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2000

## Changes Needed to SEC Rulemaking Proposal to Reflect ISB Projects on Family Relationships, Financial Interests, and Mutual Funds

Independence Standards Board

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August 31, 2000

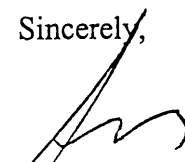
Jonathan G. Katz  
*Secretary*  
U.S. Securities and Exchange Commission  
450 Fifth Street NW  
Washington, DC 20549

Dear Mr. Katz;

On August 18, at the direction of ISB Chairman Allen, I submitted a memorandum summarizing suggestions promised at the July 26 public hearing to make the Commission's proposed rules fully consistent with ISB Standard No. 3 on employment and our proposed standard on appraisals. Enclosed today is a similar memorandum with conforming recommendations for ISB Standard No. 2 on mutual funds and our proposed standard on financial interests and family relationships. Please note that we have not recommended any changes to the Commission's proposed definition of "affiliate of the audit client" because the ISB has not considered the "affiliate" concept.

Please contact me at 212-596-6141 if I can provide any additional information.

Sincerely,

  
Arthur Siegel  
Executive Director

Enclosure

Copy with enclosure to: SEC Commissioners  
Lynn Turner  
ISB Board members

Independence Standards Board

Changes Needed to SEC Rulemaking Proposal to Reflect ISB Projects on Family Relationships,  
Financial Interests, and Mutual Funds

X. Statutory Bases and Text of Amendments

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**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**

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§210.2-01 Qualifications of accountants.

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(c)(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 or material indirect 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~~ A close family member of an audit engagement team member has a material direct or indirect investment in an audit client or an affiliate of an audit client - material to both the relative and the firm professional.

(C) A partner from an office of the accounting firm that participates in a significant portion of the audit, or any of his or her immediate family members, has a direct or material indirect investment in an audit client or an affiliate of an audit client, other than an investment in an audit client held by an immediate family member through an employer-sponsored benefit plan. However, if the immediate family member changes his or her employment and restrictions on the sale of such investments lapse, then the investments must be disposed of within ninety days.

(D) ~~Any partner or managerial 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~~ any firm professional or member of his or her immediate family, or any other close family member of a partner, controls an audit client.

~~(C)~~(E) The accounting firm, any covered person in the firm, any partner from an office that participates in a significant portion of the audit, 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 a member of the audit engagement team, 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 on the audit engagement team or an immediate family member of a covered person in the firm professional on the audit engagement team.~~

~~(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. As to investment companies and their related entities, the following investment restrictions apply to the accounting firm, any covered person, and any of his or her immediate family members:~~

- ~~(1) 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. However, if the only audit clients in the investment company complex are investment companies, then~~

restrictions are limited to all investment companies in the complex advised by the same investment adviser as advises the audit client investment company (ies);

(2) All investment companies advised by an audit client adviser, including those outside the investment company complex; and

(3) When the non-audit client adviser of an investment company client is outside that investment company complex, then restrictions apply to the adviser and any parent company to which the investment advisory fees from the client investment company (ies) are material, and all other subsidiaries of those parent companies.

(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~~ within 30 days.

(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).

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(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:

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(ii) Employment at audit client of certain relatives of accountant.

A(A) An audit engagement team member has (i) an immediate family member who has any employment relationship, or (ii) an other close family member of a covered person in the firm is in an accounting or financial reporting oversight role who has a key policy-making position or sensitive financial position at an audit client or an affiliate of an audit client, or was in such a role relationship during any period covered by an audit for which the covered person in the firm is a covered person partner or employee is a member of the audit engagement team;

(B) A partner or employee in a position to influence the audit has (i) an immediate family member who has a key policy-making position or sensitive financial position, or (ii) an other close family member who has a key policy-making position at an audit client or an affiliate of an audit client, or was in such a relationship during any period covered by the audit for which the partner or employee is in a position to influence the audit; or

(C) A partner from an office of the accounting firm that participates in a significant portion of the audit has an immediate family member who is employed as chief executive officer, chief operating officer, chief financial officer, controller, or director of internal audit, of an audit client or an affiliate of an audit client, or was in such a relationship during any period covered by the audit.

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

(1) ~~The covered person~~ firm partner or professional ~~did not know, and was reasonable in not knowing, of that the circumstances giving gave rise to the a~~ lack of independence. However, firm partners and professionals are responsible for knowing about investment and employment relationships of immediate family members. As to other close family members, knowledge of the relative's financial interests and employment should be based on the best information available to the firm and the individual partner or professional, but all are presumed to be aware of information in the client's proxy statement; ;

~~(2) The covered person's~~(2) The firm partner or professional's lack of independence was corrected promptly after the ~~covered person~~ individual or accounting firm became aware of it; and

\*\*\*\*\*

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

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~~(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.~~

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

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~~(13)~~(12) Covered persons in the firm means (i) those on the ~~the~~ following partners, principals, shareholders, and employees of an accounting firm:

~~(i) The "audit engagement team;"~~, " and (ii) "those in a position to influence the audit."

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

~~(15)(14) Immediate family members means a person's spouse, spousal equivalent, and dependent.~~

(15) Indirect investment means an investment in one or more investees through an intermediary, such as a mutual fund, unless:

(A) The holder of an interest in the intermediary has control over that entity or its investment activities; or

(B) The intermediary has an investment in the investee that amounts to 20% or more of its total investments, in which case the investment is considered to be direct.

(16) Investment company complex. (i) "Investment company complex" includes:

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

(B) Any entity directly or indirectly 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) Key policy-making position means a director, or an officer or employee with significant influence over financial accounting or operating policies of the client. It also includes individuals acting as a promoter, voting trustee, or as an officer of a firm with management responsibility for a material underwriting engagement for the client.

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

(19) Partner includes partners, principals, and shareholders in the firm.

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(21) Sensitive financial position means one that could have more than minimal influence on the financial affairs of the company through its accounting, reporting, and financial management, or through its system of internal accounting control.

(22) Those in a position to influence the audit means those persons who (i) supervise or have direct management responsibility for those on the audit (i.e., the management chain of command, at all successively senior levels up through the firm's chief executive), (ii) provide technical consultation, quality

control or other oversight of those on the audit, or (iii) are partners or managerial employees who provide only non-audit services to the client. However, a partner or managerial employee who participates in a non-audit engagement for less than ten hours is not included in this category if that person's service could not have any direct effect on the financial statements being audited.

### Commentary

The principal difference between the ISB's and the SEC's proposed rules on financial interests in the audit client, and family relationships between audit firm and audit client personnel, is that the SEC would generally apply restrictions across the board to all "covered persons" in the firm, while the ISB uses a "tiered" approach, targeting the more stringent restrictions on those closest to the audit.

Other significant differences between the ISB and SEC proposals include the following:

1. (c)(i)
  - (B) - Some differences exist in the restrictions on firm control or 5% beneficial interests in the client.
  - (D) - The ISB established its "indirect" investment rules based on a threat assessment. Therefore, our indirect investment definition has a "control" test and a "concentration of investment" test to determine whether the holder is deemed to have sufficient economic interest in the ultimate investee such that the investment should be considered direct rather than indirect.
2. (c)(ii) - Other financial interests – The ISB believes these "other" investment restrictions generally involve less risk than those in (i) and, therefore, should be limited to those on the audit engagement team. On the other hand, the ISB has not provided an exemption for client bank or brokerage accounts covered by insurance because the depositor or other relationship itself could provide the opportunity for favoritism.
3. (c)(ii)(G) - Investment companies – The Board analyzed the use of common service providers and concluded that the use among investment companies of a common investment adviser is an important enough link to provide the basis for an independence restriction. Therefore, when only investment companies are audited in the complex, the Board's restrictions to other nonclient investment companies extends only to such "sister funds." However, the Board also believes that it is not uncommon for an investment company to be advised by an entity outside that investment company's own complex and that the scope of the independence restrictions should be specified.
4. (f) Definitions of terms - In several cases, the ISB believes its terms better fit the independence restrictions. Examples are "in a position to influence the audit" (instead of "chain of command") and "key policy-making" and "sensitive financial positions" (instead of "accounting or financial reporting oversight roles").