Investment Company Act and periodic reports, proxy and information statements, or other reports under the Exchange Act or the Investment Company Act, as well as smaller registered investment advisers and smaller accounting firms. The RFA defines "small entity" to mean "small business," "small organization," or "small governmental jurisdiction."[166] The Commission's rules define "small business" and "small organization" for purposes of the Regulatory Flexibility Act for each of the types of entities regulated by the Commission. Securities Act Rule 157[167] and Exchange Act Rule 0-10(a)[168] define an issuer, other than an investment company, to be a "small business" or "small organization" if it had total assets of $5 million or less on the last day of its most recent fiscal year. We estimate that, as of

[166] 5 U.S.C. 601(6).

[167] 17 CFR 230.157.

[168] 17 CFR 240.0-10(a).

December 31, 2018, there are approximately 1,173 issuers, other than registered investment companies, that may be subject to the final amendments.[169] The final amendments will affect small entities that have a class of securities that are registered under Section 12 of the Exchange Act or that are required to file reports under Section 15(d) of the Exchange Act. In addition, the final amendments will affect small entities that file, or have filed, a registration statement that has not yet become effective under the Securities Act and that has not been withdrawn.

An investment company is considered to be a "small business" for purposes of the RFA, if it, together with other investment companies in the same group of related investment companies, has net assets of $50 million or less at the end of the most recent fiscal year.[170] We estimate that, as of December 2018, there were 114 investment companies that would be considered small entities.[171] We estimate that, as of December 31, 2018, there were 59 open-end investment companies that will be subject to the final amendments that may be considered small entities. This number includes open-end ETFs.[172]

For purposes of the RFA, an investment adviser is a small entity if it:

(1) has assets under management having a total value of less than $25 million;

(2) did not have total assets of $5 million or more on the last day of the most recent fiscal year; and

169 This estimate is based on staff analysis of issuers, excluding co-registrants, with EDGAR filings on Forms 10-K, 20-F, and 40-F, or amendments filed during the calendar year of January 1, 2018 to December 31, 2018. The analysis is based on data from XBRL filings, Compustat, and Ives Group Audit Analytics.

170 17 CFR 270.0-10(a).

171 This estimate is based on staff review of data obtained from Morningstar Direct as well as data reported on Forms N-CEN, N-Q, 10-K, and 10-Q filed with the Commission as of June 2018.

172 This estimate is derived from an analysis of data obtained from Morningstar Direct as well as data reported on Form N-SAR filed with the Commission for the period ending June 30, 2017.

(3) does not control, is not controlled by, and is not under common control with another investment adviser that has assets under management of $25 million or more, or any person (other than a natural person) that had total assets of $5 million or more on the last day of its most recent fiscal year.[173] We estimate that there are approximately 552 investment advisers that will be subject to the final amendments that may be considered small entities.[174]

For purposes of the RFA, a broker-dealer is considered to be a "small business" if its total capital (net worth plus subordinated liabilities) is less than $500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared pursuant to Rule 17a-5(d) under the Exchange Act,[175] or, if not required to file such statements, a broker-dealer with total capital (net worth plus subordinated liabilities) of less than $500,000 on the last day of the preceding fiscal year (or in the time that it has been in business, if shorter); and that is not affiliated with any person (other than a natural person) that is not a small business or small organization.[176] As of December 2018, there were approximately 985 small entity broker-dealers that will be subject to the final amendments.[177]

Our rules do not define "small business" or "small organization" for purposes of accounting firms. The Small Business Administration (SBA) defines "small business," for

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173 17 CFR 275.0-7.

174 This estimate is based on Commission-registered investment adviser responses to Form ADV, Part 1A, Items 5.F and 12.

175 17 CFR 240.17a-5(d).

176 17 CFR 240.0-10(c).

177 This estimate is based on the most recent information available, as provided in Form X-17A-5 Financial and Operational Combined Uniform Single Reports filed pursuant to Section 17 of the Exchange Act and Rule 17a-5 thereunder.

purposes of accounting firms, as those with under $20.5 million in annual revenues.[178] We have limited data indicating revenues for accounting firms, and we cannot estimate the number of firms with less than $20.5 million in annual revenue. We also did not receive any data from commenters that would enable us to make such an estimate.

D. Projected Reporting, Recordkeeping and Other Compliance Requirements

The final amendments will not impose any reporting, recordkeeping, or disclosure requirements. The final amendments will impose new compliance requirements with respect to the Loan Provision.

Although we are replacing the 10 percent bright-line test with a "significant influence" test that requires the application of more judgment, we believe that the final amendments will not significantly increase costs for smaller entities, including smaller accounting firms. The concept of "significant influence" already exists in the auditor independence rules and in U.S. GAAP,[179] and accounting firms, issuers and their audit committees are already required to apply the concept in these contexts and may have developed practices, processes or controls for complying with these provisions.[180] We believe that these entities likely will be able to leverage any existing practices, processes, or controls to comply with the final amendments. We are also providing additional guidance in this release to clarify the application of the significant influence test in the fund context, which may further facilitate compliance.

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[178] 13 CFR 121.201 and North American Industry Classification System (NAICS) code 541211. The SBA calculates "annual receipts" as all revenue. *See* 13 CFR 121.104.

[179] *See* ASC 323 and *supra* footnote 44.

[180] Although the concept of "significant influence" is not as routinely applied today in the funds context for financial reporting purposes, nevertheless, the concept of significant influence is applicable to funds under existing auditor independence rules.

We also believe that the "known through reasonable inquiry" standard will not significantly increase costs for smaller entities, including smaller accounting firms. The "known through reasonable inquiry" standard is generally consistent with regulations implementing the Investment Company Act, the Securities Act, and the Exchange Act.[181] Smaller entities, including smaller accounting firms, should therefore already be familiar with the concept. To further facilitate compliance, we are also providing additional guidance in this release to clarify what the "known through reasonable inquiry" standard requires.

In addition, we believe that the final amendments to exclude record owners and certain fund affiliates for purposes of the Loan Provision will reduce costs for smaller entities, including smaller accounting firms.

Compliance with the final amendments will require the use of professional skills, including accounting and legal skills. The final amendments are discussed in detail in Section II above. We discuss the economic impact, including the estimated costs, of the final amendments in Section V above.

E. Agency Action to Minimize Effect on Small Entities

The RFA directs us to consider significant alternatives that would accomplish our stated objectives, while minimizing any significant adverse impacts on small entities. Accordingly, we considered the following alternatives:

- establishing different compliance or reporting requirements or timetables that take into account the resources available to small entities;
- clarifying, consolidating, or simplifying compliance and reporting requirements

[181] *See supra* footnote 111.

under the amendments for small entities;

- using performance rather than design standards; and
- exempting small entities from coverage of all or part of the amendments.

In connection with the amendments to Rule 2-01 of Regulation S-X, we do not think it feasible or appropriate to establish different compliance or reporting requirements or timetables for small entities. The amendments are designed to address compliance challenges for both large and small issuers and audit firms. With respect to clarification, consolidation or simplification of compliance and reporting requirements for small entities, the amendments do not contain any new reporting requirements. While the amendments create a new compliance requirement that focuses on "significant influence" over the audit client to better identify those lending relationships that could impair an auditor's objectivity and impartiality, that standard is more qualitative in nature and its application will vary according to the circumstances. This more flexible standard will be applicable to all issuers, regardless of size.

With respect to using performance rather than design standards, we note that our amendments establishing a "significant influence" test and adding a "known through reasonable inquiry" standard are more akin to performance standards. Rather than prescribe the specific steps necessary to apply such standards, the amendments recognize that "significant influence" and "known through reasonable inquiry" can be implemented in a variety of ways. We believe that the use of these standards will accommodate entities of various sizes while potentially avoiding overly burdensome methods that may be ill-suited or unnecessary given the entity's particular facts and circumstances.

The amendments are intended to address significant compliance challenges for audit firms and their clients, including those that are small entities. In this respect, exempting small entities from the amendments would increase, rather than decrease, their regulatory burden relative to larger entities.

VII. Codification Update

The "Codification of Financial Reporting Policies" announced in Financial Reporting Release No. 1[182] (April 15, 1982) is updated by adding at the end of Section 602, under the Financial Reporting Release Number (FR-85) assigned to this final release, the text in Sections I and II of this release.

The Codification is a separate publication of the Commission. It will not be published in the Code of Federal Regulations.

VIII. Statutory Basis

The amendments described in this release are being adopted under the authority set forth in Schedule A and Sections 7, 8, 10, and 19 of the Securities Act, Sections 3, 10A, 12, 13, 14, 17, and 23 of the Exchange Act, Sections 8, 30, 31, and 38 of the Investment Company Act, and Sections 203 and 211 of the Investment Advisers Act.

List of Subjects

17 CFR Parts 210

Accountants, Accounting, Banks, Banking, Employee benefit plans, Holding companies, Insurance companies, Investment companies, Oil and gas exploration, Reporting and recordkeeping requirements, Securities, Utilities.

In accordance with the foregoing, the Commission amends title 17, chapter II of the Code

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[182] 47 FR 21028 (May 17, 1982).

of Federal Regulations as follows:

PART 210 – FORM AND CONTENT OF AND REQUIREMENTS FOR FINANCIAL STATEMENTS, SECURITIES ACT OF 1933, SECURITIES EXCHANGE ACT OF 1934, INVESTMENT COMPANY ACT OF 1940, INVESTMENT ADVISERS ACT OF 1940, AND ENERGY POLICY AND CONSERVATION ACT OF 1975

1. The authority citation for part 210 continues to read as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 77z-2, 77z-3, 77aa(25), 77aa(26), 77nn(25), 77nn(26), 78c, 78j-1, 78*l,* 78m, 78n, 78*o*(d), 78q, 78u-5, 78w, 78*ll,* 78mm, 80a-8, 80a-20, 80a-29, 80a-30, 80a-31, 80a-37(a), 80b-3, 80b-11, 7202 and 7262, and sec. 102(c), Pub. L. 112-106, 126 Stat. 310 (2012), unless otherwise noted.

2. Amend § 210.2-01 by revising paragraph (c)(1)(ii)(A) to read as follows:

§ 210.2-01 Qualifications of accountants.

* * * * *

(c) * * *

(1) * * *

(ii) * * *

(A) *Loans/debtor-creditor relationship*.

(*1*) Any loan (including any margin loan) to or from an audit client, or an audit client's officers, directors, or beneficial owners (known through reasonable inquiry) of the audit client's equity securities where such beneficial owner has significant influence over the audit client, except for the following loans obtained from a financial institution under its normal lending procedures, terms, and requirements:

(*i*) Automobile loans and leases collateralized by the automobile;

(*ii*) Loans fully collateralized by the cash surrender value of an insurance policy;

(*iii*) Loans fully collateralized by cash deposits at the same financial institution; and

(*iv*) A mortgage loan collateralized by the borrower's primary residence provided the loan was not obtained while the covered person in the firm was a covered person.

(*2*) For purposes of paragraph (c)(1)(ii)(A) of this section:

(*i*) The term *audit client* for a fund under audit excludes any other fund that otherwise would be considered an *affiliate of the audit client*;

(*ii*) The term *fund* means: an investment company or an entity that would be an investment company but for the exclusions provided by Section 3(c) of the Investment Company Act of 1940 (15 U.S.C. 80a-3(c)); or a commodity pool as defined in Section 1a(10) of the U.S. Commodity Exchange Act, as amended [(7 U.S.C. 1-1a(10)], that is not included in paragraph (c)(2)(ii)(a) of this section.

By the Commission.

Dated: June 18, 2019

Vanessa Countryman

Acting Secretary

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 210

[Release No. 33-10876; 34-90210; FR-88; IA-5613; IC-34052; File No. S7-26-19]

RIN: 3235-AM63

Qualifications of Accountants

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission ("Commission" or "SEC") is adopting amendments to update certain auditor independence requirements. These amendments are intended to more effectively focus the independence analysis on those relationships or services that are more likely to pose threats to an auditor's objectivity and impartiality.

DATES: *Effective date:* [INSERT DATE 180 DAYS AFTER PUBLICATION IN THE FEDERAL REGISTER].

Compliance dates: See Section II.G for further information on transitioning to the final amendments.

FOR FURTHER INFORMATION CONTACT: Duc Dang, Senior Special Counsel, or Natasha Guinan, Chief Counsel, Office of the Chief Accountant, at (202) 551-5300; Alexis Cunningham, or Jenson Wayne, Assistant Chief Accountants, Chief Accountant's Office, Division of Investment Management, at (202) 551-6918, or Pamela K. Ellis, Senior Counsel, Brian McLaughlin Johnson, Assistant Director, Investment Company Regulation Office, or Sirimal R. Mukerjee, Branch Chief, Investment Adviser Regulation Office, Division of Investment Management, at (202) 551-6792, U.S. Securities and Exchange Commission, 100 F Street NE, Washington, DC 20549.

SUPPLEMENTARY INFORMATION: We are adopting amendments to 17 CFR 210.2-01 ("Rule 2-01") of 17 CFR 210.01 *et seq.* ("Regulation S-X").[1]

Table of Contents

[1] Hereinafter, all references to Rule 2-01 and any paragraphs included within the rule refer to Rule 2-01 of Regulation S-X.

I. INTRODUCTION

On December 30, 2019, the Commission proposed amendments to Rule 2-01 to update certain auditor independence requirements, including by focusing the requirements on those relationships and services that are more likely to threaten an auditor's objectivity and impartiality in light of current market conditions and industry practice.[2] Specifically, the Commission

[2] *Amendments to Rule 2-01, Qualifications of Accountants*, Release No. 33-10738, Dec. 30, 2019 [85 FR 2332 (Jan. 15, 2020)] (the "Proposing Release").

proposed amendments to the definitions of "affiliate of the audit client," "investment company complex," and "audit and professional engagement period" in Rule 2-01. The Commission also proposed amending requirements relating to certain loans or debtor-creditor relationships in 17 CFR 210.2-01(c)(1) ("Rule 2-01(c)(1)") and the reference to "substantial stockholders" in 17 CFR 210.2-01(c)(3) ("Rule 2-01(c)(3)" and the "Business Relationships Rule"). Finally, the Commission proposed amendments to address inadvertent violations of the independence requirements as a result of mergers and acquisitions and to make certain miscellaneous updates.

The Commission has long recognized that an audit by an objective, impartial, and skilled professional contributes to both investor protection and investor confidence.[3] If investors do not perceive that the auditor is independent from the audit client, investors will derive less confidence from the auditor's report and the audited financial statements. As such, the Commission's auditor independence rule, as set forth in Rule 2-01, requires auditors[4] to be independent of their audit clients both "in fact and in appearance."[5]

As the Commission noted in the Proposing Release, except for revisions made in connection with amendments required by the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley

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3 *See Revision of the Commission's Auditor Independence Requirements*, Release No. 33-7919 (Nov. 21, 2000) [65 FR 76008 (Dec. 5, 2000)] ("2000 Adopting Release").

4 We use the terms "accountants" and "auditors" interchangeably in this release.

5 *See* current Preliminary Note 1 to §210.2-01 and 17 CFR 210.2-01(b) ("Rule 2-01(b)"). *See also United States v. Arthur Young & Co.*, 465 U.S. 805, 819 n.15 (1984) ("It is therefore not enough that financial statements be accurate; the public must also perceive them as being accurate. Public faith in the reliability of a corporation's financial statements depends upon the public perception of the outside auditor as an independent professional.").

Act")[6] and the recent amendments related to certain debtor-creditor relationships,[7] many of the provisions from the 2000 Adopting Release have remained unchanged since adoption. The amendments we are adopting maintain the bedrock principle that auditors must be independent in fact and in appearance while improving the relevance of the Commission's auditor independence standards in light of existing market conditions by more effectively focusing the independence analysis on those relationships or services that are more likely[8] to threaten an auditor's objectivity and impartiality.

Many commenters broadly supported the objectives of the proposed amendments or were generally in favor of the proposals.[9] A few commenters did not support the proposals.[10] One of these commenters expressed the view that the proposals could negatively affect investor

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6 *See Strengthening the Commission's Requirements Regarding Auditor Independence*, Release No. 33-8183 (Jan. 28, 2003) [68 FR 6005 (Feb. 5, 2003)].

7 *See Auditor Independence With Respect to Certain Loans or Debtor-Creditor Relationships*, Release 33-10648 (June 18, 2019) [84 FR 32040 (July 5, 2019)] ("Loan Provision Adopting Release"*)*. In this release, references to the "Loan Provision" mean 17 CFR 210.2-01(c)(1)(ii)(A) ("Rule 2-01(c)(1)(ii)(A)").

8 As compared to the relationships and services that are deemed independence-impairing under existing Rule 2-01, but are unlikely to threaten an auditor's objectivity and impartiality and would no longer be deemed independence-impairing pursuant to the final amendments.

9 *See, e.g.,* letters from American Investment Council (Mar. 16, 2020) ("AIC"), Investment Company Institute and Independent Directors Council (Mar. 16, 2020) ("ICI/IDC"), EQT AB (Mar. 13, 2020) ("EQT"), Financial Executives International (Mar. 16, 2020) ("FEI"), Center For Capital Markets Competitiveness – U.S. Chamber of Commerce (Mar. 16, 2020) ("CCMC"), National Association of State Boards of Accountancy (Feb. 25, 2020) ("NASBA"), New York State Society of Certified Public Accountants (Mar. 13, 2020) ("NYSSCPA"), Center for Audit Quality (Mar. 16, 2020) ("CAQ"), American Institute of Certified Public Accountants (Mar. 16, 2020) ("AICPA"), Deloitte LLP (Mar. 4, 2020) ("Deloitte"), BDO USA, LLP (Mar. 10, 2020) ("BDO"), Ernst & Young LLP (Mar. 13, 2020) ("EY"), KPMG LLP (Mar. 13, 2020) ("KPMG"), RSM LLP (Mar. 16, 2020) ("RSM"), PricewaterhouseCoopers LLP (Mar. 16, 2020) ("PwC"), Grant Thornton LLP (Mar. 16, 2020) ("GT"), Crowe LLP (Mar. 16, 2020) ("Crowe"), and William G. Parrett (Mar. 16, 2020) ("Parrett"). The comment letters on the Proposing Release are available at https://www.sec.gov/comments/s7-26-19/s72619.htm.

10 *See, e.g.,* letters from Council of Institutional Investors (Mar. 16, 2020) ("CII"), Consumer Federation of America (May 4, 2020) ("CFA"), Center for American Progress, *et al* (May 26, 2020) ("CAP"), and Roy T. Van Brunt (July 23, 2020) ("Van Brunt").

protection and capital formation and suggested that, in lieu of the proposals, more should be done to strengthen auditor independence standards and the enforcement of such standards.[11]

While commenters were largely supportive of the proposals, we also received recommendations for modifying or clarifying certain aspects of the proposed amendments. After reviewing and considering the public comments and recommendations received, we are adopting the amendments largely as proposed. As we discuss further below, in certain cases we are adopting the proposed amendments with modifications that are intended to address comments received.

II. AMENDMENTS

A. Amendments to Definitions

1. Amendments to the Definitions of Affiliate of the Audit Client and the Investment Company Complex

The term "audit client"[12] is defined as "the entity whose financial statements or other information is being audited, reviewed or attested"[13] and "any affiliates of the audit client."[14] The current definition of affiliate of the audit client includes, in part, "[a]n entity that has control over the audit client, or over which the audit client has control, or which is under common control with the audit client, including the audit client's parents and subsidiaries" and

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11 *See* letter from CFA.

12 17 CFR 210.2-01(f)(6) ("Rule 2-01(f)(6)").

13 The term "entity under audit" as used herein and in the final amendments refers to this part of the Rule 2-01(f)(6) definition of audit client.

14 *See* Rule 2-01(f)(6). For purposes of 17 CFR 210.2-01(c)(1)(i) ("Rule 2-01(c)(1)(i)") (*Investments in Audit Clients*), entities covered by 17 CFR 210.2-01(f)(4)(ii) ("Rule 2-01(f)(4)(ii)") or 17 CFR 210.2-01(f)(4)(iii) ("Rule 2-01(f)(4)(iii)") are not considered affiliates of the audit client, as they are already addressed by 17 CFR 210.2-01(c)(1)(i)(E).

"[e]ach entity in the investment company complex when the audit client is an entity that is part of an investment company complex."[15]

Under current Rule 2-01, the requirement to identify and monitor for potential independence-impairing relationships and services applies to affiliated entities, including sister entities,[16] regardless of whether the sister entities are material to the controlling entity.[17] This same requirement to identify and monitor for potential independence-impairing relationships and services applies to entities, including sister entities that are part of an investment company complex ("ICC").[18]

The Proposing Release noted the challenges in practical application that are associated with the current definitions of affiliate of the audit client and ICC.[19] In particular, the Proposing Release noted how these definitions can result in relationships with and services to certain sister entities that are less likely to threaten an auditor's objectivity and impartiality being deemed independence-impairing under our rules.[20] To address those challenges, the Commission proposed amendments to the definitions of both affiliate of the audit client and ICC. After considering the public comments and recommendations received, we are adopting amendments to both definitions with modifications, as discussed in further detail below.

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15 17 CFR 210.2-01(f)(4)(i) ("Rule 2-01(f)(4)(i)") and 17 CFR 210.2-01(f)(4)(iv) ("Rule 2-01(f)(4)(iv)").

16 *See* 17 CFR 210.2-01(f)(4) ("Rule 2-01(f)(4)") and Rule 2-01(f)(6). We use the term "sister entities" to refer to entities that are under common control with the entity under audit.

17 *See* Rule 2-01(f)(4).

18 *Id.* and 17 CFR 210.2-01(f)(14) ("Rule 2-01(f)(14)").

19 *See* Section II.A.1 of the Proposing Release.

20 *Id.*

a. Amendments with Respect to Common Control and Affiliate of the Audit Client

i. Proposed Amendments

The Commission proposed amending the definition of an affiliate of the audit client set forth in Rule 2-01(f)(4)(i) to include a materiality qualifier with respect to operating companies, including portfolio companies, under common control[21] and to clarify the application of this definition to operating companies and direct auditors of an investment company or investment adviser or sponsor to the ICC definition.[22] In the Proposing Release, the Commission discussed challenges related to applying the current affiliate of the audit client and ICC definitions, including challenges related to the limited pool of available qualified auditors, ongoing monitoring for independence, and related costs.[23]

Under the proposal, a sister entity would be deemed an affiliate of the audit client "unless the entity is not material to the controlling entity." The Proposing Release set forth the Commission's view that it is appropriate to exclude sister entities that are not material to the controlling entity from being considered affiliates of the audit client because an auditor's relationships and services with such sister entities do not typically pose a threat to the auditor's

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21 *See* Proposed Rule 2-01(f)(4)(i)(B).

22 *See* Proposed Rule 2-01(f)(4)(ii). Specifically, the "and" between the second significant influence provision would be replaced by an "or." Consistent with footnote 18 of the Proposing Release, the term "operating company" in this release refers to entities that are not investment companies, investment advisers, or sponsors, and the term "portfolio company" refers to an operating company that has investment companies or unregistered funds in private equity structures among its investors. In Section II.A.1.a of the Proposing Release, the Commission expressed its belief that it would be appropriate to identify the affiliates of the audit client for a portfolio company under audit using the proposed affiliate of the audit client definition, rather than the proposed ICC definition, because portfolio companies are a type of operating company that are often unrelated to each other, even though they are controlled by the same entity in the private equity structure or ICC.

23 *See* Section II.A.1.a of the Proposing Release.

objectivity and impartiality and their exclusion would allow auditors and audit clients to focus on those relationships that are more likely to threaten the auditor's objectivity and impartiality.

The Proposing Release noted that materiality is applied in the existing affiliate of the audit client definition in Rules 2-01(f)(4)(ii) and (iii)[24] and that the proposed materiality qualifier would be consistent, in part, with the definition of "affiliate" used by the American Institute of Certified Public Accountants ("AICPA") in its ethics and independence rules.[25] The AICPA ethics and independence rules typically apply when domestic companies are not also subject to the Commission and PCAOB independence requirements. Auditors therefore have experience in applying a materiality standard when identifying affiliates, whether applying the independence rules of the Commission or the AICPA.

ii. Comments Received

Commenters generally supported the proposed changes to the definition of the affiliate of the audit client.[26] Consistent with the discussion in the Proposing Release, commenters

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24 Rule 2-01(f)(4)(ii) includes as an affiliate of the audit client "an entity over which the audit client has significant influence, unless the entity is not material to the audit client." Rule 2-01(f)(4)(iii) includes as an affiliate of the audit client "an entity that has significant influence over the audit client, unless the audit client is not material to the entity."

25 *See* AICPA Professional Code of Conduct, *available at* https://pub.aicpa.org/codeofconduct/ethicsresources/et-cod.pdf. The Proposing Release acknowledged that the proposed amendment may not result in the same number of sister entities being deemed material to the controlling entity under Commission rules and the AICPA rules. For example, in defining control, the AICPA uses the accounting standards adopted by the Financial Accounting Standards Board ("FASB"), whereas the Commission defines control in Rule 1-02(g) of Regulation S-X. Also, the AICPA affiliate definition pertaining to common control deems a sister entity as an affiliate if the entity under audit and the sister entity are each material to the entity that controls both. The proposed amendment only focused on the materiality of the sister entity to the controlling entity.

26 *See e.g.,* letters from Illinois CPA Society (Feb. 21, 2020) ("Illinois CPA"), SEC Professional Group (Feb. 25, 2020) ("SEC Pro Group"), International Bancshares Corporation ("Mar. 13, 2020") ("IBC"), NASBA, CAQ, AICPA, Deloitte, BDO, EY, KPMG, RSM, PwC, GT, Crowe, Parrett, AIC, ICI/IDC, EQT, FEI, and CCMC.

discussed the challenges presented by the current definitions (*e.g.,* cost, difficulty of application, and impact on the available pool of qualified auditors) and agreed that introducing a materiality qualifier into the analysis would better focus the analysis on threats to an auditor's objectivity and impartiality and address some of those challenges.[27]

A few commenters opposed the proposed materiality qualifier to the affiliate of the audit client definition.[28] These commenters asserted that introducing a materiality qualifier would increase the risk that auditors would be performing audits when they are not objective and impartial, noting that there is evidence that auditors' materiality judgments vary widely.[29] One of these commenters suggested that the Commission "examine the evidence before changing its current approach."[30]

In addition to these comments on the proposed amendments, we also received feedback on additional changes to the definition of affiliate of the audit client and other related changes, as discussed in more detail below.

Comments Recommending a Dual Materiality Threshold

Many commenters recommended that we further amend the common control provision in the affiliate of the audit client definition to add a materiality qualifier with respect to the entity

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27 *See e.g.,* letters from Deloitte, GT, EQT, and CAQ.

28 *See e.g.,* letters from CFA and CII. Both commenters expressed their disagreement regarding the proposed materiality qualifier within a discussion that covers both the affiliate of the audit client and the ICC definitions.

29 *See* letters from CFA and CII (citing Katherine Schipper et al., *Auditors' Quantitative Materiality Judgments: Properties and Implications for Financial Reporting Reliability*, 52 J. Acct. Res. 1303 (Dec. 2019), *available at* https://onlinelibrary.wiley.com/doi/full/10.1111/1475-679X.12286). *See infra* note 262 and accompanying text.

30 *See* letter from CFA.

under audit to accompany the proposed materiality qualifier with respect to the sister entity (a "dual materiality threshold").[31] This dual materiality threshold would result in a sister entity being deemed an affiliate of the audit client only if the entity under audit and the sister entity are each material to the controlling entity.[32]

These commenters stated that, when the entity under audit is not material to the controlling entity, services provided to or relationships with sister entities typically do not create threats to an auditor's objectivity and impartiality.[33] For example, one commenter stated that, in its experience, the entity under audit and the sister entities typically have their own governance structures, which indicates that there is no mutuality of interest between the auditor and the audit client.[34] Another commenter stated that the proposed single materiality threshold would, in fact, "increase" the burden on private equity firms by requiring more time and resources to monitor the "continuously evolving universe of entities that the private firm would need to address…"[35] This commenter contended that in the event the entity under audit is not material to the controlling entity, a dual materiality threshold would alleviate the burdens associated with a materiality analysis that would otherwise have to be conducted on each sister entity.

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31 *See e.g.,* letters from CAQ, AICPA, Deloitte, BDO, EY, KPMG, RSM, PwC, GT, Crowe, Parrett, AIC, CCMC, New York State Society of Certified Public Accountants (Mar. 13, 2020) ("NYSSCPA"), and Connecticut Society of Certified Public Accountants (Apr. 15, 2020) ("CTCPA"). These commenters noted that analogous provisions exist in the AICPA and the International Ethics Standards Board for Accountants ("IESBA") ethics and independence requirements.

32 *Id*.

33 *See e.g.,* letters from BDO, Deloitte, EY, KPMG, PwC, Crowe, CTCPA, CCMC, and GT.

34 *See* letter from Deloitte.

35 *See* letter from AIC.

Commenters also suggested that because a dual materiality threshold is used by the AICPA and IESBA ethics and independence requirements, adopting a similar threshold would ease compliance burdens associated with the application of the affiliate definition and on-going monitoring for audit firms and clients.[36] A few commenters noted that any risks associated with a potential dual materiality threshold would be mitigated by the continued protections afforded by Rule 2-01(b).[37]

One commenter that opposed the proposed amendment noted that it also opposed the "double trigger threshold" of the AICPA.[38]

Other Comments on Materiality and Monitoring

In response to a request for comment as to whether the proposed amendments should include a materiality assessment between the entity under audit and sister entities, commenters generally did not support adding such a provision.[39] For example, one commenter stated that concepts of financial materiality do not lend themselves to an evaluation of relationships between sister entities, and noted that if one entity had a material investment in the other, the other provisions of the affiliate of the audit client definition would address such a relationship.[40]

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36 *See e.g.,* letters from CAQ, Deloitte, BDO, RSM, PwC, CCMC, GT, and CTCPA.

37 *See e.g.,* letters from BDO, AICPA, AIC, and EY.

38 *See* letter from CII. This commenter cited footnote 20 of the Proposing Release and indicated its agreement that requiring materiality between the entity under audit and the controlling entity may exclude, from the proposed definition, sister entities whose relationships with or services from an auditor would impair the auditor's objectivity and impartiality.

39 *See e.g.,* letters from Deloitte, KPMG, RSM, and PwC.

40 *See* letter from KPMG.

Some commenters suggested that a materiality qualifier also should be applied when considering whether an entity that has control over the entity under audit (*i.e.*, a controlling entity) is an affiliate under Rule 2-01(f)(4).[41] However, another commenter disagreed, stating that it believes parents and subsidiaries should continue to be affiliates regardless of materiality.[42]

In response to a request for comment as to whether auditors and audit clients would face challenges in applying the materiality concept in connection with the proposed amendment and whether additional guidance was needed, some commenters noted that the concept of materiality already exists within Rule 2-01, and as such, indicated that current materiality guidance is sufficient.[43] By contrast, other commenters suggested that there may be challenges in applying the materiality concept in connection with the proposed amendments,[44] and a few commenters requested additional guidance or examples.[45] One commenter suggested that to ease the burden of monitoring for compliance in connection with unforeseen changes in circumstances, the Commission should consider establishing a framework to allow auditors to address "inadvertent independence violations that might arise when a materiality threshold is crossed."[46]

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41 *See e.g.,* letters from CAQ, AICPA, Deloitte, BDO, Crowe, CTCPA, and AIC. *See also supra* 25. The relevant AICPA definition, 0.400.02, includes as an affiliate "[a]n entity (for example, parent, partnership, or LLC) that *controls a financial statement attest client* when the *financial statement attest client* is material to such entity" (emphasis in original).

42 *See* letter from RSM.

43 *See e.g.,* letters from Deloitte, EY, and Crowe.

44 *See e.g.,* letters from NYSSCPA and PwC. For example, one commenter suggested the Commission define "controlling entity." *See* letter from PwC.

45 *See e.g.,* letters from NYSSCPA, CTCPA, and AIC.

46 *See* letter from PwC.

Some commenters suggested that the Commission reiterate the shared responsibility of audit firms and their audit clients to monitor independence, including monitoring affiliates and obtaining information necessary to assess materiality.[47] One commenter recommended the Commission clarify that, once the initial materiality assessment has been made, the auditor and audit client could satisfy their obligations under the proposed amendments by reevaluating materiality in response to significant transactions, Commission filings, or other information that become known to the auditor or the audit client through reasonable inquiry.[48] Another commenter requested the Commission discuss expectations regarding best efforts to obtain information and monitoring if, for example, certain information can only be obtained annually.[49]

Comments on "Entity under Audit"

In the Proposing Release, the Commission used the term "entity under audit" to describe the application of the proposed amendments. The Commission explained that it was using this term to refer to the entity "whose financial statements or other information is being audited, reviewed or attested."[50] The quoted language is the first clause of the definition of the term "audit client" in Rule 2-01(f)(6). Because the definition of audit client also includes any affiliates of the audit client, the Commission used the term "entity under audit" to describe those entities whose financial statements were subject to audit, review, or attestation, in an attempt to avoid the potential confusion that may arise from using the term "audit client."

47 *See e.g.,* letters from CAQ, PwC, and EY.

48 *See* letter from Deloitte.

49 *See* letter from GT.

50 *See* footnote 11 of the Proposing Release and accompanying text.

In response to this discussion, some commenters suggested that Rule 2-01 incorporate more precise usage of the terms "audit client" and "entity under audit," which may require defining the term "entity under audit."[51] Several of those commenters recommended that the term "entity under audit" be included in the definition of affiliate of the audit client,[52] because the term "audit client," which is defined to include affiliates in the definition of affiliate of the audit client, may cause confusion. One of these commenters characterized the reference to audit client in the existing affiliate of the audit client definition as a "circular reference."[53]

Comments on "Controlling Entity" and "Control"

While we did not propose any amendments to the term "control" as defined in 17 CFR 210.1-02(g) ("Rule 1-02(g)") of Regulation S-X, a few commenters suggested that, for private equity firms, the term "controlling entity" should be defined as the overall private equity firm or the ultimate parent.[54] One of these commenters requested further explanation or guidance, such as through illustrative examples, to address whether the relationship between an investment adviser and a fund it advises should be treated as a control relationship and suggested that the term "control" should be linked to the accounting literature.[55] While these comments pertained to entities within an ICC, the comments are relevant when the entity under audit is not an

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51 *See e.g.,* letters from AICPA, Deloitte, EY, Crowe, PwC, and GT.

52 *See e.g.,* letters from AICPA, Deloitte, EY, and Crowe.

53 *See* letter from Crowe.

54 *See e.g.,* letters from PwC and AIC.

55 *See* letter from PwC.

investment company or investment adviser or sponsor, but the entity under audit controls or is controlled by an investment company or investment adviser or sponsor.[56]

iii. Final Amendments

After considering the public comments and recommendations received, we are adopting amended 17 CFR 210.2-01(f)(4) ("amended Rule 2-01(f)(4)") with certain modifications from the proposal, as described below. We considered the comments received opposing the addition of materiality to the common control provision, but continue to believe that materiality is an appropriate principle to effectively focus on relationships with and services provided to sister entities that are more likely to threaten an auditor's objectivity and impartiality.

Dual Materiality Threshold

In response to comments, we are modifying the proposed amendments to Rule 2-01(f)(4)(ii) to incorporate a dual materiality threshold such that a sister entity will be included as an affiliate of the audit client if the sister entity and the entity under audit are each material to the controlling entity. Under the final amendments, if either the sister entity or the entity under audit is not material to the controlling entity, then the sister entity will not be deemed an affiliate of the audit client pursuant to amended 17 CFR 210.2-01(f)(4)(ii) ("amended Rule 2-01(f)(4)(ii)").[57] In the Proposing Release, the Commission suggested that requiring that the entity under audit be material to the controlling entity as part of the proposed definition may exclude sister entities whose relationships with or services from an auditor would impair the auditor's objectivity and impartiality.[58] However, after consideration of the comments received and further evaluation,

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56 *See infra* Examples 3 and 4 in Section II.A.1.a.iii.

57 We also are making a technical amendment to renumber the paragraphs within amended Rule 2-01(f)(4).

58 *See* footnote 20 of the Proposing Release.

we are persuaded that where the entity under audit is not material to the controlling entity, an auditor's relationships with or services provided to sister entities would generally not threaten the auditor's objectivity and impartiality. In this regard, we agree that when the entity under audit is not material to the controlling entity, it is less likely that a mutuality of interest would develop as a result of relationships with or services provided to sister entities. For example, as one commenter observed, sister entities with separate governance structures, such as sister portfolio companies within an ICC, typically lack decision-making capacity over other sister entities, including an entity under audit.

We also recognize the benefit to auditors, audit clients, and investors of reducing compliance-related challenges. The adopted dual materiality threshold may help address some commenters' concerns about the inability to obtain all relevant information needed to make a materiality determination with respect to sister entities under the proposed single materiality threshold. Under the adopted dual materiality threshold, the need to assess the materiality relationship between the entity under audit and each of the controlling entities should reduce information access concerns because, in the event the entity under audit is not material to the controlling entity, the materiality assessment would be made for fewer sister entities as compared to the proposed single materiality threshold. However, as discussed in Section II.A.1.b.ii below, the auditor's non-audit services to and relationships with sister entities that are no longer deemed affiliates as a result of applying the dual materiality threshold will continue to be subject to the principles set forth in Rule 2-01(b), and as such, knowledge of services to and relationships with such non-affiliate sister entities will be needed to sufficiently consider the general standard.

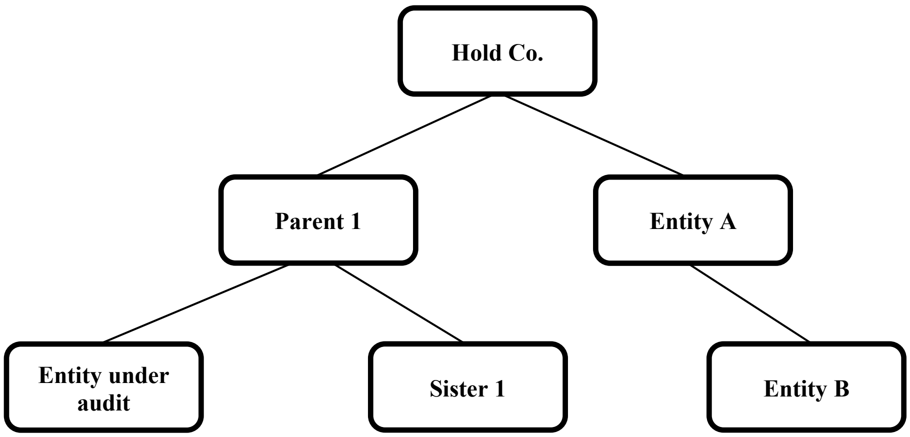
Some commenters also suggested that we incorporate a materiality qualifier in the evaluation of whether controlling entities would be considered affiliates, similar to analogous provisions in the AICPA and IESBA ethics and independence requirements. While commenters cited the benefits of having a common regime for the consideration of controlling entities, we were not persuaded that the benefits from such conformity would justify the potential risk to an auditor's objectivity and impartiality in these circumstances. In particular, commenters did not specifically highlight ongoing monitoring or other compliance challenges associated with the identification of affiliates that control an entity under audit. It does not appear that the challenges related to the changing population of potential affiliates and the ability to obtain appropriate information that occur in the common control context also exist when evaluating entities that have control over the entity under audit. In addition, the relationship between sister entities and an entity under audit is generally different than the relationship between a controlling entity and the entity under audit. The controlling entity typically has some decision-making ability or an ability to influence the entity under audit. As such, we believe an auditor's independence likely would be impaired if the auditor provides non-audit services to or engages in relationships with the controlling entity that are described in Rule 2-01(c), even in situations in which the entity under audit is not material to the controlling entity. Accordingly, we are not adopting commenters' recommendations to incorporate a materiality qualifier in the evaluation of whether controlling entities should be considered affiliates.

Entity under Audit

We are making modifications to incorporate the term "entity under audit" within amended 17 CFR 210.2-01(f)(4)(i) ("amended Rule 2-01(f)(4)(i)") and amended 17 CFR 210.2-01(f)(4)(ii) ("amended Rule 2-01(f)(4)(ii)"). Given the comments received on this point and in light of other changes we are making to the final amendments, we believe it is appropriate to replace the term "audit client" with "entity under audit" in amended Rules 2-01(f)(4)(i) and (ii).

Specifically, as illustrated in the example below, we are concerned that if we do not revise this terminology, it could be applied in a manner that would negate the adopted dual materiality threshold.

Figure 1



In Figure 1, assume the controlling entities (*i.e.,* Parent 1 and Hold Co.) have control over all entities downstream from them. If amended Rules 2-01(f)(4)(i) and (ii) referred to an "audit client" instead of an "entity under audit," Sister 1 may be deemed an affiliate of the audit client regardless of the materiality of Sister 1 or the Entity Under Audit to Parent 1 based on the following application:

- Parent 1 controls the entity under audit, which makes Parent 1 an affiliate of the audit client. Parent 1 also is an "audit client" because the definition of such term includes affiliates. A practitioner might then apply the control provision in amended Rule 2-01(f)(4)(i) to Parent 1 and deem Sister 1 an affiliate of the audit client, regardless of the dual materiality threshold. The practitioner would consider Sister 1 an affiliate because it is controlled by "audit client" Parent 1 without applying the materiality analysis in the common control provision of amended Rule 2-01(f)(4)(ii).

Similarly, Entities A and B may be deemed affiliates of the audit client regardless of the materiality of Entity A, Entity B, or the entity under audit to Hold Co. based on the following application:

- Under the existing and amended rules, Hold Co. is an affiliate of the audit client (*i.e.*, Hold Co. has control over the entity under audit) and, as such, also is an audit client. A practitioner might then apply the control provision in amended Rule 2-01(f)(4)(i) to Hold Co. and deem both Entities A and B as affiliates of the audit client, regardless of the dual materiality threshold in amended Rule 2-01(f)(4)(ii). Again, the practitioner may deem Entities A and B to be affiliates because "audit client" Hold Co. controls both Entities A and B.[59]

Absent clarification, the above-illustrated application (*i.e.,* circular reading) of the final amendments could negate the Commission's objective to focus the common control provision on those relationships and services that are more likely to threaten the objectivity and impartiality of an auditor by introducing a dual materiality threshold. While the proposal did not use the term "entity under audit" in the rule text, we believe this modification is consistent with the proposal to separate out common control from existing Rule 2-01(f)(4)(i) and include a materiality provision within the definition. Now that the amended common control provision includes a dual materiality threshold, we believe the modification to use the term "entity under audit" in place of the term "audit client" in amended Rules 2-01(f)(4)(i) and (ii) is important to avoid any

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59 Relatedly, when assessing whether Entities A and B are affiliates under amended Rule 2-01(f)(4)(ii), it may otherwise be unclear to a practitioner assessing materiality of the "audit client" whether such assessment applies to the entity under audit or an affiliate (such as Parent 1).

misunderstandings about how the common control provision should be applied in the final amendments.

While some commenters requested that we further amend our rules to incorporate more precise usage of the term "entity under audit"[60] in other paragraphs that currently refer to the "audit client," those requests are beyond the scope of this rulemaking. We did not propose or seek comment on those particular amendments. Moreover, those additional amendments are not necessary to effectuate any aspect of the proposal. As such, we are not incorporating the term "entity under audit" into other paragraphs of the rule that currently refer to "audit client," including the significant influence provisions of amended 17 CFR 210.2-01(f)(4)(iii) ("amended Rule 2-01(f)(4)(iii)") and 17 CFR 210.2-01(f)(4)(iv) ("amended Rule 2-01(f)(4)(iv)"). However, the incorporation of "entity under audit" in amended Rules 2-01(f)(4)(i) and (ii), while leaving the term "audit client" within the significant influence provisions in amended Rules 2-01(f)(4)(iii) and (iv), does not imply a change from the historical practical application of these provisions, which has focused and should continue to focus on the entity under audit.

Assessing Materiality and Monitoring

Several commenters requested clarification and examples of the application of the proposed amendments, including the proposed materiality qualifier. In response, we are providing several examples to illustrate the application of the final amendments to particular fact patterns.

Auditors and their audit clients have a shared responsibility to monitor independence in order to satisfy, as applicable, the requirements of the federal securities laws, including Rule 2-

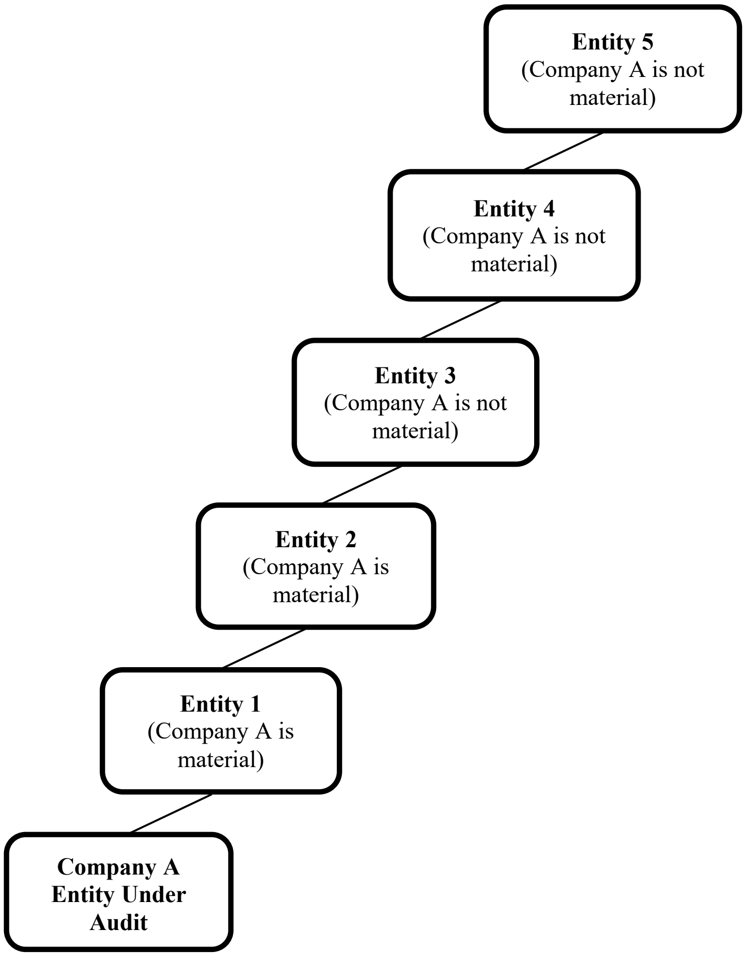
60 *See supra* note 51.

01 and 17 CFR 210.2-02.[61] This shared responsibility between auditors and audit clients applies to all aspects of Rule 2-01, including the final amendments. This responsibility includes the monitoring of affiliates and obtaining information necessary to assess materiality. We believe this process works most effectively when management, audit committees, and audit firms work together to evaluate the auditor's compliance with the independence rules. For example, auditors and their audit clients may need to work together to identify and monitor potential affiliates based on the affiliate of the audit client definition in the independence rules. In this regard, it will be important for management to notify the auditor in a timely manner of changes in circumstances that may affect the population of potential affiliates, such as by notifying an auditor of acquisitions before the acquisitions are effective. Additionally, management should consider communicating to auditors as early as possible the intent of private companies to file a registration statement in order for the SEC and PCAOB independence rules to be considered in advance. Issuers and their audit committees may want to consider having their own policies and procedures to identify, consider, and monitor the provision of services by and relationships with the issuer's independent accountant, which may help supplement the audit firm's system of quality control.

The following are intended as illustrative examples only, and practitioners and audit clients should be aware that an assessment of materiality requires consideration of all relevant facts and circumstances, including quantitative and qualitative factors.

61 For an overview of the obligations of auditors and audit clients with respect to auditor independence under the federal securities laws, please *see* footnote 101 of the Loan Provision Adopting Release.

Example 1 – Assessing Materiality of Sister Entities



In this example, Company A, the entity under audit, has five controlling entities, Entities 1 through 5, with Entity 5 as the ultimate parent. Since each of Entities 1 through 5 controls Company A, directly or indirectly, each of the entities is an affiliate of Company A regardless of materiality. For purposes of this example, assume that Company A is material to Entity 1 and Entity 2 and that Company A is not material to Entity 3, Entity 4, or Entity 5. Each of Entities 1 through 5 controls other entities (*i.e.*, sister entities) other than those listed in this example. In this example, the auditor must evaluate the materiality of the sister entities controlled by each of Entity 1 and Entity 2 to determine which sister entities are affiliates of the audit client. For a sister entity controlled by Entity 1, the auditor must assess the materiality of such sister entity to

Entity 1. For a sister entity controlled by Entity 2, the auditor must assess the materiality of that sister entity to Entity 2.

Example 2 – Controlling and Sister Entities and Monitoring Expectations

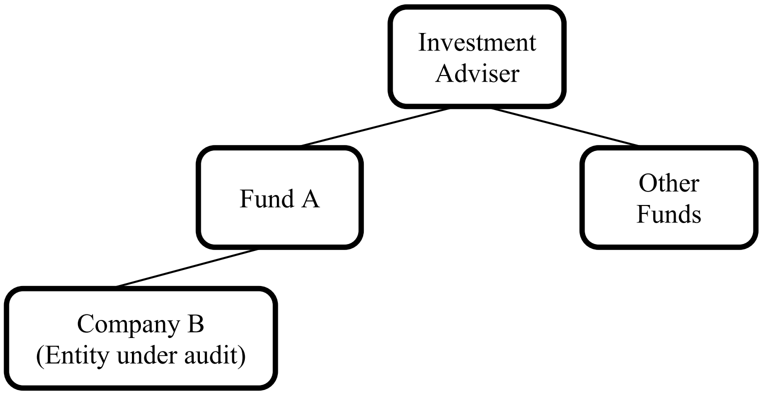
Assume the same facts as in Example 1. Company A and the controlling entities should provide the auditor with sufficient information to enable the auditor to appropriately monitor controlling entities and identify sister entities, even at the levels of Entities 3 through 5. We acknowledge the concerns raised by commenters that identifying sister entities that are not considered affiliates under the final amendments and re-assessing the materiality of the entity under audit and its sister entities may increase existing compliance burdens. However, identifying sister entities will be important for complying with the amended rules because there can be qualitative and quantitative changes that affect the materiality of such relationships, and audit firms will need to timely address when a sister entity becomes an affiliate. Such information also will be necessary for an audit firm to appropriately consider and apply Rule 2-01(b) on an ongoing basis.

After the initial materiality assessment is performed to identify potential affiliates, the auditor, with the assistance of and information provided by the audit client, should perform updated assessments based on, among other things, transactions, Commission filings, or other information that becomes known to the auditor and the audit client through reasonable inquiry. As a result, obtaining accurate organizational and financial information will be important to the auditor's and the audit client's ability to anticipate and plan for potential changes in materiality status that may lead to the identification of new affiliates at any point during the audit and professional engagement period. We understand that this likely will require additional compliance efforts and believe such efforts and the resultant costs are appropriate to ensure that an auditor is independent from its audit client for purposes of investor protection and investor confidence. To the extent the final amendments mitigate the compliance challenges associated with independence violations or prohibitions, or allow an auditor to expand its audit or non-audit services or relationships, we expect that the auditor will weigh any related benefits against any additional monitoring and compliance costs. Also, auditors may already be familiar with the monitoring efforts related to a dual materiality threshold, as the AICPA and IESBA have analogous provisions. Where an auditor is unable to obtain the information needed to make reasonable determinations of affiliate status for sister entities, the auditor should treat such sister entities as affiliates of the audit client for the purpose of the Commission's independence requirements to avoid potentially impairing the auditor's objectivity and impartiality.

The final amendments do not include a transition framework, as requested by a commenter, to address changes in the materiality of the entity under audit or a sister entity to a controlling entity. As noted, above, we expect auditors and their clients to be able to anticipate and plan for changes in materiality and believe this approach fosters an auditor's objectivity and impartiality. To the extent that changes in materiality of the entity under audit or sister entities result in an independence violation, we encourage registrants and accountants to consult with the Commission's Office of the Chief Accountant.[62]

[62] *See* Section II.E.3 and amended introductory paragraph to Rule 2-01.

Example 3 – Identifying Affiliates of an Entity under Audit that is a Portfolio Company



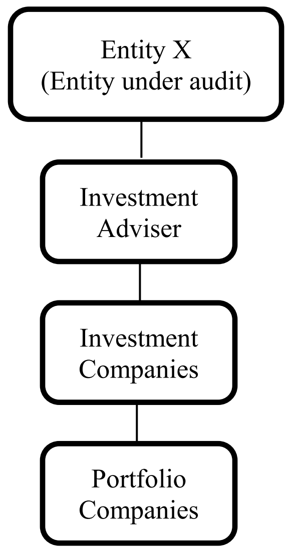
Company B is the entity under audit and a portfolio company controlled by Fund A. Fund A is an investment company within an ICC. Company B's auditor will identify affiliates of the audit client by applying amended Rules 2-01(f)(4)(i) through (iv). While there are entities described in the ICC definition that are part of Company B's organizational structure, including Fund A and its investment adviser or sponsor, Company B's auditor, assuming it does not audit any entity described in the ICC definition, such as Fund A or the Investment Adviser, will not apply the ICC definition. Company B's auditor must apply amended Rules 2-01(f)(4)(i) through (iv) to identify affiliates, which may result in certain investment companies and investment advisers or sponsors being deemed an affiliate of the audit client.

As noted above, we received a few comments related to the term "controlling entity" and the term "control,"[63] which is defined in Rule 1-02(g). We are not amending Rule 1-02(g) to link the definition of "control" to the accounting literature as one commenter suggested. We believe the suggestion to define "controlling entity" solely as the overall private equity firm when assessing materiality of entities, including a portfolio company, in a private equity

63 *See supra* note 54.

structure[64] could raise issues beyond the scope of the proposal that warrant further consideration. We are therefore not adopting this approach. Under Rule 1-02(g), whether the entity under audit is a subsidiary of an operating or holding company or a portfolio company within a private equity structure, all entities that are identified to have control over an entity under audit are controlling entities.

Example 4 – Application of the Affiliate of the Audit Client Definition When the Entity under Audit Controls Entities within an ICC



Entity X is the entity under audit and is not an investment company, an investment adviser, or sponsor. Entity X has a subsidiary that serves as an investment adviser to several investment companies. If the auditor is not engaged to audit the investment company or investment adviser or sponsor on a standalone basis, the auditor will apply amended Rules 2-01(f)(4)(i) through (iv) to determine the affiliates of the audit client.

We note that in determining the affiliates of Entity X, in the context of amended Rules 2-01(f)(4)(i) through (iv), it will be important to consider the relationships between the investment

64 *Id.*

adviser and the investment companies it advises. Even where an investment company has an independent board that oversees the investment company's operations and approves the advisory contract, the services provided by the investment adviser are generally critical to the management of day-to-day operations and execution of policies for the investment company. Therefore, the investment adviser generally will have a controlling relationship over the investment company for purposes of Rule 1-02(g).

In this example, if the auditor audited Entity X and the investment adviser subsidiary on a standalone basis, then the auditor would have to apply both amended Rules 2-01(f)(4)(i) through (iv) as they relate to the audit of Entity X and amended Rule 2-01(f)(14) as it relates to the audit of the investment adviser.[65]

b. Proposing Release's Discussion of Rule 2-01(b)

As noted in the 2000 Adopting Release, "[c]ircumstances that are not specifically set forth in our rule are measured by the general standard set forth in Rule 2-01(b)." The general standard includes, in part, 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."

The Commission explained in the Proposing Release that relationships and services affected by the proposed amendments to the affiliate of the audit client definition remain subject to the general independence standard in Rule 2-01(b).[66] The Commission also noted that such

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65 This is consistent with the discussion and example included in Section II.A.1.b.i of the Proposing Release.

66 *See* Section II.A.1 of the Proposing Release.

relationships and services, individually or in the aggregate, could raise independence concerns pursuant to the general standard in Rule 2-01(b) due to the nature, extent, relative importance or other aspects of the service or relationship that may make the service or relationship a threat to an auditor's objectivity and impartiality. The Commission indicated that such services or relationships should be "easily known" due to the nature, extent, relative importance or other aspects of the services or relationships. Although the Commission did not propose amendments to Rule 2-01(b), a number of commenters provided feedback on the application of the general independence standard in light of the proposed amendments.

i. Comments on the Proposing Release's Discussion of Rule 2-01(b)

Several commenters agreed that relationships and services with entities that would no longer be deemed affiliates should still be evaluated under Rule 2-01(b).[67] However, one commenter recommended that the Commission consider whether Rule 2-01(b) is sufficient, or whether further clarification or rulemaking might be appropriate to address situations where relationships or non-attest services provided to a sister entity that is no longer an affiliate under the proposed definitions are of a magnitude that "eclipse" the attest services provided within a private equity or investment company complex.[68]

A few commenters raised concerns with the Proposing Release's discussion of Rule 2-01(b).[69] One commenter asserted that the statements were inconsistent with the 2000 Adopting

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[67] *See e.g.,* letters from Deloitte, EY, KPMG, GT, and Crowe. Some commenters also indicated that the general standard in Rule 2-01(b) is sufficient to mitigate the risks when relationships and services, individually or in the aggregate, with sister entities that are no longer deemed affiliates under the final amendments could impact an auditor's objectivity and impartiality. *See e.g.*, letters from Deloitte, EY, and KPMG.

[68] *See* letter from BDO.

[69] *See e.g.,* letters from RSM and PwC.

Release, which stated that "[c]ircumstances that are not specifically set forth in our rule are measured by the general standard set forth in Rule 2-01(b)"[70] and expressed concern that the Proposing Release's discussion of Rule 2-01(b) could be applied more broadly than just to the entities captured by the affiliate of the audit client definition. Another commenter asserted that it "may be understood in practice as a change in application and operation of Rule 2-01(b)."[71] In voicing their concerns, these commenters noted that the consideration of Rule 2-01(b) would reduce the benefits expected to result from the proposed amendments as the auditor would continue to have to track relationships and services that are being provided to entities that are no longer affiliates.[72]

One commenter disagreed with the Proposing Release's reference to "easily known" when describing the types of services or relationships that should be evaluated under Rule 2-01(b) as 17 CFR 210.2-01(c) ("Rule 2-01(c)") no longer specifically addresses such items.[73] A few commenters asserted that the Proposing Release's use of "easily known" appears to establish an expectation of continued monitoring that may reduce the benefits, efficiencies, and cost savings expected to result from the proposed amendments.[74] Two of these commenters requested further guidance on on-going monitoring obligations if Rule 2-01(b) continues to apply to non-affiliates and requested the Commission consider clarifying the reference to "easily

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70 *See* letter from RSM (citing to the 2000 Adopting Release at 65 FR 76030). *See infra* discussion in Section II.A.1.b.ii.

71 *See* letter from PwC.

72 *See e.g.,* letters from RSM and PwC.

73 *See* letter from RSM.

74 *See e.g.,* letters from PwC, RSM, and AIC.

known" in the Proposing Release's discussion of the general standard by utilizing the "knows or has reason to believe" approach of the AICPA ethics and independence rules.[75]

ii. Application of Rule 2-01(b) to the Final Amendments

After considering the public comments and recommendations received, we affirm our view that Rule 2-01(b) applies to those relationships and services that previously were, but are no longer, covered by Rule 2-01(c) as a result of the final amendments. We do not believe that this position broadens the scope of the "all relevant facts and circumstances" concept in the general standard. Nor are we persuaded that this scope should be narrowed in light of the amendments we are adopting. Otherwise, for example, an auditor could have any number or magnitude of relationships with or provide services to sister entities that are no longer deemed affiliates under the final amendments—even where, for example, the importance of such relationships or services to the auditor and the controlling entity threatens the auditor's objectivity and impartiality.

In response to commenters who noted that "easily known" is not a defined term and requested further explanation, we are clarifying that the types of relationships and services that must be evaluated under Rule 2-01(b) are those that are known or should be known to the auditor because of the nature, extent, relative importance or other relevant aspects of the relationships or services. Consistent with our discussion in Example 2 above, auditors, with the assistance of their audit clients, are expected to have sufficient information to be able to be aware of and prepare for changes in materiality that could lead to changes in affiliate status of entities in a large corporate or ICC structure. As such, we do not expect that identifying and monitoring

[75] *See* letters from PwC and AIC.

relationships with and services provided to non-affiliate sister entities that are known or should be known would require significant additional effort by audit firms. For example, if audit firms are performing a high volume of services for or have a number of relationships with non-affiliate sister entities, the audit firm should already know that these relationships exist.

As noted in Section II.A.1.a.iii, the final amendments will more effectively focus the independence rules and reduce the time and attention that auditors and audit committees spend avoiding or addressing compliance challenges that arise under the existing rules and should permit auditors and audit committees to use their resources more effectively to the benefit of investors. Nothing in the final amendments is intended to change the application of the general independence standard in Rule 2-01(b). As the Commission noted in the 2000 Adopting Release and in the rule text for Rule 2-01(c), paragraph (c) is a "non-exclusive" specification of circumstances. As such, while Rule 2-01(c) enumerates specific circumstances that are inconsistent with Rule 2-01(b), the general standard of Rule 2-01(b) may encompass relationships and services that are not otherwise deemed independence-impairing by Rule 2-01(c).

c. Amendments to the Investment Company Complex Definition

i. Proposed Amendments

The Commission proposed to amend Rule 2-01(f)(4) to clarify that, with respect to an entity under audit that is an investment company or an investment adviser or sponsor, the auditor and the audit client should look to proposed Rule 2-01(f)(14) (*i.e.*, the ICC definition) to identify affiliates of the audit client and not to proposed Rule 2-01(f)(4).[76] The Commission also

[76] The proposed amendment would replace the existing "and" that appears at the end of existing Rule 2-01(f)(4)(iii) with an "or" in order to direct auditors of an investment company or an investment adviser or

proposed to amend the ICC definition in Rule 2-01(f)(14) to provide additional clarity by incorporating the term "entity under audit" into Rule 2-01(f)(14) to focus the analysis from the perspective of the entity under audit and to explicitly define the term "investment company" to include unregistered funds for the purpose of the ICC definition.[77] In the Proposing Release, the Commission indicated that the proposed amendments were designed to more effectively focus the independence analysis on the entity under audit, including unregistered funds under audit, and align that analysis with the independence analysis required for all investment companies.

In addition to the proposed amendments to clarify certain aspects of the ICC definition, the Commission proposed to include a materiality qualifier in the common control provision of the ICC definition to align with the proposed amendments to the affiliate of the audit client definition.[78] To further align with the affiliate of the audit client definition, the Commission proposed including a significant influence provision in the ICC definition.[79] Both of these proposed amendments were meant to provide consistency between the definitions of affiliate of the audit client and ICC in light of the proposed amendment specifying that auditors of an

sponsor to the ICC definition. In the final amendments, the "or" now appears at the end of amended Rule 2-01(f)(4)(iv) and before amended 17 CFR 210.2-01(f)(4)(v).

77 We use the term "unregistered fund" in this release to refer to entities that are not considered investment companies pursuant to the exclusions in Section 3(c) of the Investment Company Act of 1940 [15 USC 80a-3(c)].

78 *See* Proposed Rule 2-01(f)(14)(i)(D)(*1*).

79 *See* Proposed Rule 2-01(f)(14)(i)(E). The existing definition of "audit client" in Rule 2-01(f)(6), for the purpose of Rule 2-01(c)(1)(i), excludes entities that are affiliates only by virtue of the significant influence provisions in existing Rules 2-01(f)(4)(ii) and (iii). To align the treatment of affiliates due to significant influence under proposed Rule 2-01(f)(14)(i)(E) with those in the affiliate of the audit client definition, the Commission proposed an amendment to the "audit client" definition in Rule 2-01(f)(6) to similarly exclude entities identified under proposed Rule 2-01(f)(14)(i)(E).

investment company or investment adviser or sponsor would apply proposed Rule 2-01(f)(14) to identify affiliates of such entity under audit.

The Commission explained in the Proposing Release that while it was introducing a materiality qualifier in the common control provision, it was retaining within the scope of the ICC definition any investment company that has an investment adviser or sponsor that is an affiliate of the audit client—regardless of whether such sister investment companies are material to the shared investment adviser or sponsor.[80]

The Commission also noted that while the proposed amendments to the ICC definition would alter the composition of entities that would be deemed affiliates of the audit client principally due to a materiality qualifier being added for sister entities, the general independence standard in Rule 2-01(b) would continue to apply.[81] The Commission stated its belief that the proposed amendments to the ICC definition would provide clarity and address certain compliance challenges, including challenges related to the number of related entities or the volume of acquisitions and dispositions in ICCs, and more effectively focus the ICC definition on those relationships and services that are more likely to threaten auditor objectivity and impartiality.[82]

ii. Comments Received

Comments on Overall Approach to ICC Definition

Commenters generally supported the Commission's proposal to clarify that with respect to an entity under audit that is an investment company or an investment adviser or sponsor, the

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80 *See* Proposed Rule 2-01(f)(14)(i)(F).

81 *See* Section II.A.1.b of the Proposing Release.

82 *See* Section II.A.1 of the Proposing Release.

auditor and the audit client should look solely to the ICC definition to identify affiliates of the audit client,[83] and no commenters specifically opposed the proposed approach.

Several commenters expressly agreed with the proposed references to "entity under audit" in Rule 2-01(f)(14),[84] and no commenters specifically opposed the proposed references.

Some commenters supported the Commission's proposal to include within the meaning of the term investment company, for the purposes of the ICC definition, entities "that would be an investment company but for the exclusions provided by Section 3(c) of the Investment Company Act."[85] For example, one commenter stated that under the current rules, "it was not clear if unregistered funds would be part of the [ICC] definition, which created uncertainty and inconsistency in practice."[86] Another commenter stated that, if adopted, the inclusion of unregistered funds within the ICC definition would enable "the asset management industry holistically [to] serve the interests of investors and provide for more consistent treatment across fund businesses."[87] No commenters expressly opposed this proposed amendment.

Many commenters who were supportive of the proposed amendments also requested clarification on the application of the proposed definitions to specific fact patterns, including the following circumstances:

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83 *See e.g.,* letters from NYSSCPA, CAQ, Deloitte, BDO, EY, KPMG, RSM, GT, Crowe, and ICI/IDC. One commenter recommended that the final amendments specify that the ICC definition applies when the entity obtains an audit "for SEC reporting or compliance purposes." *See* letter from KPMG. We believe this concept is implied by the requirements to apply Rule 2-01 in certain applicable provisions of the Federal securities laws.

84 *See e.g.,* letters from NYSSCPA, Deloitte, BDO, EY, KPMG, and GT.

85 *See e.g.,* letters from Deloitte, EY, KPMG, Crowe, and RSM.

86 *See* letter from Crowe.

87 *See* letter from EY.

- An investment adviser is the entity under audit and is both an issuer and parent entity;[88]
- An operating company is the entity under audit and has sister entities that include an investment company or an investment adviser or sponsor,[89] or the operating company under audit has a subsidiary that is an investment adviser that manages investment companies;[90] and
- The entity under audit is an investment company with sister funds advised by the same investment adviser, and such sister funds control portfolio companies.[91]

Regarding other general aspects of the proposed ICC definition, one commenter sought clarification about whether the reference to investment adviser or sponsor in the proposed ICC definition also would include custodians.[92] A different commenter requested that we revise the ICC definition to separately address affiliates of an investment company and affiliates of an investment adviser or sponsor.[93]

88 *See e.g.,* letters from CAQ and ICI/IDC. Consistent with the discussion in Section II.A.1 of the Proposing Release, where an auditor is auditing only an investment company or investment adviser or sponsor, such auditor would look to the amended ICC definition to identify affiliates of the audit client. Even where the investment adviser under audit is an issuer and a parent entity, the final amendments dictate that the adviser's auditor look solely to the amended ICC definition to identify affiliates of the audit client.

89 *See e.g.,* letters from CAQ and Deloitte. The discussion in Section II.A.1.a.iii, above, including Example 3, illustrates how to apply the amended definitions where an auditor audits only a portfolio company.

90 *See* letter from EY. The discussion in Section II.A.1.a.iii, above, including Example 4, illustrates how to apply the amended definitions in response to this circumstance.

91 *See e.g.,* letters from CAQ, BDO, EY, KPMG, Crowe, and AIC. The discussion in Section II.A.1.c.iii, including Example 5, below, illustrates how to apply the amended definitions in response to this circumstance. One commenter raised a related fact pattern and suggested aligning the proposed amendments with the recent amendments to the Loan Provision. *See* letter from PwC.

92 *See* letter from EY; *see also infra* note 118.

93 *See* letter from RSM. We do not see a compelling reason to adopt this approach and create separate provisions for these related entities within an ICC. Additionally, such an approach may be duplicative and add unnecessary complexity to the amended ICC definition.

Comments on Proposed Rule 2-01(f)(14)(i)(D)(*1*) – Common Control and Materiality

Many commenters supported the inclusion of a materiality qualifier within proposed Rule 2-01(f)(14)(i)(D)(*1*), the common control provision of the proposed ICC definition.[94] Consistent with feedback received in response to the proposed materiality qualifier for operating companies under common control,[95] some commenters expressed the view that the materiality qualifier would not increase the risk to auditor objectivity and impartiality.[96] A few commenters, consistent with their feedback on the affiliate of the audit client definition, also recommended that proposed Rule 2-01(f)(14)(i)(D)(*1*) include a dual materiality threshold that would include consideration of whether the entity under audit is material to the controlling entity.[97]

However, the two commenters that opposed the proposed materiality qualifier in the affiliate of the audit client definition also opposed, for similar reasons, the inclusion of such a qualifier in the proposed ICC amendments.[98]

While some commenters indicated that auditors would not experience significant challenges or burdens with assessing materiality in the ICC context,[99] other commenters voiced concerns or noted that additional guidance about the application of materiality would be helpful.[100] Some commenters noted the importance of access to current financial information of

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94 *See e.g.,* letters from CAQ, BDO, EY, KPMG, RSM, PwC, GT, Crowe, AIC, ICI/IDC, IBC, CCMC, and Charles E. Andrews, Audit Committee Chair, Washington Mutual Investors Fund, *et al* (Mar. 10, 2020) ("Fund AC Chairs").

95 *See* Section II.A.1.a.iii.

96 *See e.g.,* letters from EY, RSM, and KPMG.

97 *See e.g.,* letters from EY, AIC, and CCMC.

98 *See* letters from CII and CFA.

99 *See e.g.,* letters from Fund AC Chairs, EY, and RSM.

100 *See e.g.,* letters from NYSSCPA, GT, RSM, KPMG, PwC and ICI/IDC.

controlling entities and sister entities for auditors and their clients if the proposed amendments were adopted.[101] In this regard, some commenters requested that the Commission address the shared responsibility of auditors, their audit clients, and audit committees.[102]

In response to a request for comment regarding potential application challenges in the Proposing Release, one commenter indicated there may be challenges in applying the materiality qualifier because the current definition does not require an assessment of materiality of sister entities in the context of the ICC.[103] The commenter suggested that such challenges could be addressed by auditors, the Commission, and companies working together to develop consistent practices and protocols for providing the information needed by auditors to maintain compliance with the independence rules. Similarly, another commenter requested guidance on the timing and frequency of monitoring materiality in the ICC context. The commenter suggested the Commission clarify that, if the sister investment adviser or a fund advised by such sister investment adviser were not deemed material to the controlling entity after an initial assessment, then the auditor could satisfy its obligation to monitor materiality on an ongoing basis in response to significant transactions, SEC filings, or other information that becomes known to the auditor, or the audit client, through reasonable inquiry.[104]

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101 *See e.g.,* letters from RSM, GT, KPMG, PwC, ICI/IDC, and Fund AC Chairs.

102 *See e.g.,* letters from PwC and EY.

103 *See* letter from KPMG.

104 *See* letter from ICI/IDC. *See also* letters from Deloitte (expressing a similar view as it relates to both Rule 2-01(f)(4) and Rule 2-01(f)(14)) and PwC (suggesting a transition framework to address inadvertent independence violations that arise out of an unexpected change in the population of affiliates for reasons other than a merger or acquisition).

Under the proposal, auditors and audit clients would have to assess the materiality of sister entities to their controlling entity even if the sister entities' investment advisers are not material to the entity that controls both the sister entities and the entity under audit. In response to a request for comment regarding whether auditors should have to assess the materiality of sister investment companies to a controlling entity even where the investment advisers for such sister investment companies are not material to a controlling entity, commenters generally thought requiring such assessment would be appropriate to account for instances when a controlling entity may have an investment in an investment company that would make the investment company material to the controlling entity even though the investment company's adviser is not material to the same controlling entity.[105]

Comments on Proposed Rule 2-01(f)(14)(i)(F) – Inclusion of Investment Companies Advised or Sponsored by an Affiliate Investment Adviser or Sponsor

In the Proposing Release, the Commission requested comment regarding whether proposed Rule 2-01(f)(14)(i)(F), which would include within an ICC any investment company that has any investment adviser or sponsor that is an affiliate of the audit client pursuant to proposed Rules 2-01(f)(14)(i)(A) through (D), should be adopted. Several commenters supported the continued inclusion of sister investment companies under proposed Rule 2-01(f)(14)(i)(F), regardless of the materiality of the sister investment companies once an investment adviser is deemed to be an affiliate under Rules 2-01(f)(14)(i)(A) through (f)(14)(i)(D).[106] However, one commenter stated that not including a materiality qualifier in

105 *See e.g.,* letters from EY, KPMG, and RSM. One commenter noted that this situation is "not likely to be common." *See* letter from EY. Another commenter requested additional guidance to foster consistent application. *See* letter from KPMG.

106 *See e.g.,* letters from BDO, EY, KPMG, and ICI/IDC.

proposed Rule 2-01(f)(14)(i)(F) renders the relief intended by the common control provision in the proposed ICC definition "inconsequential."[107] Another commenter, while supportive of proposed Rule 2-01(f)(14)(i)(F), recommended that the reference to proposed Rule 2-01(f)(14)(i)(D) be removed from proposed Rule 2-01(f)(14)(i)(F) with respect to investment companies advised by sister investment advisers, because the proposed provision appeared to be inconsistent with other proposed provisions that would include a materiality qualifier for sister entity affiliates.[108]

Comments on Proposed Rule 2-01(f)(14)(i)(E)—the Significant Influence Provision

Some commenters expressly supported the proposed amendment to introduce a significant influence provision in proposed Rule 2-01(f)(14)(i)(E),[109] and no commenters specifically opposed the proposed amendment. One commenter, while not explicitly supporting or objecting, recommended that the Commission reiterate the statement from the Loan Provision Adopting Release that provides guidance on how to apply significant influence in an investment company context.[110]

Commenters that addressed this aspect of the proposal also supported the proposed conforming amendment to Rule 2-01(f)(6) to reference the proposed significant influence provision in the ICC definition.[111]

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107 *See* letter from RSM. Specifically, the commenter stated that all entities with a common investment adviser or sponsor should not automatically be deemed affiliates when other common control entities that are not material to the controlling entity are not deemed affiliates.

108 *See* letter from KPMG.

109 *See e.g.,* letters from CAQ, BDO, EY, KPMG, and RSM.

110 *See* letter from ICI/IDC.

111 *See e.g.,* letters from EY, KPMG, and RSM.

iii. Final Amendments

Overall Approach to ICC Definition

After considering the public comments and recommendations received, we are adopting, substantially as proposed, amendments to the ICC definition in amended 17 CFR 210.2-01(f)(14) ("amended Rule 2-01(f)(14)"), with modifications to address the concerns and suggestions raised by commenters and to align the ICC definition with the final amendment related to the dual materiality threshold in amended Rule 2-01(f)(4)(ii) discussed above.[112]

Consistent with the proposal, the final amendments to Rule 2-01(f)(4), the affiliate of the audit client definition, direct an auditor of an investment company or investment adviser or sponsor to apply the ICC definition in amended Rule 2-01(f)(14) to identify affiliates. As proposed, the amended ICC definition uses the term "entity under audit" as the starting point for the analysis of entities included within the ICC definition.[113] We also are adopting as proposed a definition of "investment company" for the purpose of amended Rule 2-01(f)(14) that includes unregistered funds.[114]

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112 *See* Section II.A.1.a.iii.

113 In addition, the final amendments make conforming technical amendments to amended 17 CFR 210.2-01(f)(14)(i) to incorporate the term "entity under audit." Using the term "entity under audit" in those subparagraphs alleviates the need to refer to each subparagraph separately, which makes the subparagraphs more concise. The conforming amendments to the subparagraphs of amended 17 CFR 210.2-01(f)(14)(i) retain the application of the ICC definition as described in the Proposing Release.

114 One commenter suggested that the Commission clarify whether commodity pools are included within the meaning of the term investment company for the purpose of applying amended Rule 2-01(f)(14). *See* letter from PwC. The term investment company, for the purpose of amended Rule 2-01(f)(14), does not include a commodity pool unless that commodity pool is an investment company or would be an investment company but for the exclusions provided by Section 3(c) of the Investment Company Act of 1940.

Similarly, the final amendments to the ICC definition include the significant influence provision of new 17 CFR 210.2-01(f)(14)(i)(E) ("Rule 2-01(f)(14)(i)(E)") substantially as proposed but modified to incorporate the term "entity under audit."

New 17 CFR 210.2-01(f)(14)(i)(D) – Common Control and Materiality

After considering the public comments and recommendations received, we are adopting, with modification, new 17 CFR 210.2-01(f)(14)(i)(D) ("Rule 2-01(f)(14)(i)(D)") to incorporate the dual materiality threshold in the common control provision, consistent with the modification to the common control provision we are adopting for the affiliate of the audit client definition.[115]

We were persuaded by commenters that the dual materiality threshold for identifying common control affiliates will be equally helpful in reducing compliance challenges in the ICC context as in the operating company context.[116] Such alignment also provides internal consistency within Rule 2-01, which should facilitate compliance efforts by reducing the potential for confusion and inconsistency when assessing common control affiliates.

Although some commenters objected to including a materiality threshold in the ICC amendments, we do not believe the adopted approach increases the risk to auditor independence. When an entity under audit is under common control with an investment company, or an investment adviser or sponsor, and the adopted dual materiality threshold is not met, we believe there is less risk to an auditor's objectivity and impartiality from the auditor's services to or relationships with such sister entity, for the reasons discussed regarding the dual materiality

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115 *See* Section II.A.1.a.iii.

116 *See e.g.,* letters from EY, AIC, and CCMC. For example, CCMC expressed the view that Rule 2-01(f)(14)(i)(D) should be amended to include sister investment advisers and investment companies only when both the sister entity and the investment adviser under audit, or the investment adviser or sponsor of an investment company under audit, are material to the controlling entity.

threshold for the common control provision in the affiliate of the audit client definition.[117] Further, we believe any threats to independence that may exist when the entity under audit is not material to the controlling entity will be sufficiently mitigated by the general independence standard in Rule 2-01(b).[118]

In response to commenters' request for guidance, consistent with the discussion in Section II.A.1.a.iii above, we remind auditors and their audit clients of their shared responsibility to monitor independence, including monitoring affiliates and obtaining information necessary to assess materiality. We are not providing any specific guidance on materiality at this time because we understand that auditors and their audit clients have developed approaches to determine materiality in compliance with current rules, and we expect those approaches would continue to be applicable under the final amendments. Auditors, working together with their audit clients, should assess materiality for the purpose of complying with Rule 2-01, as amended, including consideration of relevant qualitative and quantitative factors. Depending on the circumstances, it may be reasonable to use certain measures, such as assets under management,

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117 Rule 2-01(f)(14)(i)(D) retains the existing provision that includes sister entities engaged in the business of providing administrative, custodian, underwriting, or transfer agent services to any entity identified by amended 17 CFR 210.2-01(f)(14)(i)(A) ("amended Rule 2-01(f)(14)(i)(A)") and amended 17 CFR 210.2-01(f)(14)(i)(B), regardless of materiality.

118 One commenter sought clarification about whether Rule 2-01(f)(14) would apply to engagements required by Rule 206(4)-2(a)(6) under the Investment Advisers Act of 1940 (the "Advisers Act Custody Rule"). *See* letter from EY; 17 CFR 275.206(4)-2(a)(6). The Advisers Act Custody Rule requires that when an investment adviser or a related person acts as a qualified custodian for client funds and securities, the investment adviser, in addition to the independent verification requirement, must annually obtain, or receive from the related person, an internal control report prepared by an independent public accountant. The Advisers Act Custody Rule defines a "related person" as "any person, directly or indirectly, controlling or controlled by [the investment adviser], and any person that is under common control with [the investment adviser]." 17 CFR 275.206(4)-2(d)(7). For purposes of this engagement, the related person qualified custodian would be the "entity under audit" under the final rule. Accordingly, the auditor engaged would apply amended Rule 2-01(f)(4)—not amended Rule 2-01(f)(14)—to determine the affiliates of the audit client, which would require the auditor to assess the investment adviser's materiality if under common control. In these circumstances, however, the accountant would be required to be independent of the adviser under Rule 2-01(b) regardless of the results of this materiality determination.

when evaluating a potential affiliate in one instance, but not when evaluating a different potential affiliate. The assessment also should be attentive to the nature of the relationship, the governance structure of the entity, certain business and financial relationships, and other relevant qualitative considerations.

As noted in Section II.A.1.a.iii, understanding the organizational structure of an audit client is important when considering the general standard under Rule 2-01(b). We believe that after the initial materiality assessment to identify potential affiliates, the auditor and the audit client should conduct updated assessments based on any transactions, Commission filings, or other information that become known to the auditor or the audit client through reasonable inquiry.

New 17 CFR 210.2-01(f)(14)(i)(F) – The Provision to Include Investment Companies Advised or Sponsored by an Affiliate Investment Adviser or Sponsor

After considering the public comments and recommendations received, we are adopting, as proposed, new 17 CFR 210.2-01(f)(14)(i)(F) ("Rule 2-01(f)(14)(i)(F)"), which includes certain sister investment companies within the ICC definition regardless of materiality. We believe that this paragraph, together with the amendments to the common control provision in Rule 2-01(f)(14)(i)(D), as discussed above, will focus the scope of our independence rules on entities where relationships and services are more likely to threaten an auditor's objectivity and impartiality.

Specifically, under the existing ICC definition, sister investment advisers or sponsors and, as a result, their funds, regardless of whether the sister investment advisers or sponsors are material to the applicable controlling entities, would be included in the ICC of an investment company under audit.[119] Rule 2-01(f)(14)(i)(F) includes within the ICC definition investment advisers or sponsors identified by amended Rules 2-01(f)(14)(i)(A) through (D), which will include sister investment advisers or sponsors where a dual material relationship exists pursuant to Rule 2-01(f)(14)(i)(D) and exclude sister investment advisers or sponsors where a dual material relationship does not exist. While some commenters indicated that Rule 2-01(f)(14)(i)(F) should include a materiality qualifier, we believe that such an approach risks excluding entities where an auditor's services to or relationships with a sister investment company could impair an auditor's objectivity and impartiality because the sister investment company is advised or sponsored by an affiliate investment adviser or sponsor.

Where a sister investment company shares the same adviser or sponsor as an investment company under audit, we continue to believe that these entities should be included as part of the ICC in evaluating the auditor's independence, regardless of whether such sister investment company is material to the shared investment adviser or sponsor. In our view, the nature of the relationship between the investment adviser and the entity under audit that it advises presents risks to an auditor's objectivity and impartiality when the auditor has relationships with or provides services to investment companies advised by such investment adviser.

Similarly, when a sister investment adviser or sponsor is included under the dual materiality threshold, we believe that the investment companies advised or sponsored by the sister investment adviser or sponsor should be included as part of the ICC in evaluating the auditor's independence, regardless of whether such sister investment companies are material to the applicable controlling entities. Once the sister investment adviser or sponsor is included in the ICC due to the dual materiality threshold, relationships with and services to investment

[119] *See* Rule 2-01(f)(14).

companies advised or sponsored by the sister investment adviser or sponsor also are more likely to pose a threat to an auditor's objectivity and impartiality.

Amended 17 CFR 210.2-01(f)(14)(i)(C) – Application to Portfolio Companies Controlled by Sister Investment Companies

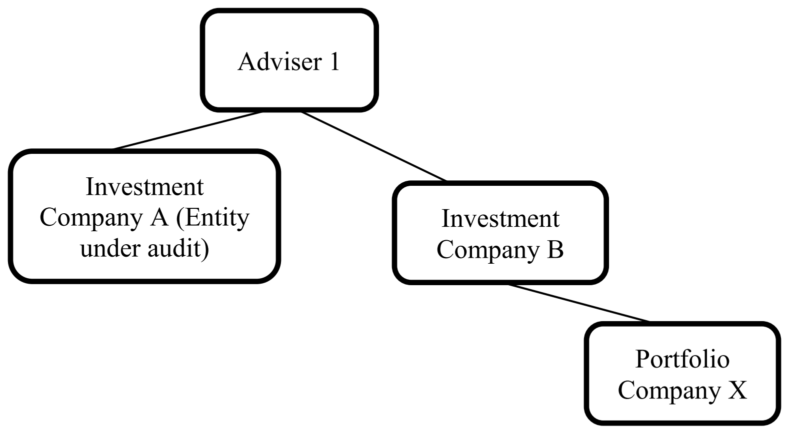
As noted above, we received several comments regarding how the control provision in proposed Rule 2-01(f)(14)(i)(C) applies to portfolio companies of an affiliate sister investment company when an investment company is under audit.[120] We are mindful of the concerns raised by commenters and are adopting the control provision in amended 17 CFR 210.2-01(f)(14)(i)(C) ("amended Rule 2-01(f)(14)(i)(C)") with modifications to apply a dual materiality threshold for portfolio companies of sister investment companies that are controlled by the investment adviser or sponsor unless the portfolio companies are engaged in the business of providing administrative, custodial, underwriting, or transfer agent services to any entity identified by amended Rules 2-01(f)(14)(i)(A) or (B). As illustrated by Example 5 below, this modification will affect only the application of the rule for portfolio companies because Rule 2-01(f)(14)(i)(F), as discussed above, will dictate when sister investment companies are included within the ICC definition.

Under a scenario where neither the investment company under audit nor the portfolio company is material to the shared investment adviser or sponsor, there is less risk to the auditor's objectivity and impartiality. The modification in amended Rule 2-01(f)(14)(i)(C) does not alter the application of the ICC definition to portfolio companies controlled by an investment company under audit, as such portfolio companies will always be included in the ICC pursuant to amended 17 CFR 210.2-01(f)(14)(i)(C)(*1*) ("amended Rule 2-01(f)(14)(i)(C)(*1*"). The

[120] *See e.g.,* letters from CAQ, BDO, EY, KPMG, Crowe, and AIC.

following is intended as an illustrative example only, and practitioners and audit clients should be aware that an assessment of materiality requires consideration of all relevant facts and circumstances, including quantitative and qualitative factors.

Example 5 – Application of New 17 CFR 210.2-01(f)(14)(i)(C)(*2*)



Investment Company A, the entity under audit, is advised by Adviser 1, which also advises Investment Company B. Investment Company B controls Portfolio Company X and, as a result, Adviser 1 is deemed to control Portfolio Company X. Pursuant to amended Rule 2-01(f)(14)(i)(C)(*1*), Investment Company A's auditor would include in the ICC any portfolio company controlled by Investment Company A even if the portfolio company is not material to Adviser 1. Pursuant to Rule 2-01(f)(14)(i)(F), the auditor also would include in the ICC Investment Company B even if Investment Company B is not material to Adviser 1. However, the auditor would apply the dual materiality threshold in new 17 CFR 210. 2-01(f)(14)(i)(C)(*2*) ("Rule 2-01(f)(14)(i)(C)(*2*)") to determine if Portfolio Company X is included in the ICC in connection with Investment Company A's audit. If neither Portfolio Company X nor Investment Company A is material to Adviser 1 and Portfolio Company X is not engaged in the business of providing administrative, custodial, underwriting, or transfer agent services to any entity identified by amended Rules 2-01(f)(14)(i)(A) and (B), Portfolio Company X would not be included in the ICC in connection with the audit of Investment Company A.

2. Amendment to the Definition of Audit and Professional Engagement Period

Rules 2-01(c)(1) through (5) prescribe certain circumstances the occurrence of which during the "audit and professional engagement period" are inconsistent with the general standard under Rule 2-01(b).[121] Under the current rule, the term "audit and professional engagement period" is defined differently for domestic issuers and foreign private issuers ("FPIs")[122] that are filing, or required to file, a registration statement or report with the Commission for the first time ("first-time filers"). Specifically, 17 CFR 210.2-01(f)(5)(i) and (ii) define the audit and professional engagement period as including both the "period covered by any financial statements being audited or reviewed" and the "period of the engagement to audit or review the . . . financial statements or to prepare a report filed with the Commission . . ." (the "look-back period"). However, 17 CFR 210.2-01(f)(5)(iii) ("Rule 2-01(f)(5)(iii)") of the definition narrows the audit and professional engagement period for audits of the financial statements of foreign private issuers to the "first day of the last fiscal year before the foreign private issuer first filed, or was required to file, a registration statement or report with the Commission, provided there has been full compliance with home country independence standards in all prior periods covered by any registration statement or report filed with the Commission."

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121 *See* Preliminary Note 2 and Rules 2-01(c)(1) through (5).

122 17 CFR 240.3b-4(c). A foreign private issuer is any foreign issuer other than a foreign government, except for an issuer that (1) has more than 50% of its outstanding voting securities held of record by U.S. residents; and (2) any of the following: (i) a majority of its executive officers or directors are citizens or residents of the United States; (ii) more than 50% of its assets are located in the United States; or (iii) its business is principally administered in the United States. *See* 17 CFR 240.3b-4(c).

a. Proposed Amendments

The Commission proposed to amend Rule 2-01(f)(5)(iii) so that the one year look-back period for first-time filers will apply to all such filers, which would result in treating all first-time filers (*i.e.*, domestic issuers and FPIs) similarly for purposes of the independence requirements under Rule 2-01.[123]

In the Proposing Release, the Commission explained that the proposed amendment would provide parity between domestic issuers and FPIs and noted feedback that such parity may also benefit capital formation.[124] The Commission stated its belief that the proposed requirement to comply with applicable independence standards in all prior periods included in the first-time filing sufficiently mitigates the risk associated with shortening the look-back provision for domestic first-time filers. In addition, as it relates to relationships and services in prior years that would not be included in the look-back period as a result of the proposed amendment, the Commission noted that such relationships and services still would be considered under the general independence standard of Rule 2-01(b), either individually or in the aggregate.

b. Comments Received

Many commenters supported the proposed amendment to shorten the domestic company look-back period for evaluating independence compliance to the most recent year to be included in the first filing with the Commission.[125] Several commenters stated that the current

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[123] The proposed amendment would not impact the compliance analysis related to the partner rotation provisions in 17 CFR 210.2-01(c)(6).

[124] *See* Section II.A.2 of the Proposing Release.

[125] *See e.g.,* letters from NASBA, CAQ, AICPA, Deloitte, BDO, EY, KPMG, RSM, PwC, Crowe, AIC, EQT, FEI, GT, CCMC, and Parrett.

requirement can result in challenges, cost, or delays to an initial public offering ("IPO").[126] One commenter indicated that these challenges are especially relevant in the private equity environment where strategies change within a one- or two-year time frame.[127] Some commenters also noted that the current provision puts domestic issuers at a disadvantage relative to FPIs.[128]

Some commenters opposed the proposed amendment and, instead, suggested the Commission lengthen the look-back period for FPIs.[129] One of these commenters posited that entities contemplate going public for years before an IPO and, as such, the current domestic look-back period is not an "egregious" burden.[130] Another commenter cited the increased risk associated with "unicorn" IPOs and asserted that this proposed amendment would weaken the applicable independence rules when serious questions "have arisen around accounting practices at some of the largest private companies."[131]

A few commenters supported the Commission's view that all relationships and services in prior periods should still be evaluated under Rule 2-01(b) and that these relationships and services should be easily known.[132]

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126 *See e.g.,* letters from CAQ, Deloitte, EY, EQT, GT, PwC, and AIC.

127 *See* letter from BDO.

128 *See e.g.,* letters from EQT and FEI.

129 *See e.g.,* letters from NYSSCPA, CII, and CFA.

130 *See* letter from NYSSCPA.

131 *See* letter from CFA.

132 *See e.g.,* letters from Deloitte and KPMG. *But see* letters from RSM and PwC. The view expressed by RSM and PwC regarding the application of Rule 2-01(b) also applies to the discussion of its applicability in this context.

Several commenters also requested that the Commission clarify how the proposed amendment would apply to specific situations such as:

- Reverse mergers or special purpose acquisition companies, if such a transaction is being considered by an audit client that is currently an issuer;[133]
- An existing and a new audit relationship;[134] and
- When a registration statement is withdrawn and a new registration statement subsequently is filed.[135]

c. Final Amendments

After considering the public comments and recommendations received, we are adopting amended 17 CFR 210.2-01(f)(5)(iii) ("amended Rule 2-01(f)(5)(iii)") as proposed. As noted in the Proposing Release, the staff has observed, from its independence consultation experience related to potential filings of initial registration statements, that often one factor, among many, in the auditor's objectivity and impartiality analysis is how long ago the service or relationship ended. If the service or relationship ended in the early years of the financial statements included in the initial registration statement, that fact may support a conclusion that the auditor is objective and impartial under Rule 2-01 at the time the IPO is consummated. As discussed above, a number of commenters supported the Commission's reasoning for the proposal.

We were not persuaded by the commenters who opposed the proposal and who recommended lengthening the look-back period for FPIs instead. As a general matter, we

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133 *See* letter from GT.

134 *See* letter from KPMG.

135 *See* letters from GT and Crowe.

believe that lengthening the look-back period would unnecessarily increase the burden on capital formation and impose new regulatory costs on FPIs without significantly enhancing investor protection. With respect to the comment regarding the impact of shortening the look-back period for "unicorn" IPOs,[136] it is not clear that financial reporting quality would be undermined or concerns, such as "inadequate corporate governance and lax accounting practices," would be exacerbated by the shorter look-back period for domestic issuers. Moreover, the final amendments do not affect the auditing standards to which a company undergoing an IPO is subject. Additionally, we continue to believe that applying Rule 2-01 to the most recent fiscal year, together with the application of the general independence standard in Rule 2-01(b) and the requirement to comply with applicable independence standards for the earlier years, mitigate the risk to an auditor's objectivity and impartiality associated with the shorter look-back period.[137]

In response to some commenters' request for clarification or guidance, we note that the final amendment applies to both existing and new audit relationships. We see no proportionate investor protection benefit to introducing complexity to a first-time filer's decision whether to retain or select a new auditor by applying different standards. Where a registrant is undergoing a reverse merger that is in substance similar to an IPO, the audit client and auditor should not apply the transition framework discussed in Section II.D, but may apply the shorter look-back period under the final amendments.[138] Finally, consistent with the position taken by the staff in

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136 *See* letter from CFA.

137 For additional guidance regarding the application of Rule 2-01(b) to the final amendments, see Section II.A.1.a.iii, above.

138 *See* Section II.D.3.

consultations, we are clarifying that where an issuer withdraws an initial registration statement, the re-filing of a new registration statement would be considered the issuer's first-time filing.

B. Amendments to Loans or Debtor-Creditor Relationships

1. Amendment to Except Student Loans

a. Proposed Amendment

The Loan Provision in Rule 2-01(c)(1)(ii)(A) provides that an accountant is not independent if it has any loan to or from an audit client and certain other persons related to the audit client. The Loan Provision also excepts four types of loans from its scope.[139] The Commission proposed to add an exception to 17 CFR 210. 2-01(c)(1)(ii)(A)(*1*) ("Rule 2-01(c)(1)(ii)(A)(*1*)") for student loans obtained from a financial institution under its normal lending procedures, terms, and requirements for a covered person's educational expenses, provided the loan was obtained by the individual prior to becoming a covered person in the firm as defined in 17 CFR 210.2-01(f)(11).[140]

In the Proposing Release, the Commission indicated that limiting the exception to student loans "not obtained while the covered person in the firm was a covered person" would provide a familiar compliance principle as it is consistent with the limitation to the primary mortgage loan exception in current 17 CFR 210.2-01(c)(1)(ii)(A)*(1)(iv)* ("Rule 2-01(c)(1)(ii)(A)*(1)(iv)*"). The Commission also expressed the belief that obtaining a student loan as a covered person poses a higher risk to the auditor's objectivity and impartiality and creates, at a minimum, an

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139 *See* Rule 2-01(c)(1)(ii)(A)(*1*)(*i*) through (*iv*), which lists as excepted loans those that are collateralized by automobiles, insurance policies, cash deposits, and primary residences.

140 *See* 17 CFR 210.2-01(f)(11), defining which partners, principals, shareholders, and employees of an accounting firm are considered covered persons.

independence appearance issue that is not present when a non-covered person obtained a similar student loan from such audit client.

The proposed amendment also limited the exclusion to student loans obtained for the covered person's educational expenses. The Commission did not propose to extend the exception to a covered person's immediate family members due to concerns, at that time, that the amount of student loan borrowings could be significant when considering student loans obtained for multiple immediate family members and thus could impact an auditor's objectivity and impartiality.

b. Comments Received

Commenters generally supported adding student loans to the list of excepted loans.[141] Many commenters recommended that the Commission expand the exception to include student loans of the covered person's immediate family members under the same terms as the proposed amendment.[142] For example, one commenter questioned the Commission's argument that "the amount of student loan borrowings could be significant when considering student loans obtained for multiple immediate family members and thus could impact an auditor's objectivity and impartiality" when considering that there is no similar proscription with respect to a mortgage loan, which could be substantially more significant than student loan debt in terms of absolute dollars.[143] However, another commenter agreed with the proposal not to include student loans of

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141 *See e.g.,* letters from NASBA, NYSSCPA, CAQ, Deloitte, BDO, EY, KPMG, RSM, PwC, GT, Crowe, CII, ICI/IDC, IBC, FEI, Fund AC Chairs, and CCMC.

142 *See e.g.,* letters from NASBA, NYSSCPA, CAQ, Deloitte, BDO, EY, KPMG, RSM, PwC, GT, Crowe and ICI/IDC.

143 *See* letter from NYSSCPA.

immediate family members in the proposed amendment.[144]

In the Proposing Release, the Commission requested comment on whether student loans of a covered person's immediate family members also should be excluded. Some commenters indicated that even if the proposed amendment were expanded to include student loans of immediate family members, there should be no limit on the amount outstanding.[145] One commenter suggested that the materiality of the loan to the covered person's net worth should be considered.[146] A few commenters indicated that Rule 2-01(b) should mitigate the risks of the amount of student loans impairing an auditor's objectivity and impartiality.[147] Without addressing immediate family members' loans, some commenters asserted that there should be no limit on the amount outstanding, similar to the existing primary residence mortgage exception.[148] We also note that certain commenters requested that the Commission clarify the scope of the term "educational expenses" and whether it includes expenses for room and board, tuition, books, and other educational supplies.[149]

c. Final Amendment

After considering the public comments and recommendations received, we are adopting amendments to except certain student loans from the Loan Provision with two modifications from the proposed amendments. Consistent with the recommendation of many commenters, the final amendment also will except student loans obtained by a covered person's immediate family

144 *See* letter from CII.

145 *See e.g.,* letters from RSM, Deloitte, and EY.

146 *See* letter from NASBA.

147 *See e.g.,* letters from Deloitte and EY.

148 *See e.g.,* letters from NYSSCPA, BDO, and KPMG.

149 *See e.g.,* letters from CAQ, BDO, PwC, Crowe, and GT.

members, as that term is defined in 17 CFR 210.2-01(f)(13). We are persuaded that there is no need to include such a limitation, especially in light of the fact that similar exclusions, such as the one for mortgage loans, are not similarly proscribed. Also, in response to comments seeking guidance on the term "educational expenses," we believe the entire balance for loans that qualify as a student loan under the applicable terms, conditions, and requirements should be within the scope of the final amendments.

The proposed amendment's reference to student loans "obtained for a covered person's or his or her immediate family members' educational expenses" was intended to make explicit that it is only student loans for the covered persons' and their immediate family members' educational expenses that should be covered and not loans that they undertake to pay for another person's educational expenses. That limitation continues to apply. However, we are modifying the rule text to delete this phrase to avoid potential confusion about whether "educational expenses" is meant as a limitation on the amount of student loans excepted.[150] The remaining terms of the exclusion are consistent with the proposal.

We are not specifying a numerical limit to the amount of outstanding student loans held by a covered person or a covered person's immediate family members that would be excepted. In light of comments received, we are persuaded that the purpose for which student loans are incurred and the standard terms associated with such loans set them apart from other debtor/creditor relationships not excepted from the Loan Rule and are less likely to threaten an auditor's objectivity and impartiality. We believe the nature of student loans and the requirement that the loans are obtained from a financial institution under its normal lending

[150] With "educational expenses" deleted, the reference to covered persons and their immediate family members would be duplicative of the same references in 17 CFR 210.2-01(c)(1)(ii).

procedures, terms, and requirements mitigate the risk such loans would pose to an auditor's objectivity and impartiality. Not including a numerical limit also is consistent with the exception for mortgage loans in Rule 2-01(c)(1)(ii)(A)*(1)(iv)*.

2. Amendment to Clarify the Reference to "A Mortgage Loan"

a. Proposed Amendment

The Commission proposed a clarifying amendment to the reference to "a mortgage loan" in Rule 2-01(c)(1)(ii)(A)(*1*)(*iv*) to refer to "mortgage loans" in the plural. As noted in the Proposing Release, Rule 2-01(c)(1)(ii)(A)(*1*)(*iv*) was not intended to exclude just one outstanding mortgage loan on a borrower's primary residence, and the Commission staff has previously provided guidance consistent with the proposed amendment.[151]

b. Comments Received

Commenters supported the proposed amendment.[152] We received no comments specifically opposing this proposed amendment. One commenter requested examples of how the proposed amendment applies to different types of mortgage loans, such as home equity or home improvement loans.[153] Another commenter suggested that the Commission consider extending the exemption to include mortgages collateralized by property other than primary residences.[154]

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151 *See* Section B. Question 1 Office of the Chief Accountant: Application of the Commission's Rules on Auditor Independence Frequently Asked Questions (June 27, 2019) (originally issued August 6, 2007) ("Auditor Independence FAQs") (indicating the staff's view that the rationale for a mortgage on a primary residence also applies to second mortgages, home improvement loans, equity lines of credit and similar mortgage obligations collateralized by a primary residence obtained from a financial institution under its normal lending procedures, terms and requirements and while not a covered person in the firm).

152 *See e.g.,* letters from NASBA, NYSSCPA, CAQ, BDO, EY, KPMG, RSM, PwC, GT, FEI, and Crowe.

153 *See* letter from FEI.

154 *See* letter from Crowe.

One commenter requested that the Commission include in the adopting release the guidance discussed in Section II.B.2 of the Proposing Release regarding the situation where a borrower becomes a covered person only because of a change in the ownership in the loan.[155]

c. Final Amendment

After considering the public comments and recommendations received, we are adopting as proposed the amendment to Rule 2-01(c)(1)(ii)(A)(*1*)(*iv*) to refer to "mortgage loans" instead of "a mortgage loan." In response to the commenter who requested examples or guidance on the application of the mortgage loan exception when a borrower has obtained different types of loans collateralized by a primary residence, we note that the Commission has previously clarified that the rationale for the mortgage loan exception focuses on the status of the covered person at the time of the loan origination.[156] The same focus applies to second mortgages, home improvement loans, equity lines of credit, and similar mortgage obligations collateralized by a primary residence obtained from a financial institution under its normal lending procedures, terms and requirements and while the borrower is not a covered person in the firm.

Also, as noted in the Proposing Release,[157] where the borrower becomes a covered person only because of a change in the ownership in the loan, and provided there is no modification in the original terms or conditions of the loan or obligation after the borrower becomes, or in contemplation of the borrower becoming, a covered person, the loan would be included within this exception.

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155 *See* letter from EY.

156 *See* 2000 Adopting Release.

157 Section II.B.2 of the Proposing Release.

Regarding a commenter's suggestion to extend the mortgage loan exception to loans collateralized by a non-primary residence (*e.g.*, a secondary or vacation home), we believe excepting loans on non-primary residences, which may be held for investment, would introduce increased risk to an auditor's objectivity and impartiality. As such, we do not see a compelling reason to expand the exception as suggested.

3. Amendment to Revise the Credit Card Rule to Refer to "Consumer Loans"

a. Proposed Amendment

The Commission proposed revising 17 CFR 210.2-01(c)(1)(ii)(E) ("Rule 2-01(c)(1)(ii)(E)") (the "Credit Card Rule") to replace the reference to "credit cards" with "consumer loans" and revise the provision to reference any consumer loan balance owed to a lender that is an audit client that is not reduced to $10,000 or less on a current basis taking into consideration the payment due date and available grace period. The Proposing Release set forth the Commission's view that a limited amount of debt that is routinely incurred by a covered person or any of his or her immediate family members for personal consumption, even if the audit client is the lending entity, would typically not impair an auditor's objectivity and impartiality. The proposed amendment would expand the current Credit Card Rule to encompass the types of consumer financing borrowers routinely obtain for personal consumption, such as, for example, retail installment loans, cell phone installment plans, and home improvement loans that are not secured by a mortgage on a primary residence. The Proposing Release explained that the types of consumer loans contemplated, like credit cards, would typically have a payment due date (*e.g.*, monthly).[158]

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[158] Section II.B.3 of the Proposing Release.

b. Comments Received

All commenters that addressed this proposed amendment expressed their support.[159] We received no comments that specifically opposed this proposed amendment. Some commenters supported the proposed $10,000 limit,[160] while other commenters recommended raising the limit to $20,000 to account for inflation.[161] One commenter suggested an increase to $20,000 or $25,000 while citing to recent studies about consumer finances.[162] Some commenters encouraged the Commission to consider adjustments of the dollar threshold to account for inflation.[163] A few commenters requested that the Commission reconsider the limit, but did not suggest an alternative amount.[164]

In the Proposing Release, the Commission requested comment on whether further guidance was needed with respect to the reference to current basis. Some commenters indicated that the term "current basis" does not require further guidance.[165] A few commenters stated that the term "consumer loans" is well understood and does not require further defining,[166] while other commenters stated that further guidance is needed.[167] One commenter recommended that

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159 *See e.g.,* letters from NASBA, NYSSCPA, CAQ, Deloitte, BDO, EY, KPMG, RSM, PwC, GT, Crowe, ICI/IDC, IBC, FEI, Fund AC Chairs, and Law Office of Edward B. Horahan III (Mar. 12, 2020) ("Horahan").

160 *See e.g.,* letters from NYSSCPA and Crowe.

161 *See e.g.,* letters from BDO and EY.

162 *See* letter from Horahan.

163 *See e.g.,* letters from CAQ, PwC, and RSM.

164 *See e.g.,* letters from KPMG and IBC.

165 *See e.g.,* letters from BDO, KPMG, RSM, and EY.

166 *See e.g.,* letters from BDO and EY.

167 *See e.g.,* letters from KPMG, RSM, IBC, and PwC.

the Commission define the term "consumer loan" along the lines of the discussion in the Proposing Release and suggested that the rule retain a reference to "credit cards" for additional clarity.[168] Another commenter suggested the Commission use the term "other consumer loans" because, in its view, consumer loans commonly include auto, home equity, and student loans and mortgages.[169] Some commenters requested that the Commission consider whether similar exclusions should be applied to other consumer financial arrangements, such as digital payment application balances,[170] deposit overdraft protections,[171] insurance policies, leases, and deposit account balances that exceed FDIC insurance limits or are not subject to FDIC or similar insurance.[172]

c. Final Amendment

After considering the public comments and recommendations received, we are adopting as proposed amended 17 CFR 210.2-01(c)(1)(ii)(E). The amendment is intended to broaden this provision so that credit card debt and other forms of consumer financing, such as retail installment loans, cell phone installment plans, and home improvement loans that are not secured by a mortgage on a primary residence, would be excluded if the outstanding balance is $10,000 or less on a current basis. Consistent with the payment terms in the current Credit Card Rule, in assessing the current basis of a consumer loan balance, the borrower would consider the payment due date, plus any available grace period, which is typically monthly for credit cards. We

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168 *See* letter from PwC.

169 *See* letter from RSM.

170 *See* letter from FEI.

171 *See e.g.,* letters from PwC, KPMG, and FEI.

172 *See* letter from PwC.

considered inflationary adjustments in light of comments received asking for an increase from the proposed $10,000 outstanding balance limit. However, we are not modifying the proposed outstanding balance limit because we believe $10,000 remains a significant amount of money for an individual covered by the final amendment (*i.e.*, any covered person or his or her immediate family members). In particular, we believe that when an individual covered by the final amendment has outstanding consumer loan(s) with an audit client in excess of this amount, the auditor's objectivity and impartiality could be impaired.

The additional exclusions suggested by commenters for other consumer financial arrangements, such as digital payment application balances, among others, were not included as part of the proposal and may involve their own unique set of issues. Accordingly, the final amendment does not cover such arrangements. Also, we believe including many enumerated types of consumer loans in the rule will increase complexity of the rule and may become outdated as consumer lending arrangements evolve. As such, we have not included within Rule 2-01(f) a definition of the term "consumer loan." We also did not adopt commenters' suggestions to use a term other than "consumer loans," such as to retain the current reference to "credit cards" or to add "other," as we believe the rule is sufficiently clear as to what types of loans are covered under this exception.

C. Amendments to the Business Relationships Rule

1. Proposed Amendment to the Reference to "Substantial Stockholder"

The Commission proposed to replace the term "substantial stockholders" in the Business Relationships Rule with the phrase "beneficial owners (known through reasonable inquiry) of the audit client's equity securities where such beneficial owner has significant influence over the audit client." Currently, Rule 2-01(c)(3) prohibits, at any point during the audit and professional engagement period, the accounting firm or any covered person from having "any direct or material indirect business relationship with an audit client, or with persons associated with the audit client in a decision-making capacity, such as an audit client's officers, directors, or *substantial stockholders* . . . ." (emphasis added).

In the Proposing Release, the Commission expressed its belief that referring to "beneficial owners (known through reasonable inquiry) of the audit client's equity securities where such beneficial owner has significant influence over the audit client" instead of "substantial stockholders" would improve the rule by making it clearer and less complex. In this regard, the Commission noted that "substantial stockholder" is not currently defined in Regulation S-X, whereas the concept of significant influence is used in the Loan Provision[173] and other aspects of the auditor independence rules.[174]

The Proposing Release also included additional guidance to explain that regardless of whether the beneficial owner owns equity securities of an audit client, including an affiliate of the audit client, the independence analysis should focus on whether the beneficial owner has significant influence over the entity under audit, as business relationships with persons with such influence could be reasonably expected to affect an auditor's objectivity and impartiality.[175]

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173 Consistent with the recently adopted amendments discussed in the Loan Provision Adopting Release, the Commission indicated that use of "significant influence" in the proposed amendments is intended to refer to the principles in the Financial Accounting Standards Board's ("FASB's") ASC Topic 323, Investments – Equity Method and Joint Ventures. *See* Section II.C.3 of the Loan Provision Adopting Release.

174 *See e.g.,* Rules 2-01(f)(4)(ii) and (iii).

175 *See* Section II.C.2 of the Proposing Release. This guidance was limited to the analysis related to associated persons in a decision-making capacity of an audit client. This guidance was not intended to change the analysis when evaluating "any direct or material indirect business relationships with an audit client." Under the current, proposed, and adopted rule, any direct or material indirect business relationships with an audit client, which includes any affiliates of the audit client, would be deemed independence-impairing.

2. Comments Received

Many commenters supported the proposal to use the significant influence concept from the Loan Provision to replace the reference to substantial stockholder in the Business Relationships Rule.[176] Commenters stated that this approach would facilitate compliance by applying a concept that is well understood.[177] Some commenters indicated the proposal would more appropriately identify those relationships that are more likely to impair an auditor's objectivity and impartiality[178] and would increase the number of qualified firms from which an issuer may choose.[179]

One commenter opposed the proposed amendment.[180] This commenter reiterated concerns regarding the concept of beneficial owner with significant influence, which the commenter previously expressed with respect to the recent amendments to the Loan Provision.[181]

Several commenters recommended that the Commission consider aligning the guidance in the Proposing Release with the Loan Provision Adopting Release to clarify that entities under common control with, or controlled by, the beneficial owner of the audit client's equity securities

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176 *See e.g.,* letters from NASBA, CAQ, Deloitte, BDO, EY, KPMG, RSM, PwC, GT, Parrett, AIC, ICI/IDC, IBC, FEI, CCMC and Crowe.

177 *See e.g.,* letters from CAQ, Deloitte, EY, KPMG, PwC, ICI/IDC, and Crowe.

178 *See e.g.,* letters from CAQ, Deloitte, ICI/IDC, EY, FEI, KPMG, RSM, PwC, and Crowe.

179 *See* letter from EY.

180 *See* letter from CII.

181 *See* letter from CII (June 28, 2018), *available at* https://www.sec.gov/comments/s7-10-18/s71018-3969965-167120.pdf.

that has significant influence over the audit client would be excluded from the scope of the Business Relationships Rule.[182]

One commenter requested that the Commission provide examples of the types of business relationships that would be "problematic" based on consultations received.[183]

In the Proposing Release, the Commission requested comment on whether additional amendments are needed to address multi-company relationships. Commenters provided their views concerning multi-company relationships, including, for some, the application of Rule 2-01(b) to these situations.[184] These commenters suggested that the Commission consider these discussions and examples when considering whether to provide future guidance in this area. Some commenters explicitly noted that they do not believe further amendments are required to identify whether the auditor's objectivity and impartiality would be impaired.[185]

One commenter suggested a broad re-examination of the Business Relationships Rule due to the changes in the business environment and multi-company relationships.[186] Another commenter stated that Rule 2-01(c)(3) currently precludes many private equity firms from investing in certain multi-company relationships and that the proposed amendments do not

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182 *See e.g.,* letters from CAQ, Deloitte, EY, AIC, CCMC, PwC, and Parrett. FEI also requested alignment with the Loan Provision Adopting Release, but did not specify the common control issue.

183 *See* letter from GT. We have not provided examples of problematic business relationships as requested by the commenter. The changes to the Business Relationships Rule set forth in this release are narrow and consistent with the Loan Provision. Providing examples or additional guidance on the broader application of Rule 2-01(c)(3) is beyond the scope of this rulemaking. As noted in Section II.A.1.a.iii and consistent with the introductory paragraph to amended Rule 2-01, registrants and auditors may consult with the Commission's Office of the Chief Accountant.

184 *See e.g.,* letters from CAQ, Deloitte, EY, KPMG, RSM, and PwC.

185 *See e.g.,* letter from EY and KPMG.

186 *See* letter from PwC.

address this issue.[187] This same commenter also noted that its recommendation to apply a dual materiality threshold in determining if a sister entity is an affiliate of the audit client would significantly alleviate the concerns around the Business Relationships Rule.

With respect to the additional guidance in the Proposing Release, many commenters expressed their support for the clarification that the focus of the significant influence analysis, as it relates to persons in a decision-making capacity, should be on the entity under audit.[188] Commenters also recommended that the Commission reiterate this guidance in the adopting release or revise the rule text to incorporate it.[189]

Two commenters requested that the Commission clarify whether this "entity under audit" guidance applies to officers and directors as referenced in the Business Relationships Rule.[190]

3. Final Amendments

After considering the public comments and recommendations received, we are adopting amendments to the Business Relationships Rule substantially as proposed with one modification. We are modifying the proposal to incorporate the guidance in the Proposing Release regarding the reference to "audit client" when identifying associated persons in a decision-making capacity, including beneficial owners. Under this approach, the independence analysis focuses on whether the associated person has decision-making capacity over the entity under audit rather than the audit client. We continue to believe that providing internal consistency between the Loan Provision and the Business Relationships Rule by leveraging the concept of "beneficial

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187 *See* letter from AIC.

188 *See e.g.,* letters from NASBA, CAQ, Deloitte, BDO, EY, KPMG, PwC, GT, CCMC, and Crowe.

189 *See e.g.,* letters from CAQ, Deloitte, KPMG, Crowe, CCMC, PwC, and GT.

190 *See* letters from EY and PwC.

owners (known through reasonable inquiry) of the audit client's equity securities where such beneficial owner has significant influence" will foster compliance and consistency in application.

Regarding the comments seeking consistency with the Loan Provision in other areas, we do not agree with the recommendation that entities controlled by or under common control with the beneficial owner of the audit client's equity securities, where such beneficial owner has significant influence over the entity under audit, should be excluded from the scope of the Business Relationships Rule. We view business relationships as presenting different threats to an auditor's objectivity and impartiality than those presented by lending relationships. We also believe the focus on beneficial owners having significant influence over the entity under audit instead of the audit client properly focuses the independence analysis on the significant threats to an auditor's objectivity and impartiality—and identifying associated persons with such influence should not impose an undue compliance burden.

We agree with commenters that requested we codify the additional guidance from the Proposing Release to provide more certainty regarding the application of the final amendment to beneficial owners of equity securities of an affiliate of the audit client. As such, the final amendment to the Business Relationships Rule has been modified to refer to "beneficial owners (known through reasonable inquiry) of the audit client's equity securities where such beneficial owner has significant influence over the *entity under audit*" (emphasis added). Further, in response to comments seeking clarification regarding the application of the Business Relationships Rule to officers and directors, we are also amending the Business Relationships Rule to refer to "an audit client's officers or directors that have the ability to affect decision-making at the entity under audit." This amendment clarifies that the Business Relationships Rule applies to relationships with officers or directors at an affiliate of the audit client when such person has the ability to affect decision-making at the entity under audit. This amendment does not change the application of the rule as it applies to the officers or directors of the entity under audit. Such persons are deemed to have the ability to affect decision-making at the entity under audit.

Although we requested comment on the need to address multi-company arrangements, after further consideration, we have determined that addressing such arrangements is beyond the scope of this rulemaking, which is focused on aligning the Business Relationships Rule with the Loan Provision and providing clarification regarding persons in a decision-making capacity. For similar reasons, we are not providing examples of problematic business relationships, as requested by one commenter. We also agree with the commenter that indicated that the proposed amendments to the affiliate of the audit client definition should significantly alleviate concerns around the Business Relationships Rule.[191] If auditors or their clients have specific questions related to multi-company arrangements, as noted in the introductory paragraph to amended Rule 2-01, they may consult with the Commission's Office of the Chief Accountant.

4. Conforming Amendments to the Loan Provision

The additional guidance provided in the Proposing Release regarding beneficial owners with significant influence set forth the Commission's view of the appropriate application of the Loan Provision. For clarity, we are adopting conforming amendments to the Loan Provision to reflect our view of how it applies to loans to or from officers or directors of affiliates of the audit client and beneficial owners of an affiliate of the audit client's equity securities.

[191] *See* letter from AIC.

D. Amendments for Inadvertent Violations for Mergers and Acquisitions

1. Proposed Amendment

For the reasons discussed in the Proposing Release,[192] the Commission introduced a transition framework to address inadvertent independence violations where the independence violation arises as a result of a corporate event, such as a merger or acquisition, and the services or relationships that are the basis for the violation would not have run afoul of applicable independence standards prior to the corporate event. The proposed amendments would require an auditor to:

- Be in compliance with the applicable independence standards related to the services or relationships when the services or relationships originated and throughout the period in which the applicable independence standards apply;
- Correct the independence violations arising from the merger or acquisition as promptly as possible under relevant circumstances associated with the merger or acquisition; and
- Have in place a quality control system as described in 17 CFR 210.2-01(d)(3) ("Rule 2-01(d)(3)") that has the following features:
  - Procedures and controls that monitor the audit client's merger and acquisition activity to provide timely notice of a merger or acquisition; and
  - Procedures and controls that allow for prompt identification of potential violations after initial notification of a potential merger or acquisition that may trigger independence violations, but before the transaction has occurred.

[192] *See* Section II.D of the Proposing Release.

2. Comments Received

Many commenters supported the proposed transition framework to allow audit firms and their clients to transition out of services or relationships that will become violations due to a merger or acquisition.[193] Commenters indicated that these inadvertent violations would not typically impair an auditor's objectivity and impartiality.[194] Some commenters also noted the potential for significant disruption when these situations arise through no action of the audit firm.[195] One commenter discussed disruption in the context of the private equity space.[196] Another commenter stated that the proposed transaction framework may increase the number of auditors a potential audit client may select or retain.[197]

A few commenters opposed the proposed transition framework.[198] One commenter indicated that it generally does not view a delay in mergers and acquisitions due to independence matters as a "possible detriment" to investors because auditor independence is critical to investor protection and investor confidence and it believes that "many, if not most, mergers and acquisitions ultimately do not enhance long-term shareholder value."[199] Another commenter indicated that it could not support the proposal "without additional guardrails."[200] This

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193 *See e.g.,* letters from NASBA, CAQ, Deloitte, BDO, EY, KPMG, RSM, PwC, GT, Parrett, AIC, ICI/IDC, IBC, FEI, CCMC, and Crowe.

194 *See e.g.,* letters from Deloitte, KPMG, Crowe, AIC, and GT.

195 *See e.g.,* letters from CAQ, Deloitte, EY, ICI/IDC, FEI, and AIC.

196 *See* letter from AIC.

197 *See* letter from KPMG.

198 *See e.g.,* letters from CII and NYSSCPA.

199 *See* letter from CII.

200 *See* letter from NYSSCPA.

commenter suggested that the relationship or service triggering the inadvertent violation should either be terminated before the merger or acquisition is effective, or within a specified period of time (*e.g.*, three months) from the announcement date of the merger or acquisition. The commenter further stated that the "as promptly as possible" provision is susceptible to abuse and that these situations are better addressed by the staff on a case by case basis as the issue arises."

One commenter recommended that the proposed transition framework should be applicable to all financial statement periods subject to compliance with Rule 2-01, such as where an entity anticipating an IPO makes an acquisition in the year subject to the one-year look-back provision as proposed.[201] The commenter's recommendation would allow a private company that engages in a merger or acquisition transaction to be able to rely on the transition framework to satisfy its independence requirements when it engages in an IPO in the following year.

Commenters generally supported the proposed quality control criteria or noted that they are sufficiently clear.[202] One commenter stated that the quality control requirement should acknowledge the applicability of the general standard with respect to the independence evaluation of the services and relationships with the new affiliate—both individually and in the aggregate.[203] Another commenter recommended that the Commission provide further guidance on the terms "timely notice" and "prompt identification" and its expectations of the procedures and controls that audit clients should have in place to inform auditors of pending transactions.[204]

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201 *See* letter from KPMG.

202 *See e.g.,* letters from Deloitte, BDO, KPMG, and RSM.

203 *See* letter from KPMG.

204 *See* letter from EY.

In the Proposing Release, the Commission requested comment on whether certain services or relationships should continue to be deemed independence-impairing, for example, if they result in the auditor auditing its own work. Some commenters indicated that Rule 2-01(b) appropriately addresses any threat to an auditor's objectivity and impartiality in situations where an inadvertent violation from a merger or acquisition could result in an audit firm auditing its own work.[205] Another commenter stated that the threat of auditing one's own work is mitigated by the proposed requirement to comply with applicable independence standards prior to the transaction and because periods prior to the transaction are not included in the accounting acquirer's financial statements.[206] However, several commenters expressed the view that "under no circumstances should the auditor be permitted" to audit its own work.[207]

Some commenters stated that a merger or acquisition that is in substance more like an IPO should be addressed by the proposed change to the definition of the "audit and professional engagement period," as the compliance challenges are similar to an IPO situation.[208] However, other commenters asserted that all mergers or acquisitions should be covered by the proposed transition framework, including transactions in which private companies merge into a public shell, as these types of reverse mergers can occur with much less notice than a traditional IPO.[209]

In the Proposing Release, the Commission requested comment on the requirement to correct inadvertent violations as "promptly as possible" and indicated that such correction should

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205 *See e.g.,* letters from Deloitte, EY, and KPMG.

206 *See* letter from RSM.

207 *See e.g.*, letters from NASBA and CII.

208 *See e.g.,* letters from Deloitte and RSM.

209 *See e.g.,* letters from EY and KPMG.

not occur more than six months after the consummation of the merger or acquisition. Many commenters supported the maximum six-month transition period.[210] A few commenters recommended that the final rule expressly reference the six-month transition period.[211] One commenter expressed concern that the "maximum six-month transition period will become the acceptable standard in practice."[212] One commenter suggested a 12- to 18-month maximum[213] while another commenter stated that a maximum period of time should not be specified.[214]

Several commenters suggested the Commission clarify that the framework applies where the triggering relationship or service is identified at or after the transaction closing but still addressed within the six-month window.[215] A few of these commenters noted that the quality control systems described in Rule 2-01(d)(3) may not, at times, identify independence-impairing relationships or services until after the close of a merger or acquisition.[216] Relatedly, some commenters indicated that there are challenges in obtaining relevant information prior to the closing of mergers or acquisitions.[217]

Several commenters questioned whether compliance with the proposed transition framework should still result in an independence violation, and stated their belief that parties that

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210 *See e.g.,* letters from CAQ, Deloitte, BDO, EY, KPMG, PwC, GT, AIC, ICI/IDC, and Crowe.

211 *See e.g.,* letters from PwC and EY.

212 *See* letter from NASBA.

213 *See* letter from IBC.

214 *See* letter from RSM.

215 *See e.g.,* letters from CAQ, EY, PwC, GT, Crowe, AIC, ICI/IDC, FEI, CCMC, and KPMG.

216 *See e.g.,* letters from EY and KPMG.

217 *See e.g.,* letters from PwC, GT, and FEI.

adhere to the framework should not be viewed as having incurred an independence violation.[218] Some of these commenters requested that the Commission use terms other than "violation" and "lack of independence" when discussing potentially independence-impairing relationships or services prior to the closing of a transaction.[219] One of these commenters noted that since the relationships or services are identified before the closing, it does not appear they should be called violations, since they are not technically violations until the merger or acquisition closes.[220]

A few commenters requested guidance on how matters covered by the proposed transition framework should be communicated to an audit committee.[221] One commenter indicated that if these matters are not deemed violations, then the matters would not be communicated to the audit committee.[222] However, other commenters asserted that even if these matters are not deemed violations, the matters should still be communicated to the audit committee.[223]

3. Final Amendments

After considering the public comments and recommendations received, we are adopting amended 17 CFR 210.2-01(e) ("amended Rule 2-01(e)") substantially as proposed to include a transition provision for inadvertent independence violations where the independence violation arises as a result of a corporate event, such as a merger or acquisition, involving audit clients.

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218 *See e.g.,* letters from CAQ, Deloitte, BDO, EY, CCMC, KPMG, Crowe, and PwC.

219 *See e.g.,* letters from Crowe and KPMG.

220 *See* letter from KPMG.

221 *See e.g.,* letters from GT and Crowe.

222 *See* letter from PwC.

223 *See e.g.,* letters from EY and CCMC.

We are adopting modifications from the proposed amendments to address comments received regarding the reference to "lack of independence" and "violation" in the proposed amendment that we found persuasive. For clarity, we also are replacing "before the transaction has occurred" with "before the effective date of the transaction." The effective date of a merger or acquisition is typically identified in the transaction documents and often made public. This change is not intended to alter the application of the rule from the proposal, but only to provide clarity and consistency with commonly used terms.

We continue to believe it is appropriate to provide, in a manner consistent with investor protection, a transition framework for mergers and acquisitions to address inadvertent violations as a result of such transactions so the auditor and its audit client can transition out of services and relationships that would currently trigger an independence violation in an orderly manner. As stated in the Proposing Release, the transition framework follows the consideration of the audit firm's quality controls similar to Rule 2-01(d)(3).[224] As proposed, we are adopting the requirements associated with the transition framework.

As noted above, the Commission requested comment regarding mergers and acquisitions that are similar to IPOs. After considering the feedback received, we believe that the adopted transition framework should not apply to merger or acquisition transactions that are in substance similar to IPOs. For example, where a shell company, reporting pursuant to Sections 13 or 15(d) of the Exchange Act, engages in a merger with a private operating company, the auditor of the

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224 The Commission adopted 17 CFR 210.2-01(d) ("Rule 2-01(d)") as a limited exception to address a covered person's violations in certain circumstances that would be attributed to an entire firm. The effect of Rule 2-01(d) is that an accounting firm with "appropriate quality controls will not be deemed to lack independence when an accountant did not know of the circumstances giving rise to the impairment, and upon discovery, the impairment is quickly resolved." *See* 2000 Adopting Release, at 65 FR 76052.

financial statements to be included in a Commission filing resulting from such transaction will not be able to rely on the transition framework in amended Rule 2-01(e). Instead, such auditor should evaluate independence compliance using the look-back period contained within the "audit and professional engagement period" definition, as amended.[225] Consistent with the introductory paragraph in amended Rule 2-01, registrants and auditors may also consult with the Commission's Office of the Chief Accountant.

a. Amended Rule 2-01(e)(1) - Compliance with All Applicable Independence Standards

Regarding this first provision, amended 17 CFR 210.2-01(e)(1) ("amended Rule 2-01(e)(1)"), the auditor must be in compliance with any independence standards that are applicable to the entities involved in the merger or acquisition transaction from the origination of the relationships or services in question and throughout the period in which the applicable independence standards apply.

b. Amended 17 CFR 210.2-01(e)(2) - Prompt Transition

We expect that the independence-impairing service or relationship, in most instances, should and could be addressed before the effective date of the merger or acquisition. However, we understand there may be situations where it might not be possible for the audit client and the auditor to transition the independence-impairing service or relationship in an orderly manner without causing significant disruption to the audit client. In those situations, we expect the relationship or service to be addressed promptly after the effective date of the merger or acquisition.

225 *See* Section II.A.2.c.

Whether a post-transaction transition occurs promptly will depend on all relevant facts and circumstances. However, as stated in the Proposing Release, we expect any necessary actions would be taken no later than six months after the effective date of the merger or acquisition. We have not included a reference to the six-month maximum transition period in amended Rule 2-01(e), as suggested by some commenters, because we do not intend, nor do we believe it would be appropriate, for audit clients and audit firms to apply this timeline to address such services or relationships in every merger or acquisition scenario. In this regard, we agree with the commenter who suggested that specifying such a timeline in the final rule could result in it becoming the standard practice in all situations, even when a shorter transition may be reasonably attainable and more appropriate.

We also are not specifying a longer maximum transition period as several commenters recommended. We continue to believe that six months is an appropriate limit for transitioning to compliance with our independence rules, which as noted above, are important for investor protection and to promote investor confidence. As stated in the Proposing Release, audit firms and audit clients already manage to this timeline as it is consistent with international ethics and independence standards for accountants.[226]

In response to comments, we are removing references to the services and relationships identified as a result of a merger or acquisition as a "lack of independence" or "violation." We agree that if the requirements in amended Rule 2-01(e) are met, then the relationships and services are not independence violations. As such, referring to independence violations or lack of independence may be confusing. The transition framework is intended to allow an auditor and

[226] *See* The International Code of Ethics for Professional Accountants (including International Independence Standards), section titled, "Mergers and Acquisitions" under, "Part 4A-Independence for Audit and Review Engagements" available at https://www.ifac.org/system/files/publications/files/Final-Pronouncement-The-Restructured-Code_0.pdf.

its audit client sufficient opportunity to transition out of services and relationships in an orderly manner without impairing the auditor's independence. With respect to comments regarding whether these services or relationships should be communicated to the audit committee, auditors should follow PCAOB Rule 3526, *Communication with Audit Committees Concerning Independence.* PCAOB Rule 3526 requires communications of all relationships that may reasonably be thought to bear on independence.

c. New 17 CFR 210.2-01(e)(3) - Quality Control System

We considered comments received requesting elimination of the proposed requirement for an accounting firm to have procedures and controls to identify independence-impairing services and relationships before the transaction has occurred in order to allow for post-transaction identification. We are not adopting this suggestion. The Commission continues to stress that having a robust quality control system is paramount to maintaining auditor independence and, ultimately, investor protection.

We believe that it is reasonable to expect that an auditor and an audit client intending to rely on the benefits of the transition framework have in place robust procedures and controls that will identify services and relationships that would result in an independence violation prior to the effective date of the triggering transactions. As such, we are adopting the transition framework, as proposed, with a slight modification regarding the reference to "effective date" discussed above, so that it applies to services and relationships that are identified prior to the effective date of a merger or acquisition transaction.

In situations where a service or relationship resulting in an independence violation is identified subsequent to the effective date of the transaction, an audit firm and the audit client's audit committee will need to take into account all relevant facts and circumstances in their evaluation of the auditor's objectivity and impartiality in carrying out an audit of the financial statements of the combined entity. Consistent with the introductory paragraph in amended Rule 2-01, registrants and auditors may also consult with the Commission's Office of the Chief Accountant.

Regarding the suggestion that the quality control requirement acknowledge the applicability of Rule 2-01(b), we do not feel this is necessary. Rule 2-01(b) applies in all cases and expressly requires the consideration of all relevant facts and circumstances. As a result, if the transition framework is followed but the nature, extent, relative importance, or other aspect of the service or relationship impairs the auditor's objectivity and impartiality, then that service or relationship would be considered an independence violation. For example, if an auditor is found to be auditing its own work over a significant amount of the acquired business as part of the audit of the financial statements, that fact most likely would affect the auditor's independence under Rule 2-01(b).

E. Miscellaneous Amendments

1. Proposed Miscellaneous Amendments

As discussed in Section II.E of the Proposal, the Commission proposed three miscellaneous amendments to:

- Make conforming amendments throughout Rule 2-01 to replace references to "concurring partner" with the term "Engagement Quality Reviewer" to be consistent with current auditing standards that use the term "Engagement Quality Reviewer" or "Engagement Quality Control Reviewer;"
- Convert the existing Preliminary Note to §210.2-01 into introductory text to Rule 2-01, consistent with *Federal Register* drafting requirements; and

- Delete the outdated transition provisions in existing Rule 2-01(e), which were added as part of the Commission's 2003 amendments[227] to address the existence of relationships and arrangements that predated those amendments.

2. Comments Received

Commenters that addressed this aspect of the proposal supported the proposed miscellaneous amendments.[228] No commenters expressed opposition to any of the three proposed miscellaneous amendments. Related to our technical amendment to re-designate the Preliminary Note to §210.2-01, one commenter requested we repeat at the adopting stage our discussion in the Proposing Release that the amendment does not affect the application of the auditor independence rules.[229]

3. Final Amendments

We are adopting the three miscellaneous amendments as proposed. As noted in the Proposing Release,[230] the final amendment to convert the existing Preliminary Note to §210.2-01 into introductory text does not affect the application of the auditor independence rules and is simply a change in rule text format.

F. Other Comments Received

Several commenters requested that the Commission collaborate with the PCAOB to evaluate and update the PCAOB independence rules and standards in light of the proposed

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227 *See supra* note 6.

228 *See e.g.,* letters from NASBA, Deloitte, BDO, EY, KPMG, RSM, PwC, GT, and CCMC.

229 *See* letter from KPMG.

230 *See* Section II.E.2 of the Proposing Release.

amendments if the proposed amendments are adopted.[231] For example, PCAOB Rule 3500T provides that registered public accounting firms must comply with the more restrictive independence rule if there are differences between the SEC and PCAOB independence rules. As a result of the final amendments, there will be differences between the SEC and PCAOB independence rules. The PCAOB has publicly disclosed a plan to conform its independence rules in response to the final amendments.[232]

G. Transition

Auditors currently subject to the independence requirements of Rule 2-01 are not required to apply the final amendments until [INSERT DATE 180 DAYS AFTER THE DATE PUBLISHED IN THE FEDERAL REGISTER] in order to have sufficient time to develop and implement processes and controls based on the final amendments. Voluntary early compliance is permitted after the amendments are published in the *Federal Register* in advance of the effective date provided that the final amendments are applied in their entirety from the date of early compliance.[233]

Compliance with the final amendments is required on a prospective basis from the earlier of the effective date or early compliance date if selected by an audit firm. Auditors are not permitted to retroactively apply the final amendments to relationships and services in existence prior to the effective date or the early compliance date if selected by an audit firm. Regarding the final amendments in Rule 2-01(c)(1)(ii)(A) and (E) and loans that were originated before the

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231 *See e.g.,* letters from CAQ, EY, GT, PwC, RSM, AIC, and CCMC.

232 *See* https://pcaobus.org/Standards/research-standard-setting-projects/Pages/auditor-independence.aspx.

233 To the extent that auditors or audit clients have questions about application of the rules in connection with early compliance, they may contact staff in the Office of the Chief Accountant for additional transition guidance.

effective date or the early compliance date, but that comply with the conditions of the final amendments as of the effective date or early compliance date, an auditor may rely on the final amendments; such loans would not be considered independence violations provided the conditions for excepting such loans continue to be met.

III. OTHER MATTERS

If any of the provisions of these amendments, or the application of these provisions to any person or circumstance, is held to be invalid, such invalidity shall not affect other provisions or application of such provisions to other persons or circumstances that can be given effect without the invalid provision or application. Pursuant to the Congressional Review Act,[234] the Office of Information and Regulatory Affairs has designated these amendments as [not] a "major rule," as defined by 5 U.S.C. 804(2).

IV. ECONOMIC ANALYSIS

A. Introduction

We are adopting amendments to the auditor independence requirements in Rule 2-01 that will: (1) amend the definition of an affiliate of the audit client to address certain affiliate relationships in common control scenarios and the ICC definition; (2) shorten the look-back period for domestic first-time filers in assessing compliance with the independence requirements; (3) add certain student loans and de minimis consumer loans to the categorical exclusions from independence-impairing lending relationships; (4) replace the reference to "substantial stockholders" in the Business Relationships Rule with the concept of beneficial owners with significant influence; (5) introduce a transition framework for merger and acquisition

[234] 5 U.S.C. 801 *et seq*.

transactions to consider whether an auditor's independence is impaired; and (6) make certain miscellaneous amendments.

We are mindful of the costs and benefits of the final amendments. The discussion below addresses the potential economic effects of the final amendments, including the likely benefits and costs, as well as the likely effects on efficiency, competition, and capital formation.[235]

We note that, where possible, we have attempted to quantify the benefits, costs, and effects on efficiency, competition, and capital formation expected to result from the final amendments. In many cases, however, we are unable to quantify the economic effects because we lack information necessary to provide a reasonable estimate. For example, we are unable to quantify, with precision, the costs to auditors and audit clients of complying with the particular aspects of the auditor independence rules and the potential compliance cost savings, increase in the number of eligible auditors and potential clients, and changes in audit quality that may arise from the amendments to Rule 2-01. In the Proposing Release, we requested data to help us quantify the economic effects of the amendments, but none of the commenters provided any data or quantitative estimates.

The remainder of the economic analysis presents the baseline, anticipated benefits and costs from the final amendments, potential effects of the amendments on efficiency, competition and capital formation, and reasonable alternatives to the amendments.

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235 Section 2(b) of the Securities Act [15 U.S.C. 77b(b)], Section 3(f) of the Exchange Act [17 U.S.C. 78c(f)], Section 2(c) of the Investment Company Act [15 U.S.C. 80a-2(c)], and Section 202(c) of the Investment Advisers Act [15 U.S.C. 80b-2(c)] require the Commission, when engaging in rulemaking where it is required to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation. Further, Section 23(a)(2) of the Exchange Act [17 U.S.C. 78w(a)(2)] requires the Commission, when making rules under the Exchange Act, to consider the impact that the rules would have on competition, and prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the Exchange Act.

B. Baseline and Affected Parties

Under current Rule 2-01, the term "affiliate of the audit client" includes "an entity that has control over the audit client or over which the audit client has control" and entities "under common control with the audit client, including the audit client's parents and subsidiaries."[236] Under this definition, affiliates of the audit client include all sister entities without regard to the materiality of the sister entity or the entity under audit to the controlling entity. The term "affiliate of the audit client" also includes each entity in an ICC when the audit client is part of the ICC.[237] In complex organizational structures, such as large ICCs, the requirement to identify and monitor for potential independence-impairing relationships and services currently applies to affiliated entities, including sister entities, regardless of whether the affiliated entities are material to the controlling entity. The current inclusion of sister entities that are not material to the controlling entity in the auditor independence analysis creates practical challenges and imposes compliance costs on both auditors and audit clients, especially those within complex organizational structures.

Currently, "audit and professional engagement period" is defined differently for first-time filers, depending on whether they are domestic issuers or FPIs.[238] Specifically, when a domestic IPO registration statement includes either two or three years of audited financial statements, the auditor of a domestic first-time filer must comply with Rule 2-01 for all audited financial

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236 Rule 2-01(f)(4)(i).

237 *See* Rule 2-01(f)(4)(iv).

238 *See* Rule 2-01(f)(5)(iii).

statement periods included in such registration statement.[239] For FPIs, the corresponding "audit and professional engagement period" includes only the fiscal year immediately preceding the initial filing of the registration statement or report. As a result, domestic issuers may have a higher compliance cost relative to FPIs in applying this rule.

Pursuant to Rule 2-01(c), an accountant is not independent if the accounting firm, any covered person in the firm, or any of his or her immediate family members has any loans (including any margin loans) to or from an audit client, or certain other entities or persons related to the audit client.[240] Those loans include, among others, student loans, certain mortgage loans, and credit card balances. In addition, under current rules, a business relationship between a substantial stockholder of the audit client, among others, and the auditor or covered person would be considered independence-impairing.[241]

Certain aspects of Rule 2-01 require auditor independence compliance during the audit and professional engagement period, which may include periods before, during, and after merger and acquisition transactions.[242] As a result, certain merger and acquisition transactions could give rise to inadvertent violations of the auditor independence requirements. For example, an auditor may provide management functions to a target firm and auditing services to an acquirer prior to the occurrence of an acquisition. Consequently, the acquisition may result in an auditor independence violation that had not existed prior to the acquisition.

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239 For example, an auditor may be excluded from consideration if the auditor provided a non-audit service (*e.g.*, management functions) to a domestic filer in the third year before the firm files the registration statement for the first time. Even though the auditor has stopped providing such service to the filer starting two years prior to the firm's filing the registration statement, under the current definition, the auditor will not qualify as "independent" under Rule 2-01.

240 Rule 2-01(c)(1)(ii)(A).

241 *See* Rule 2-01(c)(3).

242 *See* Rule 2-01(f)(5).

The amendments will update the auditor independence requirements, which will affect auditors, audit clients, and any other entity that is currently or may become an affiliate of the audit client. Other parties that may be affected by the amendments include "covered persons" of accounting firms and their immediate family members. As discussed further below, the amendments will affect investors indirectly.

We are not able to reasonably estimate the number of current audit engagements that will be immediately affected by the amendments as we lack relevant data about such engagements. We also do not have precise data on audit clients' ownership and control structures. With respect to the amendments relating to treatment of student loans and consumer loans, there is no data readily available to us relating to how "covered persons" and their immediate family members arrange their financing. Similarly, there is no readily available data to quantify the number of business relationships that audit firms have with beneficial owners of an audit client's equity securities where the beneficial owner has significant influence over the audit client. As such, we are not able to identify those auditor-client relationships that would be impacted by the amendments to the Business Relationships Rule. We therefore are not able to quantify the effects of these aspects of the amendments. In the Proposing Release, we requested data in connection with the request for comment on all aspects of the economic analysis,[243] but none of the commenters provided any data or quantitative estimates with respect to these aspects of the amendments.

We have relied on information from PCAOB Forms 2 to approximate the potential

243 *See* Section III.F of the Proposing Release.

universe of auditors that will be affected by the amendments.[244] According to aggregated information from PCAOB Forms 2, as of August 3, 2020, there were 1,729 audit firms registered with the PCAOB (of which 876 are domestic audit firms, with the remaining 853 audit firms located outside the United States). According to a report provided by Audit Analytics in 2020, the four largest accounting firms audit about 73% of accelerated and large accelerated filers[245] and about 49.2% of all registrants.[246]

We estimate that approximately 6,792 issuers filing on domestic forms[247] and 849 FPIs filing on foreign forms would be affected by the amendments.[248] Among the issuers that file on domestic forms, approximately 31% are large accelerated filers, 19% are accelerated filers, and 50% are non-accelerated filers.[249] In addition, we estimate that approximately 19.1% of

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244 All registered public accounting firms must file annual reports on Form 2 with the PCAOB. To determine the number of audit firms registered with the PCAOB, we aggregated the total number of entities who filed a Form 2 with the PCAOB.

245 Accelerated filers and large accelerated filers are defined in Rule 12b-2 of the Exchange Act of 1934 [17 CFR 240.12b-2].

246 *See Who Audits Public Companies-2020 Edition*, *available at* https://blog.auditanalytics.com/who-audits-public-companies-2020-edition; *see also* Daniel Hood, "Top firms' share of public co. audits creeps up," Accounting Today (June 5, 2020), available at: https://www.accountingtoday.com/news/top-firms-share-of-public-co-audits-creeps-up.

247 This number includes fewer than 25 foreign issuers that file on domestic forms and approximately 100 business development companies.

248 The number of issuers that file on domestic forms is estimated as the number of unique issuers, identified by Central Index Key (CIK), that filed Forms 10-K, or an amendment thereto, with the Commission during calendar year 2019. The number of foreign private issuers is estimated as the number of unique issuers, identified by CIK, that filed either Form 20-F, 40-F, or an amendment thereto, with the Commission during calendar year 2019. Of FPIs with a self-reported status, approximately 37% are large accelerated filers, 21% are accelerated filers, and 42% are non-accelerated filers. Additionally, 26% are emerging growth companies.

249 The estimates for the percentages of smaller reporting companies, accelerated filers, large accelerated filers, and non-accelerated filers are based on data obtained by Commission staff using a computer program that analyzes SEC filings, with supplemental data from Ives Group Audit Analytics.

domestic issuers are emerging growth companies,[250] and 42.5% are smaller reporting companies.[251]

The amendment related to the "look-back" period for assessing independence compliance will affect future domestic first-time filers, but not future FPI first-time filers. To assess the effects of this amendment, we utilized historical data for domestic IPOs. According to Thompson Reuters' Security Data Company ("SDC") database, there were approximately 543 domestic IPOs during the period between January 1, 2017, and December 31, 2019.

The amendment related to a transition framework for merger and acquisition transactions will affect issuers that might engage in mergers and acquisitions. To assess the overall market activity for mergers and acquisitions, we examined mergers and acquisitions data from SDC. During the period from January 1, 2017, to December 31, 2019, there were 6,057 mergers and acquisitions entered into by publicly listed U.S. firms.

The amendments to the ICC definition would potentially affect registered investment companies and unregistered funds.[252] As of September 2020, there were 2,763 registered

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250 An "emerging growth company" is defined as an issuer that had total annual gross revenues of less than \$1.07 billion during its most recently completed fiscal year. *See* 17 CFR 230.405 and 17 CFR 240.12b-2. *See* Rule 405; Rule 12b-2; 15 U.S.C. 77b(a)(19); 15 U.S.C. 78c(a)(80); and Inflation Adjustments and Other Technical Amendments under Titles I and II of the JOBS Act, Release No. 33- 10332 (Mar. 31, 2017) [82 FR 17545 (Apr. 12, 2017)]. We based the estimate of the percentage of emerging growth companies on whether a registrant claimed emerging growth company status, as derived from Ives Group Audit Analytics data as of December 2019.

251 "Smaller reporting company" is defined in 17 CFR 229.10(f) as an issuer that is not an investment company, an asset-backed issuer (as defined in 17 CFR 229.1101), or a majority-owned subsidiary of a parent that is not a smaller reporting company and that: (i) had a public float of less than \$250 million; or (ii) had annual revenues of less than \$100 million and either: (A) no public float; or (B) a public float of less than \$700 million.

252 Based on the current reporting requirements for unregistered funds, we do not have data readily available regarding unregistered funds that would allow us to quantify the number of unregistered funds that would be affected by the final amendments. We did not receive data regarding unregistered funds from commenters.

investment companies that filed annual reports on Form N-CEN. As of July 2020, there were 10,092 mutual funds (excluding money market funds) with $19,528 billion in total net assets, 2,142 exchange traded funds ("ETFs") organized as an open-end fund or as a share-class of an open-end fund with $3,462 billion in total net assets, 666 registered closed-end funds with $307 billion in total net assets, and 13 variable annuity separate accounts registered as management investment companies on Form N-3 with $216 billion in total net assets. There also were 420 money market funds with $3,881 billion in total net assets.[253] Also, as of July 2020, there were 99 business development companies ("BDCs") with $58 billion in total net assets.[254]

C. Potential Costs and Benefits

1. Overall Potential Costs and Benefits

We anticipate the final amendments will benefit audit firms, audit clients, and investors in several ways. First, by revising our rules to emphasize those relationships and services that are more likely to threaten auditor objectivity and impartiality, the final amendments will reduce compliance costs for audit firms and their clients. Under the amended rules, auditors and their clients will be able to focus their resources and attention on monitoring those relationships and services that pose the greatest risk to auditor independence. This will reduce overall compliance burdens without significantly diminishing investor protections.

The final amendments also may enhance the audit process by expanding the pool of

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253 Estimates of the number of registered investment companies and their total net assets are based on a staff analysis of Form N-CEN filings as of July 8, 2020. For open-end funds that have mutual fund and ETF share classes, which only one fund sponsor currently operates, we count each type of share class as a separate fund and use data from Morningstar to determine the amount of total net assets reported on Form N-CEN attributable to the ETF share class. As money market funds generally are excluded we report their number and net assets separately from those of other mutual funds.

254 Estimates of the number of BDCs and their net assets are based on a staff analysis of Form 10-K and Form 10-Q filings as of July 30, 2020. Our estimate includes BDCs that may be delinquent or have filed extensions for their filings, and it excludes six wholly-owned subsidiaries of other BDCs.

eligible auditors. The potential larger pool of eligible auditors may allow audit clients to better align audit expertise with the needs of the audit engagement, which may lead to an improvement in audit quality and financial statement quality.[255] For example, audit clients in certain industries might have more complicated or very specialized businesses that would benefit from auditors with certain expertise or experience. If the pool of potential independent auditors is restricted due to provisions under current Rule 2-01 that are the subject of the final amendments, an audit client might have to choose a non-preferred audit firm, which may not provide the desired scope or quality of audit services. Because audit quality is correlated with financial reporting quality,[256] any improved financial reporting quality resulting from the final amendments will provide additional benefits by potentially reducing information asymmetry between issuers and their investors, improving firms' liquidity, and decreasing cost of capital.[257] Investors similarly will benefit from any resulting improvement in financial reporting quality.

With a larger pool of eligible auditors, audit clients could potentially avoid costs associated with searching for a new independent auditor and related costs resulting from switching from one audit firm to another, for example, when a new sister entity gives rise to an independence-impairing relationship for the entity under audit. A larger pool of potentially

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255 *See* Mark DeFond and Jieying Zhang, A Review of Archival Auditing Research, 58 J. Acct. Econ. 275 (2014).

256 *See id*.

257 *See* Siew H. Teoh and T. J. Wong, Perceived Auditor Quality and the Earnings Response Coefficient, 68 Acct. Rev. (1993) 346-366. *See also* Jeffery A. Pittman and Steve Fortin, Auditor Choice and the Cost of Debt Capital for Newly Public Firms, 37. J. Acct. Econ. (2004). 113-136; Jere R. Francis and Bin Ke, Disclosure of Fees Paid to Auditors and the Market Valuation of Earnings Surprises, 11 Rev. Acct. Stud. (2006) 495-523; Chan Li, Yuan Xie, and Jian Zhou, National Level, City Level Auditor Industry Specialization and Cost of Debt, 24 Acct. Horizon (2010) 395-417; and Jagan Krishnan, Chan Li, and Qian Wang, Auditor Industry Expertise and Cost of Equity, 27 Acct. Horizon (2013) 667-691.

qualified independent auditors may promote competition among audit firms, which may lower audit fees for comparable audit quality. Reduction in audit fees would lead to cash savings for audit clients, who could further invest those savings or return those savings to investors, all of which may accrue to the benefit of investors. However, this competitive effect may be limited because the audit profession is highly concentrated[258] with the four largest audit firms auditing about 49.2% of all registrants.[259] More specifically, as noted above, the four largest audit firms audit about 73% of accelerated and large accelerated filers.[260]

Auditors also could benefit from potentially having a broader spectrum of audit clients and clients for non-audit services as a result of the final amendments. If the amendments reduce certain burdensome constraints on auditors in complying with the independence requirements, auditors likely will incur fewer compliance costs. For example, audit firms will not need to discontinue their non-audit services or switch their audit services as a result of certain client affiliations that are no longer deemed independence-impairing under the dual materiality thresholds. In addition, the final amendments potentially could reduce auditor turnover due to changes in audit clients' organizational structure arising from certain merger and acquisition activities. The final amendments also may benefit auditors that provide non-audit services, as those audit firms, under the final amendments, will be permitted to provide such services to a sister entity, so long as either the entity under audit or the sister entity is not material to the controlling entity. Similarly, under the final amendments, audit firms that currently provide non-

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258 *See* United States Government Accountability Office. Audits of Public Companies – Continued Concentration in Audit Market for Large Public Companies Does Not Call for Immediate Action, *available at* www.gao.gov/new.items/d08163.pdf (2008).

259 *See supra* note 246.

260 *Id*.

audit services will be able to provide auditing services to sister entities under common control as long as the dual materiality thresholds are not triggered.

There also could be certain costs associated with the final amendments. For example, if the amendments increase the risk of auditors' objectivity and impartiality being threatened by relationships and services that are no longer deemed independence-impairing, audit quality could be negatively affected and investors could have less confidence in the quality of financial reporting, which could lead to less efficient investment allocations and increased cost of capital. One commenter asserted that the final amendments would undermine the credibility of auditors, with harmful effects on investor protection and capital formation.[261] We note, however, that relationships and services impacted by the final amendments remain subject to the general independence standard in Rule 2-01(b). Additionally, auditors will incur ongoing costs associated with the monitoring of potential affiliate status if they elect to rely on the final amendments to realize the associated benefits (*e.g.*, the ability to retain or acquire new engagements that were previously deemed independence-impairing). Overall, however, we do not anticipate significant costs to investors or other market participants associated with the final amendments because the amendments address those relationships and services that are less likely to threaten auditors' objectivity and impartiality.

2. Costs and Benefits of Specific Amendments

We expect the final amendments will result in benefits and costs to auditors, audit clients, and investors, and we discuss those benefits and costs qualitatively, item by item, in this section.

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[261] *See* letter from CFA.

a. Amendments to the Definition of an Affiliate of the Audit Client and Investment Company Complex

i. Affiliate of the Audit Client

The inclusion of all sister entities regardless of materiality in the definition of affiliate of the audit client in current Rule 2-01(f)(4) creates practical challenges and imposes compliance costs on both auditors and audit clients, especially those with complex organizational structures. As it relates to the common control provision, the proposed amendment included as affiliates of the audit client sister entities that are material to the controlling entity. As discussed in Section II.A.1.a, commenters recommended further aligning the common control provision with analogous provisions of the AICPA and IESBA ethics and independence requirements, and the final amendments now include a dual materiality threshold such that a sister entity would be deemed an affiliate of the audit client only when both the entity under audit and the sister entity are material to the controlling entity. Conditioning affiliate status on the entity under audit being material to the controlling entity, and excluding sister entities that are not material to the controlling entity, likely will reduce overall compliance burdens and challenges associated with having to resolve independence violations arising from services or relationships with sister entities. Two commenters argued that relying on materiality may increase the risk of auditors performing audits when they are not objective and impartial, citing evidence that auditors' materiality judgments vary widely.[262] While we acknowledge that the use of materiality introduces judgment compared to a bright-line test, we note that the evidence presented by these

[262] *See supra* note 29.

commenters, on which their conclusion is based, is not directly related to materiality assessments in the context of sister entities.

As discussed in Section II.A.1.a.iii, monitoring-related compliance burdens may not be reduced. Under the current rules, an auditor needs to examine an audit client's organizational structure and identify all sister entities that will be considered affiliates on the basis of a bright-line standard. Under the final amendments, auditors, with the assistance of their audit clients, still need to understand an audit client's organizational structure to identify any affiliates of the audit client as well as monitor for changes in the structure and materiality status of those affiliates on an on-going basis.[263] Thus, auditors may incur some incremental cost related to monitoring potential affiliate status and assessing materiality. Auditors, however, would weigh whether the associated benefits (*e.g.*, the possibilities of offering new services or entering into new relationships) are worth the incremental materiality assessment and monitoring efforts. We expect an auditor would rely on the final amendments only if the benefits of using the amendments outweigh the costs involved. If an auditor decides it does not want to incur any increased monitoring-related compliance burdens, it could treat all sister entities as affiliates and avoid the effort to assess materiality.

The final amendments related to the dual materiality threshold should reduce the overall compliance related challenges associated with the existing rule. Under existing Rule 2-01(f)(4), all sister entities are deemed affiliates. Existing Rule 2-01(f)(4) creates compliance challenges that require the auditor's and the audit client's attention to resolve or that can restrict the choices of the auditor and the audit client, even when the violations or potential violations are with sister

[263] As discussed in Section II.A.1.a.iii, identifying sister entities and monitoring for potential affiliate status will be important to timely address when a sister entity may become an affiliate and is important for an audit firm to appropriately consider and apply Rule 2-01(b).

entities that are less likely to affect an auditor's objectivity and impartiality. For example, the dual materiality threshold will help avoid the costs that audit clients could incur to switch auditors where an auditor provides services to or has an existing relationship with a newly acquired sister entity and either the entity under audit or sister entity is not material to the controlling entity. These cost savings could be especially pronounced for entities with complex organizational structures that have an expansive and constantly changing list of affiliates because the final amendments may significantly reduce the number of sister entities that are deemed affiliates of the audit client.

Under the current definition of affiliate of the audit client, an auditor with desired expertise may be excluded from a firm's audit engagement consideration because, for example, the auditor currently provides non-audit services to the firm's sister entity, even though neither that entity nor the firm under audit is material to the controlling entity. The exclusion of certain auditors from an audit engagement due to their relationships with or services provided to a sister entity, in this example, might lead to the audit engagement not being matched with the most qualified auditors. Such an outcome could compromise audit quality and decrease financial reporting quality, thereby imposing compliance costs on audit clients and reducing the quality of financial information investors receive. In addition, the lack of matching between auditor expertise and necessary audit procedures and considerations for a particular audit client might result in inefficiencies in the auditing processes, which likely increases the costs of audit services (*e.g.*, audit fees).

The amended definition of affiliate of the audit client may result in an expansion of the pool of qualified auditors. With an expanded pool of eligible auditors, competition among auditors might increase, thereby reducing audit fees for audit clients.[264] However, because the market for auditing services is highly concentrated, such cost savings are likely to be limited. The expanded pool of qualified auditors also might improve matching between auditor expertise and necessary audit procedures and considerations for a particular audit client, thereby improving audit efficiency and reducing audit costs.[265] Furthermore, any improvement in matching would positively influence audit quality and financial reporting quality.[266]

The final amendments are likely to benefit investors indirectly. First, investors will benefit from any improvements in financial reporting quality that may be derived from improvements in audit quality, as discussed above.[267] Better financial reporting quality helps investors make more efficient investment decisions, thereby improving market efficiency. Second, the potential reduction in audit fees from possible increased competition among auditors and improved audit efficiency might generate cash savings to audit clients, which may be deployed in a manner that benefits investors. We acknowledge, however, that potentially this

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264 *See* Paul K. Chaney, Debra C. Jeter, and Pamela E. Shaw, Client-Auditor Realignment and Restrictions on Auditor Solicitation, 72 Acct. Rev. (1997) 433. *See also* Emilie R. Feldman, A Basic Quantification of the Competitive Implications of the Demise of Arthur Andersen, 29 R. Ind. Org. (2006) 193; Michael Ettredge, Chan Li, and Susan Scholz, Audit Fees and Auditor Dismissals in the SOX Era, 21 Acct Horizon (2011) 371; Wieteke Numan and Marleen Willekens, An Empirical Test of Spatial Competition in the Audit Market, 20 J. Acct Econ. 450 (2012); and Joseph Gerakos and Chad Syverson, Competition in the Audit Market: Policy Implications, 53 J. Acct Res. 725 (2015).

265 This could result in some crowding-out effect, as the four largest audit firms may be deemed to be independent from more clients under the final amendments, thereby crowding out smaller audit firms. However, we believe that better matching between auditor specialization and their clients and the reduction in unnecessary auditor turnovers could potentially prevent any decline in audit quality and in the long run may improve audit quality.

266 *See* Chen-Lung Chin, and Hsin-Yi Chin, Reducing Restatements with Increased Industry Expertise, 26 Cont. Acct. Res., (2009) 729; Michael Ettredge, James Heintz, Chan Li, and Susan Scholz, Auditor Realignments Accompanying Implementation of SOX 404 ICFR Reporting Requirements, 25 Acct Horizon (2011) 17; and Jacob Z. Haislip, Gary F Peters, and Vernon J Richardson, The Effect of Auditor IT Expertise on Internal Controls, 20 Int. J. Acct. Inf. Sys. 1 (2016).

267 *See supra* note 255.

competitive effect will be limited given the concentrated nature of the audit profession, as explained above.

The final amendments also include a modification to use the term “entity under audit” in place of the term “audit client” within Rules 2-01(f)(4)(i) and (ii). As discussed in Section II.A.1.a.iii, these modifications are intended to address potential confusion that may result from an application that would negate the amendments to the common control provision. This clarification could assist audit firms and audit clients in their compliance with the independence requirements.

The dual materiality threshold in the amended definition of an affiliate of the audit client might require more efforts from audit firms and audit clients to familiarize themselves with and to apply the threshold. However, given that the materiality concept is already part of the Commission’s auditor independence rules,[268] and that the analogous provisions of the AICPA and IESBA for sister entities also include a dual materiality threshold, we do not expect a significant learning curve in applying the threshold or significant incremental compliance costs for auditors.

ii. Investment Company Complex

As discussed in Section II.A.1.c above, the final amendments: (1) direct an auditor of an investment company or an investment adviser or sponsor to Rule 2-01(f)(14) (*i.e.*, the ICC definition) to identify affiliates of the audit client and focus the ICC definition on the perspective of the entity under audit; (2) include within the meaning of the term investment company, for the purposes of the ICC definition, unregistered funds; (3) amend the common control portion of the

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268 *See e.g.,* Rule 2-01(f)(4)(ii) and (iii).

ICC definition to incorporate the dual materiality threshold included in the amended affiliate of the audit client definition; (4) add a dual materiality threshold in the control prong of the ICC definition, for portfolio companies of sister funds controlled by an investment adviser or sponsor of an investment company under audit; and (5) include within the ICC definition entities where significant influence exists between those entities and the entity under audit.

The amendments related to the ICC definition will affect the analysis used to identify entities that are considered affiliates of registered investment companies, unregistered funds, and investment advisers or sponsors that are under audit. The final rule should lead to improved clarity in the application of the ICC definition and, for the purpose of auditor independence analysis, could facilitate compliance by audit firms and the entities they audit within an ICC with the auditor independence requirements. The improved clarity under the amended definition may result in compliance cost savings that benefit audit firms and audit clients.

The economic implications of the amended common control provision within the ICC definition are largely similar to those of the analogous provision for operating companies. For example, under the current ICC definition, an investment company under audit may have a rather restricted set of independence compliant auditors due to the current common control provisions. The amended ICC definition excludes from the affiliate analysis sister entities when both the sister entities and the entity under audit are not material to the controlling entity, which potentially reduces compliance costs for an investment company under audit.

Auditors currently engaging in relationships with or providing services to entities within an ICC that are independence-impairing under Rule 2-01(c) may become eligible to serve as an auditor to a different entity within the same ICC under the amended definition, including the amended common control provision. The potential expanded pool of eligible auditors could help registered investment companies and unregistered funds hire (and retain) auditors who have more relevant industry expertise, which could lead to better financial reporting for investment companies. Better financial reporting quality, in turn, would benefit investors in registered investment companies and unregistered funds by allowing them to make more informed investment decisions. With an expanded pool of eligible auditors, competition among auditors might increase, thereby reducing audit fees for audit clients for comparable audit quality, though potentially this competitive effect will be limited given the market concentration discussed above.

With respect to the amendments that include unregistered funds within the meaning of the term investment company for purposes of the ICC definition,[269] we believe the amendments provide a useful update to the ICC definition that was initially adopted in 2000. Specifically, we believe the final amendments provide clarity for unregistered funds, their investment advisers or sponsors, and their auditors. In addition, defining an investment company to include unregistered funds will promote consistency in the application of Rule 2-01 to registered investment companies and unregistered funds so that these two types of audit clients, which share some similar characteristics, will not be subject to disparate application of the independence rules.

We do not anticipate significant incremental costs associated with the final amendments to the ICC definition for registered investment companies, unregistered funds, investment advisers or sponsors, or their auditors as well as investment company investors. The amendments may require additional efforts from audit firms and the entities they audit within an

[269] *See* amended Rule 2-01(f)(14)(ii).

ICC to become familiar with the application of the amended ICC definition. This may potentially lead to an initial increase in compliance costs. However, the amendments would improve the clarity of the ICC definition and therefore likely would decrease overall compliance costs after affected parties adjust to the amended definition.

The materiality test that we are adopting is already part of the Commission's auditor independence rules[270] and also is aligned with the final common control prong of the affiliate of the audit client definition. Consistent with our discussion in the preceding section, we do not expect a significant learning curve in applying the dual materiality threshold or significant incremental compliance costs for auditors or their audit clients.

As with auditors of operating companies, auditors of investment companies or investment advisers or sponsors will be required to consider significant influence when identifying affiliates of the audit client. We do not expect any significant economic effects associated with adding the "significant influence" provision[271] to the amended ICC definition. As discussed in Section II.A.1.c.iii above, audit clients and auditors should already be familiar with this concept as a result of the application of existing Rule 2-01(f)(4)(ii) and (iii).

b. Amendment to the Definition of Audit and Professional Engagement Period

Currently, the term "audit and professional engagement period" is defined differently for domestic first-time filers and FPI first-time filers.[272] A domestic IPO registration statement must include either two or three years of audited financial statements, and auditors of domestic first -

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270 *See e.g.,* Rules 2-01(f)(4)(ii) and (iii).

271 *See* amended Rule 2-01(f)(14)(i)(E).

272 *See* Rule 2-01(f)(5)(iii).

time filers need to comply with Rule 2-01 for all audited financial statement periods included in the registration statement.[273] This may result in certain inefficiencies in the IPO process for domestic filers, such as the need to delay the offering or switch to a different auditor to comply with independence requirements. In comparison, for FPIs, the corresponding "audit and professional engagement period" includes only the fiscal year immediately preceding the initial filing of the registration statement or report. As a consequence, the current definition of the "audit and professional engagement period" creates disparate application of the independence requirements between domestic issuers and FPIs. To address this disparate treatment, we are amending the definition such that the one-year look-back provision applies to all first-time filers, domestic and foreign.

The final amendment to the definition of "audit and professional engagement period" will require domestic first-time filers to assess auditor independence over a shortened look-back period (*i.e.,* a single immediate preceding year). As a result, this amendment could help domestic firms avoid the compliance costs associated with switching auditors or delaying the filing of an initial registration statement when there is an independence-impairing relationship or service in earlier years. In this way, shortening the look-back period may promote efficiency and facilitate capital formation.

This amendment might also expand the pool of eligible auditors for domestic first-time filers. The potential increase in the number of eligible auditors for these filers could foster competition among eligible auditors and thus reduce the cost of audit services.[274] Specifically, where an audit client is looking to change auditors in connection with an IPO, an audit client

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273 *See* Rule 2-01(f)(5).

274 *See supra* note 264.

would be able to select from a broader group of auditors to perform audit services, even if there were independence-impairing services or relationships in the second or third year prior to the filing of the initial registration statement. However, the audit profession is already highly concentrated, especially with respect to IPOs.[275] Consequently, any such benefit may not be significant. The expanded pool of qualified auditors also could allow the first-time domestic filers to better match auditor expertise to audit engagements. We anticipate that the improved alignment between auditor expertise and audit engagement likely will positively influence audit and financial reporting quality, thereby benefiting investors and improving market efficiency.[276]

The change in the look-back period for domestic first-time filers might lead to some financial statements in early years being audited by auditors that do not meet the Commission's current independence requirements, thus potentially compromising the integrity and reliability of financial reporting information related to the earlier second and third years, if included in the first filing. However, this potential adverse effect would be mitigated by the requirement for these auditors to meet applicable independence requirements—such as AICPA independence requirements—for the audits of these periods and by the application of the general independence standard in Rule 2-01(b) to the relationships and services in those earlier years. In addition, there are often, if not always, internal and external governance mechanisms (*e.g.*, audit committees and underwriters) in place at first-time filers, and auditors are subject to heightened litigation risk

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275 *See* United State Government Accountability Office, Audits of Public Companies – Continued Concentration in Audit Market for Large Public Companies Does Not Call for Immediate Action (2008) *available at* www.gao.gov/new.items/d08163.pdf. *See also* Patrick Velte and Markus Stiglbauer, Audit Market Concentration and Its Influence on Audit Quality, 5 Intl. Bus. Res. (2012) 146; and Xiaotao Liu and Biyu Wu, Do IPO Firms Misclassify Expenses? Working paper, (2019) (showing that 84.2% of IPO firms of their sample use Big 4 auditors before going public).

276 *See supra* note 255 and accompanying text.

around IPOs.[277]

c. Amendments to Loans or Debtor-Creditor Relationships

Currently, Rule 2-01 prohibits certain loans/debtor-creditor relationships and other financial interests with a few exceptions.[278] As discussed in Sections II.B.1 and 3, the final amendments will address two types of loans that are less likely to threaten an auditor's objectivity and impartiality by making the following changes: (1) include, as part of the exceptions, student loans for a covered person and his/her immediate family members as long as the loan was obtained while the covered person was not a covered person; and (2) amend the Credit Card Rule to refer instead to "consumer loans" in order to except personal consumption loans such as retail installment loans, cell phone installment plans, and home improvement loans that are not secured by a mortgage on a primary residence.

The amendments to except certain student and consumer loans that are less likely to pose threats to auditors' objectivity or impartiality may alleviate some compliance burdens. For instance, audit firms will be able to reduce the level of monitoring for such student and consumer loans as part of their compliance program. The amendments would permit certain covered persons (including audit partners and staff) to be considered independent even when covered persons or their immediate family members have student loans or consumer loans with an audit client. The potential expansion of qualified audit partners and staff may allow audit firms to more readily identify audit partners and staff for a given audit engagement and improve matching between partner and staff experience with audit engagements. The improved

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277 *See* Ray Ball and Lakshmana Shivakumar, Earnings Quality at Initial Public Offerings, 45, J. Acct. Econ. (2008) 324-349. *See also* Ramgopal Venkataraman, Joseph P. Weber and Michael Willenborg, Litigation Risk, Audit Quality, and Audit Fees: Evidence from Initial Public Offerings, 83 Acct Rev. (2008) 1315-1345.

278 *See* Rule 2-01(c)(1)(ii).

alignment between partner and staff experience and audit engagements can increase audit efficiency and reduce audit costs. Such efficiency gains may transfer to audit clients in the form of reduced audit fees and audit delays.

Moreover, the better alignment between partner and staff experience and audit engagement may increase audit quality.[279] Since audit quality improvement increases financial reporting quality, this benefit likely will accrue to the overall investment community.[280] Finally, the final amendments may make it easier for covered persons and their immediate family members to obtain necessary consumer loans without having to determine if such loans are with audit clients of the accounting firm.

d. Amendments to the Business Relationships Rule

As discussed in Section II.C, the Business Relationships Rule currently refers to "substantial stockholders" to identify a type of "person associated with the audit client in a decision-making capacity." [281] Under the current rule, a business relationship between a substantial stockholder of the audit client, among others, and the auditor or covered person would be considered independence-impairing. The final amendment will change the term "substantial stockholders" to "beneficial owners (known through reasonable inquiry) of the audit client's equity securities where such beneficial owner has significant influence over the entity under audit" to align this rule with changes recently made to the Loan Provision.[282] In a

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279 *See e.g.,* G. Bradley Bennett & Richard C. Hatfield, The Effect of the Social Mismatch between Staff Auditors and Client Management on the Collection of Audit Evidence, 88 Acct. Rev. (2013) 31-50.

280 *See supra* note 255 and accompanying text.

281 *See* Rule 2-01(c)(3).

282 *See* Section II.C.4.

modification from the proposal, the final rule now codifies the guidance provided in the Proposing Release, which clarified that "significant influence over the audit client" is meant to focus on the entity under audit. Also, the final amendment clarifies that with respect to other persons in a decision-making capacity, such as officers and directors, the focus is similarly meant to be on the entity under audit. This amendment should improve compliance with the auditor independence rules by improving the clarity and reducing the complexity of application of the Business Relationships Rule.

There may be some additional compliance costs to auditors and audit clients associated with having to comply with a standard that now requires identifying beneficial owners of equity securities that have "significant influence" over the audit client, as opposed to identifying "substantial stockholders." However, any such additional cost should be limited given that the concept of "significant influence" has been part of the Commission's auditor independence rules since 2000 as part of the definition of affiliate of the audit client.[283] We therefore do not expect a significant learning curve in applying the test for auditors and registrants.

e. Amendments for Inadvertent Violations for Mergers and Acquisitions

As discussed in Section II.D, certain merger and acquisition transactions can give rise to inadvertent violations of auditor independence requirements. For example, an auditor may provide non-audit services to a target firm and audit services to an acquirer prior to the occurrence of an acquisition. As a result, the acquisition may result in an auditor independence violation that had not existed prior to the acquisition. In this scenario, the auditor's objectivity and impartiality likely is not impaired.[284]

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[283] *See e.g.,* Rule 2-01(f)(4)(ii) and (iii).

[284] *See* Section II.D.

There may be compliance costs associated with the application of the current rule in that registrants might have to: (i) delay mergers and acquisitions in order to comply with Rule 2-01; (ii) forgo such transactions altogether; or (iii) switch auditors or stop the relationships or services mid-stream, potentially resulting in costly disruptions to the registrant.

As discussed in Section II.D.3, the final amendments to Rule 2-01(e) establish a transition framework for mergers and acquisitions to address these costs. Under the amendments, auditors and their audit clients will be able to transition out of independence-impairing relationships or services in an orderly manner, subject to certain conditions. As such, the amendments likely will reduce audit clients' compliance costs in merger and acquisition transactions by reducing the uncertainty associated with incidences of inadvertent violations of auditor independence due to these corporate events.

For example, the transition framework will allow auditors and audit clients, subject to certain conditions, up to six months after the transaction effective date to terminate the independence-impairing relationships or services. As a result, this framework will help audit clients, especially those entities with complex organizational structures and those actively pursuing merger and acquisition transactions, retain an auditor that is compliant with the auditor independence requirements when they undertake mergers and acquisitions without missing out on the ideal timing for such transactions. In addition, investors may indirectly benefit from the value created through timely mergers and acquisitions and costs saved from managing inadvertent independence violations.

There may be some learning curve for auditors and audit clients as they adapt to the transition framework. However, given that the framework follows the consideration of the audit firm's quality controls similar to existing Rule 2-01(d), we do not expect a significant learning curve in applying the framework for auditors and audit clients. The framework does not alter the independence requirements for entities involved in mergers and acquisitions *per se*; rather, the framework offers a more practical approach to, and timeline for, addressing inadvertent independence violations as a result of merger and acquisition transactions. Thus, we do not anticipate significant compliance costs associated with this amendment.

D. Effects on Efficiency, Competition and Capital Formation

We believe that the final amendments likely will improve the practical application of Rule 2-01, enhance efficiency of rule implementation, reduce compliance burdens, and increase competition among auditors. They also may facilitate capital formation.

One commenter questioned our conclusion and argued that the final amendments would undermine the credibility of auditors and have harmful effects on capital formation.[285] We disagree with the commenter's assessment. The final amendments to Rule 2-01 aim to reduce or remove certain practical challenges associated with the auditor independence analysis by focusing the analysis on those relationships and services that are more likely to pose a threat to an auditor's objectivity and impartiality. The amendments are expected to expand the pool of auditors and covered persons eligible to undertake audit engagements. As a result, audit clients should have more options for audit services and audit costs may decrease for comparable audit quality. The potential expansion of eligible auditors may also lead to better alignment between the audit client's needs and the auditor's expertise. The improved alignment between auditor expertise and audit client needs should enable auditors to perform audit services more efficiently and effectively, thus potentially reducing audit fees and increasing audit quality over the long term.

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285 *See* letter from CFA.

Under the final amendments, certain relationships and services between an auditor and an audit client that are currently deemed independence-impairing but are unlikely to threaten auditor objectivity and impartiality will no longer be deemed independence-impairing (subject to the general independence standard in Rule 2-01(b)), thus allowing auditors and audit clients to focus on those relationships and services that are more likely to threaten the auditor's objectivity and impartiality. To the extent that the amendments may reduce the amount of audit client or audit committee attention spent on independence questions when objectivity and impartiality is not at issue, the quality of financial reporting is likely to improve, thus allowing audit committees to focus on their other responsibilities. Furthermore, we expect that improved identification of threats to auditor independence would increase investor confidence about the quality and accuracy of the information reported. Reduced uncertainty about the quality and accuracy of financial reporting should attract capital and thus reduce the cost of capital, facilitate capital formation, and improve overall market efficiency.[286]

Under the final amendments, we expect some accounting firms to become eligible to provide audit services to new audit clients that were previously deemed independence-impairing under existing Rule 2-01. If the larger accounting firms are currently engaged in non-audit relationships with and providing services to potential audit clients that preclude such accounting firms from serving as the auditor under existing Rule 2-01, then these firms are more likely to be positively affected by the final amendments. In particular, these accounting firms may be able to compete for or retain a larger pool of audit clients. At the same time, the larger accounting

286 *See supra* note 255. *See also* Nilabhra Bhattacharya, Frank Ecker, Per Olsson, and Katherine Schipper, Direct and Mediated Associations among Earnings Quality, Information Asymmetry and the Cost of Equity, 87, Acct Rev. (2012) 449-482; and Shuai Ma. Economic Links and the Spillover Effect of Earnings Quality on Market Risk. 92 Acct Rev. (2017). 213-245.

firms' potentially increased ability to compete for audit clients could potentially crowd out the audit business of smaller audit firms. However, we estimate that the four largest accounting firms already perform 49.2% of audits for all registrants (or about 73% of accelerated and large accelerated filers) and more than 80% in the registered investment company space.[287] As a result, we do not expect any potential change in the competitive dynamics among accounting firms to be significant.

E. Alternatives

We considered certain alternative approaches to the final amendments, which we summarize below.

As an alternative to the dual materiality threshold for the definition of affiliate of the audit client that we are adopting, we could have adopted the single materiality threshold that was proposed in the Proposing Release. Under such an alternative, a sister entity would be deemed an affiliate of the audit client unless the entity is not material to the controlling entity, and there would be no materiality qualifier with respect to the entity under audit. Such an alternative, however, would introduce costs for both auditors and audit clients' sister entities relative to the final amendments when the entity under audit is not material to the controlling entity. For example, an auditor would not be allowed to provide certain services to sister entities even though its services with those entities would generally not threaten the auditor's objectivity and impartiality. One commenter argued that such an alternative would increase the burden on private equity firms by requiring more time and resources to monitor the "continuously evolving

[287] *See supra* note 246. Also, as of December 2018, there were approximately 12,577 fund series, with total net assets of $23 trillion that are covered by Morningstar Direct with identified accounting firms. There were 23 accounting firms performing audits for these investment companies. The market for these audit services was highly concentrated, as 86% of the funds were audited by the four largest accounting firms.

universe of entities that the private firm would need to address."[288]

An alternative approach to the amendments to the definition of "audit and professional engagement period" would be to increase the look-back period for FPI first-time filers to align with the current requirement for domestic first-time filers. While this alternative would help level the playing field for both domestic and FPI first-time filers, similar to the final amendment to shorten the look-back period for a first-time domestic filer, and reduce the likelihood of potential independence-impairing relationships and services, it would increase compliance burdens for FPI first-time issuers and thus may reduce the incentives for the FPI first-time filers to list in the United States, thereby impeding capital formation and limiting investment opportunities for U.S. investors. As discussed above, we believe services or relationships that ended prior to the start of the most recently completed fiscal year are less likely to threaten an auditor's objectivity and impartiality. We do not, therefore, believe that lengthening the look-back period for FPIs would enhance investor protection in a manner that would justify an associated increase in compliance costs and a potential negative impact on capital formation.

An alternative to the complete exclusion of student loans of the covered person would be a bright-line test in which, if the percentage of the aggregate amount of the student loans of a covered person and his or her immediate family members to the total wealth of the covered person's family is below a certain threshold, then all of the students loans would be excluded from the prohibition. This alternative has the advantage of taking into consideration the importance of the student loans to the covered person's financial interests. However, this alternative, because it is a bright-line test, may lead to over-identifying or under-identifying scenarios where the auditor's objectivity and impartiality are deemed impaired, especially in

[288] *See* letter from AIC.

cases close to the selected percentage threshold. In addition, this alternative could present operational and privacy challenges in calculating and monitoring changes to a family's total wealth.

An alternative with respect to the exclusion for consumer loans would be to increase the outstanding balance limit, currently set at $10,000. For example, several commenters suggested inflationary adjustments to the outstanding balance limit to make it as high as $20,000 or $25,000.[289] Such an increase would make it easier for covered persons to meet the requirements of the rule, and thus benefit audit clients by making it easier for them to find an auditor. Such an alternative, however, also would allow a covered person to have a significant amount of outstanding consumer loan(s) with an audit client, increasing the risk to the auditor's objectivity and impartiality and potentially negatively affecting investor protection.

Finally, the transition framework for merger and acquisition transactions includes a provision that, subject to certain conditions, allows affected auditors and audit clients to address independence-impairing relationships or services promptly, but in no event more than six months, following the effective date of the transaction. An alternative approach would be to require the independence-impairing relationship or service to be addressed within six months following the merger or acquisition announcement. A benefit of this alternative approach would be the improved timeliness of auditor compliance following merger and acquisition transactions. Under this alternative, auditors and registrants would assess independence immediately following the announcement that a definite agreement has been reached. However, some mergers and acquisitions take a long time to be completed and a substantial portion of such

[289] *See e.g.,* letters from BDO, EY, Horahan, CAQ, PwC, and RSM.

transactions never reach completion. As a result, an alternative window of six months following announcement of the merger or acquisition may unnecessarily increase compliance burdens and associated costs (*e.g.*, switching costs) for both affected companies and their auditors when such transactions are delayed or never successfully completed. A commenter suggested another alternative with respect to merger and acquisition transactions: to require the relationship or service triggering the inadvertent violation to be terminated before the merger or acquisition is effective.[290] Requiring termination prior to the merger and acquisition transaction, however, would generate significant costs for the auditor and the audit client, including search costs for finding a new auditor and disruption to valuable relationships and services for the company.

V. PAPERWORK REDUCTION ACT

The final amendments do not impose any new "collections of information" within the meaning of the Paperwork Reduction Act of 1995 ("PRA"),[291] nor do they create any new filing, reporting, recordkeeping, or disclosure requirements. Accordingly, we are not submitting the final amendments to the Office of Management and Budget for review in accordance with the PRA.[292] In the Proposing Release, the Commission asked about the conclusion that the amendments would not impose any new collections of information. We did not receive any comments in response.

[290] *See* letter from NYSSCPA.

[291] 44 U.S.C. 3501 *et seq*.

[292] 44 U.S.C. 3507(d) and 5 CFR 1320.11.

VI. FINAL REGULATORY FLEXIBILITY ACT ANALYSIS

The Regulatory Flexibility Act ("RFA")[293] requires the Commission, in promulgating rules under section 553 of the Administrative Procedure Act,[294] to consider the impact of those rules on small entities. We have prepared this Final Regulatory Flexibility Analysis ("FRFA") in accordance with Section 604 of the RFA.[295] This FRFA relates to final amendments to Rule 2-01 of Regulation S-X. An Initial Regulatory Flexibility Analysis ("IRFA") was prepared in accordance with the RFA and was included in the Proposing Release.

A. Need for, and Objectives of, the Final Amendments

As discussed above, the primary reason for, and objective of, the final amendments is to update certain provisions within the Commission's auditor independence requirements to more effectively focus the analysis under Rule 2-01 on those relationships or services that are more likely to pose threats to an auditor's objectivity and impartiality. Specifically, the final amendments:

- Amend the definitions of affiliate of the audit client and ICC to address certain affiliate relationships;
- Shorten the look-back period for domestic first-time filers in assessing compliance with the independence requirements;
- Add certain student loans and de minimis consumer loans to the categorical exclusions from independence-impairing lending relationships;
- Replace the reference to "substantial stockholders" in the Business Relationships

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[293] 5 U.S.C. 601 *et seq*.

[294] 5 U.S.C. 553.

[295] 5 U.S.C. 604.

Rule with the concept of beneficial owners with significant influence;

- Introduce a transition framework for merger and acquisition transactions to consider whether an auditor's independence is impaired; and
- Make certain other miscellaneous updates.

The reasons for, and objectives of, the final amendments are discussed in more detail in Sections I and II above.

B. Significant Issues Raised by Public Comment

In the Proposing Release, we requested comments on the IRFA. In particular, we requested comments on the number of small entities that would be subject to the proposed amendments to Rule 2-01 of Regulation S-X and the existence or nature of the potential impact of the proposed amendments on small entities discussed in the analysis. In addition, we requested comments regarding how to quantify the impact of the proposed amendments and alternatives that would accomplish our stated objectives while minimizing any significant adverse impact on small entities. We also requested that commenters describe the nature of any effects on small entities subject to the proposed amendments to Rule 2-01 of Regulation S-X and provide empirical data to support the nature and extent of such effects. Furthermore, we requested comment on the number of accounting firms with revenue under $20.5 million. We did not receive comments regarding the impact of the proposal on small entities.

C. Small Entities Subject to the Proposed Rules

The final amendments will affect small entities that file registration statements under the Securities Act, the Exchange Act, and the Investment Company Act and periodic reports, proxy and information statements, or other reports under the Exchange Act or the Investment Company Act, as well as smaller registered investment advisers and smaller accounting firms. The RFA defines "small entity" to mean "small business," "small organization," or "small governmental jurisdiction."[296] The Commission's rules define "small business" and "small organization" for purposes of the Regulatory Flexibility Act for each of the types of entities regulated by the Commission. Title 17 CFR 230.157 and 17 CFR 240.0-10(a) define an issuer, other than an investment company, to be a "small business" or "small organization" if it had total assets of $5 million or less on the last day of its most recent fiscal year. We estimate that, as of December 31, 2019, there are approximately 1,056 issuers, other than registered investment companies, that may be small entities subject to the final amendments.[297] The final amendments will affect small entities that have a class of securities that are registered under Section 12 of the Exchange Act or that are required to file reports under Section 15(d) of the Exchange Act. In addition, the final amendments will affect small entities that file, or have filed, a registration statement that has not yet become effective under the Securities Act and that has not been withdrawn.

An investment company is considered to be a "small business" for purposes of the RFA, if it, together with other investment companies in the same group of related investment companies, has net assets of $50 million or less at the end of the most recent fiscal year.[298] We estimate that, as of June 2020, approximately 39 registered open-end mutual funds, 8 registered ETFs, 26 registered closed-end funds, and 12 BDCs are small entities.[299]

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[296] 5 U.S.C. 601(6).

[297] This estimate is based on staff analysis of issuers, excluding co-registrants, with EDGAR filings on Forms 10-K, 20-F and 40-F, or amendments thereto, filed during the calendar year of January 1, 2019, to December 31, 2019. The analysis is based on data from XBRL filings, Compustat, and Ives Group Audit Analytics.

[298] 17 CFR 270.0-10(a).

[299] This estimate is based on staff analysis of data obtained from Morningstar Direct as well as data reported to the Commission for the period ending June 30, 2020.

For purposes of the RFA, an investment adviser is a small entity if it:

(1) Has assets under management having a total value of less than $25 million;

(2) Did not have total assets of $5 million or more on the last day of the most recent fiscal year; and

(3) Does not control, is not controlled by, and is not under common control with another investment adviser that has assets under management of $25 million or more, or any person (other than a natural person) that had total assets of $5 million or more on the last day of its most recent fiscal year.[300]

We estimate, as of June 30, 2020, that there are approximately 524 investment advisers that would be subject to the final amendments that may be considered small entities.[301]

For purposes of the RFA, a broker-dealer is considered to be a "small business" if its total capital (net worth plus subordinated liabilities) is less than $500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared pursuant to 17 CFR 240.17a-5(d) under the Exchange Act, or, if not required to file such statements, a broker-dealer with total capital (net worth plus subordinated liabilities) of less than $500,000 on the last day of the preceding fiscal year (or in the time that it has been in business, if shorter); and that is not affiliated with any person (other than a natural person) that is not a small business or small organization.[302] As of June 30, 2020, we estimate that there are approximately 852 small entity

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300 17 CFR 275.0-7.

301 This estimate is based on SEC registered investment adviser responses to Item 12 of Form ADV.

302 17 CFR 240.0-10(c).

broker-dealers that will be subject to the final amendments.[303]

Our rules do not define “small business” or “small organization” for purposes of accounting firms. The Small Business Administration (SBA) defines “small business,” for purposes of accounting firms, as those with under $20.5 million in annual revenues.[304] We have limited data indicating revenues for accounting firms, and we cannot estimate the number of firms with less than $20.5 million in annual revenues. As noted in the preceding section, we also did not receive any data from commenters that would enable us to make such an estimate.

D. Projected Reporting, Recordkeeping and Other Compliance Requirements

The final amendments will not impose any reporting, recordkeeping, or disclosure requirements. The final amendments will impose new compliance requirements with respect to Rule 2-01.

With respect to the final amendments related to student loans, consumer loans, and the definition of the audit and engagement period for first-time filers, we believe these amendments are less burdensome than the current requirements and will not increase costs for smaller entities, including smaller accounting firms. With respect to the final amendments to the definitions of affiliate of the audit client and ICC, these amendments will reduce the number of entities that are deemed affiliates of the audit client. As such, any additional compliance effort related to the revised definitions (such as the need to monitor the materiality of entities under common control) will be offset by the less burdensome nature of the amended definitions as compared to the

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303 This estimate is based on staff analysis of the most recent information available, as provided in Form X-17A-5 Financial and Operational Combined Uniform Single Reports filed pursuant to Section 17 of the Exchange Act and Rule 17a-5 thereunder.

304 13 CFR 121.201 and North American Industry Classification System (NAICS) code 541211. The SBA calculates “annual receipts” as all revenue. *See* 13 CFR 121.104.

current definitions.

With respect to the final amendment adding a merger and acquisition transition framework, small entities, including smaller accounting firms, will incur a new compliance burden only if an auditor and its client seek to avail themselves of the framework. As such, any additional compliance effort will be offset in any circumstance where relationships and services prohibited under the current rule will be deemed not to impair independence under the final amendments. Overall, the adopted transition framework provides a more practical approach to, and timeline for, addressing inadvertent independence violations that arise solely due to merger or acquisition transactions and reduces some of the cost associated with such inadvertent violations.

Regarding the final amendment to the Business Relationships Rule to replace the reference to "substantial stockholders" with the concept of beneficial owners with significant influence, the concept of "significant influence" already exists in other parts of the auditor independence rules, including the recently amended Loan Provision.[305] As such, we believe that affected entities will likely be able to leverage existing practices, processes, or controls to comply with the final amendments compared to having separate compliance requirements by retaining the reference to the substantial stockholder.

Compliance with the final amendments will require the use of professional skills, including accounting and legal skills. The final amendments are discussed in detail in Section II above. We discuss the economic impact, including the estimated costs, of the final amendments in Section III (Economic Analysis) above.

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305 *See* Loan Provision Adopting Release.

E. Agency Action to Minimize Effect on Small Entities

The RFA directs us to consider alternatives that would accomplish our stated objectives while minimizing any significant adverse impacts on small entities. Accordingly, we considered the following alternatives:

- Establishing different compliance or reporting requirements that take into account the resources available to small entities;
- Clarifying, consolidating, or simplifying compliance and reporting requirements under the rules for small entities;
- Using performance rather than design standards; and
- Exempting small entities from all or part of the requirements.

In connection with the final amendments to Rule 2-01, we do not think it feasible or appropriate to establish different compliance or reporting requirements or timetables for small entities. The final amendments are designed to address compliance challenges for both large and small audit clients and audit firms, including smaller accounting firms. With respect to clarification, consolidation, or simplification of compliance and reporting requirements for small entities, the final amendments do not contain any new reporting requirements.

Some of the final amendments, such as establishing a dual materiality threshold for the common control provision in the affiliate of the audit client definition, amending the ICC definition, and incorporating the concept of "significant influence" into the Business Relationships Rule, will create new compliance requirements. However, the amendments to the affiliate of the audit client and the ICC definitions are less burdensome in nature when compared to the existing rules, and the amendment to the Business Relationships Rule will help with compliance by using a consistent concept that is defined and understood. These amendments are meant to better identify those relationships and services that are more likely to impair an auditor's objectivity and impartiality, thereby resulting in fewer instances where certain relationships and services would cause the auditor to violate our independence requirements, as compared to the existing rule. The flexibility that could result from the final amendments will be applicable to all affected entities, regardless of size.

With respect to using performance rather than design standards, we note that several of the final amendments are more akin to performance standards. Rather than prescribe the specific steps necessary to apply such standards, the final amendments recognize that "materiality" and "significant influence" can be implemented using reasonable judgment to achieve the intended result. Regarding the mergers and acquisitions transition framework, the final amendments do not prescribe specific procedures or processes and instead focus on requiring the performance that would lead to the identification of potential violations and how to address such violations. We believe that the use of these standards will accommodate entities of various sizes while potentially avoiding overly burdensome methods that may be ill-suited or unnecessary given the facts and circumstances.

The final amendments are intended to update the independence rules to reflect recent feedback received from the public and the Commission's experience administering those rules since their adoption nearly two decades ago and address certain compliance challenges for audit firms and their clients, including those that are small entities. Overall, the final amendments are expected to be less burdensome in nature than the existing rule. For this reason, exempting small entities from the final amendments would increase, rather than decrease, their regulatory burden relative to larger entities. The potential benefits to be derived from the final amendments discussed in the Economic Analysis apply to small entities as well as the larger entities. As such, exempting small entities from any of the final amendments would deprive them of the intended benefits and create the potential for confusion maintaining two sets of independence requirements.

VII. CODIFICATION UPDATE

The "Codification of Financial Reporting Policies" announced in Financial Reporting Release No. 1[306] (April 15, 1982) is updated by adding at the end of Section 602, under the Financial Reporting Release Number (FR-85) assigned to this final release, the text in Sections I and II of this release.

The Codification is a separate publication of the Commission. It will not be published in the Code of Federal Regulations.

VIII. STATUTORY BASIS

The amendments described in this release are being adopted under the authority set forth in Schedule A and Sections 7, 8, 10, and 19 of the Securities Act, Sections 3, 10A, 12, 13, 14, 17, and 23 of the Exchange Act, Sections 8, 30, 31, and 38 of the Investment Company Act of 1940, Sections 203 and 211 of the Investment Advisers Act of 1940, and Section 3(a) of the Sarbanes Oxley Act of 2002.

List of Subjects in 17 CFR Part 210

Accountants, Accounting, Banks, Banking, Employee benefit plans, Holding companies, Insurance companies, Investment companies, Oil and gas exploration, Reporting and recordkeeping requirements, Securities, Utilities.

In accordance with the foregoing, the Commission amends title 17, chapter II of the Code

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[306] 47 FR 21028 (May 17, 1982).

of Federal Regulations as follows:

PART 210 – FORM AND CONTENT OF AND REQUIREMENTS FOR FINANCIAL STATEMENTS, SECURITIES ACT OF 1933, SECURITIES EXCHANGE ACT OF 1934, INVESTMENT COMPANY ACT OF 1940, INVESTMENT ADVISERS ACT OF 1940, AND ENERGY POLICY AND CONSERVATION ACT OF 1975

1. The authority citation for part 210 continues to read as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 77z-2, 77z-3, 77aa(25), 77aa(26), 77nn(25), 77nn(26), 78c, 78j-1, 78*l,* 78m, 78n, 78*o*(d), 78q, 78u-5, 78w, 78*ll,* 78mm, 80a-8, 80a-20, 80a-29, 80a-30, 80a-31, 80a-37(a), 80b-3, 80b-11, 7202 and 7262, and sec. 102(c), Pub. L. 112-106, 126 Stat. 310 (2012), unless otherwise noted.

2. Amend § 210.2-01 by

   a. Removing Preliminary Note to §210.2-01;

   b. Adding an introductory paragraph;

   c. Revising paragraph (c)(1)(ii)(A)(*1*)(*iii*);

   d. Revising paragraph (c)(1)(ii)(A)(*1*)(*iv*);

   e. Adding paragraph (c)(1)(ii)(A)(*1*)(*v*);

   f. Revising paragraph (c)(1)(ii)(E);

   g. Revising paragraph (c)(2)(iii)(B)(*2*)(*i*);

   h. Revising paragraph (c)(2)(iii)(C)(*3*)(*i*);

   i. Revising paragraph (c)(3);

   j. Revising paragraph (c)(6)(i)(A)(*1*);

   k. Revising paragraph (c)(6)(i)(B)(*1*);

   l. Revising paragraph (e);

m. Revising paragraph (f)(4);

n. Revising paragraph (f)(5)(iii);

o. Revising paragraph (f)(6); and

p. Revising paragraph (f)(14).

The revisions and additions read as follows:

§ 210.2-01 Qualifications of accountants.

Section 210.2-01 is designed to ensure that auditors are qualified and independent of their audit clients both in fact and in appearance. Accordingly, the rule sets forth restrictions on financial, employment, and business relationships between an accountant and an audit client and restrictions on an accountant providing certain non-audit services to an audit client. Section 210.2-01(b) sets forth the general standard of auditor independence. Paragraphs (c)(1) to (c)(5) of this section reflect the application of the general standard to particular circumstances. The rule does not purport to, and the Commission could not, consider all circumstances that raise independence concerns, and these are subject to the general standard in §210.2-01(b). In considering this standard, the Commission looks in the first instance to whether a relationship or the provision of a service: creates a mutual or conflicting interest between the accountant and the audit client; places the accountant in the position of auditing his or her own work; results in the accountant acting as management or an employee of the audit client; or places the accountant in a position of being an advocate for the audit client. These factors are general guidance only, and their application may depend on particular facts and circumstances. For that reason, §210.2-01(b) provides that, in determining whether an accountant is independent, the Commission will consider all relevant facts and circumstances. For the same reason, registrants and accountants are encouraged to consult with the Commission's Office of the Chief Accountant before entering into relationships, including relationships involving the provision of services that are not explicitly described in the rule.

*   *   *   *   *

(c) * * *

(1) * * *

(ii) * * *

(A) *Loans/debtor-creditor relationship.* (*1*) Any loan (including any margin loan) to or from an audit client, an audit client's officers or directors that have the ability to affect decision-making at the entity under audit, or beneficial owners (known through reasonable inquiry) of the audit client's equity securities where such beneficial owner has significant influence over the entity under audit. The following loans obtained from a financial institution under its normal lending procedures, terms, and requirements are excepted from this paragraph (c)(1)(ii)(A)(*1*):

* * * * *

(*iii*) Loans fully collateralized by cash deposits at the same financial institution;

(*iv*) Mortgage loans collateralized by the borrower's primary residence provided the loans were not obtained while the covered person in the firm was a covered person; and

(*v*) Student loans provided the loans were not obtained while the covered person in the firm was a covered person.

* * * * *

(E) *Consumer loans*. Any aggregate outstanding consumer loan balance owed to a lender that is an audit client that is not reduced to $10,000 or less on a current basis taking into consideration the payment due date and any available grace period.

* * * * *

(2) * * *

(iii) * * *

(B) * * *

(*2*) * * *

(*i*) Persons, other than the lead partner and the Engagement Quality Reviewer, who provided 10 or fewer hours of audit, review, or attest services during the period covered by paragraph (c)(2)(iii)(B)(*1*) of this section;

* * * * *

(C) * * *

(*3*) * * *

(*i*) Persons, other than the lead partner and the Engagement Quality Reviewer, who provided 10 or fewer hours of audit, review, or attest services during the period covered by paragraph (c)(2)(iii)(C)(*2*) of this section;

* * * * *

(3) *Business relationships.* An accountant is not independent if, at any point during the audit and professional engagement period, the accounting firm or any covered person in the firm has any direct or material indirect business relationship with an audit client, or with persons associated with the audit client in a decision-making capacity, such as an audit client's officers or directors that have the ability to affect decision-making at the entity under audit or beneficial owners (known through reasonable inquiry) of the audit client's equity securities where such beneficial owner has significant influence over the entity under audit. The relationships described in this paragraph (c)(3) do not include a relationship in which the accounting firm or

covered person in the firm provides professional services to an audit client or is a consumer in the ordinary course of business.

* * * * *

(6) * * *

(i) * * *

(A) * * *

(*1*) The services of a lead partner, as defined in paragraph (f)(7)(ii)(A) of this section, or Engagement Quality Reviewer, as defined in paragraph (f)(7)(ii)(B) of this section; for more than five consecutive years; or

* * * * *

(B) * * *

(*1*) Within the five consecutive year period following the performance of services for the maximum period permitted under paragraph (c)(6)(i)(A)(*1*) of this section, performs for that audit client the services of a lead partner, as defined in paragraph (f)(7)(ii)(A) of this section, or Engagement Quality Reviewer, as defined in paragraph (f)(7)(ii)(B) of this section, or a combination of those services; or

* * * * *

(e) *Transition provisions for mergers and acquisitions involving audit clients*. An accounting firm's independence will not be impaired because an audit client engages in a merger or acquisition that gives rise to a relationship or service that is inconsistent with this rule, provided that:

(1) The accounting firm is in compliance with the applicable independence standards related to such services or relationships when the services or relationships originated and throughout the period in which the applicable independence standards apply;

(2) The accounting firm has or will address such services or relationships promptly under relevant circumstances as a result of the occurrence of the merger or acquisition;

(3) The accounting firm has in place a quality control system as described in paragraph (d)(3) of this section that has the following features:

(i) Procedures and controls that monitor the audit client's merger and acquisition activity to provide timely notice of a merger or acquisition; and

(ii) Procedures and controls that allow for prompt identification of such services or relationships after initial notification of a potential merger or acquisition that may trigger independence violations, but before the effective date of the transaction.

(f) * * *

(4) *Affiliate of the audit client* means:

(i) An entity that has control over the entity under audit, or over which the entity under audit has control, including the entity under audit's parents and subsidiaries;

(ii) An entity that is under common control with the entity under audit, including the entity under audit's parents and subsidiaries, when the entity and the entity under audit are each material to the controlling entity;

(iii) An entity over which the audit client has significant influence, unless the entity is not material to the audit client;

(iv) An entity that has significant influence over the audit client, unless the audit client is not material to the entity; or

(v) Each entity in the investment company complex as determined in paragraph (f)(14) of this section when the entity under audit is an investment company or investment adviser or sponsor, as those terms are defined in paragraphs (f)(14)(ii), (iii), and (iv) of this section.

(5) * * *

(iii) The "audit and professional engagement period" does not include periods ended prior to the first day of the last fiscal year before the issuer first filed, or was required to file, a registration statement or report with the Commission, provided there has been full compliance with applicable independence standards in all prior periods covered by any registration statement or report filed with the Commission.

(6) *Audit client* means the entity whose financial statements or other information is being audited, reviewed, or attested to and any affiliates of the audit client, other than, for purposes of paragraph (c)(1)(i) of this section, entities that are affiliates of the audit client only by virtue of paragraphs (f)(4)(iii), (f)(4)(iv), or (f)(14)(i)(E) of this section.

* * * * *

(14) *Investment company complex.* (i) "Investment company complex" includes:

(A) An entity under audit that is an:

(*1*) Investment company; or

(*2*) Investment adviser or sponsor;

(B) The investment adviser or sponsor of any investment company identified in paragraph (f)(14)(i)(A)(*1*) of this section;

(C) Any entity controlled by or controlling:

(1) An entity under audit identified by paragraph (f)(14)(i)(A) of this section, or

(2) An investment adviser or sponsor identified by paragraph (f)(14)(i)(B) of this section. When the entity is controlled by an investment adviser or sponsor identified by paragraph (f)(14)(i)(B), such entity is included within the investment company complex if:

(i) The entity and the entity under audit are each material to the investment adviser or sponsor identified by paragraph (f)(14)(i)(B) of this section; or

(ii) The entity is engaged in the business of providing administrative, custodial, underwriting, or transfer agent services to any entity identified by paragraphs (f)(14)(i)(A) or (B) of this section;

(D) Any entity under common control with an entity under audit identified by paragraph (f)(14)(i)(A) of this section, any investment adviser or sponsor identified by paragraph (f)(14)(i)(B) of this section, or any entity identified by paragraph (f)(14)(i)(C) of this section; if the entity:

(1) Is an investment company or an investment adviser or sponsor, when the entity and the entity under audit identified by paragraph (f)(14)(i)(A) of this section are each material to the controlling entity; or

(2) Is engaged in the business of providing administrative, custodian, underwriting, or transfer agent services to any entity identified by paragraphs (f)(14)(i)(A) and (f)(14)(i)(B) of this section;

(E) Any entity over which an entity under audit identified by paragraph (f)(14)(i)(A) of this section has significant influence, unless the entity is not material to the entity under audit identified by paragraph (f)(14)(i)(A) of this section, or any entity that has significant influence over an entity under audit identified by paragraph (f)(14)(i)(A) of this section, unless the entity under audit identified by paragraph (f)(14)(i)(A) of this section is not material to the entity that has significant influence over it; and

(F) Any investment company that has an investment adviser or sponsor included in this definition by paragraphs (f)(14)(i)(A) through (f)(14)(i)(D) of this section.

(ii) An investment company, for purposes of paragraph (f)(14) of this section, means any investment company or an entity that would be an investment company but for the exclusions provided by Section 3(c) of the Investment Company Act of 1940 (15 U.S.C. 80a-3(c)).

(iii) An investment adviser, for purposes of this definition, does not include a subadviser whose role is primarily portfolio management and is subcontracted with or overseen by another investment adviser.

(iv) Sponsor, for purposes of this definition, is an entity that establishes a unit investment trust.

* * * * *

By the Commission.

Dated: October 16, 2020.

Eduardo A. Aleman,

Deputy Secretary.