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Independence Standards Board

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Independence Standard No. 2

Certain Independence Implications of Audits of Mutual Funds and Related Entities

December 1999



**Independence
Standards
Board**

Independence Standards Board

Standard No. 2

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Audits of Mutual Funds and Related Entities***

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SUMMARY

This Independence Standard, as described in more detail herein:

- A. Requires the audit firm, certain of its retirement plans, the audit engagement team and those in a position to influence the audit, when the firm is auditing mutual funds, to be independent of all sister funds and all related non-fund entities. In addition, when auditing a related non-fund entity, independence would be required by the same entities and individuals of all funds in the mutual fund complex.
- B. Permits:
 - i. Direct investment in non-audit client sister funds by all other partners and employees of the firm.
 - ii. Spouses and dependents of partners, other than of the audit engagement team and in a position to influence the audit, to invest through an employee benefit plan in mutual funds that are audit clients.
- C. Is effective with respect to audits of financial statements for periods beginning after June 15, 2000, with earlier application encouraged. However, in certain respects, current rules of the Securities and Exchange Commission (SEC) and, as to spousal employee benefit plan interests, of the American Institute of Certified Public Accountants (AICPA), are more restrictive than the provisions of this Standard. Compliance with those existing more restrictive rules continues to be necessary unless and until both the SEC and the AICPA revise those rules. Notification that these changes have been made will be posted to the ISB's website at www.cpaindependence.org when confirmation is received by the Board. Where provisions of this Standard are more restrictive, those provisions are to be complied with as of the above effective date.

Independence Standards Board Standard No. 2

Certain Independence Implications of Audits of Mutual Funds and Related Entities

December 1999

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INDEPENDENCE STANDARD

(Please note that terms appearing for the first time in **bold** type are defined in paragraph 6.)

Applicability

1. This Standard applies to the determination of auditor independence with respect to audits of **mutual funds** and related entities which are subject to the independence requirements of the SEC.

Standard

2. The auditing firm will not be considered independent of all of the entities within the **mutual fund complex** if the partners in the firm, either individually or collectively, have significant influence over any entity in that complex.

3. In other situations:

a. The auditing firm itself, and its retirement plans (*other than self-directed defined contribution employee benefit plans, such as 401(k) plans*), and

b. The audit engagement team and **those in a position to influence the audit**, when the firm is auditing:

i. A *fund*, must be independent of all **sister funds**.

ii. A *related non-fund entity*, must be independent of all *related non-client funds*—that is, all funds in the complex.¹

iii. One or more *funds*, must be independent of all *related non-fund entities* in the mutual fund complex.²

¹ If the related non-fund entity is an **investment adviser**, this would include all funds it advises, even if they are outside this mutual fund complex.

² If the fund's investment adviser is outside the mutual fund complex, the independence requirement still applies. That independence restriction further extends to any parent company to which the investment advisory fees from the client funds are material, and to all other subsidiaries of those covered parent companies.

4. A spouse, cohabitant or dependent of a partner not on the audit engagement team, and not in a position to influence the audit, is permitted to invest through an employer-sponsored benefit plan in mutual funds that are audit clients of the firm.

Effective Date

5. The above requirements are effective with respect to audits of financial statements for periods beginning after June 15, 2000, with earlier application encouraged. However, in certain respects, current rules of the SEC and, as to spousal employee benefit plan interests, of the AICPA, are more restrictive than the provisions of this Standard. Compliance with those existing more restrictive rules continues to be necessary unless and until both the SEC and the AICPA revise those rules. Notification that these changes have been made will be posted to the ISB's website at www.cpaindependence.org when confirmation is received by the Board. Where provisions of this Standard are more restrictive, those provisions are to be complied with as of the above effective date.

Definitions

6. Terms and phrases noted in **bold** in the Standard are defined below:

a. **Investment adviser.** Manages the mutual fund's portfolio according to the objectives and policies described in the fund's prospectus, executes its portfolio transactions, and typically serves as distributor of its shares to investors. When a "**sub-adviser**" substantively acts in the overall management role of an investment adviser with respect to a fund, it is to be considered the same as an investment adviser. (A **sub-adviser** is an entity generally identified, subcontracted and overseen by the investment adviser for a portfolio management role.)

b. **Mutual funds.** Investment companies subject to the Investment Company Act of 1940. These include, for example, open-end and closed-end funds, and unit investment trusts.

c. **Mutual fund complex.** The mutual fund operation in its entirety, including all the funds, plus the sponsor, its ultimate parent company, and their subsidiaries.

d. **Non-fund entity.** For example, the investment adviser, a broker-dealer, a bank, or an insurance company in the mutual fund complex.

e. **Sister funds.** Mutual funds in a complex with a common investment adviser.

f. **Those in a position to influence the audit.** Those in a position to influence the audit are those who supervise or have direct management responsibility for, (including at all successively senior levels, up through the firm's chief executive), or provide technical consultation, quality control or other oversight of, the partners and staff members involved in the audit. (In determining whether an individual meets one of these criteria, firms must be sensitive to their immediate practice environment. For example, in a small office, practice unit or firm, all partners might be considered as in a position to influence the audit, even if in an informal manner.)

BACKGROUND

7. At its March 12, 1999 meeting, the Board agreed that certain mutual fund issues should be added to its project agenda, and that the project should be expedited by moving directly to an Exposure Draft (ED). The project had been recommended in a letter from the Chief Accountant of the SEC and also requested through practice experience. A Board Oversight Task Force was appointed to provide guidance for the project, and a broad-based Project Task Force reviewed the documents for completeness and clarity.

8. In September 1999 the ISB issued ED 99-1, *Certain Independence Implications of Audits of Mutual Funds and Related Entities*. The ED proposed rules similar to those in this final Standard, except that it also would have required independence of partners (and, in certain cases, those defined as "managerial employees") in an office participating in a significant portion of the audit engagement.

9. The Board received twelve letters in response to the ED, all of which were generally supportive, and many had specific suggestions for changes. After deliberation, the Board agreed with certain of those recommendations, as described in the "Basis for Conclusions."

10. The Board's general rules (the published SEC rules adopted at the commencement of the Board) require an audit firm, and its "members" (as defined), to be independent of its audit clients. This general independence requirement is not changed by ISB Standard No. 2, except as to paragraph 4.

BASIS FOR CONCLUSIONS

Introduction

11. The Board's desire is to provide guidance in mutual fund auditor independence issues to help ensure, in a rapidly changing environment, the continued integrity of audited financial statements for the ultimate benefit of investors and other users of these statements.

12. It is believed the Standard will also significantly reduce a perceived lack of clarity in present guidance, and thereby reduce likely diversity in practice.

13. To accomplish its goal, the ISB weighed a variety of significant factors, some of which are described below, in reaching its determination of an appropriate Standard.

Attributes of the Mutual Fund Organizational Structure

14. The organizational structure of a mutual funds complex (See Appendices A and B) varies significantly from that of a typical corporation, and the Board believes these differences are relevant to the setting of auditor independence standards. Specifically, SEC Regulation S-X, Rule 2-01 (b) states that auditor independence is required as to the client and "...any of its parents, its subsidiaries, or other affiliates..." but the typical mutual fund/adviser relationship is not that of a subsidiary/parent. Among the principal differences are that:

a. In an investment adviser/mutual fund relationship, there is no majority ownership or voting control, as is present in a parent of a subsidiary; and

b. Unlike the case of a subsidiary, the investment income of a mutual fund, after the deduction of adviser management fees, distribution fees, and other fund expenses, is distributed to the fund shareholders as opposed to the related investment adviser.

On the other hand, while not having voting control of a fund, the investment adviser usually provides the fund's officers and performs substantially all services required in its operations, and thus plays an important, even controlling, role in its policies and operations.

Analysis of Common Service Providers

15. Mutual funds often use common service providers to centralize services and control costs, and the Board believes such common services are relevant to the related independence issues. In analyzing the key factors and threats relevant to the sister fund issue, the Board concluded that the use among funds of a common investment adviser was an important enough link to provide the basis for the independence restriction. In response to comments received on the ED, the circumstances under which "sub-advisers" also would be restricted

were clarified to cover only those situations in which the sub-adviser substantively acts in the overall management role of an investment adviser, because it is in that role, rather than as a portfolio manager, that any potential threat to independence exists.

16. The Board also considered the providers of other common services, including fund boards of directors and accounting systems, but concluded they were less relevant than a common investment adviser and that the independence restriction should be based solely on the presence of common investment advisers.

Difference between Defined Benefit and Defined Contribution Plan Investments

17. The Board distinguished between the firm-directed investments of firm defined benefit plans and the self-directed investment choices available in certain firm defined contribution plans (such as 401(k) plans), and concluded that the risks differed sufficiently to provide a lesser restriction for certain personnel in the defined contribution plans. That is, the direct beneficiary of investment performance in a defined benefit plan is the firm sponsor, since the level of further firm contributions will be affected by the investment performance. By contrast, the direct beneficiary of investment performance in a defined contribution plan is the employee. As a result, the Board concluded that the firm's defined benefit plans should not be able to invest in non-audit client sister funds, but that the firm could offer a sister fund investment alternative in its defined contribution plans to non-involved partners and staff without impairing its independence.

Partner Spousal Employee Benefit Plan Investments

18. The Board recognizes that permitting investments through employer-sponsored benefit plans by partners' spouses in mutual funds that are audit clients is not consistent with the present rules. However, the Board also believes this change to be warranted as a practical good in this changing social environment, because the risk that such investments will adversely affect audit quality appears trivial. A number of factors were considered in reaching this conclusion, including the following:

- a. Many more spouses are working today;
- b. Benefit plans (especially 401(k)s) have become much more common;
- c. Audits of mutual funds in those plans have become more concentrated within a few large firms due to consolidation of both financial institutions and auditors;
- d. A number of plans provide only one family of mutual fund investments. Under existing rules, if the funds are audit clients of a firm, the spouses and dependents of all partners in the firm would be prohibited from participating in the plans. As a result, the person would lose tax deferral benefits and employer matching contributions, and sometimes have to forfeit accumulated benefits; and

- e. It is highly unlikely that those who are exempted could influence the audit.

This decision will be reconsidered when the Board addresses the question of investment in audit clients comprehensively.

Firm Significant Influence Over an Entity in the Mutual Fund Complex

19. Paragraph 2 restricts a firm when its partners collectively have significant influence over an entity in the mutual fund complex. The intent in making such a determination is to address situations where partners are “acting together” in this investment. On the other hand, later knowledge that numerous partners, not having knowledge of one another’s common investments, could have had “significant influence” over the entity if they acted together would not indicate that “significant influence” had existed at the earlier date.

Those in a Position to Influence the Audit

20. Paragraph 3 restricts firm partners and employees who are on the audit engagement team and those in a position to influence the audit. (The phrase “those in a position to influence the audit” was substituted for “chain of command,” in response to comments received on the ED because it is more descriptive of the individuals included.) The definition of the phrase “those in a position to influence the audit” in paragraph 6f. describes two groups of individuals who may have such influence: those with direct management responsibility, and those who provide technical or related consultation. It is intended that the individuals with direct management responsibility for the audit and for related accounting, auditing and similar consultation services be subject to the restrictions of this Standard, whether or not they participate in any way in the audit. On the other hand, professionals in a consulting department, other than the person in charge, may be “recused” and therefore made not subject to the Standard’s restrictions, if they in fact are not, and will not be, involved in any way in the audit.

Uninvolved Partners and Managerial Employees

21. Several respondents to the ED suggested that it was unnecessary to include all partners and managerial employees working in the office conducting the audit in the category of those in a position to influence the audit. After deliberation, the Board agreed that there was at most a remote threat to independence from such individuals, if they were otherwise uninvolved in the audit. Consequently, the final Standard does not restrict those persons from investing in sister mutual funds, or their immediate family members from investing in client mutual funds through an employer defined contribution plan. Existing independence rules, however, prohibit their direct investment in client funds.

Analysis of Other Bases for Evaluating Independence Restrictions

22. In addition to considering the commonality of service providers for sister funds as described above, the Board also considered other and broader alternative bases for evaluating auditor independence in the mutual fund environment. For example, various applications of materiality tests were considered, as was the application of independence restrictions on a case-by-case basis to counter specific threats. The Board concluded that its Standard better fulfills its needs, in part because it provides a simpler but effective approach to addressing the independence threats raised.

Risks/Threats and Safeguards Analysis

23. In view of the importance of a risks/threats analysis and the need for related safeguards, the Board considered extensively the potential for particular independence concerns. This included those threats possible if an auditor were to encounter a systemic problem during the course of auditing one fund that would adversely impact another non-client fund in the complex, shares of which are owned by other individuals in the auditor's firm. (A safeguard to mitigate this potential threat is the fact that the non-client fund would be audited by a different firm.) The general concerns--the possible loss of objectivity in the audit and the need for independence in both fact and appearance--also were discussed. The Board's determination was that while some threats could be envisioned specific to mutual fund-related situations, any remaining threats to the auditor's independence, after considering existing controls and the application of this Standard, were insignificant.

Summary

24. Based upon:

- a. Its consideration of the unique organizational structure of mutual fund entities;
- b. The differences inherent in self-directed defined contribution employee benefit plans;
- c. The lack of apparent significant independence risk from mutual fund audits; and
- d. The very limited threats to auditor independence from participation in an employer-sponsored benefit plan by spouses and dependents of those neither on the audit engagement team nor in a position to influence the audit,

the Board believes its Standard is appropriately restrictive to protect the public interest and be responsive to those threats that were envisioned, while not imposing restrictions on those other individuals and plans where the Board believes the risks are minimal.

25. The Board recognizes that every additional requirement imposes costs, but the Board believes that the costs to implement this pronouncement will be small when compared with the benefits.

26. This Standard was adopted unanimously by the members of the Board.

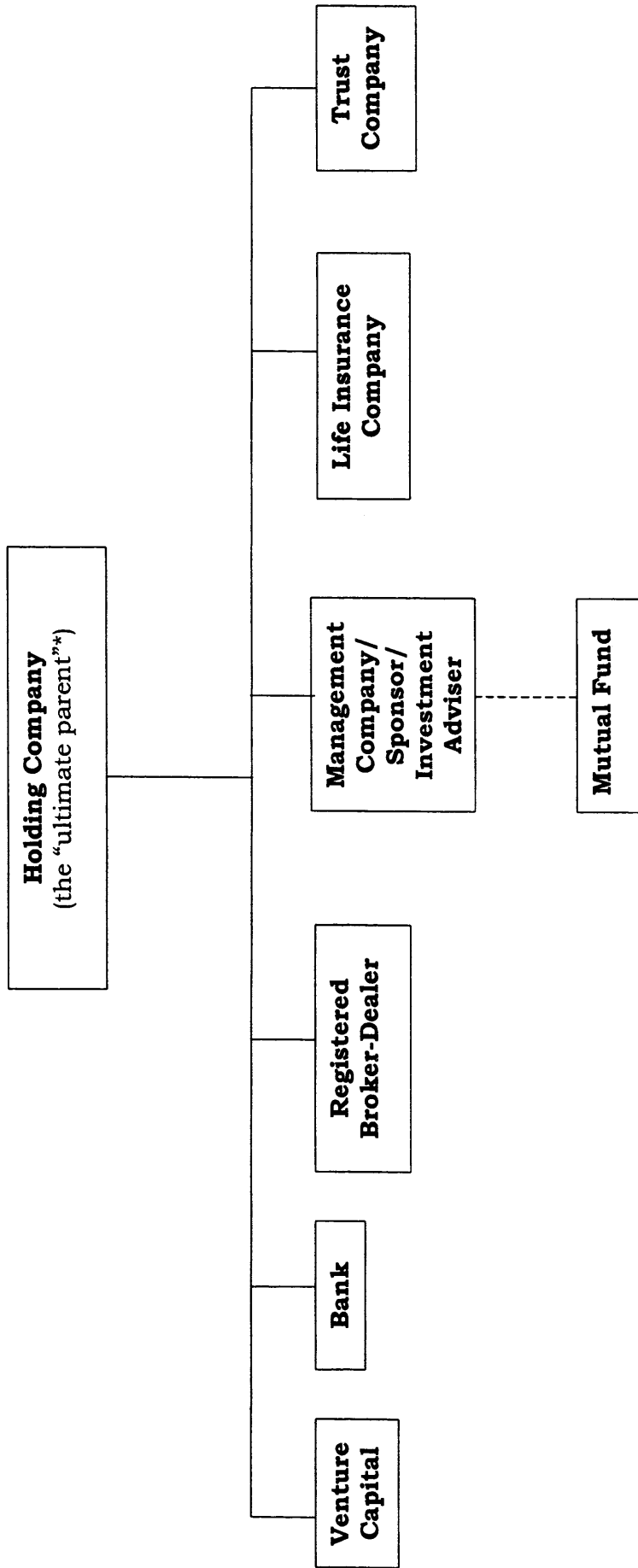
Members of the Independence Standards Board

William T. Allen, Chair
John C. Bogle
Stephen G. Butler
Robert E. Denham

Manuel H. Johnson
Philip A. Laskawy
Barry C. Melancon
James J. Schiro

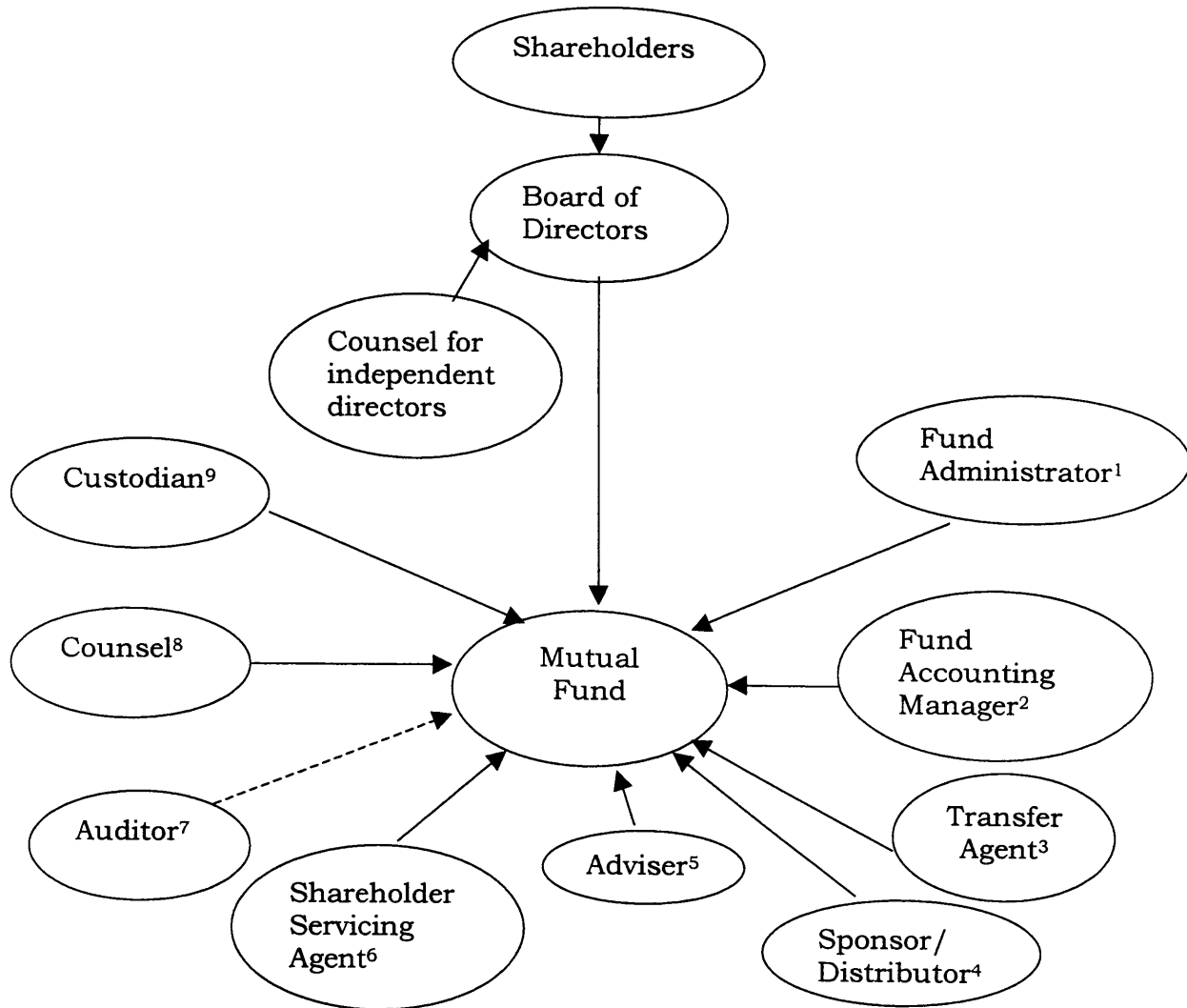
Appendix A

**Organization Chart
The Structure of a Typical Mutual Fund Complex**



*May include any number of levels of subsidiaries, and may be public or private.

**Organization Chart
The Structure of a Typical Mutual Fund**



1. Makes presentations for the board, and prepares SEC, tax and shareholder reports.
2. Maintains *fund's* accounting records, computes net asset value (NAV) daily and forwards NAV to transfer agent, and prepares the fund's financial statements.
3. Maintains *shareholder* accounting records and issues share certificates.
4. Conceives the fund and markets it to investors.
5. Manages the fund and executes its portfolio transactions. Also provides portfolio management services and overall executive management of the fund, including (in consultation with the board) selection of other service providers.
6. Responds to shareholders' inquiries by accessing records maintained by Transfer Agent.
7. Audits the fund's financial statements.
8. Provides legal services.
9. Holds securities in safekeeping; receives and delivers securities as instructed. Except for the auditor, the only entity servicing the fund which (absent meeting certain incremental criteria) *must* be independent of the fund complex.



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