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Strengthening the Commission's Requirements Regarding Auditor Independence; Final Rule

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

[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.

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

[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 Web site, *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).

''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

[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.

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

[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.

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. Other 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 May 6, 2004 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 May 6, 2003.[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

[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 an 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.

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

[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.

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

[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.

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

[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.

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

[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

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

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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).

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.

[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.

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]

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[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, 2002; 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

Continued

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

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. Vigaǹo''The Impact Of Mandatory Audit Rotation On Audit Quality And On Audit Pricing: The Case Of Italy,'' SDA Universita̍ 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 Institute 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.

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

[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.''

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

[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.

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 will 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

[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.

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*

[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).

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

[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.

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

[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.

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

[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.

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

[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)].

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

[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

Continued

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

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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.

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

[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.

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

[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 American 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.''

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

[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.

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 *de minimis* exception. 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 U.S. 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

[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.

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.

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[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.

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 × 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 × 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 × 3,700 filers) additional burden hours. We

[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.

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

[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.

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

[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.

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

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[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.

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 proposed 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-

[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).

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

[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).

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

[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).

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

[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.

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.

[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.

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, 78*l*, 78m, 78n, 78o(d), 78q, 78u–5, 78w(a), 78*ll*, 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 May 6, 2003 will not be deemed to impair an accountant's independence:

(i) Employment relationships that commenced at the issuer prior to May 6, 2003 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 May 6, 2004, the provision of services described in paragraph (c)(4) of this section provided those services are pursuant to contracts in existence on May 6, 2003.

(iv) The provision of services by the accountant under contracts in existence on May 6, 2003 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 May 6, 2003 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 May 6, 2004 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 May 6, 2003; 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 May 6, 2003.

* * * * *

(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), that were not pre-approved by the registered investment company's audit committee pursuant to §210.2–01 (c)(7).

(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, 78*l*, 78m, 78n, 78o, 78p, 78q, 78s, 78u–5, 78w, 78x, 78*ll*, 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).

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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 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 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.

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By the Commission.

Dated: January 28, 2003.

Jill M. Peterson,

Assistant Secretary.

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