# Exposure draft: certain independence implications of audits of mutual funds and related entities, September 1999; ED 99-1

Independence Standards Board

ED 99-1

# Exposure Draft

## Certain Independence Implications of Audits of Mutual Funds and Related Entities

September 1999

ISB

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# Exposure Draft
# (ED 99-1)

# Certain Independence Implications of Audits of Mutual Funds and Related Entities

September 1999

Comments should be received by October 31, 1999, and may be sent via:

1. Mail: Independence Standards Board
   6th Floor
   1211 Avenue of the Americas
   New York, NY 10036-8775
2. Fax (212) 596-6137
3. e-mail isb@cpaindependence.org

Please reference ED 99-1 in your correspondence.

ISB
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Date: September 1999

To: Interested Parties

From: William T. Allen, Chairman

The mission of the Independence Standards Board (ISB or Board) is to establish independence standards applicable to the audits of public entities in order to serve the public interest and to protect and promote investors' confidence in the securities markets. Two of the founding precepts of the ISB are that (1) while many factors may affect the functioning of the capital markets, those markets will not function effectively unless investors have confidence in the information they use to make investment decisions, and (2) an independent audit is essential to providing that sense of confidence. If knowledgeable and reasonable investors believed that the independent auditor placed the interests of the accounting firm, the audit client, or any other person, over the interests of investors, then the value of the audit function would be impaired.

It is with this mission in mind, and while working concurrently on its project to establish a conceptual framework for auditor independence to serve as a foundation for principles-based independence standards, the Board has, in a limited scope and expedited project, studied certain independence concerns related to the audit of mutual funds and related entities. The Board seeks comment on its proposal for <u>Certain Independence Implications of Audits of Mutual Funds and Related Entities</u>, as described in this Exposure Draft (ED).

The operating policies of the ISB are designed to permit timely, thorough and open study of issues involving auditor independence, and to encourage broad public participation in the process of establishing and improving independence standards. All of the ISB's constituencies, including members of the public, are encouraged to express their views on matters under consideration in order to stimulate constructive public dialogue.

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The ISB is seeking specific input on the questions posed on page 12 of this ED. In addition, we welcome comments and suggestions on any other aspects of this proposal.

Any individual or organization may obtain one copy of this Exposure Draft (ED 99-1), without charge, by contacting the ISB. The ED is also available on the ISB website at www.cpaindependence.org.

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All responses will be available for public inspection and copying for one year at the offices of the Independence Standards Board and also at the library of the American Institute of Certified Public Accountants (AICPA), Harborside Financial Center, 201 Plaza Three, Jersey City, New Jersey.

## Summary

(Please note: Terms appearing for the first time in **bold** type are defined in the Glossary.)

The proposed Independence Standard would, as described in more detail herein:

- require the audit firm, certain of its retirement plans, the audit engagement team (considered broadly) and certain others, 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.**

- permit:
  - A. direct investment in non-audit client sister funds by all other partners and employees of the firm.

  - B. spouses and dependents of partners, other than of the engagement team and in a work office, to invest through an employee benefit plan in mutual funds that are audit clients.

- be effective with respect to audits of financial statements for periods beginning after June 15, 2000, with earlier application encouraged.

**Proposed Independence Standard**

**Certain Independence Implications of Audits of Mutual Funds and Related Entities**

**September 1999**

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**Proposed Independence Standard**

**Certain Independence Implications of Audits of Mutual Funds and Related Entities**

**September 1999**

## INTRODUCTION

### Purpose

1. The purpose of this project is to provide standards by which the independence of the audit firm and its partners and employees from mutual fund complexes may be established. The primary issues are whether knowledgeable and reasonable investors believe that (a) investments by certain partners of an audit firm in non-client funds within a mutual fund complex, or (b) investments through an employee benefit plan by the spouses and dependents of such partners in client mutual funds create conflicting interests that compromise the credibility of the auditor's reports on the financial statements of the entities it audits. The corporate governance and legal structure of mutual funds and mutual fund complexes are unique as are the independence issues affecting auditors of mutual funds and their affiliates. Accordingly, the guidance provided by this standard, when finalized, will apply only to entities within mutual fund complexes which are subject to the independence requirements of the Securities and Exchange Commission (SEC), and are not to be analogized to other circumstances affecting auditors' independence.

### Background

2. During deliberation at its March 12, 1999 meeting, the Board agreed that the mutual fund issues described below 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 of the Chief Accountant of the SEC and also requested through practice experience.

### Project Issue

3. The project is limited in scope and focuses on three issues—within a mutual fund complex, when is auditor independence required:

   A. As to non-client "sister funds," when auditing a fund?
      (e.g., as to non-client Fund A, when auditing Fund B advised by the same investment adviser)

B. As to related non-client funds, when auditing a related non-fund entity?
(e.g., as to non-client Fund A, when auditing a broker-dealer in the same complex)

C. As to all related non-fund entities, when auditing one or more mutual funds?
(e.g., as to a broker-dealer or ultimate parent, when auditing Fund B in the same complex.)

4. The Board's general rules (the 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 the proposed standard, except as to paragraph 13.

**RISKS OR CONFLICTS**

5. There are risks or conflicts that need to be considered in establishing guidelines for independence with respect to entities within mutual fund complexes. Those areas relate principally to the organization that has access to information and has influence over the financial operations and reporting of the mutual fund, which is typically the mutual fund's investment adviser. It is in the area of valuation of the mutual fund's assets and in the investment decision-making process that the most sensitivity would exist toward undue influence being placed on an auditor's judgment. Specifically, the following areas would be considered risk areas that should be considered in establishing the guidelines for independence with respect to entities within mutual fund complexes:

- An auditor may encounter a systemic problem during the course of auditing one mutual fund in a complex that would adversely impact another non-client fund in the complex that is held by other individuals in the firm as a direct investment or held through the firm's defined contribution retirement plan.

- An auditor may encounter an issue during the course of auditing an investment adviser that would adversely impact investments held by others at the firm in mutual funds sponsored by the adviser.

- An individual in the firm's chain of command may influence an auditor's judgment with respect to an audit of a fund within a mutual fund complex where that individual has an investment.

In each of the aforementioned situations, an auditor might be reluctant to promptly recommend a resolution of a problem if resolution might adversely impact the mutual funds held as investments by his or her associates.

6. A conflict may also arise where certain members of the audit firm act for the firm as fiduciaries over the firm's 401(k) plan at the same time other

members of the firm audit the investment adviser or mutual funds in the same mutual fund complex. Conflicts may arise between the audit firm's duty of confidentiality to the audit client and the audit firm's duty as fiduciary to the participants in the firm's 401(k) plan.

7. In order to maintain public confidence, the profession also requires that an auditor be independent in both fact and appearance. Consequently, consideration must also be given to whether auditing funds or entities in a mutual fund complex, while the auditing firm or persons associated with the firm invest in funds that are not audit clients, creates the appearance of a lack of independence.

## PROJECT DEVELOPMENT CHRONOLOGY

8. A Board Oversight Task Force was appointed to provide direction to the project. Under its guidance, a broad-based Project Task Force was formed and met on June 3, 1999. Among other matters, it reviewed a neutral Board Discussion Paper developed by the ISB staff and designed to assist the Board in assessing the issues raised and possible solutions.

9. After considering this matter at its June 25, 1999 meeting, the ISB unanimously agreed on the principles underlying this draft Independence Standard and delegated to its Oversight Task Force the authority to supervise and approve the issuance of this proposal after consultation with the Chief Accountant of the SEC. At the request of the Oversight Task Force, the draft ED was also reviewed for clarity with the Board's Project Task Force on August 27, 1999.

## INDEPENDENCE STANDARD

### Applicability

10. 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

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

12. In other situations:

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

  The audit engagement team and its **chain of command**, and the partners and **managerial employees** in offices participating in a significant portion of the audit, when the firm is auditing:

- a *fund,* must be independent of all *sister funds.*
- a *related non-fund entity,* must be independent of all *related non-client funds*—that is, all funds in the complex.[1]
- one or more *funds,* must be independent of all *related non-fund entities* in the mutual fund complex.[2]

13. A spouse, cohabitant or dependent of a partner not on the engagement team, not in its chain of command, and not in an office participating in a significant portion of the engagement, is permitted to invest through an employer-sponsored benefit plan in mutual funds that are audit clients of the firm.

**Effective Date**

14. The above requirements are effective with respect to audits of financial statements for periods beginning after June 15, 2000, with earlier application encouraged.

**BASIS FOR CONCLUSIONS**

**Introduction**

15. 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 those statements. To accomplish this goal and develop a prudent and balanced standard, the ISB weighed a variety of significant factors, some of which are described below, in reaching its determination of an appropriate Independence Standard for Certain Independence Implications of Audits of Mutual Funds and Related Entities. It is believed that the Standard will also significantly reduce a perceived lack of clarity in present guidance, and thereby reduce likely diversity in practice.

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[1] If the related non-fund entity is an *investment adviser* (or sub-adviser), the auditor must be independent of all funds it advises, even if they are outside this mutual fund complex.

[2] If the fund's investment adviser (or sub-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 adviser is material, and to all other subsidiaries of those covered parent companies.

## Attributes of Mutual Fund Organization Structure

16. 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 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 typically is present of a parent in 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

17. Mutual funds often use common service providers, to centralize services and thereby 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. 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

18. 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 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**

19. 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, and that 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 the 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. (It also is noted that existing AICPA rules provide certain limitations, including as to immateriality, on such spousal investments, and such rules would need to be conformed before the above exemption could become effective.)

**Analysis of Other Bases for Evaluating Independence Restrictions**

20. 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 proposed 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

21. 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, including those described in paragraphs 5 and 6, which might occur during the audits of mutual funds and their related entities. The general concerns--the possible loss of objectivity in the audit and the need for independence to be perceived as well--are discussed in paragraph 7. 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 the application of this standard, were insignificant, especially considering existing controls.

## Summary

22. 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 apparent very limited threats to auditor independence from spouses and dependents outside a work office participating in an employer-sponsored benefit plan, the Board believes its proposal 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.

**QUESTIONS FOR RESPONDENTS**

**Q1.** The Board's proposal proscribes investments in non-audit client sister funds by an expanded "on the engagement" group, in addition to all partners and managerial employees in offices participating in a significant portion of the audit. As a result, the proposal will permit investments in such other funds by all other partners. Is this proposal appropriate, too restrictive, or not restrictive enough? Please provide the basis for your views, including the applicable threats to independence.

**Q2.** **A.** As part of its reasoning in developing its sister fund proposal, the Board believes that the investment adviser/mutual fund relationship is sufficiently different from the relationship of a parent and its subsidiary, as described in paragraph 16, to warrant only the restrictions proposed. Do you agree that these relationship differences are substantive enough to support the Board's proposal? Or, do you believe that investment advisers have strong enough operating control over, or financial interests relating to, the funds they advise to be more like a parent/subsidiary relationship, and therefore require additional independence restrictions and, if so, what restrictions do you suggest?

**B.** As described in paragraph 17, the Board concluded that the commonality of an investment adviser among funds was of primary importance in analyzing the sister fund issue, believing that the limited independence threats envisioned are appropriately addressed in the proposed restrictions. Do you instead believe even if the investment advisers are different, if other common services are utilized, that additional independence restrictions should be required and, if so, why, and what restrictions do you suggest?

**Q3.** The independence requirements noted in the footnotes to paragraph 12 address extending restrictions beyond the original mutual fund complex for certain fund/adviser relationships. Do you believe these extensions are warranted and extend to the appropriate levels?

**Q4.** The Board's proposed standard permits the audit firm to have self-directed defined contribution employee benefit plans (most typically, 401(k) plans) with non-client sister fund choices available to all but the engagement team, its chain of command, and certain others. Do you believe that the reasons described in paragraph 18 provide an appropriate basis for this distinction from direct investments and the firm's defined benefit plans (which may not hold such funds)?

**Q5.** The Board's proposal permits spouses and dependents of partners, other than of the engagement team, its chain of command, and in a work office, to invest through an employee benefit plan in mutual funds that are audit clients. Do you agree that the threats to audit quality are sufficiently remote to support this exemption? Would it make a difference if the investment grew to an amount that is material to the partner?

**Q6.** The costs of implementing this proposed Independence Standard appear to be modest, while the benefits of a policy crisply focused on the areas of potential risk, but flexible in areas of negligible perceived risk, appears appropriate. Do your agree or disagree with this statement, and why? If you disagree, please offer your suggestions for change.

**Q7.** One of the ISB's mandates is the use of original and archival research in the development of principles-based independence standards. Are you aware of any relevant research, either available or that you suggest be commissioned, on the specific topic of auditor independence with respect to mutual funds? If so, please advise us.

# GLOSSARY

(This glossary contains definitions of terms and phrases noted in **bold** in this proposal.)

**Chain of command**

Those who supervise or have direct management responsibility for, (including all successively senior levels), or provide technical or industry specialized consultation, quality control or other oversight of, the partners and staff members involved in the audit.

**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.

**Managerial employees**

Staff members in a position having continuing managerial responsibility for the overall planning and supervision of engagements for specified clients, or authority to determine that an engagement is complete subject to final partner approval, if required, or responsibility for client relationships, or overall management of the firm, or development or implementation of, or compliance with, firm policies on technical matters including quality control.

**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.

**Mutual fund complex**

The mutual fund operation in its entirety, including all the funds, plus the investment adviser, its ultimate parent company, and their subsidiaries. (See Appendix A for an example.)

**Non-fund entities**

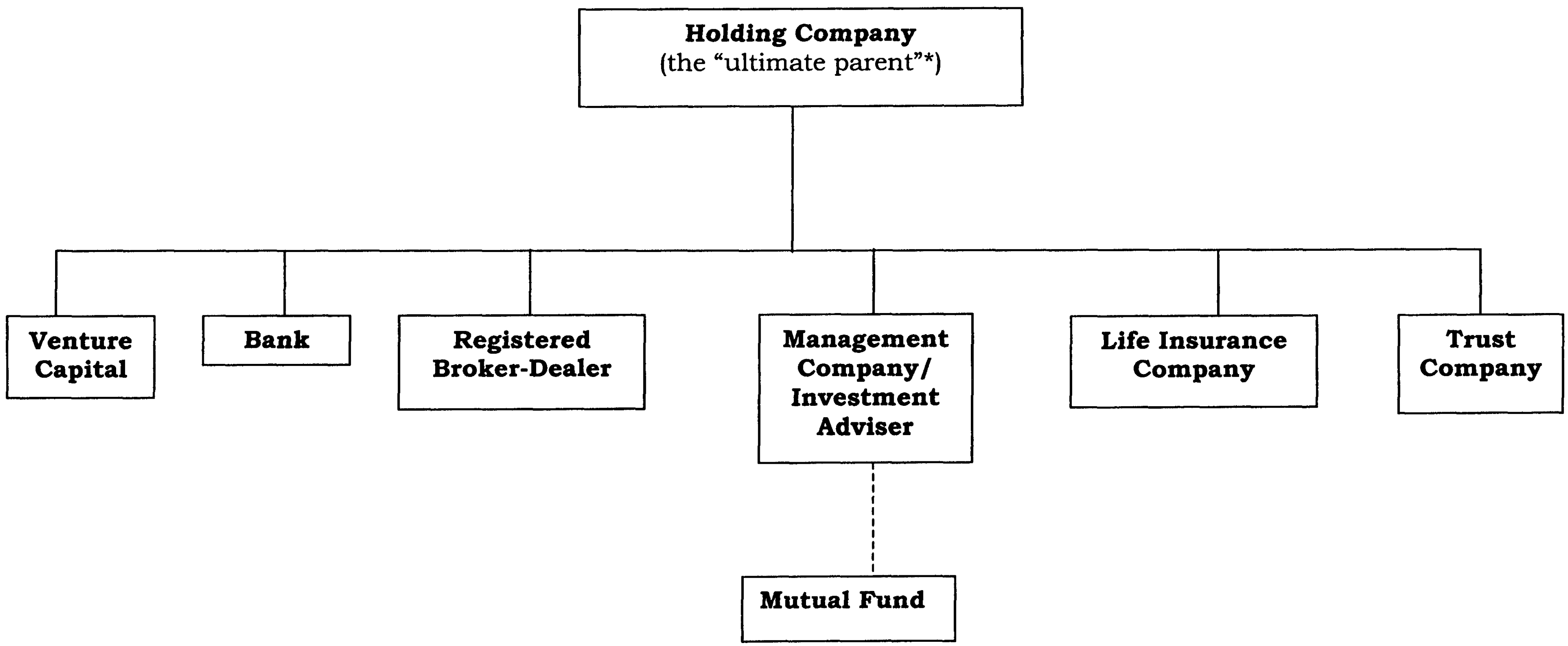
For example, the investment adviser, a broker-dealer, a bank, or an insurance company in the mutual fund complex.

**Sister funds**

Mutual funds in the complex with an investment adviser common with any fund audited by the firm.

Appendix A

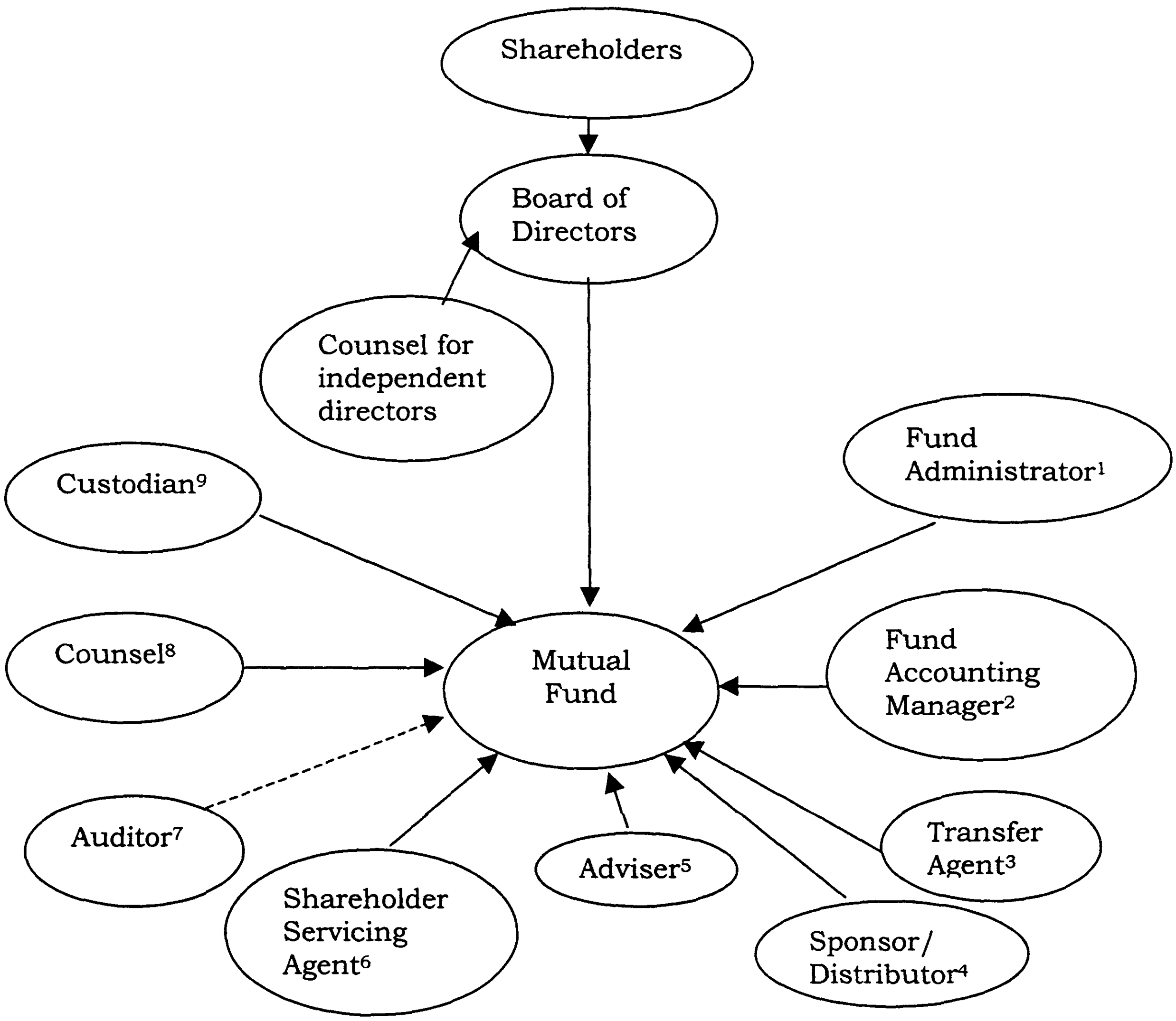
**Organization Chart**
**The Structure of a Typical Mutual Fund *Complex***




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

Appendix B

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




Functions

1. Presentations for the board, SEC filings.
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, manages and trades the fund.
5. Manages the fund and executes its portfolio transactions.
6. Responds to Shareholders' inquiries by accessing records maintained by Transfer Agent.
7. Audits the fund's financial statements.
8. Legal Services.
9. Except for the Auditor, the only other entity servicing the fund which (absent meeting certain incremental criteria) *must* be independent and not affiliated. Holds securities in safekeeping; receives and delivers securities as instructed.

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